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UNITED STATES

Implications of the Uruguay Round Multilateral Trade Agreements for American Subnational Taxation of International Commerce

Walter Hellerstein

Walter Hellerstein is Professor of Law at the University of Georgia and Of Counsel to the international law firm of Morrison & Foerster. He has written and practised extensively in the field of state taxation in the United States, and he is co-author of a two-volume treatise on state taxation published by Warren Gorham Lamont.

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I. INTRODUCTION

Those unfamiliar with the role of the individual states in the American federal system may be puzzled by the controversy over the impact of the recently concluded round of multilateral trade agreements upon American subnational taxation of international commerce. In most countries, the political and fiscal independence of subnational taxing units, if such units exist at all, is modest, and especially so with regard to matters affecting international commerce. Indeed, the very notion that a subnational political unit could adopt a tax policy at odds with the policy embraced by its national government and embodied in international accords would appear unthinkable to many observers.

One need look no further than the US Supreme Court's recent decision in *Barclays Bank PLC v. Franchise Tax Board of California*,[1] however, to understand that matters stand quite differently in the United States. In *Barclays*, the US Supreme Court sustained California's power to require a foreign-owned multinational corporation to apportion its income on a worldwide combined basis, even though California's unitary taxation scheme was contrary to the separate entity accounting method employed by all major developed nations (including the United States). The *Barclays* decision reflects the long tradition of independent taxing power that the individual states have enjoyed within the American constitutional framework. Subject only to the broad restraints imposed by the US Constitution, the American states are generally free to go their own way in matters of taxation. This holds true even if the states' taxing policies deviate from those adopted by the Federal Government, unless the Federal Government explicitly exercises its legislative power to limit state taxing authority, which it has rarely done.

II. THE URUGUAY ROUND MULTILATERAL TRADE AGREEMENTS

In April 1994, after years of discussion, more than 100 participating countries signed agreements reached in the Uruguay Round of multilateral trade negotiations. The Uruguay Round negotiations were conducted under the auspices of the General Agreement on Tariffs and Trade ("GATT"). The results of the Uruguay Round consist of the Agreement Establishing the World Trade Organization ("WTO") plus 16 multilateral and two plurilateral agreements, which are annexed to the WTO Agreement. In addition, there are related understandings, decisions and declarations, as well as schedules of specific tariff, non-tariff and services commitments of the signatory countries. Under the Uruguay Round Agreements, tariffs will be greatly reduced or eliminated in steel, paper, pharmaceuticals, electronics, semiconductor equipment, medical equipment, agricultural equipment, toys, furniture and many other sectors. It has been estimated that over the next ten years, tariffs on industrial commodities alone will fall by almost $ 750 billion.[2]

The WTO Agreement establishes an international organization that encompasses the existing GATT institutional structure and extends it to the new Uruguay Round rules on services, intellectual property and investment. These new rules are set forth respectively in the General Agreement on Trade in Services ("GATS"), the Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS") and the Agreement on Trade-Related Investment Measures ("TRIMS"). The most significant of the pre-existing GATT rules bearing on taxation are those requiring "national treatment" of foreign products, i.e. foreign products must be treated no less favourably than domestic products[3] and those

1. 114 S.Ct. 2268 (1994).
2. US House of Representatives, Committee on Energy and Commerce, H.R. Rep. No. 103-826, pt. 2, at 2 (1994).
3. GATT Art. III:1.

guaranteeing most-favoured-nation status.[4] These rules are likewise embodied in GATS, which requires "national treatment" in trade in services[5] as well as most-favoured-nation treatment.[6] In addition, whereas GATT implicates only indirect taxes, such as sales, use and excise taxes, GATS implicates not only indirect but also direct taxes, such as income or capital-based taxes.[7] GATS, moreover, is explicitly made applicable to subnational measures.[8]

The WTO Agreement also creates new procedures for the settlement of disputes under GATT, GATS and related agreements. The Understanding on Rules and Procedures Governing the Settlement of Disputes[9] establishes a Dispute Settlement Body ("DSB"), which has authority to create panels, adopt panel and Appellate Body reports, maintain surveillance of implementation of rulings and recommendations, and authorize suspension of concessions and other obligations under the covered agreements.

Under the dispute settlement procedures, at the request of a complaining party, the DSB may establish a panel to resolve disputes between member countries. The panels consist of qualified citizens of member countries not involved in the dispute. Where parties to a dispute have failed to develop a mutually satisfactory solution, the panel submits its findings in the form of a written report to the DSB.[10] The DSB may adopt or not adopt a panel report, unless the report is appealed, in which case it is heard by the Appellate Body without consideration by the DSB.[11] The Appellate Body, a standing body of seven persons of recognized authority appointed by the DSB for four-year terms, issues reports on panel decisions which "shall be adopted by the DSB and unconditionally accepted by the parties to the dispute unless the DSB decides by consensus not to adopt the Appellate Body report within 30 days following its circulation to members".[12]

When a panel or the Appellate Body concludes that a measure is inconsistent with a covered agreement, it shall recommend that the member concerned bring the measure into conformity with the agreement.[13] After the DSB adopts a panel or Appellate Body report, the member concerned must inform the DSB of its intentions regarding the implementation of the recommendations and rulings of the DSB.[14] If the member fails to bring the disputed measure into compliance with the agreement within "a reasonable period of time",[15] the member who invoked the dispute settlement procedures may seek compensation from the offending member and, if no satisfactory compensation is agreed to, may request authorization from the DSB to suspend the application to the member concerned of concessions or other obligations under the covered agreement.[16] The dispute resolution procedures are explicitly made applicable to measures taken by "regional or local governments or authorities within the territory of a Member".[17]

III. AMERICAN STATES' CONCERNS WITH THE URUGUAY ROUND AGREEMENTS

The American states have expressed considerable misgivings about the impact of the Uruguay Round Agreements on their taxing authority. Speaking through the Multistate Tax Commission ("MTC")[18] and the Federation of Tax Administrators ("FTA"),[19] the states have identified a number of concerns regarding the possible implications of the Uruguay Round Agreements with respect to their power to tax.[20]

A. Restrictions imposed by GATT/GATS standards on the states' traditional taxing powers

Perhaps the most fundamental objection the American states have raised to the Uruguay Round Agreements is that the standards embodied in GATT, GATS and related agreements impose unduly restrictive limitations on their taxing power. The states recognize the general principle that foreign and domestic commerce should be accorded equivalent treatment under state taxing measures. They nevertheless express concern that the application of the GATT/GATS standards to their taxing regimes will impose stricter rules of non-discrimination than those to which they are held under American constitutional standards.

4. *Id.* Art I.
5. GATS Art. XVII.
6. *Id.* Art. II.
7. *Id.* Arts. XIV(d), XXVIII(o) (defining "direct taxes").
8. *Id.* Art. I:3(a) (defining "measures by Members" as meaning "measures taken by . . . central, regional or local governments and authorities"). The provisions of GATT have generally been viewed as applicable to subnational governments under GATT Article XXIV:12, which provides that "[e]ach contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories." See R.E. Hudec, "The Legal Status of GATT in the Domestic Law of the United States," in Hilf, Jacobs and Petersmann, eds., *The European Community and GATT* 221 (1986) ("Article XXIV:12 obligates the United States to compel state adherence to [GATT] . . . .").
9. Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, 15 April 1994, Annex II.
10. *Id.* Art. 12:7.
11. *Id.* Art. 16:4.
12. *Id.* Art. 17:14.
13. *Id.* Art. 19:1.
14. *Id.* Art. 21:3.
15. The "reasonable period of time" to implement panel or Appellate Body decisions is specified in the dispute resolution procedures. *Id.* Art. 21. Generally, it should not exceed 15 months from the date of the adoption of a panel or Appellate Body report. *Id.*
16. *Id.* Art. 22:2.
17. *Id.* Art. 22:9.
18. The MTC is the administrative arm of the Multistate Tax Compact. The Compact seeks to facilitate proper determinations of state and local tax liability of multistate taxpayers, promote uniformity or compatibility of state tax systems, facilitate taxpayer convenience and compliance and avoid duplicative taxation. The MTC frequently supports the states' interests before judicial and legislative bodies. There are 19 state members and 14 state associate members of the Multistate Tax Compact.
19. The FTA frequently represents the interests of states and state tax administrators before legislative bodies.
20. MTC and FTA spokesmen have expressed these concerns formally and informally to the Executive Branch, to Congress, and to the tax community through oral and written submissions. Their views are summarized in Multistate Tax Commission and Federation of Tax Administrators, "Ensuring That States Treat Foreign, U.S. Taxpayers Equally Under GATT and GATS", *State Tax Notes* (13 June 1994), at 1523 [hereinafter cited as "*States' GATT/GATS Concerns*"]; Federation of Tax Administrators, "US Trade Agreements Could Greatly Affect States", 55 *Tax Administrators News* 52 (May 1994).

By way of illustration, the states point to the decision of a GATT panel in a dispute between Canada and the United States over the question whether various US national and subnational taxes and regulations applicable to alcoholic beverages were consistent with the "national treatment" requirements of Article III of GATT.[21] Among the measures which the panel found violative of Article III because they subjected foreign products "to internal taxes . . . in excess of those applied . . . to like domestic products"[22] were exemptions, credits and reduced tax rates limited to alcoholic beverages produced within the state; preferential tax treatment limited to wine produced from local ingredients; and tax preferences limited to local or limited-capacity breweries and wineries, which were permitted to sell directly to retailers and at retail thereby avoiding a wholesale level tax or distribution burden.[23]

Some of these measures, such as explicit preferences for in-state products, are plainly unconstitutional under US constitutional doctrine.[24] Others, such as tax preferences limited to small breweries regardless of their location, raise closer questions under US law. The GATT panel, while uncertain whether a state's tax credit for beer from small breweries was available to foreign as well as in-state breweries, ultimately found that fact irrelevant in concluding that the credit violated GATT. It reasoned that "beer produced by large breweries is not unlike beer produced by small breweries".[25]

Accordingly, the panel ruled that

> even if [the state] were to grant the tax credits on a non-discriminatory basis to small breweries inside and outside the United States, imported beer from large breweries would be "subject . . . to internal taxes . . . in excess of those applied . . . to like domestic products" from small breweries and there would still be an inconsistency with Article III:2, first sentence.[26]

The states contend that the GATT panel report adopts an "overly broad concept of discrimination"[27] and "fails to acknowledge the sovereign right of states in a federal system to establish different, but non-discriminatory laws that reflect local conditions that do not necessarily pertain in all states".[28] While the states may be correct in suggesting that a small-brewery exemption would have survived constitutional scrutiny under American constitutional standards,[29] it is by no means clear that such an outcome is warranted, at least in situations in which a capacity limitation is little more than a subterfuge for protecting small-capacity in-state businesses from their larger out-of-state competitors.

For present purposes, however, the question is not whether the states or the GATT panel have the better of the argument. Rather the point is simply that the states believe, probably with some justification, that the standards of non-discrimination to which they are likely to be held under GATT and GATS are more restrictive than those to which they have been held under the US Constitution.[30] More generally, they worry that, because GATT and GATS do not recognize federalism interests that are reflected in the US Constitution, and, in particular the authority of state governments as a positive value warranting protection, dispute settlement bodies will be under no obligation to balance the claims of international trading interests with subnational governmental rights. It is in this context that the states' efforts to limit the impact of GATT and GATS upon their "sovereign" taxing powers – efforts that are described below – become more comprehensible.

B. Impact of the new dispute settlement procedures upon the states

Beyond their concern over the substantive discipline to which their taxing regimes will be subjected if the GATT/GATS rules are applied to the states without regard to values of US federalism, the states are disturbed over the procedures by which GATT/GATS principles may be imposed upon them. The states are dismayed over the fact that they have no guaranteed standing before the dispute settlement bodies established by the Uruguay Round Agreements.[31] They have been apprehensive that their interests will not be represented adequately before DSBs, because the vigour of their defence will lie in the hands (and, hence, the discretion) of the US Government. The states fear that the US Government will be less protective of their interests – at least as the states' perceive them – than the states themselves would be.

The states are also troubled by the possibility that GATT/GATS rulings may bind the states more tightly than they bind the Federal Government. As noted above, the ultimate effect of a DSB panel or Appellate Body ruling finding a violation of covered agreements is to require one of three actions: (1) a change in the offending measure; (2) if no change is made, compensation to the injured party; or (3) if no satisfactory compensation arrangement is made, an authorization to the injured party to seek proportional trade retaliation. Hence an adverse DSB panel or Appellate Body ruling does not, *ipso facto*, invalidate the law of the offending

21. *United States – Measures Affecting Alcoholic and Malt Beverages*, GATT Doc. No. DS23/R (7 February 1992) (report of the panel).
22. GATT Art. III:2.
23. *United States – Measures Affecting Alcoholic and Malt Beverages*, GATT Doc. No. DS23/R (7 February 1992) (report of the panel), at 98-100.
24. See e.g. *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating exemption for locally-produced alcoholic beverages under Commerce Clause of US Constitution); *Division of Alcoholic Beverages & Tobacco v. McKesson Corp.*, 524 So.2d 100 (Fla. 1988) (invalidating preference for alcoholic beverages manufactured from specified crops, all of which were grown locally and few of which were grown in other states), *reversed on other grounds*, 496 U.S. 18 (1990).
25. *United States – Measures Affecting Alcoholic and Malt Beverages*, GATT Doc. No. DS23/R (7 February 1992) (report of the panel), at 75.
26. *Id.*
27. MTC and FTA, *States' GATT/GATS Concerns*, *supra* note 20, at 1526.
28. *Id.*
29. See *Archer Daniels Midland Co. v. State*, 690 P.2d 177 (Colo. 1984) (sustaining tax preference for gasoline produced from limited-capacity fuel-grade alcohol production facilities, even though no in-state fuel-grade alcohol producers were large enough to be affected by the production capacity limitation while several out-of-state producers were so affected); *but see Russell Stewart Oil Co. v. Department of Revenue*, 529 N.E.2d 484 (Ill. 1988) (invalidating tax preference for alcohol made from products that were used by almost all in-state producers of fuel-grade alcohol but not by many out-of-state producers of fuel-grade alcohol).
30. It is also worth noting, as the states' own example of a *pre*-Uruguay Round Agreement panel decision demonstrates, that the states' concerns are directed not merely to the standards embodied in the Uruguay Round Agreements, but also to standards embodied in the preexisting GATT rules.
31. FTA and MTC, *States' GATT/GATS Concerns*, *supra* note 20, at 1524.

party, nor can the offending party be compelled to change its law or provide compensation, although it may suffer reduced trade concessions because of its failure to do so.

The American states, on the other hand, arguably will be bound by a DSB panel or Appellate Body determination. The argument goes as follows: GATT and GATS are part of the foreign commercial policy of the United States. Under US constitutional doctrine, which reflects both the supremacy of the Federal Government as well as the allocation of power over foreign commerce to the Federal Government, US courts may construe US foreign commercial policy interests to limit state power, including state taxing power.[32] Unless the Federal Government formally rejects a DSB panel or Appellate Body ruling, US courts may therefore consider such rulings as official expressions of US foreign policy. Consequently, if a DSB panel or Appellate Body issues a ruling which holds an American state taxing measure inconsistent with GATT or GATS, and the US Government does not disavow the ruling, foreign governments may be able to invoke the ruling in a US court action contending that the state or local tax practice violates the US Constitution by virtue of its inconsistency with US foreign commercial policy embodied in GATT and GATS.

To be sure, one could contend that, in light of cases like *Barclays*,[33] there is a serious question whether the impact of US foreign commercial policy upon subnational taxing measures, even when the policy is embodied in international agreements, is as forceful as the states suggest, at least when the international agreement does not explicitly bind the states.[34] But the point, once again, is not whether the states' argument is wholly persuasive. Rather the point is that the states are deeply concerned about the prospect of foreign governments enforcing adverse GATT and GATS panel or Appellate body rulings in US courts, and this has led them to press the Federal Government for guarantees that, as implemented by the United States, the Uruguay Round Agreements will be sensitive to state interests.

IV. STATE-PROTECTIVE ASPECTS OF US CONGRESSIONAL LEGISLATION IMPLEMENTING THE URUGUAY ROUND AGREEMENTS

In enacting legislation implementing the Uruguay Round Agreements,[35] the US Congress sought to allay the states' concerns over the Agreements by providing a mechanism for federal-state consultation over issues arising under the Agreements and by strictly limiting the domestic legal effect of a DSB panel or Appellate Body ruling.

A. Federal-state consultation

Section 102(b)(1) of the Uruguay Round Agreements Act establishes a federal-state consultation process to facilitate implementation of obligations assumed under the Uruguay Round Agreements as they pertain to state laws. The Act requires the President to consult with the states through intergovernmental policy advisory committees for the purpose of achieving conformity of state laws and practises with the Uruguay Round Agreements.[36] It further provides for the establishment within the office of the US Trade Representative ("USTR") a federal-state consultation process for issues arising under the Uruguay Round Agreements that "directly relate to, or will potentially have a direct effect on, the States".[37] Specifically, the process will include procedures under which (1) the states will be informed on a continuing basis of matters that directly relate to, or will potentially have a direct impact on, the states; (2) the states will be provided on a continuing basis with an opportunity to submit information and advice concerning these matters to the USTR; and (3) the USTR will take account of the information received from the states when formulating US positions regarding these matters.[38]

With regard to the WTO dispute settlement procedures in particular, the Act provides that when a WTO member requests consultations with the United States under Act's settlement procedures with respect to whether a state law is inconsistent with US obligations under the Uruguay Round Agreements, the USTR will notify the Governor and chief legal officer of the state within seven days and consult with state representatives within 30 days.[39] The USTR will also make every effort to ensure that the state is involved in the development of the US position at each stage of the consultations and subsequent dispute settlement proceedings.[40] If a DSB panel or Appellate Body finds that the state law is inconsistent with US obligations under the Agreements, the USTR will consult with the state to seek to develop a mutually agreeable response and make every effort to ensure that the state is involved in the development of the US position.[41]

In its Statement of Administrative Action accompanying the Uruguay Round Agreements Act – a statement that "represents an authoritative expression by the Administration concerning its views regarding the interpretation and application of the Uruguay Round agreements",[42] the Administration declared that it is "committed to carrying out US obligations under the Uruguay Round Agreements, as they apply to the states, through the greatest possible degree of state-federal consultation and cooperation, in conformity with the consul-

32. See *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 452 (1979) (invalidating state tax on foreign cargo containers because it "prevents this Nation from 'speaking with one voice' in regulating foreign trade").
33. See *supra* note 1 and accompanying text.
34. As noted above, however, GATS is explicitly made applicable to subnational measures and GATT is generally believed to be applicable to subnational governments. See *supra* note 8.
35. "The Uruguay Round Agreements Act," 108 Stat. __ (1994) [hereinafter cited as *Uruguay Round Agreements Act* § __"]. The legislation was approved by the House of Representatives on 29 November 1944 and by the US Senate on 1 December 1994.
36. Uruguay Round Agreements Act § 102(b)(1)(A).
37. *Id.* § 102(b)(1)(B).
38. *Id.*
39. *Id.* § 102(b)(1)(C).
40. *Id.*
41. *Id.*
42. The Uruguay Round Agreements Act, Statement of Administrative Action, at 1, *reprinted in* House Doc. 103-316, vol. I, at 656, 103rd Cong., 2nd Sess. (1994) [hereinafter cited as "*Statement of Administrative Action*"].

tative framework established under section 102(b)(1) of the bill".[43]

B. Effect in the United States of DSB rulings affecting laws of the American states

The provision of the Uruguay Round Agreements Act that probably accords the greatest protection to state measures jeopardized by the Uruguay Round Agreements is the congressional directive that

> [n]o State law, or the application of such a State law, may be declared invalid as to any person or circumstance on the ground that the provision or application is inconsistent with any of the Uruguay Round Agreements, except in an action brought by the United States for the purpose of declaring such law or application invalid.[44]

Thus, as the Administration declared in its ongoing effort to assuage state fears that the Uruguay Round Agreements might be trenching on state prerogatives, the Agreements "do not automatically 'preempt' or invalidate state laws that do not conform to the rules set out in those agreements – even if a dispute settlement panel were to find a state measure inconsistent with such an agreement".[45] Rather, the *exclusive* avenue by which a state law may be invalidated pursuant to GATT/GATS criteria is in an action brought by the United States.

Indeed, the Uruguay Agreements Act specifically provides that no person other than the United States shall have a cause of action or defence under any of the Uruguay Round Agreements by virtue of congressional approval of such agreements.[46] Nor may any person mount a legal challenge to the action or inaction of a state (or its political subdivision) on the ground that the action or inaction is inconsistent with the Agreements.[47] To remove any room for doubt regarding its purposes, Congress declared its "intention" to "preclud[e] any person other than the United States from bringing any action against any State or political subdivision thereof or raising any defence to the application of State law under or in connection with the Uruguay Round Agreements . . . on any . . . basis".[48]

Moreover, in those instances in which the United States does choose to bring an action against a state on the ground that a state measure is inconsistent with the Uruguay Round Agreements, the DSB panel or Appellate Body report may not be considered as binding or otherwise accorded deference; the United States has the burden of proving that the state law in question is inconsistent with the Agreement; any state whose interests may be impaired in the action has the unconditional right to intervene in the action as a party, and the United States is entitled to amend its complaint to include a claim or cross-claim of the intervening state; and any state law that is declared will be deemed invalid on a prospective basis only, after the court's judgment becomes final and all appeals of such judgment are exhausted.[49]

Beyond these congressionally mandated protections of state interests, even when their measures violate the substantive standards of the Uruguay Round Agreements, the Administration has made it clear that it will exercise its authority (through the US Attorney General) to bring an action against a state "only as a 'last resort,' in the unlikely event that efforts to achieve consistency through the cooperative approach . . . have not succeeded."[50] Furthermore, the Administration has pledged that the "Attorney General *will be particularly careful* in considering recourse to this authority where the state measure involved is . . . *a state tax of a type that has been held to be consistent with the requirements of the U.S. Constitution*".[51]

V. ADMINISTRATION RESERVATIONS TO "NATIONAL TREATMENT" OF SUBNATIONAL TAXES UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES

As noted above, the Uruguay Round Agreements extend the GATT principles, which apply only to trade in goods, to trade in services through the GATS. GATS adopts the "national treatment" principle embodied in GATT[52] by providing that

> each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.[53]

Moreover, GATS "measures" explicitly include "measures taken by central, regional or local governments or authorities",[54] and GATS applies to direct as well as indirect taxes.

Because of the broad sweep of GATS, and its unmistakable application to state and local measures, the states were particularly concerned about the potential ramifications of the impact of the national treatment principles upon their taxing regimes. Consequently, after extensive discussions between federal and state governmental representatives, the USTR submitted a formal list of US reservations to GATS bearing on national treatment of "sub-federal" (i.e. subnational) taxes.[55]

43. *Statement of Administrative Action, supra* note 42, at 14.
44. Uruguay Round Agreements Act § 102(b)(2). The term "State law" is defined to include "any law of a political subdivision of a State," *id.* § 102(b)(3), e.g. a city or a county.
45. *Statement of Administrative Action, supra* note 42, at 14.
46. Uruguay Round Agreements Act § 102(c)(1)(A).
47. *Id.* § 102(c)(1)(B).
48. *Id.* § 102(c)(2).
49. *Id.* § 102(b)(2)(B).
50. *Statement of Administrative Action, supra* note 42, at 18.
51. *Id.* (emphasis added).
52. GATT Art. III.
53. GATS Art. XVII.
54. *Id.* Art. I:3(a)(i).
55. These reservations were submitted to the GATT on 29 June 1994 as a "Schedule of Specific Commitments for the US" and will be cited hereafter as "*US GATS Reservations*". It is worth noting that GATS itself recognizes an exception from national treatment for certain tax measures that are "aimed at ensuring the equitable or effective imposition of direct taxes in respect of services or service suppliers of other Members". GATS Art. XIV(d). Footnote 6 to GATS, which was inserted at the behest of the US Treasury Department at the 11th hour of the GATS negotiations when it became concerned about GATS' potential impact on federal tax law, provides that certain differences in the treatment of foreign and domestic taxpayers do not constitute a violation of the national treatment obligation. Primarily these relates to tax collection, administration, and enforcement techniques as well as procedures for eliminating double taxation. Footnote 6 also provides that methods of apportionment and allocation are removed from the purview of GATS.

As the ensuing discussion of these reservations reveals, the states have prevailed upon the US Government to carve out a significant body of exceptions from the national treatment principle, so that one may legitimately ask if the exception has not swallowed the rule.

A. Differences between taxing measures of different sub-federal jurisdictions

The United States reserved from the scope of the GATS national treatment requirement:

> Sub-federal tax measures which afford less favourable treatment to services or service suppliers within a sub-federal jurisdiction than the treatment which would be provided to those services or service suppliers by another sub-federal jurisdiction.[56]

This reservation is evidently designed to assure the states that their taxing measures will not be vulnerable to attack merely because other states afford more favourable tax treatment to services or service suppliers. In light of the diversity among the states' taxing regimes, any other rule would effectively destroy such regimes as we now know them. Moreover, permitting diverse (as distinguished from discriminatory) treatment by the states does not appear to offend the core principle underlying the national treatment ideal.

B. Providing less favourable treatment to out-of-state than to in-state services or service providers

The United States reserved from the scope of the GATS national treatment requirement:

> Sub-federal tax measures which afford less favourable treatment to a service that is performed or consumed, or to a service supplier that is located, outside the sub-federal jurisdiction (with respect to this distinction, treatment will not be less favourable than the treatment accorded by the sub-federal jurisdiction imposing the tax measure to a service performed or consumed, or to a service supplier located, in any other sub-federal jurisdiction.)[57]

On its face, this reservation appears to cut a broad swath across the national treatment principle by allowing states to provide tax preferences with respect to services provided within the state or to service providers located within the state. While the reservation may be designed to protect existing state tax incentives designed to attract business to a state, the reservation is hard to justify as a matter of sound tax policy.

C. Providing less favourable treatment to services or service suppliers of another member based on the state's allocation or apportionment methods

The United States reserved from the scope of the GATS national treatment requirement:

> Sub-federal tax measures which afford less favourable treatment to services or service suppliers of another Member based on the method of allocating or apportioning the income, profit, gain, losses, deductions, credits, assets or tax base of such service suppliers or the proceeds of a services transaction.[58]

This reservation is apparently intended to assure that the states retain the freedom, which the US Supreme Court recognized in *Barclays*,[59] to tax foreign corporations under apportionment and related methodologies that do not follow the international norms for dividing a tax base, even if the result may be to disfavour the foreign corporation. The reservation is understandable in light of the long controversy over the constitutionality of worldwide combined reporting that culminated in *Barclays* – a controversy in which the Administration walked a political tightrope between its long-standing policy in support of arm's length separate accounting and President Clinton's promise to side with California in the litigation. On the other hand, if it can be shown that the application of the state's methodology does in fact provide "less favourable treatment" to services or service providers of other members than that provided to services or service providers of US taxpayers, the Administration's reservations would seem to run afoul of the fairness criterion that underlies the national treatment principle.

D. Providing less favourable treatment to services or service suppliers based on specified criteria unrelated to the location of the services or service suppliers

The United States reserved from the scope of the GATS national treatment requirement:

> Sub-federal tax measures affording less favourable treatment to service suppliers or to services based on any of the following criteria:
>
> - the size or income of service supplier or methods (including environmental and health and safety measures) of performance;
> - the extent of ownership or participation by minority or other disadvantaged groups (whether or not subject to citizenship or residence requirements);[60]
> - the eligibility for differential tax treatment of Indians (Native Americans), an Indian Tribe, tribal or other Indian land, a corporation organized under a law for the protection of such persons or land owned by such corporations, or of other persons, based on a relationship to such persons, entities or land;
> - eligibility for tax exemption and other tax benefits derived from non-profit status;
> - eligibility for exemption from or reduction of sub-federal tax on obligations of the sub-federal jurisdiction or on contracts with the sub-federal jurisdiction;
> - whether the service is performed or consumed, or the service provider is located, in a jurisdiction with which a sub-federal jurisdiction has arrangements for tax cooperation and assistance for the prevention of double taxation;
> - the application of a sub-federal jurisdiction's property tax classification, including appraisal methods applicable to the classification;

56. *US GATS Reservations* para. 1.
57. *Id.* para. 2.
58. *Id.* para. 3.
59. See note 1 *supra* and accompanying text.
60. This reservation may not be needed should discussions on the scope of the GATS resolve that measures of this nature are outside the scope of the GATS. [Footnote in original.]

- the application of measures, including compliance measures, to prevent the avoidance or evasion of the tax of a sub-federal jurisdiction.[61]

These reservations, which generally preserve long-established lines that the states have drawn in their taxing schemes – sometimes out of federal constitutional compulsion (e.g. favourable treatment of Indian Tribes) – are justifiable accommodations to the states' concerns in preserving their role in the US federal system. Although tax classifications drawn on the basis of the criteria described above may occasionally treat taxpayers from other members less favourably than US taxpayers, the disparate treatment is adventitious rather than systematic and does not seriously undermine the national treatment principle.

E. Other reservations

The United States set forth a number of other specific (and largely self-explanatory) reservations for sub-federal measures

- incorporating provisions of federal law subject to a national treatment reservation under GATS;[62]
- reflecting restrictions placed on sub-federal taxing power by federal law;[63]
- imposing distinctions for the equitable or effective imposition or collection of franchise or corporation taxes;[64]
- compensating for other taxes that are nondiscriminatory by virtue of their relationship to other measures;[65]
- drawing classifications among various types of insurers;[66] and
- providing subsidies to socially or economically disadvantaged groups, to foreign persons organized or incorporated in the sub-federal jurisdiction, to entities with a principal place of business or significant commercial presence in the sub-federal jurisdiction, and to Alaskan and Hawaiian natives by Alaska and Hawaii.[67]

VI. CONCLUSION

The concerns that the American states have raised regarding the restraints that the Uruguay Round Agreements might impose upon the taxing powers they have traditionally exercised under US federal constitutional principles have resulted in significant limitations on the application of the Uruguay Round Agreements to the states. The US Congress, with the Administration's blessing, has not only required extensive consultation with the states during the dispute settlement process to assure that state interests are fairly represented, it has also severely limited the direct impact of a DSB panel or Appellate Body ruling that a state taxing measure is inconsistent with the Agreements. Moreover, the Administration's reservations to GATS, while in some respects justified by a proper regard for the role of states in the American constitutional structure, in other respects trench on the underlying principles of fairness and economic neutrality that are the cornerstone of national treatment obligations. It remains to be seen how US trading partners will respond to the state-protective actions it has taken in its implementation of the Uruguay Round Agreements.

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61. *US GATS Reservations*, *supra* note 56, para. 4.
62. *Id.* para. 5.
63. *Id.* para. 6.
64. *Id.* para. 7; *cf. supra* note 55.
65. *Id.* para. 8. For a discussion of compensating taxes in the United States, see generally Walter Hellerstein, "Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination", 39 *Tax Law.* (1986), at 405.
66. *US GATS Reservations*, paras. 9-11. With respect to the taxation and regulation of insurance, Congress has exempted the states from the restraints of the Commerce Clause that normally preclude the states from discriminating against out-of-state business. 15 U.S.C. § 1011-15 (1992) (the "McCarran-Ferguson Act"); *see Western & Southern Life Ins. Co. v. State Board of Equalization*, 451 U.S. 648 (1981).
67. *US GATS Reservations*, Addendum, paras. 1-4. The states have generally been permitted to provide direct subsidies to in-state persons free of federal constitutional restraint, even though they are forbidden from using their tax or regulatory power to favour in-state persons. See *West Lynn Creamery, Inc. v. Healy*, 114 S. Ct. 2205 (1994). In *West Lynn*, the Court acknowledged that it has "never squarely confronted the constitutionality of subsidies" (*id.* at 2214 n.15), but that it had observed that "'[d]irect subsidization of domestic industry does not ordinarily run afoul' of the negative Commerce Clause". *Id.* (quoting *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 278 (1988)). While acknowledging in *New Energy* that a local subsidization programme may constitute "a scheme no less discriminatory" than a discriminatory tax or regulation and "no less effective in conferring a commercial advantage over out-of-state competitors," *New Energy*, 486 U.S. at 278, the Court observed that "[t]he Commerce Clause does not prohibit all state action designed to give its residents an advantage in the marketplace, but only action of that description *in connection with the State's regulation of interstate commerce*". *Id.* (emphasis in original).

INTERNATIONAL

Overview of Privatization in the Area of Tax and Customs Administration

Peter D. Byrne

Deputy Director of the International Tax Program at Harvard University.

Tax administration has been caught up in the tide of privatization sweeping the world during the last decade. The logic is the same as in other types of privatization: the private sector should be able to carry out certain duties more efficiently than the public sector.[1] However, most candidates for privatization are enterprises that historically have been private. The enterprises may have ended up in government hands through expropriation, or perhaps to save jobs when private owners could no longer operate at a profit. The enterprise may have been created by the state to fill a perceived need (in a "strategic" industry, for example). When the foregoing types of operations are privatized, it is generally understood that private ownership is intrinsically superior and will be permanent.

Few activities, however, seem as inappropriate for private management as tax administration. The profit motive appears out of place for an organization charged with extracting money from the population. So, why is privatization under discussion?

First, privatization in the area of tax administration is a more traditional concept than one might think. The areas of voluntary compliance or employer withholding, for example, are undramatic but clear examples of participation by the private sector in tax administration.[2]

Second, there is immense dissatisfaction in many countries with the operation of the tax administration. What might be considered inadvisable under normal circumstances becomes reasonable when significant change is urgently needed.

Third, no one proposes total privatization. The challenge is to isolate parts of tax administration that can be privatized, but allow proper supervision from public entities.

Fourth, it might be useful to look at "privatization" in a broader sense. Even in areas where literal privatization is difficult or impossible, management practices used in the private sector may be implemented by a tax administration.[3] Unfortunately, this sort of "public privatization" often is not feasible, which may lead to calls for actual privatization.

In analysing the efficiency of a reform, especially when the proposed reform is privatization, one must look at "efficiency" from a societal point of view, not just the tax administration's point of view.[4] For example, a tax administrator might be tempted to hire new auditors as long as they bring in revenue in excess of their salary. This may be sensible from the tax administration's viewpoint; however, it is the duty of the tax administration to consider the expense incurred by the taxpayer. Therefore, when "efficiency" is analysed, compliance costs must be taken into consideration. In addition, the tax administration must make a serious effort to calculate the real cost to the government of performing a function. An employee's salary is not the only issue; benefits, opportunity costs, office space and equipment, support staff, etc. must also be factored in to provide a realistic comparison. Finally, the tax administration must factor in the cost of monitoring the private contractor.

I. THE ROOT OF THE PROBLEM

It is no secret that privatization in tax administration is under discussion because there is a significant problem. The developing country tax administration that operates efficiently is still the exception. Too often the tax administration is overstaffed with incompetent personnel. Low performance standards combine with low salaries to make corruption almost inevitable. The reasons for this dismal situation are varied. In some cases, wage levels are linked to and limited by low civil service pay scales. Unions often impede any attempt to discipline or dismiss employees for incompetence or corruption. In other cases, the tax and customs administrations are used as resources for political patronage. Turnover due to political changes discourages professionalism, especially if political supporters traditionally have sought such positions because of the opportunities for illicit activity.[5]

1. See Stuart M. Butler, "Turning Privatization from a Concept into a Program", *The Privatization Review* (Winter 1987).
2. Tax farming provides another example of private participation in tax collection with a long history. See P. Stella, "Tax Farming: A Radical Solution for Developing Country Tax Problems?", *IMF Staff Papers*, Vol. 40, No. 1 (March 1993).
3. L.F. Ramirez Acuna, "Privatization of Tax Administration," *Improving Tax Administration in Developing Countries*, ed. Bird and Casanegra (Madrid 1992), at 394. Many items included in this article are discussed in Mr Ramirez's article. This article attempts to complement Mr Ramirez's excellent article.
4. See Sanford, Godwin and Hardwick, *Administration and Compliance Cost of Taxation* (Fiscal Publications, BATH BA2 SAR 1989), at 10-23.
5. Stories abound of low-level customs and tax positions being sought by a new government's supporters. Opportunities for enrichment are the only explanation.

The general level of incompetence often reflects the government as a whole. In the case of tax and customs, the problem is particularly serious because the opportunities for corruption are so numerous, and because the rest of the government depends on tax and customs revenue for its operations. In addition, ineffective tax and customs administration causes upward pressure on rates to make up for lost revenue. Corruption and inefficiency in the tax and customs administration also can cause the citizens to lose confidence in their government.

Some commentators emphasize modernization and greater professionalism in the tax administration.[6] The general idea is to make the tax administration autonomous, with its own pay scale and standards. This echoes the approach taken by many countries to assure the competence and integrity of the Central Bank.

Peru is a dramatic example of this approach. The Superintendencia Nacional de Administracion Tributaria ("SUNAT") was established in 1988, but real reforms took place in 1991. Between March and September of that year, SUNAT's workforce was reduced from over 3000 to 800.[7] This downscaling was achieved through voluntary resignations (with monetary incentives) and competency tests. The "new" SUNAT implemented higher standards and salaries competitive with the private sector. SUNAT now is a place where recent university graduates aspire to work. SUNAT obviously has hired many new people to replace those who departed. Notwithstanding their lack of experience, the investment in new personnel appears to be paying off: revenues as a percentage of GDP nearly doubled in the first three years of the new institution.

This is an example of "privatization" in the sense of reforming the tax administration to function more like a private enterprise. Any private enterprise would appreciate the logic of paying higher salaries to enlist more talented professionals when it can be demonstrated that the professionals will bring in money far in excess of the salaries they demand; it is a simple cost/benefit analysis. However, when unions are involved, tax officials earn large sums through corrupt activities, and many taxpayers are happy because they can minimize their tax liability through unofficial payments, the forces of inertia are daunting. Many politicians will balk at the notion of throwing thousands of employees out of work, no matter how incompetent or corrupt.

For better or worse, the Peruvian approach often is not politically feasible. True privatization may offer a reasonable alternative in such cases.

II. PROSPECTS FOR PRIVATIZATION

A. Taxpayer preparation of returns (voluntary compliance)

Some countries still have an official assessment system for income tax where the tax administration calculates each taxpayer's liability. Needless to say, this involves intensive labour.[8] The extensive contact between tax administrator and taxpayer provides ample opportunities for corruption. As a result, most countries already have a voluntary compliance system. The shift to voluntary compliance means that more resources must be allocated to auditing and taxpayer education. However, most tax administrations have found that the cost is more than offset by the resources that are saved by having the taxpayers prepare their own returns.

B. Withholding/reporting

Employer withholding on wages for income or payroll taxes, or withholding on dividends, interest or other payments is another form of privatization. The withholding agent is charged with the responsibility of collecting amounts that correspond to tax liability owed by another person.[9] The requirement to withhold may be viewed as a simple condition for doing business. However, businesses may be more favourably inclined to cooperate if there is a benefit for them. Normally, the benefit is the right to retain the money for a period before turning it over to the government.

For purposes of both taxpayer preparation of returns and withholding, the compliance cost to the private sector must be considered. Nearly all countries have decided that these mechanisms should be implemented, but this does not relieve the tax administration of its duty to facilitate the process for the taxpayer. Educational programmes and taxpayer assistance (discussed below) ought to be provided.

C. Filing returns/payment of tax at banks

The most significant trend in tax privatization is authorizing banks to accept tax payments.[10] There are several compelling reasons for this movement: the mail service is unreliable; tax offices are too busy and inconveniently located; and computerization/electronic transfers make the arrangement feasible. As noted above, the incentive to the bank ordinarily is use of the money for a brief interval, so there is little expense to the government. Banks also may use this service as an opportunity to attract new customers. The tax authority will benefit from the fact that the banks will be less likely to make mistakes than the taxpayers.

While this arrangement has been largely successful, there are lessons to be learned from the experience of other countries. For example, payment at the tax office should not be an

6. See G. Jenkins, "Modernization of Tax Administrations: Revenue Boards as an Instrument for Change", 48 *Bulletin for International Fiscal Documentation* (February 1994), at 75.

7. See S. Fuentes Acurio, et al., "Reform of the Tax System and Administration", paper presented at the IDB Seminar, "Tax Reform in Latin America and the Caribbean: Achievements and Prospects" (July 1993).

8. Leon Yudkin, *A Legal Structure for Effective Income Tax Administration* (Tax Technique Handbook, Harvard Law School, 1971).

9. Bolivia imposes additional requirements. Businesses must calculate the amount of tax to be withheld from employee's salaries after the employees submit value added tax receipts for credit.

10. Ramirez Acuna, *supra* note 3.

option in a bank payment system.[11] This not only complicates the system unnecessarily, but also distracts the tax office from other tasks.

There is also the temptation to allow payment of tax at any bank branch in the country. Computer experts correctly point out that this is possible from a technical point of view. However, from a practical point of view, much less can go wrong where the taxpayer must choose one bank to be his paying bank. In addition to being simple, this system also introduces a useful psychological element: the paying bank will normally be the taxpayer's principal bank, and the taxpayer will be more careful about paying taxes to remain "respectable" in the bank's view. An efficient system for payment at banks should provide incentives based on number of returns received, so that the banks will not focus only on larger taxpayers. Refunds present another problem area. Banks should only be authorized to issue refunds if substantial safeguards are in place.

D. Printing, storage, etc.

Printing and storage are two examples of duties that may be prime candidates for privatization. In many countries, government operated printers or warehouses may be very inefficient. It may be difficult to subject such operations to a cost-benefit analysis because the true costs are hidden, or because tradition makes it difficult to look at other options. Nevertheless, the experience of several countries demonstrates that great savings might be derived by privatization of these and other similar operations.[12]

When analysing warehouse cost (or analogous costs), opportunity cost ought to be considered. For example, it may not be accurate to compare private storage with the expense of a government-owned warehouse if overhead (such as the cost of the warehouse) is not included. A government might consider selling or leasing the warehouse to a private entity – the overall expense may turn out to be far less.

In the area of printing, the entire expense of the printing department must be included, not just the marginal cost of certain projects. When office space and equipment, personnel and overhead are considered, it may be sensible to downscale a printing department and subcontract most projects. An option to consider for certain projects, such as tax forms, is to issue specifications and allow any printer to do the job and sell the item to the public at a fixed price.[13] The question here is whether the additional compliance cost offsets the savings to the tax administration.

Any other task, from painting to plumbing, could be subjected to the above analysis.

E. Valuation of assets

Some countries have had success contracting out the valuation of certain items that constitute the tax base. The most often cited example of this is aerial photography for purposes of calculating property tax. Theoretically, this practice facilitates rapid assessment of land size, use and value without problems of access. Care must be taken, however, to ensure that this system does not become an excuse for further delays in collection of property tax. Most delays in collection of property tax arise from a lack of political will, not from inaccurate valuation.

The emergence in several Latin American countries of an alternative minimum tax based on assets may provide another appropriate candidate for private valuation.[14] Needless to say, it is beyond the capacity of most tax administrations to place a value on the assets of each business in the country. Therefore, the administration must rely on either self-assessment or some other type of private valuation. Appraisal by private professionals may be considered.

F. Computer systems

The growing importance of computers in tax administration cannot be doubted. By now all national tax administrations surely use computers for some tasks. The question is whether some computer tasks can be more effectively performed if done privately rather than by the tax administration.[15] The logic is that computers are so critical that the most capable computer experts should be utilized, and they are in the private sector. In certain areas such as data entry, a private contractor will have more flexibility to provide the necessary incentives for quick and accurate performance. Moreover, the private sector can adapt to advances in computer technology more rapidly than the public sector, and greater use of private contractors will make the advances available for use more quickly.

To be sure, efficient use of computers should be a focal point for any tax administration. However, privatization must be handled carefully. First, confidential information often will be part of a project, and disclosing this information to a private contractor will be problematic. Second, the vital nature of computers may argue *against* privatization; rather, efforts should be made to bring very strong computer experts into the tax administration. This is a clear case where not paying adequate salaries will result in disproportionate revenue loss. There may always be good reasons for contracting out some

11. Mexico is one example in which the tax administration has authorized banks to be the only recipients of tax payments. See F. Gil Diaz, "The Subsidiarity Principle Applied to Tax Administration", Conference on Information Technology and Fiscal Compliance, Harvard University (5-6 November 1992).

12. The author is advised that Jamaica's tax from printers, now privatized, turn a profit. Prior to privatization, the same basic operation cost the government more *and* operated at a loss.

13. Several Latin American countries have privatized some aspect of printing operations or form distribution. See Ramirez Acuna, *supra* note 3, and Gil Diaz, *supra* note 11.

14. P.D. Byrne, "The Assets of Tax in Latin America – No Credit Where It Is Due", *Tax Notes International* (15 August 1994), at 533. This point perhaps fits more comfortably in the audit category since value for purposes of this tax ordinarily is based on book value.

15. Computer functions may be shared between the tax administration and the private sector. For example, the function of data entry may be done by banks and processing by the administration. Countries electing to do this are Colombia, Bolivia and Ecuador. See Ramirez Acuna, *supra* note 3.

computer work, but having strong computer experts at the tax authority will help to ensure that such contracts are sensible.

G. Education

A significant part of any tax administration's duties should be facilitating compliance. Not only can this enhance revenue, but it also can reduce taxpayer irritation with the tax system. One part of facilitating compliance is streamlining the forms and procedures for filing; another is educating the taxpaying public.[16] Television may be the best means to reach a broad spectrum for the more basic issues. For more complex issues, seminars might be organized. In either case, private contracting may be the preferred option. For television spots, there may be a competitive bidding procedure, designed to utilize private companies' expertise in television production, but at the same time ensuring the desired content. Seminars may also be arranged on a competitive basis. University professors or tax professionals who have considerable experience may be appropriate for such seminars. In some cases, tax professionals may be willing to perform such duties at no charge as a matter of public service, or for public relations purposes. In most cases, a tax administration representative should participate in order to assure that the seminar explains how to comply with the tax law, not how to avoid it.

For such television spots or seminars, private participation is desirable because private persons have more experience in the area and therefore can do a better job. In addition, such experience should *save* money, because doing the project in-house would involve considerable start-up costs. Performance should be monitored, and successful participants should be rewarded with further contracts. After a few years, the projects can be evaluated to determine whether the tax administration should develop its own capacity, or should continue to use private contractors.

Another area falling under the general heading of education is taxpayer assistance. Whether by telephone or in person, this involves answering taxpayers' questions. An evaluation should be undertaken to determine whether the tax administration has the resources to perform such duties itself, and at what cost. After such evaluation, it may be decided that a private entity could perform the task more efficiently. When evaluating the cost of subcontracting in this area, the cost to the tax administration of adequate monitoring should be included.

H. Return certification

Many taxpayers routinely pay private tax experts to prepare their returns. This practice benefits the tax authority because it reduces errors. However, return preparers always want to save their client money. This often results in aggressive tax planning, and occasionally in unethical conduct. The question thus becomes whether the positive effects of private tax preparation can be preserved while eliminating the negative.

One option would be to require an accountant's signature on the tax return of any taxpayer with assets or turnover above a threshold amount.[17] Expanded use of tax professionals would reduce errors, and tax preparers may do their job more carefully if they must sign.

Return certification is a more aggressive possibility. The tax administration can establish a registry of authorized tax preparers (perhaps certified public accountants) whose certification will result in a lower level of scrutiny by the tax administration. Unsatisfactory performance (judged by taxpayer errors not detected, or otherwise not representing the government's interests adequately) will result in being deleted from the registry.[18]

For this approach to work, the appropriate incentives must be in place for the tax preparer to be willing to do this type of work, for taxpayers to use the procedure voluntarily, and to ensure that the government's interests are protected. This means adequate compensation for the tax preparer. Whether the compensation comes from the taxpayer, government or both, must be carefully considered. Charging the taxpayer discourages use of the system, and payment by the government exhausts resources (though it must be viewed in light of the resources this procedure saves, and the additional revenue collected). To encourage tax preparers to exercise adequate care, it has been proposed that tax preparer, rather than the taxpayer, be held liable for the amount of understated tax.[19] The harshness of this penalty (in cases other than fraud by the tax preparer, which should be treated as a crime) casts doubt on whether it would be enforced.

Tax preparers on the registry must be subject to guidelines so that the tax authority can monitor their performance. In addition to rules regarding fees, there must be records covering (among others) quantity of returns certified, additional revenue collected because of the certification, and taxpayer complaints. Of course, the tax administration should not surrender its ultimate assessment authority, and must carry out performance spot checks.

I. Advance rulings

In many countries, taxpayers are permitted to submit a proposed transaction to the tax authority for its opinion ("advance ruling") on the tax characterization of the transaction. Normally the taxpayer will pay a fee for the opinion, and the opinion will be binding on the tax authority as long as the transaction is carried out in the manner set forth in the proposal.[20] If the taxpayer disagrees with the opinion and wishes to challenge it in court, it may do so. This practice is

16. The SUNAT of Peru implemented a campaign of public information that sought to make all taxpayers aware of their obligations and the work of SUNAT. See Fuentes Acurio, *supra* note 7. Mexico also has undertaken a broad information campaign.

17. See Ramirez Acuna, *supra* note 3.

18. The tax administration may use chartered accountants for this purpose. See S. Terkper, "Improving the Accountancy Content of Tax Reform in Developing Countries", 48 *Bulletin for International Fiscal Documentation* (January 1994).

19. Ramirez Acuna, *supra* note 3, at 388.

20. The private letter ruling system in the United States has a long and useful history.

desirable because it gives taxpayers a vehicle to achieve the predictability so important for investment decisions. It is advantageous for the tax authority because more transactions can be monitored at less cost (because of the fee). A tax authority may not have the resources, however, to manage an advance ruling system efficiently.

This type of advance ruling combines elements of private tax planning and assessment by the tax authority. Because advance rulings already contain elements of private tax planning, they provide a good possibility for privatization. Under ordinary private tax planning by tax professionals, the tax authority must examine the tax treatment closely because the tax professional is paid by the taxpayer to find a favourable solution. Private tax professionals will be more neutral in their analysis if they are paid by the tax authority, their work is subject to review and future work is conditioned on satisfactory performance.

To implement a privatized advance ruling scheme, it will be necessary to establish a fee schedule for taxpayers, guidelines for format and payment to private contractors, and a review mechanism that protects the tax authority's interest and creates a history of the contractor's work to use in deciding whether to employ such contractor in the future.

J. Taxpayer audit

The audit function goes to the very heart of tax administration, and therefore presents a more controversial proposal for privatization than any of the foregoing. In addition, items such as certification of returns or advance rulings are voluntary on the part of the taxpayer, and rights to confidentiality can be explicitly waived. There is no such voluntary aspect to audit. Nevertheless, unsatisfactory audit capacity in the public sector of so many developing countries has caused serious consideration of this controversial concept. The close contact between auditor and taxpayer, combined with the low wage scale for tax inspectors, provides a perfect environment for corruption.

The serious problem with confidentiality must be overcome before other issues can be addressed. One option would be to solicit a limited waiver from the taxpayer after the taxpayer has been selected for audit. In many countries this mechanism is used with respect to the statute of limitations. A less desirable option is to shield the taxpayer's identity, but this may make most audits ineffectual.

If the confidentiality problem is overcome, other obstacles remain. For example, private auditors will be subject to many of the same pressures that lead to corruption in the public sector. Therefore, tax administration must review the performance of the private auditors with care. Such control may be more effective than efforts to control corruption within the tax administration because there is more distance between the auditor and the reviewer, institutional corruption cannot be protected through unions or civil service rules, and the private auditor may consider his professional reputation more important than government tax agents do.

For the foregoing reasons, private audits may occasionally be sensible. However, it is a less desirable option than ridding the tax administration of the conditions that cause ineffective audit. Resorting to private audits as an interim measure may be necessary to move the tax administration in the direction of reform.

A final issue is how private persons can help the tax administration identify tax cheats for audit. Several countries offer rewards (generally a percentage of the recovery) for information leading to greater revenue.[21] This policy not only discourages evasion, but also discourages flaunting of tax evasion. This latter point is important, because nothing embitters honest taxpayers more than the knowledge that others are not supporting their share of the burden.

K. Collections

Many tax administrations suffer from an inability to collect taxes after they have been assessed. At times, collection is frustrated even after the tax authority has prevailed in court. This may be a result of simple inefficiency or corruption in the tax administration, but often is the result of ineffective performance by the legal system, both law enforcement and the courts. For this reason, it would be better to attack the root of the problem, which involves imposing meaningful interest and penalties, empowering the tax administration to do more functions itself (close businesses and seize property) as well as creating a separate, efficient tax court. Where the foregoing options are not politically feasible, unusual measures may be necessary to break the vicious cycle in which taxpayers do not pay what is due, and demoralized tax officials do not pursue collections vigorously because there is little hope of success. Privatization may offer some improvement.[22]

One candidate for privatization is the legal work associated with collecting an assessment. Especially where the amount of money is large, it is a sensible investment for the tax authority simply to hire an experienced outside lawyer (the United States hires top quality outside lawyers for certain claims, though not normally in the tax area). Compensation may be performance rated.

A more extreme option is simply to sell to private persons the right to a taxpayer's debt.[23] The government receives all or most of its money immediately, and collecting the tax debt becomes the sole concern of the private contractor. A private party may be able to collect the debt more efficiently because it is not subject to the same limitations as the government. Obviously the private contractor has more incentive to collect quickly than a tax official who will not benefit directly from the collection. For this scheme to function, there must be adequate safeguards.[24] First, there must be control to ensure that the private collector does not use illegal means

21. In the United States, jilted spouses and lovers are the most willing participants in this programme.
22. Some interesting approaches have been proposed. See C. Hood, "Privatizing UK Tax Law Enforcement?", 64 *Public Administration* (Autumn 1986).
23. See Hood, *supra* note 22 and Yudkin, *supra* note 8, at 41.
24. See Ramirez Acuna, *supra* note 3.

(e.g. threats of physical violence) in his efforts. Second, the sale of the tax debt cannot be an opportunity for the taxpayer to purchase his own debt at a discount.

L. Pre-shipping inspection (customs)

One aspect of customs enforcement has been privatized already in many parts of the developing world, and that is pre-shipping inspection ("PSI"). Several large international companies provide this service, which involves inspection of international cargo for quantity, quality and legality, *prior* to import. After the cargo is inspected, it may proceed to the border (often in sealed containers). The PSI companies charge the importer a fee for the service, usually based on the value of the shipment.

The PSI concept has several components. First, customs is often the most corrupt government institution. The potential for bribery is immense, because the money involved is considerable (an importer saves both customs duty and value added tax) and the borders are often remote and difficult to control. The PSI company creates a record of the shipment that facilitates control. Second, it is supposed that the PSI companies have computer capacity and technical expertise in valuation that many customs agencies lack. The PSI companies are less subject to corruption because they have their international reputation to protect, and because their fee is based on value, which discourages under-valuing of goods. Third, proper use of the PSI mechanism involves forwarding the import information to the tax authority, which should improve value added tax enforcement.

The PSI system has been deemed a success in many situations. However, the approach is not without flaws, and illustrates some of the problems that can arise in a privatization. Most important, the PSI mechanism is useless if the customs administration does not use the information and shipments continue to pass customs after a bribe is paid. As in other potential areas for privatization, the contractor's efficient work may be frustrated because of a lack of political will or competence in the government. Another common flaw in PSI is using more than one PSI company. When the PSI companies must compete for business, an importer can play the PSI companies against each other. This drives valuations down and can encourage corruption. This lesson should be applied to other privatization possibilities: private contractors should never be put in the position of competing with each other in such a way that the government's interests are compromised.

M. Customs warehouses

Privately owned and operated customs warehouses have been instituted in some countries. The customs administration's role is limited to inspection and control. It is possible to arrange the warehouse operations so that the various warehouses compete to offer superior service. The privately operated customs warehouses have been favourably received, and can raise revenue for the government.

N. Internal audit

One of the most difficult areas of official corruption to eliminate is the corruption of those charged with exposing internal corruption. It is never a popular duty and can be dangerous if done well. Therefore, whether in the area of tax or customs, it must be performed by an elite group, and private companies may be the best source of such a group.[25] Unlike an internal anti-corruption group, a private organization will have the necessary distance from the people it is controlling. In addition, the private company can simply be dismissed for inadequate performance.

III. CONCLUSIONS

As can be seen from the foregoing, there are a number of areas of tax administration where a government might consider privatization. Some are more practical than others, and some tax administrations may determine, after analysing privatization possibilities, that no further privatization is warranted. Such an analysis should nevertheless be undertaken.

The most realistic possibilities for privatization at present (other than self-assessment and withholding) are authorizing payment at banks, and hiring outside contractors to do specific tasks, such as printing or lawyers to prosecute cases. In the area of customs, pre-shipping inspection companies are already widely used and warehouses should be scrutinized for privatization potential. More aggressive efforts to privatize might consider the concept of return certification or contracting out advance rulings. The consideration of these options should include the fact that fewer responsibilities will enable the tax administration to focus its efforts and do a better job in areas remaining under its control.

The areas of private auditing or computerization are initially appealing, but involve several problems, such as confidentiality.

While considering privatization, it should be noted that some tasks are appropriate for the private sector, but that certain fundamental areas of tax administration naturally belong in the public sector. For areas such as audit and certain computer functions, privatization should only be considered as an interim measure to correct serious problems. Eventual overhaul of the tax authority is preferred.

In *all* situations, the introduction of private-sector concepts of operating should be studied. Dramatic revenue growth has been registered in many developing countries by increasing pay to attract more qualified tax and customs administration employees. Any efficient private company would increase the pay scale where it could be demonstrated that the company would recoup the amount many times over. Merit must be the major factor for advancement, and reasonable performance must be a prerequisite to keeping one's job. Unfortunately, many tax administrations are paralysed by tradition,

25. Mexico used this approach to help root out corruption in customs. Gil Diaz, *supra* note 11.

civil service rules or unions. A different danger is presented by too much change in personnel for political patronage purposes. In general, only the top few tax officials should be political appointments. The key is to balance safeguards against political interference in personnel decisions against the ability to dismiss or reassign ineffective personnel. Autonomy of the revenue authority can help achieve these goals.

Finally, some problems cannot be solved through any sort of privatization because the problem is legal or outside the tax administration (in the courts, for example). In such situations, the only recourse is to push for legal reforms, including establishment of a tax court. Other branches of the government may need to be reminded that their revenue depends on such reforms, and that such reforms more than pay for themselves without increasing levels of taxation.

Conference diary

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

JANUARY 1995

Internationales Steuerseminar, St. Moritz, Switzerland, 9-13 January 1995 (German):

Attn: Internationales Steuerseminar Zürich, c/o Bank Leu AG, Postbach, CH-8022 Zürich, Switzerland, Tel.: 41-1-2-192399.

Leading Edge Tax Strategies for the Corporate Tax Manager, London, 10 and 11 January 1995 (English):

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VIETNAM

INTRODUCTION TO VIETNAMESE FOREIGN INVESTMENT TAXATION LAW

Christopher Potter

Christopher Potter holds an LL B from King's College London, a "maîtrise" and a "Diplôme d'Etudes Approfondies" in taxation law from the University of Paris. He is a French "avocat" and currently the resident associate of Siméon & Associés in Hanoi.

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This is the first article in a series and is intended to give the reader an overview of Vietnamese taxation law as it stands today. The following articles will each consider a tax or series of taxes in more detail. However, Vietnamese law is evolving extremely rapidly and articles written with regard to certain aspects may become very rapidly outdated. Specialist advice should be sought before any action is taken in Vietnam.

I. INTRODUCTION

The Socialist Republic of Vietnam is located at the centre of Southern Asia, and is bordered by Cambodia, Laos and China. The population is of approximately 70 million. What is more, this population is well-educated, with a literacy rate of around 70 percent. Consequently, this country presents foreign investors with an educated and motivated, but low cost workforce.

Vietnam also has many other assets in its favour. It has abundant mineral and natural resources, and a government committed to encouraging investment. This has promoted growth of about 9 percent in the first half of 1994. Vietnam's rich cultural and natural beauty is also very appealing for the tourist industry.

One of the main characteristics of Vietnam's history is the country's struggle against foreign occupation. Over the last 2000 years, foreign invaders (Chinese, French, American) have tried to take control of the country. In 1945, Vietnam was declared independent by the Viet-Minh, a nationalist liberation movement. In 1954, the partition of Vietnam led to two economic systems. The South was backed by the United States, and Socialist doctrine oriented the northern Vietnamese economy. Then, in 1975 the government of South Vietnam crumbled and the North took control of the whole country.

As a result of this war, the economy was in a disastrous state, with inflation at about 100 percent and very low per-capita income. The population depended largely on agriculture with low labour productivity whilst industry belonged almost entirely to the State sector.

The breakthrough came in 1986 with the introduction of the "Doi-Moi" or "renovation" policy which began the move from a centrally-planned to a market economy. The Sixth Vietnamese Party Congress embarked upon a project for the development of the Vietnamese economy, employing both domestic and external resources. It approved two main economic policies, the first being to reduce state intervention in business, and the second to open Vietnam to foreign investment.

In order to implement this new policy, the National Assembly voted the "Law on Foreign Investment in Vietnam" at the end of 1987.

The economy of Vietnam has continued to make positive progress, and there has been an increasing growth in both production and service sectors. The financial and monetary sector has also been stabilized. Vietnam has managed to overcome rampant inflation and the government has now reduced it to around 10 percent.[1]

Recent newspaper reports suggested that as a result of increased foreign investment, growth is expected to rise to 10-12 percent. Vietnam has become a new and attractive market for investors and is often considered to be the next Asian "Tiger".

Indeed, foreign investment is pouring into Vietnam. In 1988, the total amount of incoming capital was $ 362.8 million. In 1993, that amount rose to $ 3,170 million.[2]

II. FOREIGN INVESTMENT

Foreign investment legislation in Vietnam is founded on the "Law on Foreign Investment in Vietnam" (the "LFI") passed by the National Assembly on 29 December 1987. The LFI provides that it is enacted "in order to expand economic cooperation with foreign countries...to encourage, and create favourable conditions for the investment in Vietnam...[and] to encourage foreign organizations and individuals to invest in Vietnam".[3] In 1989, the Vietnamese government became aware that the targets which had been set in 1986 would not

1. *Vietnam Investment Review* 24-30 October 1994.
2. *Vietnam Economic News* 27 July-2 August 1994.
3. Preamble LFI.

be reached. Consequently, the LFI was amended first on 30 June 1990, then on 23 December 1992.

The LFI is supplemented by implementing regulations contained in the "Decree providing regulations on foreign investment in Vietnam" No.18-CP of 16 April 1993 (the "Decree"), and together the LFI and Decree are often described as some of the most progressive and favourable foreign investment legislation in Asia.

In addition to the LFI, there are several texts relating to other varieties of foreign investment such as the "Decree on Foreign Banks" of 15 June 1991 and the "Regulation on Representative Offices" first issued on 5 November 1990 and replaced by the Decree of 2 August 1994.

A. Investment priorities

Foreigners may in theory invest in any sector of the economy. However, the LFI particularly encourages investment in areas such as "implementation of major economic programmes, export oriented production and import substitution, the use of high technology, skilled labour ... production which is labour intensive and uses existing materials and natural resources ... building of infrastructure projects, [and] foreign currency earning services..."[4]

Unfortunately projects which are considered relatively uninteresting to Vietnam (either because they do not include sufficient investment, a transfer of high technology or such like) are unlikely to ever receive a licence from the State Committee for Cooperation and Investment, the State body responsible for authorizing foreign investment.

B. Forms of investment

In its chapter II, the LFI provides for three forms of investment: the Business Co-operation Contract, the Joint-Venture Enterprise and the Wholly Foreign-Owned Enterprise.

1. Business Co-operation Contract (the "BCC")

A BCC, which can be described as a partnership although it is not a distinct legal entity, is an agreement between one or more foreign investors and one or more Vietnamese entities to conduct business operations in Vietnam.

Parties to a BCC are free to determine their rights and duties, but under Article 10 of the Decree, they must define mutual responsibilities and the sharing of business profits in the contract. The contract must also include information such as its duration, and a list of equipment required for the activity. It is interesting to note that neither the LFI nor the Decree provide a legal maximum for the duration of the BCC.

The BCC is the most flexible form of investment but also the most rarely used. This may be explained by the fact that foreign investors in a legal environment in perpetual flux prefer a more rigidly regulated form of investment.

2. Joint-Venture enterprise

The Joint-Venture enterprise is by the far the most popular form of foreign investment in Vietnam. Such an enterprise is established by means of a joint-venture contract between one or more Vietnamese partners and one or more foreign partners.[5] It is a Vietnamese legal entity, subject to Vietnamese laws and regulations.

Under the LFI (Article 7), foreign contribution to the capital of the joint-venture enterprise may comprise foreign currencies, equipment and technological know-how. The Vietnamese party may contribute buildings, local currency and land-use rights. The LFI also provides that the foreign investor's contribution must be at least 30 percent of the legal capital. It should be noted that the partner's liability is limited to the capital contributed.

Articles 12 and 13 of the LFI cover the management of a joint-venture enterprise. The highest body is the Board of Management which has the authority to make decisions on important matters.

3. Wholly Foreign-Owned Enterprise (the "WFOE")

A WFOE is a Vietnamese legal entity which is established and owned by one or more foreign investors. It is the form of investment which appeals most to foreign enterprises, and in particular Korean and Hong-Kong firms, seeking to sell their produce on the Vietnamese market.

In contrast with BCCs for which neither the LFI nor the Decree provide a maximum duration, it should be noted that under article 15 of the LFI the duration of a joint-venture or WFOE may in principle not exceed 50 years.

C. Guarantees of foreign investors' rights

The LFI also provides for guarantee measures for foreign investors in its Chapter III. Foreign organizations must be treated "fairly and equitably". The capital and assets of foreign investors may not be requisitioned or expropriated. What is more, the LFI provides that "an enterprise with foreign owned capital shall not be nationalized".[6]

Foreign investors are also entitled to transfer abroad their share of profits after tax, as well as invested capital, personal income and the principal of loans as well as any interest that the loan may have earned. This provision is very important because it means firstly that foreign investors will not lose what they invest in Vietnam (unless the investment fails and its debts absorb its assets) and secondly that investors who obtain a return on their investment may recover both the investment and the profit. This relates to Article 24 of the LFI which gives the foreign investor the right to convert currency.

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4. LFI Art. 3.
5. The fact that the Joint-Venture enterprise is the only legal entity involving both Vietnamese and foreign parties may explain why the European Community International Programme (the "ECIP") offers grants to European investors entering into a joint-venture with a Vietnamese partner.
6. LFIArt. 21 LFI.

Furthermore, it should be noted that the Vietnamese government has signed bilateral agreements for the protection of foreign investments with several countries including Australia, Thailand and France.

D. Labour

The LFI contains provisions on labour relations. Under the Decree, a foreign enterprise is required to comply with Decree No. 233 of 22 June 1990 and with the ordinance of September 1990.[7] It should be noted that these regulations apply equally to Vietnamese nationals and foreign expatriates working for foreign enterprises in Vietnam. The LFI does not specifically refer to the new labour code,[8] although this code may be applicable to foreigners when its terms are clarified.

Foreign enterprises may recruit either Vietnamese nationals or foreigners, but the LFI requires that priority be given to Vietnamese citizens. An expatriate may only be recruited where there is no Vietnamese national available with the necessary qualifications or training. The rights and obligations of the employees must be defined by labour contracts. In addition to these individual contracts, foreign enterprises are required to sign a collective labour agreement with workers' elected representatives.

E. Representative offices

The establishment of representative offices does not fall within the scope of the LFI and is regulated by a decree of 1994.[9]

The representative office represents the simplest form of presence of a foreign company in Vietnam, but is a form which is not permitted to make a profit in Vietnam. Any profits must be made by the head office abroad. A foreign investor wanting to set up a representative office must already have commercial relations with Vietnamese economic organizations, or a project for cooperation in Vietnam. A representative office requires a licence to operate, which is delivered by the Ministry of Commerce.[10]

F. State Committee for Co-operation and Investment

The State body in charge of foreign investment is the State Committee for Co-operation and Investment (the "SCCI") and was founded on 25 March 1989.[11]

According to Chapter V of the LFI, the SCCI has "the overall responsibility for matters relating to the investment activities of foreign organizations and individuals in Vietnam".[12] The functions, duties and powers of the SCCI are fully described by a decree of 1993,[13] and also in the LFI and the Decree.

The SCCI has the power to grant investment licences.[14] The Vietnamese authorities consider that it is essential that all investors pass by one body, the SCCI, which gives one authorization and not several bodies, which could lead to long delays and confusion. The SCCI therefore receives all investment licence applications and consults the appropriate authorities as the required licences are only granted after a number of authorities have also given their approval. The role of the SCCI is therefore to coordinate these authorities, to receive their comments and to communicate these comments to foreign investors. This is why the SCCI is often labelled a "one-stop" licensing body.

G. Investment licensing procedure

Much is made of the attempts by the authorities to simplify the procedure for obtaining a licence, as described by the LFI and the Decree. This is clearly necessary if formalities and bureaucracy are not to discourage foreign investors. Only the following documents are now necessary: a duly completed application form, contracts signed by the parties (BCC or Joint-Venture Enterprise), the enterprise's charter (Joint-Venture Enterprise or WFOE), a feasibility study and finally information evidencing the foreign investor's legal form and financial position.

Under Article 38 of the LFI the SCCI must notify its decision to investors within three months of the date of receipt of the application. In reality, it appears that the formalities often cause this time limit to be overrun. Further, according to Articles 11 and 23 of the Decree, the SCCI may require more documentation about the investment project from the parties. In this event, it "shall send a request to [the parties] within one month from the date of receipt of the application". The parties have to reply within 45 days in order to avoid the application being invalidated. If the reply supplied by the parties does not satisfy the SCCI, then the three month delay mentioned in Article 38 of the LFI is extended until the reply is considered adequate. It should be noted that the SCCI alone judges the adequacy of applications or replies. In reality the three month delay is very often exceeded.

When the SCCI approves the application, it delivers an investment licence. It should be noted that the investment activity must respect the terms and conditions fixed by the licence.

Other than the specific power to grant licences, the SCCI is responsible for the promotion of foreign investment and the preparation and submission to the government of all drafts of laws relating to foreign investments. It guides foreign investors and monitors the evolution of investment and its impact on socio-economic development in Vietnam.

7. Ordinance on Labour Contracts 10 September 1990.
8. Labour Code of the Socialist Republic of Vietnam of 23 June 1994, coming into force on 1 January 1995.
9. Decree No. 82-CP of 2 August 1994.
10. This licence is distinct from the investment licence granted by the SCCI for the investment projects listed above (BCC, WFOE, Joint-Venture Enterprise).
11. Decree No. 31-HDBT of 25 March 1989.
12. LFI Art. 36.
13. Decree No. 39-CP of 9 June 1993.
14. See *supra* note 11.

III. TAXATION

In order to understand the structure of Vietnamese tax law it is necessary to briefly examine the layout of the taxation provisions. As discussed above the LFI contains a few provisions[15] which serve as a foundation upon which the system is to be built. Indeed the LFI sets out the principles of taxation of foreign investors, and may provide maximum and minimum rates of taxation. The LFI is completed by the Decree, which although still being a "general" text relating to all aspects of foreign investment, devotes a chapter (euphemistically entitled "Financial Matters") to clarifying and detailing the taxation provisions of the LFI. In this respect, and in the case of profits tax, it provides for specific rates within the minimum and maximum rates set out by the LFI. The Decree is in turn complemented by the Circular on Taxation of Foreign Investment (the "Circular").[16] This text is, as its title suggests, devoted entirely to taxation matters and it introduces provisions on breaches and complaints. The picture is completed by a series of specific texts laying down provisions for each variety of taxation created by the LFI, more often than not composed of a law, a decree and a Circular, ordinance or decision. However it is quite possible for a form of taxation not to have its own law (for instance personal taxation is entirely governed by a series of ordinances).

Given this structure of Vietnamese taxation law this article will introduce the basic concepts of each form of taxation in the same way – discussing the foundations laid by the LFI, the clarifications (if any) contributed by the Decree, the effect of the Circular and finally the general provisions of the texts specific to each tax. This first general article will be followed by a series of further articles each discussing in detail one or more of the forms of taxation introduced below.

The LFI provides for the levying of profits tax, withholding tax, royalties, import and export taxes. Turnover tax, special sales tax, land taxes and personal income tax were created by later texts.

A. Profits tax

All forms of foreign business organizations under the LFI are subject to profits tax. Article 26 of the LFI provides that they "shall be liable to pay profits tax at a rate of between 15 and 25 percent of profits earned". Profits derived from exploitation of oil and gas are subject to a higher rate "in accordance with accepted international practice".[17]

The LFI also provides for specific tax holidays and tax reductions as incentives for joint-ventures or WFOEs conducting business in sectors where investment is needed and to be particularly encouraged. Under Article 27 an enterprise may be exempted "from payment of profits tax for a maximum period of two years commencing from the first profit making year and it may be allowed a 50 percent reduction of profits tax for a maximum period of the two successive years".

It is interesting to note the existence of a provision relating to the reinvestment of profits. Indeed, under Article 32 of the LFI the foreign investor who reinvests part of its share of the profits "shall receive a refund from the tax authorities of the amount of profits tax already paid on that part of those profits".

As regards losses, paragraph 2 of Article 27 states that "losses may be carried forward to the following year and set off against the profits of that year". The enterprise may carry its losses forward for a total of five years.

The Decree provides for one standard rate for profits tax which is fixed at 25 percent. The principle contained in the LFI by which the rates of taxation depend on the taxable activity are very unclear and difficult to apply in practice. In an attempt to correct this, the Decree gives many more details on the preferential rates and periods of partial exemption, and under Article 68, it gives a list of projects excluded from these preferential rates.[18] Finally it should be noted that the Decree provides for a 10 percent tax rate applicable to those projects which are to be particularly favoured including Build-Operate-Transfer projects ("BOTs").

In contrast to the LFI, the Decree gives a precise list of deductible expenditure which may be subtracted from revenue for the purpose of calculating an enterprise's taxable profits. This list is reproduced and each element is discussed in detail in the Circular.

As regards BCCs, the SCCI is responsible for determining the method which will be used to calculate the taxable profits.

The Circular, as well as contributing to the elucidation of taxable revenue and deductible expenditure, also provides for the payment of profits tax and the reimbursement of profits tax where the net profits are reinvested.

B. Tax on the transfer of profits abroad

As regards profits transferred abroad, the LFI states that they are subject to a tax at rates ranging from 5 to 10 percent.

The Decree[19] is more precise and provides for three different rates of 5, 7 and 10 percent depending upon the foreign enterprise's contribution to the capital of the transferring entity.

As is the case for profits tax, the Decree is complemented by the Circular which defines of the taxable transfer of profits, the taxpayers subject to withholding tax, the amount of tax payable and the procedure for collection of the tax.

Finally it should be noted that Vietnam has a very rapidly expanding network of double taxation treaties. If the beneficiary of a transfer of profits abroad falls within the scope of such a treaty, the rates provided in that treaty will take precedence over those provided for by the LFI, Decree and Circular.

15. Arts. 26 to 35a.
16. Circular No. 03-TM-DT of 2 July 1993.
17. LFI Art. 26.
18. This leaves open the question of existence of any hierarchy between laws, decrees and other statutory instruments.
19. Art. 70.

C. Export and import duties

For export and import duties, the LFI refers to the "Law on Export and Import Duties on Commercial Goods" of 26 December 1991 as amended in 1992 and 1993. Products exported or imported by foreign enterprises will be subject to these duties in accordance with the provisions of this law. With respect to tax incentives, the LFI merely states that exemptions and reductions may be granted in cases where investment is widely needed.

The Decree and Circular complete the LFI by laying down some precise provisions regarding the exemptions. Under Article 76 of the Decree, a foreign enterprise will be exempted from import duties when importing equipment, machinery or other materials necessary to its activity.[20] The same exemption will be granted to a foreign enterprise that imports materials "for the production of goods for export". What is more, if those materials have been subject to customs duties, the foreign enterprise has a right to reimbursement. These exemptions are dealt with in slightly more detail in the Circular. Finally, Article 76-3 of the Decree states that "licences, know-how, technological processes and technical services used as a contribution to the capital" shall be exempted from export and import duties.

The "Law on Export and Import Duties" provides for two rates for each category of goods: the standard rate and the preferential rate applicable to imports from countries with which Vietnam has signed "terms for preferential trading relations". It should also be mentioned that the law gives precise details about reductions or exemptions from custom duties which conflict with those given in the LFI and the Decree and with those given in the "Decree on Export and Import Duties".

D. Turnover tax

The LFI and the Decree contain no provision relating to turnover tax. This tax is regulated by the Circular and by a law issued on 30 June 1990, amended on 5 July 1993. Turnover tax applies to all business establishments in Vietnam with the exception of those involved in agricultural production, production of commodities which are subject to special sales tax or production of goods for export.

Turnover tax is calculated by multiplying an enterprise's taxable turnover by the applicable rate. Further, where a product is the object of processing by a number of different enterprises, turnover tax is applicable to each separate enterprise as no mechanism for the avoidance of double taxation exists. There are several different tax rates which depend on the type of business, ranging from 1 to 40 percent.

Finally it should be noted that there are almost no incentives relating to turnover tax for foreign investors, often rendering this form of taxation of more consequence to foreign investors than profits tax.

E. Special sales tax

This tax is regulated by the "Law on Special Sales Tax" voted on 30 June 1990 and amended on 5 July 1993. It applies to the production of a limited range of consumer goods including tobacco, alcohol, beer, firecrackers[21] and playing cards. The rates for special sales tax range from 15 to 100 percent. It should be noted that if revenue is subject to this tax it will be exempt from turnover tax.

F. Royalties

Royalties are a tax payable by industries exploiting natural resources such as minerals, forests and so on. Indeed insofar as the State owns national resources, foreign enterprises which want to exploit these resources "shall pay royalties" to the State. The regulation of royalties is founded on the "Ordinance on Royalties" of 30 March 1990, the Decree of 7 January 1991 and the Circular of 7 February 1991.

There are several rates applicable which depend on the type of products exploited, ranging from a minimum of 1 percent to a maximum of 40 percent. Metal minerals are for instance subject to a rate from 2 to 10 percent and products of natural forests to a rate from 10 to 40 percent.

G. Land taxes

This is a category of taxes rather than a specific tax. Into this category are often grouped taxes such as the housing tax, applicable to house owners and the recently introduced tax on the transfer of land. This latter tax is applicable to the vendor if the land is put to a different use by the buyer of the land use right. Thus if agricultural land is transferred to a buyer who builds a factory on it, a 20 percent tax is due by the vendor.

H. Personal income tax

Personal income tax was introduced in Vietnam by the "Ordinance on Income Tax of High Income Earners" of 27 December 1990, replaced by the Ordinance of 19 May 1994.

This tax applies to both Vietnamese and foreigners and is levied on income paid to foreigners resident in Vietnam or to any income paid to Vietnamese nationals irrespective of whether or not they are resident in Vietnam. It should be noted that income tax rates are different for foreigners and for Vietnamese nationals resident in Vietnam.[22] Taxable income includes salaries and also non-permanent income in the form of gifts sent from abroad, gains from transfer of technology, income from trademarks and lottery prizes.

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20. However, no mention is made of exemption from Export duties should the investors wish to repatriate machinery at the end of a project.
21. Now banned.
22. Non-resident Vietnamese nationals are grouped with foreigners for the purposes of this tax.

Resident Vietnamese nationals are liable to pay income tax if their monthly income exceeds 1,200,000 dong. Income tax is levied at rates which range from 10 to 60 percent.

Foreigners residing in Vietnam whose monthly income exceeds 5,000,000 dong are liable to income tax at rates varying from 10 to 50 percent.

I. Double taxation treaties

Vietnam has signed double taxation treaties with a number of States. Of these treaties those signed with Australia, France, Thailand, Sweden, Singapore and South Korea have entered into force.[23] These treaties are based on the OECD model treaty, and tend, as a result, to contain notions slightly in advance of Vietnamese national law. Thus the tax treaty with Australia made use of the notion of residence before this notion was incorporated into Vietnamese national law, and all tax treaties use the notion of permanent establishment which is presently difficult to assimilate into Vietnam's national taxation structure.

J. Procedure, breaches and complaints

The Circular is probably of most importance with regard to the relations between taxpayers and the tax authorities. Under Part V of the Circular, foreign enterprises have certain obligations with respect to the tax authorities. They must "carry out all necessary registration procedures at the tax office of the province or city where the head managing office is located".[24] They also have to comply with the regulations relating to tax, to pay tax in time and to produce documents as required by the tax authorities.

In return, the tax authorities are required to guide taxpayers in registering and filing returns in accordance with the regulations. The Circular contains provisions on the powers and duties of the tax authorities. The tax authorities examine the taxpayers' "declarations",[25] accounting documents and may request a clarification by a taxpayer on any particular point. They should also calculate tax to be paid when it appears that a taxpayer has not submitted its "declaration" or has made a false one.

Part VII of the Circular is expressly devoted to "breaches and complaints". The Circular provides for penalties in the event of breaches of which there are several categories. Breaches relating to filing a declaration are subject to a fine of 0.5 percent of the tax due, those relating to false declarations and tax avoidance to a fine of five times the amount avoided. In the event of late payment, the fine will be of 0.2 percent of the unpaid tax.

The simple existence of a section on complaints is in itself very significant. This means that although the tax office has wide-ranging powers, these powers are in theory limited. This is undoubtably a very important guarantee for the taxpayer. The Circular provides that complaints must be dealt with by the tax office and in the event that this does not resolve the disagreement the taxpayer will have the right to refer his complaint to a higher tax office or to the Ministry of Finance. However, there is at present no case law or precedent on the subject and it is impossible to say if such a complaint may be concluded in a satisfactory manner. Further the creation of an independent court with jurisdiction to deal with tax litigation is clearly necessary.

Finally, it should be noted that many of the specific texts which relate to taxes have their own section devoted to breaches and complaints.

The next article in this series will deal in detail with profits tax.

23. As at 1 November 1994.
24. Circular Part V, para. 1.
25. I.e. tax return.

PEOPLE'S REPUBLIC OF CHINA

VALUE ADDED TAX, CONSUMPTION TAX AND BUSINESS TAX

Lee Fook Hong

Lee Fook Hong, MBA, Ph.D, FCIS, FAIA, ACIArb is the Principal Consultant of Lee Fook Hong & Co and an Adjunct Associate Professor in the School of Accountancy and Business, Nanyang Technological University, Singapore.

Value added tax, consumption tax and business tax are three of several major tax laws which have come into effect since 1 January 1994.[1] These laws replace a number of existing tax laws and bring about important changes to the tax system in the PRC. This article discusses the value added tax, the consumption tax and the business tax.

I. VALUE ADDED TAX

VAT is the principal indirect tax, replacing the Industrial Consolidated Tax and Product Tax in force from 1984 until 31 December 1993.

VAT is imposed on Chinese nationals and foreign individuals and entities, which include foreign investment enterprises,[2] foreign enterprises,[3] joint stock companies, state-owned enterprises, collectively-owned enterprises and privately-owned enterprises. VAT is imposed whenever goods and certain services are sold or imported.

A. Rates

Four rates of VAT are imposed under the new law. The standard rate is 17 percent for taxpayers selling or importing goods, and for taxpayers engaged in the processing of goods or repair or maintenance services. A reduced rate of 13 percent applies for taxpayers selling or importing grains, edible oils, tap water, heating, air conditioning, hot water, coal gas, liquified petroleum gas, natural gas, coal/charcoal products for household use, books, newspapers, magazines, feeds, chemical fertilizer, agricultural chemicals, agricultural machinery and plastic film for farming.

A simplified formula for calculating VAT is adopted for small-scale taxpayers engaged in the sale of goods or the provision of taxable services.[4] The rate of tax for such small-scale taxpayers is 6 percent.

Goods for export are zero rated, unless otherwise regulated by the State Council.

B. Input tax credits

A taxpayer may credit the tax charged to him on the acquisition of goods or use of services, or paid by him on imports, against his VAT liability. To be creditable, however, goods or services must have borne VAT.

Input tax on the following items is not available as credit against output tax:
- fixed assets;
- goods and services used in making non-taxable supplies;
- goods and services used for tax-exempt supplies;
- goods and services used for personal consumption or group welfare of employees;
- goods and services lost as a result of disasters; and
- goods or services consumed in the production of work-in-progress or finished goods which sustain extraordinary losses.

Where the output tax for the period is insufficient to offset the input tax for the period, the excess input tax may be carried forward to subsequent periods.

C. Exemptions

The following items are exempt from VAT:[5]
- agricultural products produced and sold directly by farmers;
- contraceptive medicines and devices;
- antique books;
- imported instruments and equipment used for scientific research and education;
- imported materials and equipment received gratuitously from foreign governments and international organizations;
- equipment and machinery required to be imported under contract processing, contract assembly and compensation trade;

1. Other new tax laws are Land Appreciation Tax, Real Estate Tax, Land Use Tax, Resource Tax and New Individual Income Tax all of which became effective on 1 January 1994. These laws are not discussed in this article.
2. Foreign investment enterprises means Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and wholly foreign-owned enterprises (established in China).
3. Foreign enterprises means foreign companies, foreign enterprises and foreign economic organizations (established in China or having income sourced in China).
4. The criteria for determining small-scale taxpayers are prescribed by the Ministry of Finance. Any adjustment to the rate applicable to small-scale taxpayers is regulated by the State Council.
5. VAT-exempt and reduced rate items are regulated by the State Council.

- articles imported for the disabled; and
- used goods.

VAT does not apply to the sale of land, buildings or other immovable property. However, such transactions are liable to business tax (see below).

An exemption or reduction in VAT (to 6 percent) is also available where the turnover does not exceed certain threshold amounts, i.e. 2,000 yuan in the case of the sale of goods and 800 yuan from the rendering of taxable services.

D. Timing

Liability to VAT generally arises at the time of supply, i.e. in the case of the sale of goods or the rendering of taxable services on the date payment is received or the date invoices are issued, and in the case of importation of goods, the date of input declaration to the customs office.

E. Compliance

The filing period for VAT assessment is either one, three, ten or 15 days, or one month depending on the amount of VAT payable. The actual VAT assessable period is determined by the tax authorities according to the amount of VAT payable. Where VAT cannot be assessed in regular periods, the tax is assessed on a transaction-by-transaction basis.

VAT on sales is computed as follows:
Turnover (i.e. Gross Receipts less VAT) x Appropriate VAT Rate

Less: Credit for VAT paid on Purchases

As noted above any excess credits from VAT paid are available for carry forward.

VAT on imports is computed as follows:

Import Price + CIF + Customs Duty + Consumption Tax x Appropriate VAT Rate

For taxpayers dealing in goods or providing taxable services subject to different tax rates, the sales amounts for goods or taxable services with different rates are computed separately. The tax payable is the balance of output tax for the period, after deducting the input tax for the same period:

Tax Payable = Output tax payable for the period
Less: Input Tax for the period

II. CONSUMPTION TAX

Consumption tax is an excise tax levied in addition to VAT on a limited range of goods, primarily luxury items. Consumption tax is imposed before VAT.

A. Scope

Consumption tax is levied on the processing, manufacturing or importation of taxable consumer goods within the PRC, at rates ranging from 3 to 45 percent (or rates which are set amounts based on volume of trade). Taxable items are specified in a list which includes tobacco products, alcoholic beverages, cosmetics, firecrackers and fireworks, gasoline, diesel oil, automobiles, motorcycles, minibuses and vans.

B. Computation of tax due

There are two methods of computing consumption tax payable: the rate on value method or the amount of volume method, as follows:

(a) Rate on Value Method
Consumption Tax = Sales amount x Tax rate; or

(b) Amount on Volume Method
Consumption Tax = Sales volume x Tax amount per unit.

Special rules are used to determine the taxable value of goods for self consumption or for processing under subcontracts. For imported goods, the taxable value is determined by the cost, insurance and freight (CIF) and import duty.

In the case of taxpayers dealing in taxable consumer goods with different tax rates, the sales consideration and the volume of sale for the taxable consumer goods must be accounted for separately. If not, or if taxable consumer goods subject to different tax rates are combined into a complete set of consumer goods for sale, the higher tax rate is applicable.

Taxable consumer goods produced by the taxpayer are subject to consumption tax upon sale. For self-produced taxable consumer goods for the taxpayer's own use in the continuous production of taxable consumer goods, no consumption tax is assessed; rather consumption tax is assessed when the goods are transferred for other use.

For taxable consumer goods subcontracted for processing, the tax is collected and paid by the subcontractor upon delivery to the contractor. For taxable consumer goods subcontracted for processing for own use by the contractor for the continuous production of taxable consumer goods, consumption tax paid is treated as a tax credit. Imported taxable consumer goods are subject to tax upon declaration of import to the customs office.

Self-produced taxable consumer goods for the taxpayer's own use subject to consumption tax are assessed according to the selling price of similar consumer goods produced by the taxpayer. If the selling price of similar consumer goods is not available, the tax is assessed according to the composite assessable value.

Taxable consumer goods subcontracted for processing are assessed according to the selling price of similar consumer goods of the subcontractor. If the selling price of similar consumer goods is not available, the tax is also assessed according to the composite assessable value.[6]

6. The formula for computing the composite assessable value is as follows:

$$\text{Composite Assessable Value} = \frac{(\text{Cost of material} + \text{Processing fee})}{(1 - \text{Consumption Tax rate})}$$

Where there is evidence that the taxable value of the taxable consumer goods of the taxpayer is low and without proper justification, the taxable value is determined by the competent tax authorities.

For taxable consumer goods sold by taxpayers where the sale consideration[7] is settled in foreign currencies, the taxable amount must be converted into Renminbi based on the exchange rate prevailing in the foreign exchange market.

C. Exemptions

Goods manufactured for export are generally exempt from consumption tax, unless otherwise determined by the State Council. The procedures for exemption of exported taxable consumer goods are regulated by the State Administration for Taxation.

D. Collection and compliance

The tax authorities are responsible for the collection of consumption tax. For importation of taxable consumer goods, the consumption tax on such goods is collected by the customs office on behalf of the tax authorities. Consumption tax on taxable consumer goods brought or mailed into the PRC by individuals is levied together with customs duty.[8]

Taxpayers selling taxable consumer goods and self-producing taxable consumer goods for their own use, unless otherwise as stipulated by the State Council, are required to report and pay consumption tax to the local tax authorities. For taxable consumer goods subcontracted for processing, the consumption tax must be paid to the local tax authorities where the subcontractors are located. For imported taxable consumer goods, the importers or their agents are required to report and pay the consumption tax to the customs offices where the imports are declared.

The consumption tax assessable period varies from one day to one month. Such periods can be one, three, five, ten or 15 days, or one month. The actual assessable periods are decided by the tax authorities having regard to the amount of the tax payable. Consumption tax which cannot be assessed in regular periods can be assessed on a transaction-by-transaction basis.

Taxpayers who adopt one month as the assessment period must report and pay tax within ten days following the end of the period. If the assessment period of one, three, five, ten or 15 days is adopted, the tax must be prepaid within five days following the end of the period, and a monthly return must be filed with any balance of the tax settled within ten days from the first day of the following month.

Taxpayers importing taxable consumer goods must pay the tax within seven days after the completion and issuance of the tax payment certificates by the customs office.

III. BUSINESS TAX

Business tax is the principal indirect turnover tax levied on business activities in China.[9]

A. Scope

Business tax is imposed on entities and individuals engaged in taxable businesses, the transfer of intangible assets and the sale of immovable property within the PRC.[10] The taxable items are determined in accordance with the "Business Tax Taxable Items and Tax Rates Table" attached to the Regulations on Business Tax.

B. Tax base

The business tax is levied on the full consideration received by a seller or provider of services, i.e. the total consideration and all other charges receivable from the buyer for the provision of taxable services, transfer of intangible assets or sales of immovable property by the taxpayer. However, in the following cases other methods are used to calculate the taxable amount:

- for transportation enterprises which carry passengers or cargoes from the territory of the PRC to overseas locations and transship passengers or cargoes to other transportation enterprises overseas, turnover is the balance of the transport charges for the whole journey less the transport charges paid to the subcontracted transportation enterprises;
- for trade enterprises which organize tourist groups to travel outside the territory of the PRC and subcontract to other travel enterprises overseas, turnover is the balance of the tourist charges for subcontracted travel enterprises;
- for the main contractors in the construction business who subcontract work to others, turnover is the balance of the total contract sum less the payments made to the subcontractors;
- for relending businesses, turnover is the balance of interest on lending less the interest on borrowing;
- for businesses buying and selling foreign currencies, marketable securities and futures, turnover is the balance of the selling prices less the buying prices;
- other situations as regulated by the Ministry of Finance.

7. Sale consideration means the total consideration and other charges receivable from the buyer for the taxable consumer goods sold by the taxpayer.
8. Detailed measures are being formulated by the Tariff Policy Committee of the State Council together with the relevant authorities.
9. The Ministry of Finance is responsible for the interpretation of the Regulations on Business Tax and for the formulation of the Detailed Rules and Regulations for the implementation of the Regulations.
The "Provisional Regulations on Business Tax" came into effect on 1 January 1994. On that same date, the "Draft Regulations of the People's Republic of China on Business Tax" promulgated by the State Council on 18 September 1984 was repealed.
10. Taxpayers of business tax are required to pay the tax in accordance with the Regulations on Business Tax.

For taxpayers engaged in taxable activities of different tax items, the turnover, transfer and sale amounts of the various items are accounted for separately; if this has not been done, the higher tax rate of 20 percent applies.

The tax payable is computed by reference to turnover and the prescribed tax rates. The formula for computing the business tax is as follows:

Tax Payable = Turnover x Tax Rate

The tax payable is computed in Renminbi. Turnover of the taxpayer settled in foreign currencies is converted into Renminbi based on the exchange rate prevailing in the foreign exchange market.

C. Exemptions

The following items are exempt from business tax:
- childcare services;
- personal services provided on an individual basis for the disabled;
- medical services;
- educational services;
- agricultural mechanical ploughing, irrigation and drainage, prevention and treatment of plant diseases and insect pests, plant protection, insurance for farming and husbandry, and related technical training services, branding and the prevention and treatment of diseases of poultry, livestock and aquatic animals;
- admission fees for cultural activities conducted by a memorial hall, museum, cultural centre, art gallery, exhibition hall, academy of painting and calligraphy, library and cultural protective units; admission fees for cultural and religious activities conducted at places of religious worship.

For taxpayers who qualify for tax-exempt or reduced rate items, turnover is accounted for separately. If turnover has not been separately accounted for, no exemption or reduction is allowed.

D. Timing

Liability to business tax arises on the date the business proceeds are received or the date that documented evidence of the right to collect business proceeds is obtained by the taxpayer.

E. Rates

The rates currently range from 3 - 20 percent depending on the type of activity.

F. Compliance and collection

The tax authorities are responsible for the collection of business tax, and the business tax withholding agents are responsible for withholding the tax for payment to the tax authorities.[11]

The place for the payment of business tax is determined in the following manner:
- Taxpayers providing taxable services must report and pay tax to the local competent tax authorities where the taxable services take place. Taxpayers engaged in the transportation business are obliged to report and pay tax to the local competent tax authorities where the business establishment is located.
- Taxpayers transferring land use rights must report and pay tax to the local competent tax authorities where the land is located. Taxpayers transferring other intangible assets must report and pay the tax to the local competent tax authorities where the establishment is located.
- Taxpayers selling immovable property must report and pay the tax to the local competent tax authorities where the immovable property is located.

The tax payment deadlines for withholding agents are stipulated in the Regulations. The business tax assessable period is either five, ten or 15 days or one month. The actual assessable period of taxpayers is determined by the competent tax authorities having regard to the amount of tax payable. Tax that cannot be assessed in regular periods may be assessed on a transaction-by-transaction basis.

Taxpayers who adopt one month as an assessable period must report and pay tax within ten days following the end of the period. If an assessable period of five, ten or 15 days is adopted, the tax must be prepaid within five days following the end of the period and a monthly tax return must be filed with any balance of tax due within ten days from the first day of the following month.

11. In the case of financial institutions authorized to grant loans, the financial institutions are the business tax withholding agents. In the case of subcontracting of construction and installation business, the main contractors are the business tax withholding agents, and other business tax withholding agents are those stipulated by the Ministry of Finance.

INDONESIA–NETHERLANDS

REVISED TAX TREATY

Emile Peters

PT Price Waterhouse Sutanto, Jakarta, Indonesia

I. INTRODUCTION

The Protocol of 23 August 1993 (hereafter "new Protocol"), amending the Protocol of 22 July 1991 (hereafter "1991 Protocol"), which in turn amended the 1973 Indonesia–Netherlands tax treaty (with accompanying Protocol) has been ratified by both countries, and entered into force on 3 May 1994. The original Protocol amending the treaty delayed because the countries could not agree upon a mutually acceptable definition of the Indonesian territory, in particular with respect to East Timor. When this issue was resolved a new Protocol was signed and the ratification procedure initiated.

This article discusses the most significant changes arising from the revisions.

A. Effective dates

The main change brought by the new Protocol is that the retroactive effect to 1 January 1988 (envisaged by the 1991 Protocol) has been removed. Considering the five year statute of limitations prevailing in both countries, retroactive effect would have resulted in many complications and practical difficulties.

The new withholding tax provisions on dividends, interest and royalties will apply to amounts arising on or after 1 June 1994. The other provisions of the new treaty will only take effect for tax years starting 1 January 1995.

B. Residents

The definition of residents in the Protocol specifically excludes permanent establishments ("PEs") and (limited) partnerships, unless all partners in the partnership are residents of the Netherlands or Indonesia. This provision was considered necessary because Indonesian tax legislation (unlike the Netherlands) regards PEs and partnerships as resident taxpayers. The exclusion is designed to prevent complications arising from the difference in treatment between the two countries and preventing abuse of the treaty benefits by residents of other countries through Dutch partnerships.

The exclusion of a PE from the treaty definition of residents will have retroactive effect to 1 January 1984, the date on which the current Indonesian tax legislation came into force.

C. Permanent establishment

A company's profits are only taxable in the other state if the business is conducted in that other state through a PE. The treaty defines what constitutes a PE and this definition was amended in the 1991 Protocol.

Compared to the 1973 treaty, the scope of the term PE has been broadened to include the provision of services in Indonesia for a period exceeding three months (approximately 91 days) in any 12 month period. A similar provision was found in the 1973 treaty but the time period was 183 days. However, the scope of the concept of PE has been narrowed for building sites or supervision connected with such sites, i.e. a PE will exist only if the total time period exceeds six months (183 days). This was 90 days in the 1973 treaty.

As in the 1973 treaty, the new Protocol allows the Netherlands and Indonesia to mutually agree that certain activities will not constitute a PE.

Similar to the 1973 treaty, the new Protocol does not contain any provision stipulating that a combination of activities (which individually are deemed not to constitute a PE) will not constitute a PE if the overall activity resulting from the combination is only preparatory or auxiliary. In this respect the new Protocol follows the 1980 UN model treaty and deviates from the 1977 and 1992 OECD model treaties.[1]

The new Protocol confirms that representative offices which have a licence from the Ministry of Trade and which operate within the limits of their licence will not be considered a PE and therefore will not be taxable in Indonesia. This comports with the current Indonesian practice of not taxing income of such offices.

D. Branch level withholding tax

Indonesia levies a withholding tax of 20 percent of the profits of a PE after income tax. This rate is reduced to 9 percent under the new Protocol if the company maintaining the branch is a resident of the Netherlands. Under the 1973 treaty the branch level withholding tax was reduced to 10 percent. The 9 percent rate, which is lower than the rate in other Indonesia treaties, was allowed because the Netherlands uses

1. Dr R. Mansury, "The Indonesian Experience in Negotiation and Implementation of Tax Treaties with the OECD Countries", *APTIRC Bulletin* (February 1993).

an exemption method to eliminate double taxation rather than the credit method. The branch level withholding tax can not be credited in the Netherlands and is a cost.

Under Indonesian domestic tax law the branch level withholding tax is due when the profits accrue in the PE, regardless of whether they are actually remitted to the head office. However, the 1973 treaty provided that this tax only arises when the profits are actually remitted to the head office in the Netherlands. This has been abolished in the new Protocol, i.e. branch profits will be subject to branch level withholding tax when they accrue.

The new Protocol contains no transitional provision dealing with the branch level withholding tax. Arguably, the consequence of this is that branch profits earned before 1 January 1995 and undistributed at that date will escape taxation altogether. On the entry into force of the new Protocol, the distribution of these profits (which have not yet been taxed under the 1973 treaty because they were not yet distributed) still cannot trigger branch withholding tax (because they accrued before the new Protocol came into effect). It is our understanding, however, that the Indonesian Government intends to correct this anomaly through a mutual exchange of letters.

E. Turnkey provision

The revised treaty provides important protection to Dutch resident turnkey contractors who operate in Indonesia through a PE. Indonesia's domestic tax legislation contains extensive force of attraction provisions. These are interpreted by the Indonesian tax authorities to force a foreign company to report its total contract profits for taxation in Indonesia, regardless of the fact that part of those profits were actually generated outside Indonesia, e.g. from equipment delivery and services conducted outside Indonesia. The extensive attribution of profits to the PE for tax purposes is based on the idea that the PE is indirectly instrumental in earning all profits, i.e. without the existence of the PE no profits could be earned. Article V of the 1991 Protocol protects against this force of attraction by providing that only those profits that are generated by the actual activity in Indonesia may be attributed to the PE.

F. Related parties

The tax authorities in the Netherlands and Indonesia may adjust the pricing of transactions between related parties if this has not been established at arm's length. As in the 1973 treaty, the new Protocol confirms this provision but adds that where one of the states makes such an adjustment, the other state must agree to a corresponding adjustment by the other state to avoid double taxation. This provision accords with the more recent OECD model treaties.

The 1991 Protocol confirms that cost sharing and service agreements may be concluded between related parties for business purposes. Such agreements may not lead to adjustments by the tax authorities if the terms and conditions of such agreements are similar to those in agreements between unrelated parties.

G. Dividends

The withholding tax rates have been revised as follows:

	1991 Protocol	1973 Treaty
Corporate shareholders with an interest of 25% or more	10%	10%*
Other shareholders	15%	20%

* The Netherlands applied a nil rate.

Under the new Protocol the reduced rates only apply if the recipient of the dividends is the beneficial owner (not merely the legal owner). The reduced rate of 10 percent is not available to partnerships, even if they have an interest of more than 25 percent in the paying company.

In the 1973 treaty income from profit-sharing bonds was considered a dividend, but in the new Protocol such income is treated as interest income.

H. Interest

The withholding tax rates have been revised as follows:

	1991 Protocol	1973 Treaty
Interest paid between banks, financial institutions and other enterprises	10%	10%
Other interest payments	10%	20%
Interest paid on loans provided by or secured by the government, central bank or financial institution owned or controlled by government	0%	–

The new Protocol limits application of the 10 percent withholding tax rates to the beneficial (not merely the legal) owner of the interest income.

Interest earned on loans secured by mortgages will now be taxed under the interest article, and not under the article dealing with income from immovable property as was the case in the previous treaty. This makes the Netherlands recipient of such income subject to withholding tax where previously it was exempt.

The tax sparing credit granted in the 1973 treaty has been abolished in the new Protocol. This provision allowed Dutch companies a credit for withholding tax even if Indonesia levied no withholding tax or only a low rate to encourage foreign investment. Since Indonesia abolished such tax facilities in 1984, the benefit of a tax sparing credit was limited to companies still benefiting from concessions allowed prior to 1984.

Finally, as mentioned above, interest on profit sharing loans is now treated as interest.

I. Royalties

The 1973 treaty allowed Indonesia to levy a withholding tax of 5, 10 or 20 percent depending on the type of royalty concerned. This distinction has been deleted in the new Protocol and all royalties are now subject to a uniform withholding tax rate of 10 percent.

The new Protocol clearly states that payments for technical services are not considered royalties. This is an important clarification in practice because the Indonesian tax authorities tend to consider such payments as royalties and to withhold tax on such payments. The term technical services is defined in the 1991 Protocol.

As with dividends and royalties, application of the reduced withholding tax rates is limited to Dutch residents that are beneficially (and not merely legally) entitled to the royalty payments.

J. Payment or accrual of dividends, interest and royalties

The Indonesian tax authorities consider withholding tax to be due at the time a dividend, interest or royalty instalment is accrued by the payor as a liability in the books, regardless of when it is actually paid. Similar to the 1973 tax treaty, the dividend, interest and royalty articles follow the text of the OECD model treaty which applies a broad interpretation of payment and does not appear to protect against this "accrual" concept. Indonesian companies must pay the withholding tax due at the time of provision even if actual payment is delayed.

K. Independent services

Non-resident persons providing professional services or exercising other activities of an independent character (e.g. freelancers) are taxed in the country where they work only if they have a fixed base there. Under the new Protocol a fixed base is considered to exist if the services continue for more than 91 days in any 12 month period. Therefore, if the services continue longer than this period, income generated by the service provider will become taxable in the state where the services are rendered.

The inclusion of this time test must be seen in conjunction with the time test applied for a PE resulting from service activities. In this respect it is remarkable that Article I Sub E-2 of the 1991 Protocol requires a period of more than three months (which can range from 90 to 92 days) and Article I Sub M of the 1991 Protocol requires 91 days. Both tests do not necessarily coincide.

L. Other changes

1. Other income

The 1973 treaty contained an article dealing with "other income", i.e income from sources not specifically listed in the treaty. This article has been abolished because the two countries could not agree on where this income would be taxed. The Netherlands insisted on taxation of such income in the country of residence (in line with the OECD model treaty). In Indonesia's standard treaty other income is taxed in the source country. In practice, the lack of an other income article will have only a limited effect. It generally provides a "final safety precaution" if countries cannot agree on the characterization of certain income sources.[2]

2. Shipping and aircraft

The 1991 Protocol contains a specific article dealing with profits from operation of ships and aircraft in international traffic. Until now this matter was dealt with through an exchange of letters outside the treaty itself. Such profits may only be taxed in the country where the effective management of the enterprise is situated. Profits earned by a Dutch enterprise may therefore not be subject to withholding tax in Indonesia. Although not specifically mentioned, this applies equally to time charter fees.

3. Taxation of capital

The provisions in Article 23 of the 1973 treaty concerning the taxation of capital have been deleted.

4. Elimination of double taxation

The new Protocol refers to Dutch law for the method of avoiding double taxation. This is current treaty policy of the Netherlands. Its main implication is that for calculation of double taxation relief, Indonesian-source income (or losses) must be accumulated with income or losses originating from other foreign countries. Elimination may not be calculated on a per country basis.

5. Non-discrimination

The new Protocol contains a non-discrimination article stipulating that Indonesia and the Netherlands may not subject residents of the other state to other or more burdensome taxation than their own nationals. An exception is allowed to Indonesia for its municipal tax.

II. CONCLUSION

Overall we endorse the view expressed by the Netherlands Ministry of Finance that the result of the negotiations is both balanced and fair. No doubt various aspects of the revised treaty will require further clarification when the treaty is applied in practice but this is unavoidable in any treaty revision.

2. An example of "other income" could be income earned in Indonesia by a branch of a Dutch company which falls outside the scope of business income and other specific income sources. Such income would be deemed business income in the Netherlands but not in Indonesia.

AUSTRALIA–FRANCE

VIVE LA DIFFERENCE? A COMPARISON OF SOME ASPECTS OF THE FRENCH AND AUSTRALIAN INCOME TAX SYSTEMS[1]

John Passant

John Passant teaches tax law in the Faculty of Law at the Australian national University in Canberra, Australia. He spent part of 1992 in France examining its tax system.

This article examines four aspects of the French income tax system – the taxation of capital gains, the tax unit, the automatic deduction allowance and the taxation of dividends in the hands of shareholders – and compares them to the situation in Australia.

In this discussion it must be remembered that the French tax system relies much more heavily than Australia on indirect taxes to raise revenue. This is done in particular through *la taxe sur la valeur ajoutée*, the TVA, the equivalent of a goods and services tax. In 1988 French taxes represented nearly 45 percent of GNP. The comparable figure for Australia was only just over 30 percent. And in France more than 37 percent of total tax receipts came from turnover taxes, while the figure for Australia was 28 percent. Australia's reliance on income tax can be seen clearly in the fact that in 1988 income tax on individuals contributed nearly 46 percent of all tax receipts. In France the comparable figure was 12.1 percent, although social security taxes on employees added another 8 percent to that figure.[2]

I. THE INCOME TAX BASE

An income tax system that does not tax all income is defective. Untaxed income means not only a diminution of revenue or a higher rate on those who earn income that is subject to tax, but it also creates economic distortions. Investment will tend to gravitate into those untaxed areas.

The real question in any discussion of the income tax base is what is income.

In Australia Section 25 of the Income Tax Assessment Act 1936 ("ITAA") includes in assessable income all gross income. The approach of the Australian judiciary has been to mouth platitudes that this means income according to ordinary concepts. Unfortunately this approach has seen Australian judges exclude capital gains from the ambit of Section 25. Thus, until 20 September 1985, capital gains were not, in general, subject to tax in Australia. This judicial approach derived from the idea that income flows from either capital or labour. An accretion to capital (i.e. a capital gain) could not be income because it did not flow from capital. It was capital.

Economists take a different view: for them any increase in the economic power of an individual is income. For economists capital gains are therefore income and should be taxed accordingly.

As part of its tax reform programme, in 1985 the Federal Labour Government in Australia broadened the tax base by taxing capital gains. Part IIIA of the ITAA includes in assessable income the net capital gain made on every asset purchased on or after 20 September 1985 and disposed of on or after that date. Thus the capital gains provisions only apply to realized gains.[3]

For tax purposes in Australia capital gains are indexed for inflation so that only the real gain is subject to tax. All other forms of income are taxed at their nominal value, i.e. no account is taken of inflation. This lenient treatment of capital gains (when compared to the treatment of other forms of income) means there is still a tax incentive in Australia to earn income in the form of a capital gain.

Capital gains in Australia have another advantage over most other forms of income: they can be averaged. In broad terms the capital gain is divided by five and added to other taxable income for the year in question. The extra tax that results from this addition is then multiplied by five to give the tax payable on the capital gain. This approach attempts to some extent to overcome the problem of "bunching". If the capital gain is not realized until after a number of years, then without averaging the gain is likely to be quite large and to be taxed at the top marginal rate. Averaging ensures that for taxpayers below the top marginal rate there is less likelihood of this occurring.[4]

In France, like Australia, there is no definition of income. This has meant there has been some question about what is income. Is it the fruit that flows from capital or labour (hence excluding capital gains) or does it include all gains, as the economists want?

The French have, among other things, an income tax regime which applies to companies ("IS") and another which applies

1. Most of the details about the French tax system contained in this article can be found in Claude Gambier and Jean-Yves Mercier, "Les Impôts en France 1993/1994", *Taxes in France*, 25th ed. (Paris: Editions Francis Lefebvre, 1993).
2. International Series Francis Lefebvre: "France: Business Law, Taxation, Social Law" (Paris: Editions Francis Lefebvre, 1992), at 154.
3. Capital losses can only be offset against capital gains. They cannot be used to reduce other assessable income.
4. An alternative solution would have been to tax unrealized gains on a regular basis, say every year.

to individuals and associations not subject to the company regime ("IR"). A progressive rate structure applies to individuals. In 1992 income up to FRF 19,220 was tax free. There were then another 12 rates imposed, culminating in a rate of 56.8 percent on income over FRF 261,290.[5] Companies are taxed at a flat tax rate of 33$^1/_3$ percent.

The taxation of individuals under the French tax system is somewhat akin to the schedular English system. Income tax is imposed on income which falls into one or more specified categories, which include rental income, industrial and commercial profits, salary and wages, agricultural profits and non-commercial profits. Capital gains are taxed under the IS or IR systems in certain situations which are outlined below.

The non-commercial schedule of the IR includes a catch-all provision which defines income not attributed to any other category as non-commercial profits. If the income earned by the individual does not fall into any of the specific categories set out in the legislation then it is not subject to income tax under the IR.

Capital gains derived by an individual in the context of a business are taxed under the particular business schedule, e.g. industrial and commercial profits, non-commercial profits or agricultural profits. These rules are generally the same as those applying to capital gains made by companies, with some exceptions.

A special tax regime applies under the IS to all capital gains made on the transfer of capital assets of a company. It can be less severe than the regime applicable to company profits and it distinguishes short and long-term gains.

Short-term gains are gains made on goods acquired or created less than two years before transfer. Long-term gains are those made on goods acquired or created more than two years before transfer. The picture becomes more complicated with depreciable property. Only gains over and above the amount of depreciation allowed are treated as long-term gains.

Long-term gains are subject to a reduced tax rate of 18 percent provided the company set up a special reserve containing the amount of the capital gain after tax. This is an attempt to keep the gain in the company for re-investment purposes. The reduced rate for long-term gains is based on the premise that gains on a company's capital assets are generally one-offs and the profit is generally re-invested in the company, often as a replacement for the asset sold. So, if the gain is distributed as a dividend, for example, the reduced rate is lost and the gain is treated as a short-term gain.

Short-term gains are taxed under the normal regime for companies, i.e. at the normal company rate of 33$^1/_3$ percent.

As mentioned above, the treatment of capital gains made by an individual on the transfer of capital assets in his business (e.g. where the individual is a single trader) is similar to that of companies where the individual's gross annual turnover is FRF 1 million or more (or FRF 300,000 for businesses which supply services, other than hotels). However, the rate is only 16 percent and the gain does not have to be kept in a special business account. It can be used by the individual without fear of the higher rate being imposed.

Where the individual's turnover is below the relevant threshold any gains made on building sites are treated under the capital gains regime for individuals under the IR (dealt with below). For other types of capital assets, if the taxpayer has been engaged in the business activity for more than five years the gain is exempt. If the activity has not been engaged in for more than five years the gain is treated as if the turnover of the taxpayer was more than FRF 1 million (or FRF 300,000 as the case may be) with the effects outlined above.

Capital gains derived by individuals outside a business context, i.e. on the transfer of private property, must be realized for valuable consideration.[6] Because the IR regime only applies where there is a transfer, it does not extend to unrealized gains or gains which arise other than as a result of a transfer of goods or a right, such as, e.g. lottery winnings and insurance pay-outs. Transfer includes not only sales but also exchanges and expropriations. The fact that the IR regime only applies to transfers for valuable consideration means that changes to title without consideration, such as gifts or bequests, escape the net.

On the basis of the above it should be clear that an individual who carries on a business (e.g. example manufacturers, farmers, tradesmen, accountants, doctors and lawyers) will have two types of property. The first will be business property, which will be subject, with certain deviations, to the capital gains business regime under the IS with its distinction between long and short-term gains. Any other goods will be private property and subject to the individual's regime for capital gains under the IR.

Precious metals, jewellery and objets d'art do not fall within the IR, but are subject to a specific capital gains regime. Capital gains on precious metals are subject to a rate of tax of 7.5 percent, while for jewellery and objets d'art the amount is 4.5 percent if the goods are sold at public auction. Australia quarantines what it calls listed personal use assets (i.e. assets listed as personal use assets under the legislation, such as jewellery, paintings, rare books and antiques). Losses made on such assets can only be offset against other listed personal use assets.

Like Australia, France exempts the principal residence from capital gains tax. In addition, capital gains derived from land used for agricultural or forestry purposes are also exempt. However, this exemption only applies up to a sale price limit of FRF 4 per square metre. The limit is higher for wineries. Cars are also exempt, as are capital gains derived from urban development and the re-allocation of land.

The taxation under the IR of capital gains made by individuals on private property also distinguishes between long and short-term gains. Short-term gains, i.e. those realized within two years of purchase, are treated as ordinary income and taxed accordingly.[7]

5. There are approximately FRF 4 to the Australian dollar.
6. The gains must also be realized by a natural person; if not the IR regime cannot apply.
7. For personal property, the short-term period is only one year.

Long-term gains, i.e. those held more than two years, are taxed under the IR regime once certain adjustments have been made. First, the cost price of goods that result in long-term gains is subject to an inflation adjustment, much like Australia's system. Secondly, the capital gain is reduced in proportion to the length of time it has been held. Roughly this reduction is at the rate of 5 percent per year, so that by the end of the 21st or 22nd year (depending on the nature of the goods and the period when the reduction starts) the gain will be totally exempt from tax.[8] And thirdly, in calculating the amount of tax payable under the IR, certain rules limit the effect of the progressive nature of the tax system. In other words, the gain is averaged. The capital gains for the year are divided by five and added to other taxable income. The increase in tax is then multiplied by five to give the amount of tax payable on the capital gains for that year. It is the same averaging system in essence as in Australia for capital gains.

Interestingly, the cost price of goods includes not only the actual purchase price but also, in certain circumstances, an allowance for acquisition costs of 10 percent of the purchase price. In Australia, certain costs associated with the purchase are included in the cost price, but these are actual costs. From an administrative point of view, an allowance of this nature seems to save time and trouble.

Transfers in the year which do not exceed FRF 30,000 for real estate and FRF 20,000 for chattels are not taken into account in calculating the amount of tax payable. As well there is an automatic reduction of FRF 6,000 from the total amount of tax payable on capital gains realized in the same year. In Australia, the nearest we come to any general exclusion relates to personal use assets. The sale of a personal use asset only produces a capital gain if the consideration for the asset being sold is more than $ 5,000.

Small businesses in France are granted an exemption for the transfer of professional or business assets. Turnover is the criteria used to determine whether or not a business is small. For example for industrial and commercial taxpayers the limit is FRF 2 million. A business with a turnover exceeding this amount is not a small business and thus cannot use the exemption. As well, the exemption only applies if the taxpayer has been carrying on the business for at least five years. It does not apply to building sites.

An example might help to see how the French capital gains tax system works in practice for an individual.

Assume a taxpayer earns taxable income of FRF 290,000 in 1992. She is married with two children. She owns her own residence but also has an apartment which she purchased in June 1981 for FRF 200,000. She sells this apartment in September 1992 for FRF 700,000.

Sale price(a)	700,000	
Purchase price	200,000	
Acquisition costs(10%)	20,000	
Total purchase pricee	220,000	
Purchase Price Inflation adjustment	220,000 x 1.72 = (b) 378,400	
Capital Gain (a) – (b) =		(c) 321,600

This capital gain is then reduced by 3 1/3 percent (because the sale is in 1992 when the reduction rate was 3 1/3 percent rather than 5 percent) for each year the apartment has been held, starting from the end of the second year, i.e. nine years. This results in a 30 percent reduction, in other words a reduction of FRF 96,480. The general reduction of FRF 6,000 must be added to this, leaving a total reduction of FRF 102,480, thus resulting in a taxable capital gain of FRF 321,600 less FRF 102,480, i.e. FRF 219,120.

To calculate the tax payable on this amount it must be averaged as follows:
1/5 of the capital gain = FRF 43,824
Amount of tax on FRF 290,000 = FRF 58,380
Amount of tax on FRF 290,000 plus FRF 43,824 = FRF 75,207
Difference in tax payable (75,207 – 58,380) = FRF 16,827
Tax payable on capital gain = 16,827 x 5 = 84,135
Total tax payable = FRF 142,515

The purpose of regaling you with all of this has not been to show you interesting little titbits from the French system, although it certainly does have some exemptions from capital gains tax which would interest particular pressure groups. Rather my intention has been to draw attention to the similarities between the treatment of capital gains in the two countries, with inflation adjustment, the exemption of the principal residence and averaging being the three most notable examples.

In addition, this consideration of the French capital gains tax shows that other jurisdictions have much the same sorts of pressures in dealing with the taxation of capital gains as the Australian Government did and that the results of that pressure find expression in similar responses. Both countries came late to taxing capital gains, France in 1976 and Australia in 1985. The political response in both circumstances to the economic necessity for a capital gains tax (for efficiency and neutrality purposes) has been a hybrid system which, on the one hand, brings capital gains within the tax net but then treats them more leniently than other income gains, for example by indexing the purchase price to take account of inflation. While economists and tax academics can rail against this legalized tax avoidance, it is politicians who have the ultimate responsibility for accepting a particular capital gains tax regime. Their constituency is wider than that of economists and academics.

II. THE TAX UNIT

In Australia, the unit of taxation has traditionally been the individual. The alternative to taxing the individual is to tax the family or some component of it, such as a married couple. One way of doing this is to aggregate the income of married couples and tax them on that income as if it were earned by one individual. This would increase the tax paid by almost every family with both partners working. Another way of taxing the family would be to split the total family income

8. For 1991 and 1992 the rate was 3 1/3%.

between the two partners. This would give an advantage to single income earners with a spouse at home compared to taxpayers without a spouse earning the same income.

The debate surrounding the question of whether to tax the individual or the family is almost endless. The argument in favour of family taxation is that a person in a family has different expenditures than an individual and hence a different ability to pay tax, and this should be reflected in the tax system. The problem is that in some instances there are economies of scale for families which lead to lower costs (e.g. household goods shared between all family members) and in other situations higher expenditure (e.g. on children). It is not easy to base a tax system on such vagaries.

The argument in favour of the individual being the unit of taxation is that this satisfies the criteria of equity and efficiency and that the costs associated with raising a family are costs of choice and should not be taken into account in the tax system.

While there have been some minor deviations in Australia from the concept of the individual as the unit of taxation, such as the spouse rebate, the fact remains that all other things being equal the person who earns income is liable to tax on that income.

This is not necessarily the case in France which uses a progressive individual income tax system. As mentioned above the IR applies to individuals and families. The regime applies to income earned by that individual as an individual as well as to income earned as a member of an organization not subject to company tax (e.g. partnership income).

The IR system has what is called a family quotient. For a long time the French Government has been concerned about the falling French birth rate and has undertaken a number of measures to attempt to redress the situation.[9] The family quotient effectively splits family income among the whole family, the rationale being that while a progressive tax system is nominally about equal treatment, a family has higher costs and hence a lesser ability to pay income tax.

A single person without children has a family quotient of one and a household without children a quotient of two.[10] The figure becomes two and a half for a household with one dependent child and three if they have two children. For the third child and any after that, the quotient increases by one for each child.

Only married couples can take advantage of the family quotient. Unmarried taxpayers, even if they are living together, are treated as separate taxpayers. For married couples, the family quotient system means that their income is combined.

For a married couple without children the quotient is two. Assume that the combined family income is FRF 200,000. Apply the quotient so that the amount of tax payable is twice the amount payable on income of FRF 100,000.

For a family with two dependent children the family quotient is three. If the combined family income is FRF 180,000 the tax payable is first calculated by dividing the quotient into the family income, in this case leaving a figure of FRF 60,000. The tax payable on FRF 60,000 in 1992 was FRF 7,246. Multiply this amount by three and the total tax payable is FRF 21,739.[11]

The problem with the family quotient system is that it discriminates against the single income earner. An unmarried individual with an income of say FRF 100,000 pays tax on that amount. Compare that to the situation where an individual earning the same amount has a non-working spouse. This latter individual pays tax on only FRF 50,000, as does the spouse, saving a large amount of tax. Why should the fact that a taxpayer is married mean less tax is paid? It does not make sense. This income splitting is socially regressive, and its effect is to induce one spouse to stay at home rather than work.

III. DEDUCTIONS

In Australia deductions are allowable against income when incurred in earning or producing that income. In other words, there must be some link between the expenditure and the income earned.

For employment income, a deduction is only allowable for employment-related expenditure when there are adequate receipts which substantiate the expenditure.[12]

The Commissioner of Taxation and his staff pay little attention to the correctness or otherwise of most taxpayers' returns. The Australian tax system is built on trust. The Commissioner assesses on the basis of what the taxpayer has disclosed in her return, without, in most cases, any checks. This is called self-assessment. The Commissioner has implemented a fuller audit coverage system to encourage compliance with the tax laws.

It has always seemed somewhat wasteful of the resources of employee taxpayers and tax officers that there is a duty imposed on salary and wage earners to keep records of their work-related expenditure. In my opinion the French method is preferable.

In France, salary and wage earners can automatically deduct against their remuneration 10 percent of their income as work expenses (the forfaitaire system.) Thus someone on, for example, a salary of FRF 160,000 can deduct FRF 16,000, leaving a net remuneration of FRF 144,000. In 1992 the minimum and maximum amounts claimable under this regime were FRF 2,120 and FRF 70,900.

Taxpayers have the option of deducting their real work-related costs if they so desire. This will only be done if the

9. One such measure, the école maternelle system, provides a type of pre-school learning environment free for four days a week for children between 2 and 6, the school starting age in France.

10. This effectively allows income splitting between husband and wife where one spouse works and the other does not, and income balancing where both work but earn different amounts.

11. The top rate of tax on FRF 60,000 in 1992 was 24% compared to 43.2% on FRF 180,000. The amount of tax saved as a consequence of the family quotient system is thus quite large.

12. There is a $ 300 limit before the substantiation provisions apply, but once that claim limit has been reached all work related expenses must be justified by receipts.

actual expenses are greater than the amount allowed under the forfaitaire system.

The one problem with the automatic deduction system (in addition to the cost to the revenue) is that it is a percentage of income earned, thus granting a larger deduction (and hence a larger reduction in taxable income) to higher salary and wage earners. This is regressive. It is presumably based on the idea that higher income earners spend a greater percentage of their income on expenses related to work than lower income earners.

The idea of an automatic deduction system for Australia has some merit. It saves a lot of record keeping and checking by taxpayers and tax officials. In the Australian context it might be more appropriate to have an automatic deduction for salary and wage earners, but with the deduction fixed at a set dollar amount. This would be less regressive than a percentage deduction, although the deduction would still be worth more for those in the top marginal bracket than for those in lower brackets. On the other hand, if the limit were set sufficiently high to ensure that most salary and wage earners did not have to justify claims for work-related expenses (say $ 1,500) then lower income earners would actually be better off than under the present system so that they would be unlikely to complain.

The French complicate their forfaitaire system by having supplementary deductions, i.e. set percentage deductions applying to certain specified types of work.[13] These special deductions are over and above the general deduction discussed above. Although the supplementary deduction is a percentage deduction, the percentage depending on the type of work, there is a limit of FRF 50,000 under this regime.

Suppose, for example, a journalist earns FRF 200,000 as salary. She will be allowed a general deduction of 10 percent, leaving FRF 180,000. Because she is a journalist she is entitled to a supplementary deduction of 30 percent of this amount, i.e. FRF 54,000. However, the supplementary deduction has a ceiling of FRF 50,000, so this is the amount she will be able to claim. This leaves her with net income of FRF 130,000. In addition, the French also provide a special reduction of 20 percent from net income (up to a maximum of, in 1992, FRF 128,800). Thus, in the case of the journalist her taxable income will be reduced by 20 percent from FRF 130,000 to FRF 104,000. In other words, her initial income has been reduced from FRF 200,000 to FRF 104,000 taxable income by means of special adjustments. These special adjustments without more have moved her from the 49 percent rate to the 38.4 percent rate.

IV. DIVIDEND IMPUTATION

Australia has a fairly pure form of dividend imputation. Companies in Australia are taxed at the rate of 33 percent on their taxable income. A company can then pay franked dividends to its resident individual shareholders. Essentially this means the dividend has a tax credit attached to it, a credit that the shareholder can offset against his determined tax liability.

For example, assume that A is the sole shareholder in a company.[14] The company makes $ 100,000 profit in the year in question. Assume the company tax rate is 33 percent and the top marginal rate on individuals is 47 percent on all income over $ 50,000 (disregarding the medicare levy of 1/4 percent), and A earns other income exceeding that amount.

On these figures the company pays $ 33,000 in tax. It decides to declare a dividend of the after-tax profit, namely $ 67,000. This A receives as a dividend payment. It is franked to the extent of the tax payable, namely $ 33,000.

The dividend imputation system means that A would include the gross dividend (i.e. the amount of the dividend plus the amount of company tax associated with that dividend) in her assessable income. In other words, she includes $ 100,000 in assessable income (along with her other income). We'll assume she has no allowable deductions that relate to that dividend income.

In relation to the dividend income, because A is already in the top marginal bracket, that $ 100,000 will be subject to the 47 percent rate. Thus A owes $ 47,000 on her dividend income. However, she will be entitled to a tax credit for the company tax paid on income that relates to that dividend, in this case $ 33,000. So, instead of paying the full $ 47,000 tax on the dividends, A will pay only $ 14,000, the difference between $ 47,000 and $ 33,000.

Where the taxpayer is on a lower rate than 33 percent, and the dividend does not push him into a tax bracket higher than that figure, the credit will be greater than the tax payable. This excess credit can be offset against other income tax payable. If there is no other income tax against which to offset the credit the excess credit is lost. It is not refunded to the taxpayer and cannot be carried forward to the next year.

The system treats the dividend paying company as a conduit for tax purposes. Tax is taken out at the company level and then applied as a credit against the tax liability of the taxpayer. In essence there is a minimum 33 percent taken out of the income that eventually finds its way into the shareholder's hands as a dividend. Taxing the company profits is a formality; the company acts as a tax collecting post for the revenue. If the shareholder has a marginal rate greater than 33 percent the taxpayer pays tax at her marginal rate on the dividend, receiving a credit for the tax paid by her "agent", the company.

Imputation was introduced in Australia to overcome the so-called double taxation of company income, once in the hands of the company and then again in the hands of the shareholder. Under the old system (i.e. the classical system) company profits were taxed in the hands of the company and dividends were treated as separate income and taxed accordingly in the hands of the shareholder. No account was taken of the tax paid at the company level in calculating the tax to be paid by the shareholder on the dividend (leaving aside consideration

13. The types of work which have supplementary deductions include travelling salesmen (whose supplementary deduction is 30%) building workers (10%) and journalists (30%).

14. This cannot be true, but the example is merely for the purposes of explaining how dividend imputation works in Australia.

of the intercorporate dividend rebate). The effect of this double taxation was that tax of upwards of 80 percent of the company income could have been paid at the company and shareholder level.

When the Treasurer introduced dividend imputation in 1987 he waxed lyrical about its benefits. Australia would be at the forefront of attracting investment. Unfortunately, the dreams of capitalist nirvana have not eventuated. However, the imputation system has resulted in a massive drain on the revenue and a tax transfer to the already rich in our society. It was estimated that in the 1993 income year the amount of dividend imputation credits totalled more than $ 3 billion. On 1992 figures almost 50 percent of imputation credits go to those with taxable incomes over $ 100 000.

France operates a special tax regime for passive income, especially for dividends. However, like other forms of income, once that income is determined it is included in total income under the IR if the recipient is a natural person, or the IS if the recipient is a company.

The regime applicable to distributions of profit from companies (often called distribution tax) mainly covers dividends. The main point about the regime, as it applies to dividends, is that each dividend has attached to it a tax credit equal to 50 percent of the amount of the dividend. The amount of income is increased accordingly.

An example will help explain how the system operates. Suppose a taxpayer is subject to tax at the marginal rate of 40 percent. The taxpayer receives a dividend of FRF 100. Her taxable dividend income will therefore be FRF 150 (FRF 100 + 50% of FRF 100), but attached to the dividend will be a tax credit ("avoir fiscal") of 50 percent of the actual dividend, namely FRF 50. Calculation of tax payable on the dividend will be as follows:

(100 + 50) x 40 percent	= FRF 60
Avoir fiscal (tax credit)	= FRF 50
Tax payable under the IR	= FRF 10

In effect, the tax payable on the dividend of FRF 100 will be in this example only FRF 10. The avoir fiscal is a sort of return of company tax. With company tax in France at $33^1/_3$ percent it effectively means total elimination of company tax on distributed dividends.

Assume a French company earns FRF 300 income subject to the IS. The rate of company tax is $33^1/_3$ percent, which means that the after-tax profit is FRF 200. This is distributed to the shareholder, whom we will assume is taxed at the 40 percent tax rate. Application of the avoir fiscal means that the taxable dividend is treated as FRF 300 in the hands of the shareholder, the exact amount of profits in the company before tax. For the purposes of calculation it is as if no company tax had been paid.

Forty percent of FRF 300 is FRF 120. If we take away the tax credit of FRF 100 this results in tax payable on the FRF 200 dividend of FRF 20. All up, tax on the income at both the company level and the shareholder level has totalled FRF 120. This is 40 percent of the original income amount of FRF 300 in the hands of the company and is the shareholder's top marginal rate. In effect, the company has paid some tax on behalf of the shareholder and the shareholder pays a top up amount to bring the amount of tax paid up to the equivalent of that which would have been paid if the income had been earned directly by the shareholder. The company is nothing more than a conduit for the income and an agent for the collection of some tax on that income as it passes through to the shareholder.

In principle, the avoir fiscal is only available to resident taxpayers, either individuals with their real domicile in France or companies with their registered office in France.

The system works adequately when all of the company's profits are subject to the full amount of company tax. Where this is not the case (e.g. some company income is exempt or subject to a lower rate of tax), then a special tax is levied equal to the amount of the tax credit attached to distribution. This is called a distribution prepayment (précompte), and basically represents a substitute for the tax under IS that has not been paid.

The payment to a shareholder of a dividend of FRF 100 paid out of profits which have not been subject to company tax at the normal rate will result in a prepayment by the company to the Treasury of FRF 50. This amount equals the amount of the tax credit attached to the dividend. There are further extensions of this process but they, like the calculations, are rather complicated and need not bother us too much.

V. CONCLUSION

This journey through some of the delights of the French income tax system has attempted to accomplish two things. First, it has afforded a glimpse of some areas where the French adopt a different approach to that adopted by Australia. We in Australia and elsewhere can learn from the French experience. But secondly, I hope it has shown that in a number of areas the general approach is similar to Australia's. The taxation of capital gains and the treatment of dividends in France show to us in Australia that the great tax issues are universal, and the solutions are often similar.

INTERNATIONAL

DEVELOPMENTS IN FISCAL DEFICITS AND TAX REVENUES IN OECD COUNTRIES SINCE 1989

Ken Messere

Ken Messere was head of the OECD Fiscal Affairs Division from 1971 to 1991, and is the author of *Tax Policy in OECD Countries: Choices and Conflicts?*

This article continues to update what I wrote in my 1992 IBFD publication, *Tax Policy in OECD Countries: Choices and Conflicts*, and my articles in the June and December 1993 issues of the *Bulletin*, in the light of most recent statistical data on fiscal deficits from *Economic Outlook* No. 56 (OECD December 1994) and on most recent tax revenue data from Revenue Statistics of OECD Member countries 1965-1993 (OECD August 1994).[1]

I. FISCAL DEFICITS

Table 1 provides details on fiscal deficits since 1979, primarily to illustrate that 1989 was the year in which they have never been lower during these last 15 years, a trend drastically reversed over the following four years.

In contrast to my 1993 articles, I no longer make moralistic comments on governments over-optimism in estimating the size of their deficits, which during the last few years had consistently to be revised upwards, nor on inadequate tax efforts of nearly all the big seven countries to reduce these deficits. The reasons for this are first because more recent forecasts about deficits (taken from successive editions of *Economic Outlook*) require much less revision and second nearly all OECD countries are making serious efforts to reduce their deficits – see last three columns of Table 1.[2]

II. TOTAL TAX RATIOS ("TTRS")

Table 2 provides details of latest estimates total tax to GDP receipts for the years 1989-93, those for 1993 being provisional and not available for all countries.

Unfortunately it is not possible to go beyond 1993 on the basis of the OECD classification (and to use other methods would throw international comparability out of the window). The picture of 1989 to 1993 is mainly a no change in TTR's in contrast to most of the 1980s when they increased considerably (average 0.5 of GDP per annum during the first half of the 1980s). Now that governments are giving higher priority to reducing fiscal deficits than tax cutting, I would expect the 1994 TTR to resume the earlier increase (e.g. the recent Clinton package, the UK tax hike), but for the moment one must wait and see. Evidently the average no-change conceals many different trends among particular countries, which are not pursued in this brief note. To summarize briefly, Table 2 shows that between 1989 and 1992/1993 there have been quite large increases in TTR's (more than 2 percentage points) in the Netherlands, Austria, Italy and Turkey with a corresponding decline in Sweden, New Zealand and the United Kingdom.

Table 3 deals with the more technical question of how reliable are initial estimates of TTR, given that estimates of both future tax revenues and future GDP have to be based on not too robust macroeconomic assumptions on the growth of inflation and unemployment, etc. It compares initial and most recent estimates of TTRs for 1991 and 1992. The differences are mostly in the realm of respectability. One can accordingly have reasonable confidence that for most countries the 1993 estimates are unlikely to be much revised especially as they are usually close to the 1992 ratios,[3] which apart from the large over-estimation of Portugal and Turkey[4] and smaller overestimation of Ireland, have required little revision.

III. SOME PARTICULAR TAX RATIOS

Table 4 summarizes major changes (taken to be at least 0.5 of GDP) in five particular tax ratios between 1989 and 1992. Such major changes have occurred in at least one tax ratio in all OECD countries except Denmark and the United States, and in more than half of them in Canada, France, Greece, Ireland, Iceland, Italy, Luxembourg, Portugal, Spain, Sweden and Turkey. Shifts in particular tax ratios have been much more volatile between 1989 and 1992 than they were between 1985 and 1990 where I employed the same 0.5 per-

1. On revenue statistics, though there is an interpretative guide to the OECD classification which is intended to maximize international comparability, some countries do not conform to them. For example, Denmark applies an accrual instead of cash basis and it is unclear how much this affects comparability with other countries. See also note 4.
2. Of course one might still take the cynical view that the more realistic forecasts of the size of deficits might not be unconnected with governments recently discovered need to persuade their voters to accept tax increases.
3. Exceptions on the plus side are Netherlands 1.3 and Italy 0.9 percentage points and on the minus side Portugal 1.9, Iceland 1.2 and Norway, Spain and United Kingdom each 0.8 percentage points.
4. See note 3 to Table 3 for the explanation of Turkey's change.

centage point change criterion but covering a five-year rather than a three-year period (see Table 4 of my June 1994 article). This could be due to governments' more desperate reactions to the combination of prolonged recession and growing fiscal deficits.

Most countries have substantially increased their income tax ratio, though a few (Sweden, New Zealand, Australia and Norway) have substantially reduced it. Doubtless as a result of declining profits, the corporate tax ratio has decreased in most countries, but again there are exceptions (Ireland, Italy, Portugal). However, the average change in the corporate tax ratio (downwards) over this period has been greater than in any other tax ratio, all the more striking because the corporation tax is a relatively small revenue raiser (OECD average 7 percent of total tax receipts). Substantial increases in the social security contribution ratio have occurred in half the countries and declined in none. Obviously governments have been cashing in on the insurance myth but it seems somewhat paradoxical that in a time of recession and high unemployment, regressive social security contributions should be the most buoyant source of government revenue. Movements in the remaining major revenue source, consumption tax ratios, have been much less volatile as regards both VAT and excises. There have been seven or eight major countries shifts, but the pluses and minuses more or less cancel out. The earlier, almost invariable increase, in VAT ratios and decline in excise ratios has in most recent years become less evident.

IV. TAX STRUCTURES[5]

Table 5 shows the relative reliance of OECD countries for 1989 and 1992 on the main source of revenues of OECD governments is personal and corporate income taxes, social security contributions and consumption taxes (VAT and excises). As in most OECD countries these three sources account for more than 90 percent of tax revenue, in a general survey of this kind, it was felt justifiable to neglect other revenue sources which rarely account for more than 5 percent of total tax revenue.

As regards the three main categories of tax, income taxes, both individual and corporate, social security contributions and consumption taxes, an OECD average shows little movement over these years (last column Table 5). Table 6 identifies the large shifts (2 percentage points or more) between 1989 and 1992 in many countries' reliance on different revenue sources, which follow no clear pattern. Though there has been little change in the tax structures of Germany, the Netherlands, Switzerland and the United States, there has been in all other OECD countries:

- Australia has shifted from personal to corporate income tax
- Austria from VAT to personal income tax
- Belgium from corporate tax to social security
- Canada from corporate tax to personal income tax and social security
- Denmark from VAT to personal income tax
- France from corporate to personal income tax
- Greece from personal income tax and social security to excises
- Iceland from other taxes to income taxes
- Ireland from excises to corporation tax
- Italy from social security to corporate taxes
- Japan from corporate tax to social security
- Luxembourg from corporation tax to consumption taxes
- New Zealand from personal income tax and excises to corporate tax and VAT
- Norway from personal to corporate income tax
- Portugal from corporate taxes and excises to personal income taxes
- Spain from corporate tax to social security
- Sweden from personal income tax to social security and VAT
- Turkey from corporation tax to VAT
- United Kingdom from other taxes to VAT.

I would like to take these random shifts as support for my often-expressed and sometimes criticized view, that though in certain areas governments are bound to be influenced by international considerations (including EU constraints), in terms of how much revenue to collect and the revenue sources for collecting it, they are free, subject to domestic political pressures, to make their own (often irrational) choices.

5. A technical remark is that the borderline between income taxes and social security contributions is not unambiguous when the levy is imposed on an income tax base but earmarked for social security welfare expenditures. The interpretative guide to the OECD classification makes it clear (para. 30 (c)) that such levies should be treated as income taxes and not as social security contributions. In most recent years two countries, Finland and the Netherlands, have apparently not followed this guideline, and so their tax structure data are not comparable with those of the other Nordic countries which have such levies.

Table 1 **General government financial balances**
Surplus (+) or deficit (–) as a percentage of nominal GDP

																Estimates and Projections		
	'78	'79	'80	'81	'82	'83	'84	'85	'86	'87	'88	'89	'90	'91	'92	'93	'94	'95	'96
United States[a]	0.1	0.4	- 1.3	- 1.0	- 3.4	- 4.1	- 2.9	- 3.1	- 3.4	- 2.5	- 2.0	- 1.5	- 2.5	- 3.2	- 4.3	- 3.4	- 2.0	- 1.8	- 1.8
Japan	- 5.5	- 4.7	- 4.4	- 3.8	- 3.6	- 3.6	- 2.1	- 0.8	- 0.9	0.5	1.5	2.5	2.9	3.0	1.8	- 0.2	- 2.0	- 1.8	- 1.8
Germany	- 2.4	- 2.6	- 2.9	- 3.7	- 3.3	- 2.6	- 1.9	- 1.2	- 1.3	- 1.9	- 2.2	0.1	- 2.0	- 3.3	- 2.9	- 3.3	- 2.7	- 2.4	- 1.8
France	- 2.1	- 0.8	0.0	- 1.9	- 2.8	- 3.2	- 2.8	- 2.9	- 2.7	- 1.9	- 1.7	- 1.2	- 1.6	- 2.2	- 3.9	- 5.8	- 5.7	- 5.0	- 4.0
Italy	-10.4	-10.2	- 8.6	-11.6	-11.3	-10.7	-11.6	-12.6	-11.6	-11.0	-10.7	- 9.9	-10.9	-10.2	- 9.5	- 9.6	- 9.7	- 9.1	- 7.8
United Kingdom	- 4.4	- 3.3	- 3.4	- 2.6	- 2.5	- 3.3	- 3.9	- 2.8	- 2.4	- 1.4	1.0	0.9	- 1.2	- 2.7	- 6.2	- 7.7	- 6.8	- 4.7	- 3.2
Canada	- 3.2	- 2.0	- 2.8	- 1.5	- 5.9	- 6.9	- 6.5	- 6.8	- 5.4	- 3.8	- 2.5	- 2.9	- 4.1	- 6.6	- 7.1	- 7.1	- 6.2	- 4.7	- 3.5
Total of above countries	- 2.6	- 2.1	- 2.7	- 2.8	- 4.0	- 4.3	- 3.5	- 3.3	- 3.3	- 2.4	- 1.8	- 1.1	- 2.0	- 2.7	- 3.6	- 3.9	- 3.5	- 3.0	- 2.6
Australia	- 2.7	- 2.2	- 1.5	- 0.6	- 0.4	- 4.0	- 3.0	- 2.7	- 2.8	- 0.1	1.2	1.2	0.5	- 2.8	- 3.9	- 3.7	- 4.0	- 2.9	- 1.8
Austria	- 2.8	- 2.4	- 1.7	- 1.8	- 3.4	- 4.0	- 2.6	- 2.5	- 3.7	- 4.3	- 3.0	- 2.8	- 2.1	- 2.5	- 2.0	- 4.2	- 4.2	- 5.0	- 4.5
Belgium	- 6.8	- 7.5	- 9.3	-13.0	-11.0	-11.5	- 9.2	- 8.7	- 9.2	- 7.4	- 6.6	- 6.3	- 5.4	- 6.5	- 6.7	- 6.6	- 5.3	- 4.6	- 4.1
Denmark	- 0.4	- 1.7	- 3.3	- 6.9	- 9.1	- 7.2	- 4.1	- 2.0	3.4	2.4	0.6	- 0.5	- 1.5	- 2.1	- 2.6	- 4.4	- 4.2	- 3.0	- 2.2
Finland	4.0	3.0	2.9	3.6	2.0	0.6	3.0	3.0	3.5	1.1	4.1	6.3	5.4	- 1.5	- 5.8	- 7.1	- 4.6	- 5.1	- 3.3
Greece	- 1.4	- 2.7	- 2.9	- 9.0	- 6.9	- 7.8	- 9.3	-12.5	-11.6	-10.9	-12.4	-14.5	-13.9	-13.0	-11.8	-13.5	-13.1	11.6	-10.1
Ireland	- 7.9	- 9.6	-10.6	-11.6	-13.1	-11.2	- 9.4	-10.8	-10.9	- 8.5	- 4.5	- 1.7	- 2.2	- 2.1	- 2.2	- 2.4	- 2.3	- 2.0	- 2.0
Netherlands	- 2.5	- 3.6	- 3.9	- 5.1	- 6.6	- 5.9	- 5.9	- 3.9	- 3.5	- 5.1	- 4.2	- 4.7	- 5.1	- 2.8	- 3.8	- 3.3	- 3.8	- 3.6	- 2.9
Norway	- 0.1	1.3	5.7	4.7	4.4	4.2	7.5	10.2	5.8	4.7	2.6	1.4	2.5	- 0.2	- 2.3	- 2.7	- 1.3	- 0.5	- 0.2
Portugal	- 6.9	- 6.3	5.5	-10.6	- 7.6	-10.1	- 7.1	- 7.4	- 6.4	- 7.3	- 5.4	- 3.1	- 5.4	- 6.1	- 3.8	- 8.0	- 7.1	- 6.6	- 5.5
Spain	- 2.0	- 1.8	- 2.2	- 3.7	- 5.4	- 4.6	- 5.2	- 6.9	- 6.0	- 3.1	- 3.3	- 2.8	- 4.1	- 4.9	- 4.2	- 7.5	- 6.8	- 6.1	- 5.2
Sweden	- 0.5	- 2.9	- 4.0	- 5.3	- 7.0	- 5.0	- 2.9	- 3.8	- 1.2	4.2	3.5	5.4	4.2	- 1.1	- 7.4	-13.5	-11.2	-10.2	- 9.7
Total of above smaller countries	- 2.5	- 2.8	- 2.5	- 4.5	- 5.2	- 5.4	- 4.5	- 4.7	- 4.1	- 2.8	- 2.4	- 2.1	- 2.7	- 4.0	- 4.7	- 6.4	- 5.9	- 5.2	- 4.4
Total of above European countries	- 4.0	- 3.7	- 3.3	- 4.9	- 5.2	- 5.0	- 4.8	- 4.7	- 4.3	- 3.7	- 3.3	- 2.5	- 3.7	- 4.4	- 5.2	- 6.5	- 6.0	- 5.2	- 4.2
Total of above OECD countries	- 2.6	- 2.2	- 2.7	- 3.0	- 4.2	- 4.5	- 3.6	- 3.5	- 3.5	- 2.5	- 1.9	- 1.2	- 2.1	- 2.8	- 3.8	- 4.2	- 3.8	- 3.3	- 2.9
General government financial balances excluding social security																			
United States[a,c,d]	0.3	0.5	- 1.2	- 0.8	- 3.3	- 4.1	- 3.0	- 3.4	- 3.8	- 3.0	- 2.9	- 2.5	- 3.5	- 4.2	- 5.1	- 4.2	- 2.9	- 2.8	- 2.9
Japan[c]	- 7.9	- 7.3	- 7.0	- 6.6	- 6.3	- 6.3	- 4.8	- 3.9	- 3.9	- 2.3	- 1.6	- 0.8	- 0.6	- 0.8	- 2.0	- 4.0	- 5.8	- 5.7	- 5.7

a) Excludes deposit insurance outlays.
b) Includes proceeds of privatizations and sales of other assets (BF 32.2 billion in 1993, BF 57.0 billion in 1994 and BF 13.5 billion in 1995).
c) OECD Secretariat estimates, derived from fiscal year data converted to a calendar year basis. The coverage of the social security systems is not the same in the United States and Japan.
d) Includes the surplus of state and local government pension schemes.

Reproduction of OECD Economic Outlook no. 56 Annex Table 29 (OECD December 1994)

TABLE 2

Total tax revenue as percentage of GDP at market prices[1]

	1989	1990	1991	1992	1993 (*)
Sweden	55.5	55.6	52.7	50.0	49.5
Denmark	50.7	48.7	48.9	49.3	50.0
Luxembourg	48.2	48.8	48.5	48.4	n.a
Netherlands	44.9	44.6	47.2	46.9	48.2
Norway	46.0	46.3	47.1	46.6	45.8
Belgium	44.6	44.9	44.9	45.4	45.7
France	43.7	43.7	44.0	43.6	44.0
Austria	41.0	41.3	42.0	43.5	43.4
Italy	37.9	39.1	39.7	42.4	43.2
Greece	34.5	37.2	38.5	40.5	n.a
Germany[2]	38.2	36.8	38.6	39.6	39.7
Ireland	35.8	35.5	36.2	36.6	37.1
Canada	35.1	36.3	37.0	36.5	36.1
New Zealand	38.7	37.2	36.0	35.9	35.6
Spain	34.6	34.4	34.8	35.8	34.7
UK	36.6	36.9	36.2	35.2	34.4
Iceland	32.4	32.3	32.4	33.4	32.2
Portugal	30.8	30.7	31.4	33.0	31.1
Switzerland	31.7	31.5	31.2	32.0	32.5
US	29.7	29.4	29.5	29.4	n.a
Japan	30.7	31.4	30.8	29.4	n.a
Australia	30.5	30.6	28.9	28.5	n.a
Turkey[3]	18.5	20.1	21.4	23.1	22.7
OECD (total) Unweighted average	38.1	38.3	38.5	38.8	n.a

* *Provisional*
n.a = not available

1. Ranked by 1992 figures of the 25 OECD countries. Data are not yet available for Mexico and I have also excluded Finland, because the figures supplied for the 1994 edition of Revenue Statistics are incompatible with those supplied in earlier editions, so no comparison over time is possible.
2. Unified Germany beginning in 1991.
3. The tax-to-GDP ratios for Turkey are substantially lower in this table and those which follow than have been published in previous volumes of OECD Revenue Statistics. This is entirely due to a revision in the methodology used by the Turkish State Institute of Statistics in calculating Turkish GDP (the tax revenue estimates themselves have not been affected by the revision in methodology). The new methodology results in a GDP estimate which, for the most recent years, is some 30% larger than was calculated using the old methodology.

(1) Source: *Revenue Statistics of OECD Member Countries 1965-93 (OECD 1994).*

TABLE 3

Differences between initial and revised estimates for 1991 et 1992 (plus or minus percentage between initial and revised figures 1991: source 1 and 2 1992: source 1 and 3

	1991 initial estimate	Difference with current estimates (b)	1992 initial estimate	Difference with current estimate (b)
Australia	29.2[a]	- 0.3	n.a	n.a
Austria	42.0	=	43.6	- 1.0
Belgium	42.0	+ 2.9	45.4	=
Canada	39.4	- 2.4	n.a	n.a
Denmark	48.2	+ 0.7	48.9	+ 0.4
France	43.7	- 0.1	43.7	- 0.1
Germany	39.2 [a]	+ 0.4	40.0	- 0.4
Greece	38.3	+ 2.2	n.a	n.a
Iceland	32.5	+ 0.9	33.2	+ 0.2
Ireland	37.9	- 1.3	38.0	- 1.4
Italy	40.5	+ 1.9	42.4	=
Japan	30.9[a]	- 0.6	30.2	- 0.3
Luxembourg	48.5 [a]	- 0.1	n.a	n.a
Netherlands	47.2	- 0.3	6.7	+ 0.2
New Zealand	36.0 [a]	- 0.1	n.a	n.a
Norway	47.0	- 0.4	46.7	- 0.1
Portugal	35.5	- 2.5	37.8	- 4.8
Spain	34.6	+ 1.2	35.9	- 0.1
Sweden	51.7	- 1.7	50.4	- 0.4
Switzerland	31.4	+ 0.6	32.2	- 0.2
Turkey [c]	30.0	- 6.9	32.1	- 9.1
UK	36.2	- 1.0	35.8	- 0.6
US	29.8[a]	- 0.4	n.a	n.a

(a) Estimates unavailable in the 1992 edition but reproduced in the 1993 edition of Revenue Statistics of OECD Member countries.
(b) See Table 2.
(c) See footnote 3 to Table 2.

Sources: 1 1994; 2 1992; 3 1993 editions of *Revenue Statistics of OECD Member Countries.*

TABLE 4

Shifts in particular tax ratios of more than 0.5 percentage points

1989-1992

	Personal income tax	Corporation tax	Social security contri-butions	VAT and sales taxes	Excises etc
Australia	- 1.7				
Austria	+ 1.3		+ 0.6		
Belgium		- 0.9	+ 1.1		
Canada	+ 0.9	- 1.2	+ 1.3		
Denmark					
France	+ 0.9	- 0.9		- 0.7	
Germany			+ 1.3	+ 0.6	
Greece			+ 0.6	+ 1.7	+ 2.1
Iceland	+ 1.1		+ 1.8	- 1.1	
Ireland		+ 1.3			- 0.9
Italy	+ 1.4	+ 1.1	+ 0.8		+ 0.6
Japan	+ 0.6	- 2.5	+ 1.1		
Luxembourg		- 2.1		+ 1.1	+ 1.1
Netherlands [1]					
New Zealand	- 2.1				- 0.6
Norway	- 0.9	+ 0.9			+ 0.6
Portugal	+ 2.4	+ 1.3		+ 0.6	
Spain	+ 0.6	- 0.7	+ 1.1		
Sweden	- 3.8	- 0.9			- 0.6
Switzerland			+ 0.8		
Turkey [2]	+ 1.5	- 0.7	+ 1.4	+ 1.6	
United Kingdom		- 1.7		+ 0.8	
United States					
Unweighted average					
1989	11.3	2.9	9.3	6.6	4.4
1992	11.5	2.5	9.9	6.7	4.5
1992 minus 1989	+ 0.2	- 0.4	+ 0.6	+ 0.1	+ 0.1

Source: See Table 1

1. Netherlands is excluded from the personal income tax and social security for technical reasons explained in the text.
2. Turkish changes probably underestimated as unidentifiable taxes represented 3.5 of GDP in 1992.
3. Of other taxes only property taxes are of any importance. Major changes are Canada + 0.7, Sweden + 0.7 and UK - 1.7.

TABLE 5

Changes in the structures of the main taxes between 1989 and 1993
(particular tax to total tax receipts to nearest percentage point)

	Personal and corporate income taxes (a)		Social security contributions (b)		Consumption taxes (c)	
	1989	1992	1989	1992	1989	1992
Australia	57 (44)	55 (41)	zero (0)	zero (0)	29 (9)	28 (8)
Austria	24 (20)	27 (22)	33 (16)	33 (16)	32 (21)	30 (19)
Belgium	37 (30)	36 (31)	34 (21)	36 (22)	25 (16)	25 (16)
Canada	47 (38)	45 (40)	13 (9)	16 (11)	29 (15)	26 (14)
Denmark	59 (52)	59 (54)	3 (0.5)	3 (1)	33 (20)	32 (20)
France	17 (12)	17 (14)	44 (27)	44 (27)	29 (19)	27 (18)
Germany	35 (29)	32 (28)	36 (18)	38 (19)	26 (15)	27 (16)
Greece	18 (13)	18 (10)	32 (13)	31 (13)	45 (26)	46 (25)
Iceland	27 (24)	30 (26)	3 (3)	8 (8)	55 (35)	50 (31)
Ireland	35 (32)	35 (24)	14 (9)	15 (9)	44 (22)	40 (20)
Italy	37 (27)	39 (27)	33 (24)	31 (22)	27 (14)	24 (13)
Japan	49 (25)	42 (25)	28 (15)	33 (17)	12 (3)	14 (5)
Luxembourg	40 (23)	35 (22)	27 (13)	28 (14)	24 (14)	28 (16)
New Zealand	59 (47)	57 (44)	zero (0)	zero (0)	33 (20)	35 (24)
Norway	33 (27)	32 (25)	27 (17)	27 (17)	36 (19)	37 (18)
Portugal	26 (14)	29 (20)	26 (16)	25 (15)	45 (20)	43 (20)
Spain	31 (23)	30 (24)	35 (26)	37 (26)	29 (17)	28 (16)
Sweden	43 (39)	38 (36)	27 (25)	29 (28)	24 (14)	26 (16)
Switzerland	40 (33)	41 (35)	33 (10)	35 (10)	19 (10)	17 (9)
Turkey	36 (26)	32 (28)	18 (10)	20 (11)	28 (20)	30 (23)
United Kingdom	39 (27)	36 (28)	17 (9)	18 (10)	30 (17)	34 (20)
United States	44 (36)	41 (34)	29 (16)	30 (17)	16 (7)	17 (8)
OECD unweighted average (d)	38 (29)	37 (30)	24 (14)	25 (14)	30 (17)	30 (17)

(a) Figures in brackets represent the **personal** income tax share.
(b) Figures in brackets represent the share of employers' contributions.
(c) Figures in brackets represent the share of VAT or sales taxes.

Footnote (1) to Table 1 regarding the exclusion of Mexico and Finland. and footnote (1) to Table 4 regarding the exclusion of the Netherlands.

Source: As Table 1

TABLE 6

Major shifts between 1989 and 1992 in countries relative reliance on different revenue sources

	Personal income tax	Corporate income tax	Social contri-butions*	VAT and sales taxes	Excises
Australia	– 3	+ 2			
Austria	+ 2			– 2	
Belgium		– 2	+ 2		
Canada	+ 2	– 4	+ 3		
Denmark	+ 2			– 2	
France	+ 2	– 2			
Germany			+ 2		
Greece	– 2		– 3		+ 3
Iceland	+ 2	+ 3	+ 5	– 4	– 2
Ireland		+ 3			– 3
Italy		+ 2	– 2	+ 2	
Japan		– 7	+ 5		
Luxembourg		– 4		+ 2	+ 2
Netherlands					
New Zealand	– 2	+ 2		+ 3	
Norway	– 2	+ 4			
Portugal	+ 6	– 2			– 2
Spain		– 2	+ 2		
Sweden	– 3		+ 2	+ 2	
Switzerland			+ 2		
Turkey		– 5		+ 2	
United Kingdom		– 4		+ 3	
United States					

* Plus or minus 2 percentage point or more

Source: As Table 1.

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VOL. 49 NO. 2 FEBRUARY 1995

17TH ANNUAL ATI CONFERENCE: INTRODUCTION

The American Tax Institute in Europe held its 17th Annual Congress 14-16 November 1994 in Cannes, France. The congress, which was well attended by a mixture of practitioners, academics and government officials, focused on a number of pressing topics relevant to today's fiscal environment: Euro-American joint ventures, the new US–France tax treaty, intellectual property rights in Europe, international mobility and European holding companies. Panels comprised of practitioners from the private sector from France, Germany, Italy, the United Kingdom and the United States discoursed on each of the topics, frequently generating spirited discussions from the delegates.

Guest speakers from the US government were Mr Joseph H. Gale, Chief Tax Counsel, Majority Office Senate Finance Committee, Christine Halphen, Assistant Chief Counsel (International), IRS and John J. Monaco, Assistant Commissioner (Examinations), IRS.

Mr Gale launched the congress with a discussion of the recent elections in the United States which resulted in a change in control of both Houses. Republican control is expected to result in significant changes. The debate on whether foreign-owned firms paid their fair share will be renewed, and treaties will probably constitute the first order of business.

Ms Halphen spoke during the second session offering insightful comments on compliance issues and the new conduit regulations. Five major compliance areas have priority: pricing, base erosion, foreign tax credit, financial products and individual compliance. Ms Halphen indicated that the IRS will continue to work with the OECD on transfer pricing issues and further will continue its dialogues with treaty partners. Advance issue resolution will be utilized in appropriate cases – the examinations division of the IRS has authority to make settlements for years being examined. The new conduit regulations should help to reduce abusive transactions in that they limit benefits in cases of multiparty financing transactions.

Mr Monaco led the discussion on the final day of the congress – the focus of his talk was the perceived abuse of the partnership to obtain tax benefits. The IRS has directed interest to partnerships with a foreign partner, and intends to step up its examinations in order to get a firmer handle on abuses in this area.

We are pleased to include in this issue several of the papers presented during the congress:
- Graham Airs looks at the treatment of intellectual property in the United Kingdom;
- Giles Entraygues overviews the new SAS form of doing business in France; and
- Olivier Delattre, in two articles, explains the use of holding companies in France and the new France–US tax treaty.

UNITED KINGDOM

TAXATION OF INTELLECTUAL PROPERTY

Graham Airs

Partner in the Tax Department of Slaughter and May in London. **Mr Airs** is also a member of the International Sub-Committee of the Revenue Law Committee of the Law Society of England and Wales.

There are essentially three issues to be addressed in examining the tax treatment of intellectual property. The first is whether tax relief is available for money spent on intellectual property, either by way of the expenses of development of it or by way of the costs of acquiring it. The second is the tax treatment of the proceeds derived from exploiting intellectual property, whether that exploitation is on the part of the original developer or a subsequent owner, and an important part of that issue is whether any withholding tax is imposed upon sums paid in respect of the use or acquisition of intellectual property. The third is whether there are any transaction taxes that fall on intellectual property transactions, such as value added tax or stamp duty.

In addressing these issues in a UK context, it is necessary to distinguish between different types of intellectual property. Patents, computer software, trade-marks, registered designs and design rights, and industrial know-how all have particular tax rules that apply to them. On the other hand, the general principles of the UK tax system will also be relevant, such as the underlying distinction between income and capital. As a general principle, for example, the UK tax system does not allow taxable income to be reduced by claims for relief for capital expenditure, or for depreciation.

I. GENERAL PRINCIPLES

Taxable income in the United Kingdom is classified under six different Schedules, two of which are divided further into different Cases. Schedules A (Income from Real Property), C (Government Securities), E (Income from Employment) and

F (Dividends) are irrelevant for the purposes of this article, as is Schedule B (which has been abolished). Any taxable income derived from intellectual property will be taxed under Schedule D, and any relief from the taxation of income that is given for the expenses of developing or acquiring intellectual property will be given according to the rules of that Schedule.

Schedule D imposes tax upon annual profits or gains arising from a UK source or earned (anywhere in the world) by a UK resident. It is sub-divided into six different "Cases". The main importance of this sub-division is the different rules that apply with respect to relief for expenditure.

Cases I and II relate to trade or professions, and they are very similar. For the purposes of those Cases, the taxable profits start with the accounting profits, which are then adjusted according to certain statutory rules which disallow some types of deduction but give special relief for other types of expenditure, so that tax relief is given for most of the expenses shown as such in the profit and loss account. Similar reliefs are allowed against income taxable under Case VI, which deals with certain items of miscellaneous income.

Case III, on the other hand, taxes interest and "annual payments". It is designed for income that is received by the recipient without the recipient having to do anything further to earn it, and so, not surprisingly, there are no express rules giving relief from income taxed under Case III for any expenses of earning that income. That would be quite important in the rather unusual case of a taxpayer which takes a licence of intellectual property in order simply to grant a licence of it. Such a taxpayer may well find that the income received is taxed under Case III, and that no relief from tax on that income is available for royalties paid in respect of its acquisition. (Cases IV and V complete the picture, dealing with overseas securities and possessions; they are not relevant to this article).

As already mentioned, none of the basic rules give any relief for capital expenditure, or for depreciation. There is, however, a system of giving capital allowances for capital expenditure incurred on certain assets. The main ones are machinery and plant, but capital allowances are also available for expenditure on patents, computer software and industrial know-how.

These capital allowances work by comparing allowable expenditure on the qualifying assets, including the balance of expenditure brought forward from previous years, with receipts from sales of similar assets (which are brought into account up to the amount of the expenditure originally incurred). An allowance is then given equal to 25 percent of the excess (if any) of that expenditure over those receipts. In the case of a person carrying on a trade or profession, the allowance is treated as a deduction in calculating the profits of that trade or profession. Otherwise, it is set against income derived from the relevant assets.

The distinction between income and capital is not only relevant, however, in the context of relief for sums spent. To constitute taxable income, receipts must generally fall within the concept of "annual profits or gains". That does not mean profits or gains which recur year after year; it means profits or gains of such a nature that they might recur, or that they are like things that do recur.

Some receipts might, on the other hand, be so much like a capital sum that they could not reasonably be classified as annual profits or gains, such as receipts derived from an outright disposal of intellectual property. In that event, a capital gain might arise, taxable under the quite different rules contained in the Taxation of Chargeable Gains Act. In calculating the amount of any such gain that is taxable, any capital expenditure on acquisition can be deducted (whereas expenditure of such a nature as to be relievable under the rules relating to the taxation of income cannot be deducted). Certain types of incidental expenditure, including the incidental costs of purchase and disposal (but not the costs of bringing something into existence) can also be deducted; and so can the indexation allowance, which, briefly, indexes the acquisition cost of an asset by reference to movements in the UK's Retail Prices Index (although the indexation allowance can be used only to eliminate a gain – not to create a loss).

In applying the Taxation of Chargeable Gains Act where capital allowances have been given for capital expenditure on an asset – such as on the acquisition of intellectual property rights – then only the excess of receipts over the original expenditure can generally give rise to a chargeable gain. Insofar as the receipts do not exceed the original expenditure they are taken into account in diminishing the capital allowances pool, as explained above.

Also as already mentioned, income tax imposed under Schedule D can extend to people who are not resident in the United Kingdom, if the income concerned is derived from UK property. Obviously, the easiest way to enforce that liability is by imposing withholding tax. Here again, the subdivision of Schedule D into cases becomes relevant. The general rule is that withholding tax is imposed only on payments of yearly interest and "annual payments" taxable under Case III. In the absence of special rules, withholding tax is not imposed on income taxable under other cases (such as the profits of a trade or profession).

There are, in fact, special rules which also impose withholding tax on patent royalties and on payments to non-resident owners of UK copyrights and design rights, whichever Case those payments fall into. On the other hand, all of these withholding tax rules – on annual payments in respect of the use of any intellectual property rights in the United Kingdom, on patent royalties, and on payments for copyright and design right – are subject to the UK's various treaties. Most of those treaties, including, for example, the treaty with the United States, follow the OECD model in giving taxing rights to the state in which the recipient of the payment is resident.

Accordingly, if any UK tax were deducted from a payment made to a resident of such another state (such as the United States), the recipient could reclaim that tax from the UK Inland Revenue. Alternatively, under the Double Taxation Relief (Taxes on Income) (General) Regulations, any such recipient of such payments can ask the Inland Revenue to direct the UK payer to make payment without deducting UK income tax.

II. VALUE ADDED TAX

Value added tax applies not only to supplies of goods, but also to supplies of services, i.e. anything that is not a supply of goods but is done for consideration by a person in the course of his business. Generally speaking, the tax applies in each of the Member States of the European Union ("EU") if the supply takes place within the territory of that Member State. Accordingly, it might be thought that if a supplier in, say, the United States makes a supply of intellectual property rights to a person in the EU, there would be no VAT on that supply.

That, however, would be incorrect. There are a number of supplies which, when received by a person within the EU for the purposes of a business, are treated as having been supplied in the Member State in which the recipient belongs. (Conversely, where those sorts of supplies are supplied to a person outside the EU, then they are treated as having been supplied there, so that there will be no VAT on the supply.) That will not necessarily be a problem, as the VAT charged can often be recovered by the recipient of the supply, but as the supplies include the following, these rules are of particular importance in intellectual property transactions:

- transfers and assignments of copyright, patents, licences, trade-marks and similar rights (including the grant of licences);
- services of consultants, engineers, consultancy bureaux, lawyers, accountants and other similar services, as well as data processing and the supply of information;
- obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred to above;
- the supply of staff.

III. STAMP DUTY

Stamp duty is a tax on instruments, but it is not by any means imposed on every written document. The main duty, and really the only one that concerns intellectual property transactions, is the duty that is imposed on a conveyance or transfer on sale of property. The duty is imposed at the rate of 1 percent.

Know-how (and show-how) are not "property" for this purpose, but the other types of intellectual property mentioned above are. It follows that a conveyance or transfer of any such intellectual property *on sale* could give rise to stamp duty. The words "on sale" indicate that, for a stamp duty liability to arise, the consideration must take the form of the payment of money or transferable securities. But the concept of a conveyance or transfer is fairly wide; for example, an irrevocable and exclusive licence to use intellectual property, granted in consideration of a payment of money or of transferable securities, would give rise to a stamp duty liability. In fact, even a written contract to transfer such intellectual property for that sort of consideration could give rise to a stamp duty liability.

Stamp duty is only payable, however, if the instrument is executed within the United Kingdom, or if it relates either to UK property (such as intellectual property rights exercisable in the United Kingdom) or to anything which has to be done in the United Kingdom. Furthermore, even if those territorial limits do apply, there are various ways of avoiding the stamp duty.

First, there is a relief for intra-group transactions. If one of the companies involved in a transaction owns 90 percent of the nominal share capital of the other company, or if 90 percent of the nominal share capital of each of them is owned by a third company, no stamp duty is payable. For this purpose it is the *nominal* share capital that counts. The shares concerned can be worthless, and companies often create fairly worthless shares in order to construct the necessary relationship to avoid stamp duty. Although if it is part of the plan that the necessary percentage of the nominal share capital of the transferee be held only temporarily, an anti-avoidance section will deny the relief.

Secondly, an intellectual property licence will give rise to a stamp duty liability only if it is both exclusive and irrevocable. A licence that is recoverable on the occurrence of an event that is not entirely unlikely will not be stampable; neither will a licence that is not exclusive, if that is acceptable to the purchaser.

Thirdly, even if the intellectual property rights concerned are exercisable in the United Kingdom, and even if an exclusive and irrevocable licence is required in circumstances in which the relief for intra-group transactions cannot apply, payment of the stamp duty can be deferred, perhaps indefinitely, simply by executing the document outside the United Kingdom, and keeping it there. The stamp duty would not then be payable unless and until the document was brought into the United Kingdom. The only effective penalty for not stamping it is that it cannot be produced in a UK court if anyone objects to it being produced, and it cannot be registered in the United Kingdom. It follows that, apart from those circumstances in which registration of a licence is thought to be necessary, a document can be executed and kept outside the United Kingdom in the hope that it will never be necessary to bring it into the United Kingdom for the purposes of litigation.

IV. PATENTS

In addition to the general rules of UK taxation outlined above, there are also some special rules relating to the taxation of receipts derived from various sorts of intellectual property, such as patents. Although the general rule is that only annual profits or gains are subjected to taxation as income, the Income and Corporation Taxes Act 1988 directs that a capital sum received on the sale of patent rights is also to be taxed as income if the seller is resident in the United Kingdom or if the patent is a UK patent. The tax is imposed on the excess of the capital sum received over any capital sum paid on any purchase of the relevant patent rights.

In the case of a UK resident, the sum is spread over a six-year period starting on the date on which it is received, so that tax is imposed for the year in which the sum is received and for the next five years, although the recipient has the right to elect to pay tax on the whole of the sum in the year in which it is received. For a non-resident, the rules are the converse. The whole of the sum is taxed for the year in which it is received, unless the non-resident elects to spread it forward over a six-year period.

It is also provided that a capital sum paid to a non-resident in respect of patent rights is subject to withholding tax, this being one of the exceptions to the general rule that withholding tax is imposed only on "annual payments". Withholding tax is also imposed on royalties paid for the use of a patent within the United Kingdom. In each case, however, that is subject to any applicable treaties, which, generally speaking, will give taxing rights exclusively to the State in which the recipient is resident.

There is also a special relieving provision relating to income (as opposed to a capital sum) received as a royalty in respect of the use of a patent for a period of two or more years, under which the sum so received can be spread back over a period equal to the period for which the use is permitted (but not exceeding six years).

V. INDUSTRIAL KNOW-HOW

There are a number of special rules relating to industrial know-how, which, for this purpose, means

> any industrial information and techniques likely to assist in the manufacture or processing of goods or materials, or in the working of a mine, oil-well or other source of mineral deposits (including the searching for, discovery or testing of deposits or the winning of access thereto), or in the carrying out of any agricultural, forestry or fishing operations.

The application of these rules depends upon whether or not the seller of the know-how is carrying on a trade, and, if the seller is carrying on a trade, on whether or not the seller has claimed capital allowances on any expenditure incurred in acquiring the know-how.

Although the general rule is that receipts on sales are brought into account for the purposes of capital allowances only up to the amount originally spent on the acquisition of the relevant asset, the rules relating to the taxation of receipts from the sale of industrial know-how include an exception to this. If capital allowances have been claimed on the costs of acquisition of industrial know-how, and it is then sold, all of the sale proceeds must be brought into account in the relevant capital allowances pool, even if the proceeds of sale exceed the cost. That might mean that the proceeds of disposal exceed the balance brought forward plus the expenditure incurred in the year in which the disposal is made. In that event the excess is taxed as income (through a mechanism known as a "balancing charge").

Capital allowances can be claimed only where expenditure has been incurred on the acquisition of industrial know-how. It is probably more likely that a trader who has industrial know-how has developed that know-how, in which case the trader will not have claimed capital allowances on any costs of acquisition. The tax treatment of any capital sum received on a sale of that know-how will then depend upon whether the seller continues to carry on the same trade or not.

If the trade continues, the sum received on the sale of the know-how is simply taxed as a receipt of the trade. If the trade is discontinued, however, that sum is treated as if it were a capital payment made on a sale of goodwill. The effect of that is that the seller is liable to tax on the capital sum received as if it were a chargeable gain, taxable in accordance with the rules in the Taxation of Chargeable Gains Act, and the purchaser gets no relief for the cost of acquiring the know-how (although if the purchaser subsequently sells it, the cost of acquiring the know-how would be deductible from any capital sum received on the sale in calculating the chargeable gain arising on that sale). However, both parties can elect for a different treatment, in which case the seller will be taxed on the sum as if it were income, and the purchaser is then able to claim capital allowances on the amount paid for the know-how.

It is also possible that the seller of industrial know-how might not be a trader at all. The amount received on a sale of the know-how, less any amount paid by the seller on acquiring the know-how, is then taxed as if it were income (and the purchaser can claim capital allowances on that amount), unless the seller and the purchaser are under common control. In that case, both parties are treated as if the amount paid for the know-how was a capital sum paid for the acquisition of goodwill (in which case, as already indicated, the seller will be taxed on the receipt in accordance with the rules contained in the Taxation of Chargeable Gains Act, and the purchaser will be denied capital allowances in respect of the price paid for the know-how).

VI. SPECIAL RELIEFS FOR EXPENSES

There are a number of special rules giving relief for expenses incurred in the intellectual property field. For example, there is an express statutory rule giving a trader tax relief for fees paid or expenses incurred in getting a patent granted or extended, or registering a design or trade-mark, or extending or renewing such a registration. In fact, relief is even given for fees paid or expenses incurred in connection with a rejected or abandoned application for a patent.

Capital allowances are given in respect of capital sums paid for the use of a patent, and, unusually, this is the case whether the payer is carrying on a trade (for the purposes of which the patent rights are acquired) or not. If the payer is not carrying on any such trade, the allowance is given initially against income derived from the patent, although if the amount of the allowance exceeds the income, it can be set off against other income of the same year, or it can be carried forward to be set off against future patent income.

Similarly, capital allowances can be claimed in respect of fees and expenses incurred in getting or maintaining or extending a patent (or in connection with an application for a patent which is rejected or abandoned) where the payer is not trading. An *individual* who incurs expenses in devising an invention in respect of which a patent is granted, but otherwise than for the purposes of a trade carried on by that individual, can also claim capital allowances.

It might also be worth adding that a trader who makes a payment of royalties for the use of a patent can claim tax relief for the payment of those royalties. Although that is what one might expect, the method of giving relief is rather unusual. There is in fact a rule that says that a trader cannot deduct money paid in respect of the use of a patent in computing trading profits, but the royalty is treated as a "charge" against the trader's taxable income, which, generally speaking, produces the same end result.

VII. COMPUTER SOFTWARE

Although computer software is protected by copyright, so that the rules applicable to copyright will also be applicable to computer software, there are some special rules relating exclusively to computer software. The Inland Revenue published its view of the correct tax treatment of expenditure incurred by a trader on computer software in November 1993.

If the computer software has a useful life of less than two years, any expenses incurred by a trader in developing or acquiring it will be deductible in computing the trader's taxable profits. Any regular payments which are like rent, paid by a trader for the use of computer software, will also be deductible.

In all other cases, however, money spent on developing or acquiring computer software which has a useful life of more than two years is regarded by the Inland Revenue as capital expenditure. That means that the trader must claim capital allowances for that expenditure, for which purpose the computer software is treated as if it were machinery or plant.

Capital allowances are not available for expenditure on other forms of copyright. If, however, the price of acquisition of machinery or plant includes a sum paid in respect of the use of copyright, capital allowances will be available for the total price paid (including the element paid in respect of the copyright). For example, allowances were held to be available in *McVeigh v. Arthur Sanderson & Sons Limited* for expenditure on designs which were incorporated on printing blocks.

It is probably also worth noting that, as computer software is generally a sort of copyright, a payment to a non-resident for the right to use computer software in the United Kingdom will be subject to UK withholding tax (subject to any applicable treaty relief). Finally, and for the sake of completeness, it might also be added that where the usual place of abode of the owner of a right in a design is not within the United Kingdom, any royalties paid to the owner in respect of the use of that right within the United Kingdom will also be subject to withholding tax (subject, again, to any applicable treaty relief).

EUROPE–UNITED STATES

EURO–AMERICAN JOINT VENTURES: A NEW LEGAL VEHICLE, THE FRENCH SOCIÉTÉ PAR ACTIONS SIMPLIFÉE

Giles Entraygues

Cleary, Gottlieb, Steen & Hamilton

I. INTRODUCTION

French Law No. 94-1 of 3 January 1994 (the "Law") introduced a new form of limited liability company, the *société par actions simplifiée*, or simplified share company ("SAS").

The purpose of the Law is to facilitate cooperation between companies. The rigidity of the Law of 24 July 1966 on commercial companies (the "Company Law"), and in particular the provisions governing *sociétés anonymes* ("SA"), which set forth the rules applicable to the management and control of companies, came to be regarded as an impediment to the establishment of joint ventures in France, thus justifying the introduction of a more flexible form of company. In addition, given the substantially simplified corporate governance rules applicable to the SAS, this form of company may also be an attractive alternative to the widely used SA where it is contemplated that the company will be wholly owned by a foreign group of companies.

The SAS is characterized by the following two features:
- extensive flexibility granted to shareholders in determining, in the company by-laws, the rules for management and control of the company, as compared to other forms of limited liability companies; and
- the freedom for shareholders in an SAS to impose restrictions on the free transferability of shares and to require shareholders to sell their shares in certain circumstances.

II. CREATION OF AN SAS

A. Shareholders

An SAS must have at least two shareholders. Only companies and certain public entities engaged in commercial or industrial activities ("EPICs") may become shareholders of an SAS. Individuals and legal entities other than companies (such as GIE and associations) may not hold an interest in an SAS.

Each shareholder (except an EPIC) is required to maintain throughout the life of the SAS a minimum fully paid-in stated capital of FRF 1,500,000 or its equivalent in foreign currency.[1] A shareholder whose stated capital falls below this threshold must increase its capital or sell its interest in the SAS within six months. Failure to do so will result in a compulsory winding-up of the SAS or its conversion into another form of company.

B. Stated capital

Pursuant to Article 71 of the Company Law that governs share companies generally, the minimum stated capital of an SAS is FRF 250,000. The capital of an SAS must be fully paid-in upon subscription, and an SAS may not publicly offer its securities.

C. Conversion into an SAS

A company can be converted into an SAS if all of its shareholders meet the requirements described above, and the resolution to convert the company into an SAS is passed by a unanimous vote of shareholders.

III. OPERATING RULES

A. Management

An SAS must appoint a President. The by-laws set forth the rules applicable to the appointment and dismissal of the President.

The President represents the company *vis-à-vis* third parties and has extensive authority to bind the company to contracts entered into with third parties, notwithstanding any provisions to the contrary in the by-laws. The President's acts may bind the company even with respect to actions or measures not within the purpose for which the company was incorporated if the third parties are not aware that the actions or measures are outside the scope of the company's purpose. As between the shareholders and the President, the shareholders retain complete freedom to establish limits on the President's powers.

The shareholders also have broad discretion in framing the rules governing other management bodies of the company, if any.[2] For instance, shareholders are free to decide that the company will be managed by a governing council or by a single person, to set the rules relating to the appointment and dismissal of managers and to allocate voting rights in the governing council. They are also free to divide decision making powers between management and shareholders, provided that certain decisions of major importance may only be made by shareholders (see below).

The President and managers of the SAS may be individuals or corporations. In the latter case, corporations need not appoint a specific individual as their representative.

The Company Law provisions governing civil and criminal liability of managers and directors of an SA also apply to the President and managers of an SAS (subject to necessary adaptation). Where the President or a manager is a legal entity, they are subject to civil and criminal liability in their own name in fulfilling the functions of President or manager of an SAS.

Contracts or other agreements between an SAS and its President or managers must be reported upon by the statutory auditors of the company and approved by shareholders. If individuals, the President or managers are prohibited from borrowing money from the company or causing the company to secure loans made to them.

B. Shareholders

The Law grants broad discretion to shareholders to set forth in the by-laws provisions for granting shareholders the right to have access to information on the company and internal decision-making rules.

The by-laws set forth the procedure whereby decisions are taken by shareholders, which may be other than in a general meeting (e.g. by written consent). The by-laws may also specify special majorities and quorums necessary to adopt resolutions.[3] Voting rights may be freely divided between shareholders, regardless of the amount of their contribution to capital. Additionally, veto rights on certain types of decisions may be granted to specific shareholders.

The by-laws may freely determine the decisions that are reserved to shareholders. The Law provides, however, that at a minimum decisions relating to the following matters may only be taken by the shareholders of an SAS: increases or reductions in capital, mergers and spin-offs, winding-up, appointment of statutory auditors, approval of annual financial statements and allocation of profits.

1. Foreign companies can therefore become shareholders of an SAS.
2. In practice, the fact that (pursuant to an amendment) the final text of the Law grants extensive power to bind the company in respect of contracts with third parties only to the President (and not to other managers) limits the freedom of the shareholders in defining the role of other management bodies. In contrast, the general manager of an SA has the same extensive authority *vis-à-vis* third parties as the Chairman.
3. A unanimous vote is required, however, for the adoption of the provisions discussed below, or the modification of such provisions.

IV. RELATIONSHIP BETWEEN SHAREHOLDERS

The Law states that the by-laws may include provisions that have traditionally been set forth in separate shareholders' agreements. In particular, the following provisions are expressly authorized by the Law:

- prohibiting transfers of shares for a period not exceeding ten years;
- subjecting transfers of shares to prior approval of the company (including transfers among existing shareholders);
- forcing a shareholder to sell his shares according to specific conditions. Until the sale has taken place, the shareholder's voting rights may be suspended; and
- requiring a shareholder to notify the SAS of any change in ownership; the SAS may then decide to suspend the voting rights of such shareholder and to "repurchase his shares".[4]

Any transfer of shares in violation of one of these provisions is null and void.

For purposes of the laws and regulations governing transactions in listed securities, the Law creates a rebuttable presumption that a shareholder of an SAS is acting in concert with other shareholders of the SAS. As a result, and unless this presumption is rebutted, regardless of the size of its shareholding in the SAS and the rights granted to it by the by-laws, a shareholder of an SAS will have to comply with certain provisions of the Company Law and Stock Exchange regulations governing transactions in listed securities concerning the companies controlled by the SAS. Such provisions, in particular, relate to notification of increases or decreases in shareholdings and to takeovers of companies by means of the acquisition of a controlling interest or a tender offer.

V. OPEN QUESTIONS OF CORPORATE LAW

According to the Law, Company Law provisions governing SAs (except provisions relating to management and control) apply to SASs to the extent they do not conflict with the Law. This creates some uncertainty as to exactly which provisions of the Company Law will be deemed applicable to SASs. For instance, if an SAS includes a provision in its by-laws requiring prior approval of the company for any transfers of shares, it is difficult to determine, absent any contrary provision of the Law, whether Article 275 paragraph 2 of the Company Law – which requires managers of an SA to cause the repurchase of the shares of the selling shareholder by another shareholder, a third party or the company itself – will apply.

Additionally, the rules of the Civil Code governing companies in general must be regarded as applicable to SASs absent contrary provisions in the Law, and these rules may limit the freedom of the shareholders. For instance, a provision in the by-laws of an SAS that would insulate a shareholder from any risk of loss, or considerably limit such risk, would in all likelihood be held null and void by application of Article 1844-1 of the Civil Code which prohibits unfair provisions between members of a company.

VI. TAX ISSUES

Pursuant to Article 32 of Law No. 93-1352 of 30 December 1993, SASs are treated as SAs for tax purposes. Accordingly, all of the rules applicable to French SAs in domestic and international contexts should apply to SASs: corporate income tax, dividend taxation, registration duties, etc. It should be pointed out, however, that the EC Directives on the taxation of companies as they are presently drafted (in particular the Merger and the Parent-Subsidiary Directive) would not apply to SASs, since the Directives do not expressly include SASs in the list of French companies to which they apply. A proposed amendment to the Directives should extend their benefits to all French companies that pay corporate income taxes; in the interim, however, particular attention should be given to this point.

4. This clause could also apply if a corporate shareholder of an SAS is replaced by another entity following the merger, spin-off or winding-up of the former.

FRANCE

HOLDING COMPANIES

Olivier Delattre

Avocat à la Cour, Stibbe Simont Monahan Duhot, Paris.

I. FRENCH TAX TREATMENT

A. Available French structures for holding companies

All French entities subject to corporation tax, either by law or by election, can be used as a holding entity.

The French Parliament recently enacted a law that introduces a new type of company, the *société par actions simplifiée* ("SAS"). It purports to bring some needed flexibility to French corporate law, and hence to induce multinational groups to establish their holdings (or joint venture operations) in France rather than in traditionally more flexible EU countries. The main characteristic of the SAS is the contractual freedom that the parties have to tailor the by-laws to meet their needs.

From a legal point of view, an SAS can be constituted with a capital of as low as FRF 250,000 and with only two shareholders, which must be French or foreign corporations with a paid-in capital of at least FRF 1.5 million. The shareholders have limited liability. They may freely determine the conditions for meetings and voting rights. A more significant departure from general principles is the fact that the by-laws may suspend a shareholder's right to sell his stock for a period not exceeding ten years; all transfers of stock may be subject to the prior agreement of the company; a shareholder's right to vote may be suspended in the event of a change of ownership affecting that shareholder; and shareholders may be excluded under certain circumstances.

For French tax purposes, this new entity will be treated as a corporation subject to corporation tax. The Technical Correction Law for 1993 expressly provides that an SAS will be treated as a *société anonyme* ("SA") for purposes of applying the provisions of the French Tax Code ("CGI"). The zero percent withholding tax pursuant to the EC directive (see below), however, will apply to distributions by an SAS but, for the time being, not to distributions from other EU subsidiaries to the SAS since the actual language of the list of entities that fall within the scope of this exemption does not permit an implied inclusion of the SAS.

B. Taxation principles

1. Corporate tax rate

Since 1 January 1993, a single rate ($33^1/_3$ percent) of corporation tax is levied on ordinary income. Long-term capital gains, however, benefit from a reduced rate as discussed below.

2. Taxation of domestic and foreign-source dividends received by a French holding company

Dividends from any source received by a French corporation are taxable in France at the standard corporation tax rate but with the following adjustments.

Under CGI Section 145 of the French tax code ("CGI"), a French parent company may be exempt from corporation tax on dividends received from a qualifying French or foreign subsidiary. This tax regime, which is optional, is available upon satisfaction of the following requirements:

- the parent corporation is subject to corporation tax at the standard rate;
- the shares of the subsidiary are in registered form or are deposited with one of the financial establishments listed by the tax authorities;
- the parent corporation owns, on the date of payment of the dividend, at least 10 percent of the voting stock of the subsidiary or has acquired the participation for at least FRF 150 million; and
- the parent corporation commits to keep the shares for at least two years unless the shares were acquired upon issuance.

If the parent-subsidiary regime of Section 145 is not available, the French parent corporation may obtain the same result through the *avoir fiscal* (a tax credit in the amount of 50 percent of the dividend received), although only with respect to its French-source dividends. The combination of the avoir fiscal and the $33^1/_3$ percent corporation tax rate results in a total neutralization of the corporation tax that is due upon receipt of the French dividends.

3. Deductibility of interest expenses

Interest paid on a debt owed to third parties is deductible on an accrued basis, provided the loan was incurred in the interest of the borrowing corporation and is accounted for in its balance sheet.

However, when the lenders are the shareholders, some limitations apply under CGI Sections 39-1-3° and 212, as follows:

- the share capital must be fully paid up;

- interest is deductible only up to the average annual rate of private bond issues in France; and
- if the lender is *de iure* or de facto managing the company or holds more than 50 percent of the stock, in terms of financial rights or voting stock of the borrowing corporation, interest relating to that part of the shareholder loan exceeding 1.5 times the share capital of the corporation is not deductible. Non-deductible interest is considered a deemed dividend subject to dividend withholding tax when paid to a foreign beneficiary.

This last limitation does not apply to interest paid by a subsidiary to its French parent corporation, but only to interest paid to a foreign parent corporation. Since there are some questions regarding the compatibility of this rule with the non-discrimination article in tax treaties, recent treaties signed by France (e.g. the new France–US income tax treaty) contain a provision specifically permitting application of this limitation.

There are some interesting opportunities for interest deductions when the acquisition of a subsidiary is debt financed. A French parent company that acquires a foreign subsidiary through indebtedness may deduct the interest on such loan from its income even though it also benefits from the parent-subsidiary regime of dividend exemption. Additionally, if the French parent company is controlling other French subsidiaries and these corporations are part of the same tax consolidated group, interest on loans incurred to acquire a French or foreign target from a non-member will be deductible from the group's taxable profits. On the other hand, debt financing should not be used when acquiring the stock of a corporation that will become a member of the consolidated group from (i) individuals or corporations that directly or indirectly control the purchasing corporation; or (ii) from corporations directly or indirectly controlled by the shareholders in (i). In such a case CGI Section 223 B provides that part of the financial expenses incurred by the group must be added back to the overall income of the group by fractions over a 15-year period.

4. Capital gains and losses on disposal of shares of operating companies

The transfer of the stock of a subsidiary does not give rise to any specific exemption from tax of the resulting capital gains (unless the transfer is part of a qualifying exempt reorganization in France or within the EU). However, as a general rule, long-term capital gains, i.e. capital gains realized by corporations on assets such as stock[1] held for at least two years prior to disposition benefit from a reduced rate of taxation: 18 percent (increased to 19 percent under the draft finance law for 1995), provided the balance of the gain is set aside in a special reserve. Amounts subsequently distributed from the special reserve are subject to an additional tax to raise the level of effective taxation up to the standard corporation tax rate. Capital gains that do not meet one of these criteria, i.e. short-term capital gains, are taxed at the standard corporation tax rate.

Long-term capital losses are deductible from other long-term capital gains realized over the next ten years or from the special reserve. Short-term capital gains are deductible from ordinary income of the current taxable year, and if such income is not sufficient it can be carried forward over the next five years or carried back over the three preceding years.[2]

5. Liquidation of the holding company

With respect to the liquidated corporation, distributions out of the special reserve for capital gains mentioned above do not give rise to additional taxation that would normally be due, and long-term capital gains that may be realized in the course of the liquidation do not have to be set aside in the special reserve. However, the effective distribution of long-term capital gains realized in the course of the liquidation will normally entail the imposition of *précompte*, normally refundable under the France–US tax treaty when the distribution is made to a resident of the United States not entitled to the avoir fiscal.[3]

For shareholders of the liquidated corporation, the liquidation of the French holding corporation is a taxable event to the extent of the difference between the amount distributed in liquidation and the amount contributed by the shareholder (*boni de liquidation*).

The boni de liquidation is considered a dividend distribution by the tax administration that may give rise to the imposition of the précompte at the level of the distributing corporation. When received by a non-resident of France it is subject to French withholding tax with the eventual benefit of the avoir fiscal under the applicable tax treaty.[4] For a corporate shareholder, a liquidation can also give rise to a capital gain or a capital loss in the amount of, respectively, the excess of the accounting value of the liquidated shares over the amount contributed or the excess of the accounting value of these shares over the amount received in liquidation. In such a case, the non-resident of France would in principle be taxable in the state of its residence under the applicable tax treaty.

6. Anti-deferral regimes relating to controlled foreign companies

The French equivalent to the US controlled foreign corporation rules is found in CGI Section 209 B, which was the focus of important changes in 1993, culminating in new Section 209 B-I bis.

1. Gains from portfolio investments are excluded from the long-term capital gains regime, and are therefore subject to the standard corporation tax rate.
2. Acquisition of a new subsidiary could generally be structured in a way to avoid capital gains taxation.
3. The précompte is an equalization tax in the amount of 50% of the dividend distributed.
4. Treating the boni de liquiditation as a dividend rather than a capital gain is not entirely free from difficulty. A decision of the "Conseil d'Etat" on the treatment of redemption may provide some grounds to challenge the dividend treatment (CE 7/8/92, no. 88734).

For structures established as of 30 September 1992, a French corporation subject to corporation tax will fall within the scope of new Section 209 B-I bis if:
- it has a foreign establishment or holds directly or indirectly at least 10 percent of the stock, shares, financial rights or voting rights of a corporation or association established outside France, or holds a participation in such a corporation or association valued at least at FRF 150 million; and
- such foreign permanent establishment, corporation or association is subject to a privileged tax regime.[5]

If the ownership and privileged regime requirements are met, the French corporation is taxed in France on the profits of the foreign structure, which must be determined separately from its other profits and according to French tax rules. To avoid this immediate taxation, the French corporation must demonstrate that the foreign structure is primarily engaged in an effective industrial or commercial activity and that this activity is exercised primarily in the local market.

II. FOREIGN SHAREHOLDER IN A FRENCH HOLDING COMPANY

A. Withholding tax on dividends paid to the United States

The 25 percent rate of withholding tax that is normally levied on French-source dividends paid to non-residents of France is reduced, under Article 9 of the France–US tax treaty to 5 percent when the recipient is a US corporation that holds at least 10 percent of the voting stock of the French distributing corporation; or to 15 percent in all other cases (i.e. individuals and less-than-10 percent corporate shareholders).

In addition to the reduced rates of withholding tax, Article 9 of the France–US tax treaty grants either payment of the avoir fiscal from the French Treasury or reimbursement of the précompte less the French withholding tax to a resident of the United States who is not entitled to the avoir fiscal (because it is a corporation which holds at least 10 percent of the French distributing corporation). The avoir fiscal is designed to alleviate the fact that taxation is imposed at the level of the distributing corporation and at the level of the shareholder. When corporation tax has been imposed on profits which are distributed as dividends, there is no other imposition and the avoir fiscal will be available to the shareholder, resident of France, and possibly to a non-resident of France if the provisions of the applicable tax treaty so provide. If corporation tax has not been levied on the distributed profits (e.g. the parent-subsidiary regime of dividend exemption applies), the avoir fiscal will still be available under the above conditions but the précompte will then be due by the distributing corporation.[6]

The impact of the précompte, which even when refunded, is a cash flow burden, can be lessened by two mechanisms:
- an exemption from the précompte is available when the French parent corporation qualifies for the regime of foreign participation regime. If certain requirements are fulfilled,[7] the dividends received by the French holding company from its foreign subsidiaries are not subject to the précompte on redistribution, and any foreign tax credit attached to the dividend redistributed is passed through to the shareholders of the French holding. Correspondingly, the shareholders are not entitled to the avoir fiscal or any refund under the applicable tax treaty; and
- under CGI Section 146, the French distributing corporation is entitled to deduct from the précompte any tax credits for foreign withholding taxes levied by tax treaty countries on the distributed dividends.

Finally, an interesting possibility regarding dividend redistribution resides in the fact that when the French company redistributes foreign-source dividends to a non-resident of France, the foreign withholding tax that had been imposed on these dividends can be used as a tax credit to offset the French withholding tax imposed upon redistribution. This tax credit can only be used with respect to the same dividends to which it is attached.

B. Effect of consolidation system on distribution of foreign profits to the United States

The French consolidation tax regime does not entail specific tax consequences for foreign-source dividends.

1. Receipt of foreign-source dividends by a French consolidated corporation

As a general rule, earnings that have been included in the overall profits of the consolidated group are exempt from the précompte when they are distributed within the consolidated group, and therefore do not give rise to the avoir fiscal. This exemption also applies to distributions out of earnings realized outside France.

2. Distribution of dividends to a resident of the United States

Upon redistribution by the parent corporation, dividends paid out of the net (after corporation tax at the standard rate) overall profits of the affiliated group will be subject to the 5 percent withholding tax (15 percent for individual residents of the United States but with the benefit of the avoir fiscal) but will not be subject to the précompte. The précompte will be

5. For practical purposes, the French tax administration presumes that a tax regime is privileged when the rate of tax levied in the foreign country is at least one-third less than the rate of tax that would be imposed in France.
6. See *supra* note 4.
7. Both on the day of distribution and at the end of the taxable year during which the distribution occurs, the distributing corporation must satisfy the following conditions:
- at least two-thirds of its assets must consist of interests in companies located outside France which are covered by the parent-subsidiary system of dividend exemption;
- at least two-thirds of its income (excluding capital gains) must come from the foreign subsidiaries; and
- its sole activity must be the administration of its interests.

due when the dividends are distributed out of untaxed profits. The parent corporation is then entitled to deduct from the gross amount of the précompte the aggregate of all avoir fiscal and tax credits normally attached to the dividends received by the group.

C. Treaty network with other European countries and Eastern European countries for dividends

1. Tax treaty network

France has an extensive tax treaty network (about 84 tax treaties), and in particular with European (EU or non-EU) countries. The tax treaty of 4 October 1984 with the then USSR is still in force as to Russia and the other Republics but not with respect to the Baltic Republics.

Tax treaties with Eastern European countries usually provide for an alternative reduced rate (except for Romania and ex-Czechoslovakia) of withholding tax on dividends, i.e. 5 percent and 15 percent, according to the shareholder and the refund of the précompte (except for the tax treaty with Russia) but not for the avoir fiscal.

2. EU benefits

In addition to the tax treaty benefits, the Parent-Subsidiary Directive has now been implemented by member states. As a result, instead of the reduced rate of withholding tax granted under the applicable tax treaty, a dividend distribution by a qualifying company located in one member state to a French holding is subject to a zero percent withholding tax. On the French side, the zero percent withholding tax rate on dividend distributions by the French holding to another EU company is available under the provisions of CGI Section 119 ter.

III. OTHER CONSIDERATIONS

The exchange control rules that, until few years ago, were restricting foreign investments by residents of France have been lifted. Thus, such investments can generally be made without any requirements of prior administrative authorization. The only formalities may take the form of an information return in cases of investments by foreign persons in France or by residents of France outside France and of liquidation of these investments.

FRANCE–UNITED STATES

NEW TAX TREATY

Olivier Delattre

Avocat à la Cour, Stibbe Simont Monahan Duhot, Paris.

I. MAJOR CHANGES

During the ratification process of the Fourth Protocol to the 1967 France–US tax treaty (signed on 16 June 1988), the US Senate asked the US tax administration to start negotiating a new protocol with its French counterpart to deal with the US tax treatment of RICs, REMICs and REITs. These negotiations culminated in a new treaty which was signed and released by both administrations on 31 August 1994.[1]

Most of the articles in the treaty have been modified. The most important changes are the introduction of a comprehensive limitation on benefits provision and modifications to the French tax treatment of French dividends paid to US pension funds and to US holders of individual retirement accounts ("IRAs"). This article describes some of the changes in the new treaty.

II. TAXES COVERED

Article 2 enumerates the income taxes covered by the treaty. As usual, US state and local income taxes are not covered. However, the draft of the first exchange of letters attached to the treaty provides that "enterprises of the United States that operate ships or aircraft in international traffic shall be automatically relieved from the *taxe professionnelle* in France, in respect of such operations provided that enterprises of France that operate ships or aircraft in international traffic are not subject to state income taxes in the United States in respect of such operations".

Excise taxes on insurance premiums paid to foreign insurers are covered to the extent that the risks covered by such premiums are not reimbursed by a person not entitled to the benefits of the treaty or any other treaty providing for an exemption.

III. RESIDENCE

In contrast to the old treaty, pension funds and not-for-profit organizations (under certain circumstances) are now specif-

1. It is interesting to note that only the English version was signed and released. Both administrations worked on the translation after 31 August 1994.

ically recognized as residents of a contracting state under Article 4.

French or US investment entities, such as RICs, REITs, REMICs, SICAVs and FCPs, even though subject to specific tax treatment, are also considered residents.

Income derived by a partnership or "similar pass-through entity", estates and trusts are deemed residents of a contracting state only to the extent the income derived by such entity is subject to tax as the income of a resident either in the hands of the partnership, trust or estate or in the hands of the members.

In addition, for purposes of US benefits under the treaty, a *société de personnes*, a *Groupement d'Intérêt Economique* or a *Groupement Européen d'Intérêt Economique* which are constituted and managed in France and which are not subject to French corporate tax (which is normally the case since these entities are pass-through entities) are treated as partnerships, and therefore will be deemed residents of France for treaty purposes.

The draft of the first exchange of letters attached to the treaty provides that if members of the above-mentioned entities are residents of a third state, the US income tax liability of the members will be determined under the US treaty (if any) with that third state.

Unfortunately, Article 4 does not provide a clear answer to the issue regarding French characterization of a US limited liability company, and the exchange of letters fails to mention that a resident of a third state who is a partner in a US partnership receiving French-source income will be able to claim treaty benefits. It is likely that these issues will be addressed in technical explanations to be issued by the French tax administration.

IV. REAL ESTATE

Nothing unusual is found in Article 6 dealing with real estate, i.e. income derived from real property is taxable in the state where the property is situated. In 1992 the French Supreme Tax Court held that a foreign corporation is not deemed to have a permanent establishment in France if it only owns residential real estate which is rented to a third party, and therefore, under some treaties, is not liable to tax in France on the rent. This decision will no longer be useful to US corporations since paragraph 4 covers this situation, i.e. income from real property also covers income derived by an enterprise.

V. BUSINESS PROFITS

Article 6 generally follows the 1992 OECD Model Treaty, except for the addition of paragraph 4 concerning partnerships which already appeared in the old treaty.

VI. SHIPPING AND AIR TRANSPORT

The new drafting of Article 8 does not change the tax rules of the old treaty.

VII. ASSOCIATED ENTERPRISES

Article 9 follows the 1992 OECD Model Treaty, except that a correlative adjustment will be made by one contracting state only if that state agrees with the reassessment made by the other state.

VIII. DIVIDENDS

The following table summarizes some of the changes:

A. Withholding taxes on dividends, and when applicable on *avoir fiscal*

	Old Treaty	*New Treaty*
1. Dividend received by:		
– corporation owning 10% or more of voting rights	5%	5%
– individual or corporation owning less than 10% of voting rights	15%	15%
– pension funds, IRA	25%	15%
2. Exceptions :		
– dividends paid by RIC and SICAV	5% or 15%	15%
– dividends paid by REIT:		
– received by individuals owning less than 10% of REIT	15%	15%
– received by corporations or individuals owning more than 10%	5% or 15%	30%

B. Entitlement to the avoir fiscal		
(normally equal to 50% of dividends)		
– US corporations owing 10% or more of the voting rights	No	No
– individuals or US corporations owning less than 10% of the voting rights	Yes	Yes
– RIC, 80% owned by US residents and owning less than 10% of the voting rights	Yes	Yes
– pension funds, IRA	No	30/85 of normal amount

The most important change in Article 10 is the right granted by France to US pension funds and to US individuals receiving dividends through an IRA to obtain certain tax benefits which considerably improve the net return.[2] It is important to note that under Article 33(3)(a), the provision relating to dividends paid to pension funds and IRAs will take effect for dividends paid on or after 1 January 1991. Once the treaty is ratified, interested taxpayers will have to claim a refund of the excess withholding taxes and the partial avoir fiscal.

Article 10(5)(a) includes in the term "dividends" income from arrangements, including debt obligations, that carry the right to participate in, or are determined with reference to, the profits of the issuer to the extent that such income is characterized as a dividend under the law of the state in which the income arises. This provision should only impact on participating loans to US borrowers since French law does not generally characterize income from such debt obligations as dividends, i.e. it is considered interest.

The benefits of Article 10 are also extended to persons who hold depository receipts evidencing ownership of shares in respect of which the dividends are paid.

Article 10(7) authorizes both states to levy their branch profit taxes at the rate of 5 percent on the net profits of a permanent establishment and on the portion of the profits attributable to a trade or a business conducted in one state through a partnership by a company that is a member of such partnership and a resident of the other contracting state.

To obtain the benefits of the treaty taxpayers must observe certain formalities. In June 1994 the French tax authorities issued regulations implementing new procedures for foreign taxpayers – in particular US tax residents – claiming a reduced rate of withholding tax and a refund of the avoir fiscal. Under the old procedure, US residents had to file, individually, three original copies of French Form 5052. The complexity of the procedure was such that US individual shareholders were in fact not receiving the benefit of the reduced rate of withholding tax and reimbursement of the avoir fiscal. The new procedure quite successfully resolves this problem by permitting a more centralized procedure to be followed by US financial institutions through which US taxpayers invest in French listed shares.

Article 10 also contains an anti-abuse provision which allows the French tax authorities to deny a refund of the avoir fiscal if the beneficial owner of the dividends cannot show (upon request) that the shareholding in respect of which the dividends are paid "does not have as its principal purpose or one of its principal purposes allowing another person to take advantage of the refund of the avoir fiscal".

IX. INTEREST

Article 11 contains a new provision, i.e. interest payments which are determined with reference to the debtor's profits may be subject to withholding tax at a rate not exceeding 15 percent. Until the French legislation which exempts interest from withholding tax is repealed, this provision will apply only to US-source interest.

X. ROYALTIES

Under Article 12, payments received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work; cinematographic film, sound or picture recording; or software are not subject to withholding tax in the source country. Under the old treaty, the zero percent rate was applicable only to copyright royalties and to gains derived from the sale of such copyrights. All other royalties, including gains derived from the alienation of property covered by the article are subject to a 5 percent withholding tax in the source country.

XI. CAPITAL GAINS

The terms "real property situated in a Contracting State" is given a very broad definition in Article 13.

XII. DIRECTORS' FEES

The old treaty did not contain a provision for directors' fees, i.e. taxation was determined under Article 22(1) which granted the right to tax to the country of residence of the beneficiary. Under new Article 16, however, directors' fees are taxable in the state of residence of the paying company to the extent that such remuneration is derived from services rendered in that state.

XIII. ARTISTS OR SPORTSMEN

No change was made to Article 17 with the exception of paragraph 3 which provides that entertainers or sportsmen will not be subject to tax in the state where the activity was carried out if the visit was principally supported by public funds of the other state.

XIV. PENSIONS

Without changing the tax rules, Article 19 replaces Articles 19 and 20 of the old treaty.

XV. PUBLIC REMUNERATION

Under Article 19 remuneration and pensions paid by a contracting state in respect of services rendered to such state (provided the services are not rendered in connection with a business carried on by a contracting state) are taxable only in that state unless the beneficiary is not a national of the state and the services have been performed in the other state.

2. Based on the French tax administration's interpretation of the old treaty, if a French gross dividend was 100, the net received was only 75. Now, out of 100, the net received will be 100 (100 – 15 + 15).

XVI. CAPITAL

Under Article 23, an individual resident of the United States will be subject to French wealth tax on French real estate on shares of French corporations in which he constructively owns rights giving him at least 25 percent of the corporate earnings, on movable property of a permanent establishment or a fixed based in France and on the capital of French enterprises that operate ships or aircraft in international represented by such ships or aircrafts and movable property pertaining to such operations. Some of these assets might be exempted from tax under French domestic law.

US nationals, not nationals of France, will continue to be exempt from French wealth tax on their assets located outside of France during the five-year period following the calendar year in which they become residents of France.

XVII. RELIEF FROM DOUBLE TAXATION

The mechanism under which the United States will grant US taxpayers a credit for taxes paid in France remains the same, i.e. a credit equal to the French tax paid is granted.

US citizens who are resident of France remain exempt from French income tax on US-source passive income (dividends, interest, royalties, capital gains, profits derived from transactions on public US options or future markets) paid by a qualifying US entity.

As is the case in all recent treaties signed by France, the relief from double taxation is now granted by a full imputation system. The tax credit which can be imputed by a resident of France is equal to the US tax (limited to the French tax attributable to such income) on dividends, interest, royalties, directors' fees and income derived by artists and sportsmen.

For all other income, the tax credit is equal to the amount of French tax attributable to such income.

XVIII. NON-DISCRIMINATION

Article 25(3)(b) provides that France can apply Article 212 of the French Tax Code to the extent that such application is consistent with the principles of the associated enterprises provision. Article 212 contains a 1.5 to 1 debt-to-equity ratio for interest paid to controlling shareholders and it denies an interest deduction for the part of the interest paid by a French corporation to a foreign corporation which owns more than 50 percent of its financial and voting rights. The non-deductible interest is recharacterized as a deemed dividend, and therefore is subject to dividend withholding tax.

XIX. MUTUAL AGREEMENT PROCEDURE

The procedure under Article 26 follows the OECD 1992 Model Treaty with certain additions, i.e. language is included to permit the French tax administration to negotiate and conclude advance pricing agreements.[3] The possibility of arbitration is also incorporated in the article, but the procedure has not yet been established.

XX. EXCHANGE OF INFORMATION

In addition to what was already included in the old treaty, four new provisions have been introduced into Article 27:
- information requested by one state may be obtained by the other state in the same manner and to the same extent as if its own taxation were involved;
- if specifically requested by the competent authorities of a contracting state, the other state must provide (if possible) information in the form of depositions of witnesses and authenticated copies of unedited original documents to the extent that such information can be obtained under the laws and practices of the other state;
- a contracting state may send its representative to the other state to interview taxpayers and look at and copy their books and records;[4] and
- all taxes imposed by the states will be considered taxes covered by the treaty for purposes of this article.

XXI. LIMITATION ON BENEFITS

Article 30 constitutes the most important change in the new treaty. Although not as extensive as the limitation on benefits provision in the US–Netherlands treaty, this provision is nevertheless quite far-reaching and complex. The limitation on benefits provision is designed to restrict treaty benefits to persons who meet certain tests.

A. Qualified persons

For purposes of the treaty the following are included within the meaning of "qualified person":
- resident individuals of both countries, and US citizens;
- the contracting states, including political subdivisions and local authorities;
- French or US pension trusts and other not-for-profit organizations if more than 50 percent of their members, beneficiaries or participants are qualified persons;
- French or US investment companies (e.g. RICs, REITs, REMICs, SICAVs and FCPs) if more than 50 percent of the shares, interests or rights in such companies are held by qualifying persons; and
- a French or US company satisfying the stock ownership test; and
- a French or US entity if 50 percent or more of the beneficial interest (or of the vote and value of the shares) in such entity is not owned by persons who are not qualified persons, and if such entity satisfies the base erosion test.

3. The French tax administration has always been of the opinion there was no legislative basis for it to enter into advance pricing agreements.
4. However, both the taxpayer and the other state must agree to such inquiries.

1. Stock ownership test

The stock ownership test can be met in several ways. First, a US or French company whose principal class of shares is listed on a recognized stock exchange in France or the United States, and which is "substantially and regularly traded" on one or more recognized stock exchanges will qualify. Alternatively, the stock ownership test can be met if more than 50 percent of the aggregate vote and value of the company's shares is owned directly or indirectly by any combination of listed French or US companies, a contracting state or companies of which more than 50 percent of the aggregate vote and value is owned by a contracting state.

Finally, the stock ownership test can be met if at least 30 percent of the aggregate vote and value of the company's shares is owned directly or indirectly by any combination of French or US listed companies, a contracting state or companies of which more than 50 percent of the aggregate vote and value is owned by a contracting state; and at least 70 percent of the aggregate vote and value of the company's shares is owned by any combination of:

- listed French or US companies or listed companies resident of one or more EU Member States;
- a contracting state or companies of which more than 50 percent of the aggregate vote and value is owned by a contracting state or by one of more EU Member States.

2. Base erosion test

The base erosion test is designed specifically to deny treaty benefits to conduit companies. Satisfaction of the following criteria will allow a company to benefit from the treaty:

- less than 50 percent of its gross income is used to make deductible payments to non-qualified persons; or
- less than 70 percent of its gross income is used to make deductible payments to non-qualified persons, and less than 30 percent of its gross income is used to make deductible payments to non-qualified persons or to persons who are not resident of an EU Member State.

Deductible payments in this context include interest or royalties but do not include an arm's length purchase price or rental of tangible property in the ordinary course of business or arm's length remuneration for services performed in the contracting state in which the payer is resident.

B. Partial treaty benefits

A French or US company which is not a qualified person may still be entitled to treaty benefits in respect of dividends, interest and royalties if:

- more than 30 percent of the aggregate vote and value of its share are owned by qualified persons resident in the same state as the company claiming the benefits;
- more than 70 percent of all shares are owned by qualified persons and persons resident in an EU Member State; and
- the company meets the deductible payments criteria in the base erosion test.

C. Active trade or business test

A resident of France or the United States who is not a qualified person will still be entitled to full treaty benefits with respect to income from the other state if:

- the resident is engaged in the active conduct of a trade or business in its state of residence;
- the income derived from the other state is connected or incidental to the trade or business in its state or residence; and
- the trade or business is substantial in relation to the activity in the state that generated the income.

Three ratios are used to determine whether the activity is substantial:

- $\dfrac{\text{Value of assets in the state of residence}}{\text{Value of assets in the other state}}$
- $\dfrac{\text{Gross income in the state of residence}}{\text{Gross income in the other state}}$
- $\dfrac{\text{Payroll expense for services in the state of residence}}{\text{Payroll expense for services in the other state}}$

The trade or business in the state of residence will be deemed substantial in relation to the activity of the other state if each ratio equals at least 7.5 percent and their average exceeds 10 percent.

D. Headquarters companies

A resident of a contracting state which does not qualify under stock ownership test, the base reduction test or the active trade or business test will be entitled to treaty benefits if it acts as a headquarters company for a multinational group. To be considered a "headquarters company" the following conditions must be met:

- the company must provide in the state of residence a substantial portion of the overall supervision and administration of the group, which may include, but cannot principally consist of, group financing;
- the group is comprised of companies resident in, and engaged in an active business in, at least five countries and the gross income from those countries meets certain ratio requirements;
- the company must not derive more than 25 percent of its gross income from the other state;
- the company has and in fact exercises independent discretionary authority to carry out its functions;
- the company is subject to the same income tax rules in its country of residence as persons engaged in the active conduct of a trade or business in that state; and
- the income derived in the other state is either derived in connection with, or is incidental to, the active business of the group.

E. Triangular cases

Provision is made to discourage the use of branch financing structures where a resident enterprise is not taxed on the profits realized by a permanent establishment situated in a third state (as is the case in France).

To qualify for treaty benefits, a certain threshold of taxation must be met. Under the triangular provision, dividends, interest and royalties derived by a resident of one of the contracting states from the other contracting state, where such income is attributable to a permanent establishment of the resident which is situated in a third state will only qualify for treaty benefits if the total taxes paid in the country of residence and the permanent establishment state are at least 60 percent of the tax that would have been levied in the state of residence. Failure to meet this threshold tax will result in the imposition of a 15 percent withholding tax on the dividend, interest and royalty income attributable to the permanent establishment.[5] However, the triangular provision will not apply if the income is derived in connection with or incidental to the active trade or business carried on by the permanent establishment in the third country.[6]

XXII. ENTRY INTO FORCE

The treaty will become effective when ratified by the US Senate and the French Parliament. The following provisions will enter into force as follows:

- for withholding taxes on dividends, interest and the US excise tax on insurance premiums paid to foreign insurers for amounts paid or credited on or after the first day of the second month following the date of entry into force;
- in respect of other taxes on income, for taxable periods beginning on or after 1 January of the year following the year in which the treaty enters into force;
- in respect of taxes not mentioned above for taxes on taxable events occurring on or after 1 January of the year following the year in which the treaty enters into force.

However, the provisions for dividends and pension funds, and royalties will take effect for dividends and royalties paid or credited on or after 1 January 1991.

5. All other income to which this provision applies will be subject to tax under the domestic law of the source country.
6. The active conduct of a trade or business does not include the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company.

Conference diary

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

FEBRUARY 1995

Course providing an international taxation overview for non-tax executives, Amsterdam, 10 February 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Death and Taxes in Europe, Planning for Cross-Border Estates, London, 13 and 14 February 1995 (English):

Vicki Goffin or Evie Kinane, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

Course on working with tax treaties, Amsterdam, 15-17 February 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Conference on VAT Planning in an enlarged European Union, Stockholm, 21 February 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MARCH 1995

Course on mergers & acquisitions, Amsterdam, 2-3 March 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Course on expatriate taxation, Amsterdam, 23-24 March 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Twelfth Munich Symposium on exemption under international tax law, Munich, 24 March 1995 (German):

Verein für Internationale Steuern und Finanzen, München e.V. c/o Lehrstuhl Prof. Dr. Klaus Vogel, Ludwigstr. 28/RG., D-80539 München, Tel.: 49-89-2180 2718, Fax: 49-89-89 333 566.

APRIL 1995

Course on international tax planning techniques, Amsterdam, 10-11 April 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MAY 1995

International Tax Executive Annual Update Conference, Amsterdam, 3 May 1995, (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Course on cross-border finance, Amsterdam, 8-9 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Course on new financial products, Amsterdam, 10 May 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

The 8th East-West Tax Conference, Warsaw, 15-16 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

INTERNATIONAL

LIMITATION ON BENEFITS: RECENTLY SIGNED US TREATIES COMPARED TO THE 1992 US–NETHERLANDS TREATY

Marco de Lignie

Marco de Lignie is an attorney in the New York office of Loyens & Volkmaars. From October 1994 to April 1995, Mr de Lignie is employed as a foreign associate in the tax department of Cravath, Swaine & Moore in New York.

I. BACKGROUND

This article highlights the features of the limitation on benefits provisions ("LOB") as included in recently signed US tax treaties with France, Sweden and Portugal, and the new amending Protocol to the US–Canada tax treaty.

The LOB generally denies treaty benefits to taxpayers residing in one of the contracting states for income from sources in the other state, unless the taxpayer satisfies one of the tests laid down in these provisions.

In view of the discussions and commotion caused by the LOB included in the 1992 US–Netherlands treaty, it might be interesting to explore the particular LOB in US treaties recently concluded with the above-mentioned OECD member countries. Such an examination is more interesting in view of the anticipated release of a new US model income tax treaty.

The LOB in the US–Netherlands tax treaty contains lengthy and detailed rules governing when a person residing in one of the contracting states may claim benefits under the treaty. The provisions are similar to those found in the 1989 US–Germany treaty. However, the LOB as included in the Dutch treaty contains additional provisions that, to a certain extent, allow certain EU resident shareholders and EU business activities to be considered in determining the qualification of Dutch companies for treaty benefits.[1] Moreover, it also contains a "headquarters company test" which is not present in any other treaty entered into by the United States before September 1994 (the new US–France treaty includes a LOB with such a test).

For discussion purposes, the LOB under the 1992 US–Netherlands treaty is used as a reference.

II. US–CANADA TREATY

A. Introduction

A third protocol amending the 1980 US–Canada tax treaty (as previously amended by a 1983 and a 1984 Protocol) was signed on 31 August 1994. Article 18 of the 1994 Protocol adds a new Article XXIXA to the treaty representing the LOB.

B. In general

1. One-way application

The LOB only applies one-way, i.e. for application of the treaty by the United States.

2. Various tests

A person who is a "qualified person" will be entitled to the benefits of the treaty, as is a person who meets the activity test or the derivative treaty benefits test.

C. Qualified person[2]

1. Direct stock exchange test

A company that has substantial and regular trading in its principal class of shares on a recognized stock exchange is a qualified person. The treaty does not contain a definition of the term "principal class of shares".[3]

The recognized stock exchanges are listed in Article XXIXA(5)(a), and currently include only US and Canadian stock exchanges. It is expected that other major stock exchanges will be added to this list as soon as the Protocol enters into force.[4]

In contrast with the direct stock exchange test under the Dutch treaty and the treaties discussed below, it is not necessary that the principal class of shares of the company be listed on a recognized stock exchange located in either the United States or Canada.

1. These provisions are similar to provisions in the LOB of the 1992 US–Mexico treaty which allow consideration of shareholders residing in countries which signed the North America Free Trade Agreement; see, for instance, Art. 17(1)(d)(iii) of US–Mexico treaty.
2. Apart from the persons meeting one of the tests described in this paragraph, the following persons are automatically entitled to the benefits of the treaty if they qualify as a resident: individuals, the Government of Canada (including its political subdivision, etc.), an estate and not-for-profit organizations and pension funds meeting certain requirements.
3. Unlike the US–Netherlands treaty; see Art. 26(8)(a).
4. See, for instance, the list of recognized stock exchanges under the new US–France treaty (Art. 30(6)(e)).

2. Indirect stock exchange test

A company that is directly or indirectly owned more than 50 percent (vote and value) by five or fewer companies meeting the direct stock exchange test can be considered a qualified person if each company in the chain of ownership is a qualified person, or a resident or citizen of the United States.

A noteworthy feature is the lack of an anti-conduit or base reduction test, unlike the indirect stock exchange test under the Dutch treaty.[5] The omission of an anti-conduit test under the indirect stock exchange test is not fully covered by the proposed US anti-conduit regulations (under these regulations a conduit entity may be disregarded even if it satisfies the requirements under a LOB of a treaty between the country of which it is a resident and the United States).[6] The scope of the anti-conduit test under the LOB in the Dutch treaty seems to be broader than the proposed anti-conduit regulations.[7]

3. Shareholder test

Companies not owned directly or indirectly more than 50 percent (vote and value) by persons other than qualified persons (or residents or citizens of the United States) are entitled to treaty relief. Apparently, the negative wording of this provision is meant to exclude a company from treaty protection if more than 50 percent of its shares are *directly* owned by qualified persons, but at the same time more than 50 percent of its shares are ultimately owned (i.e. directly and indirectly) by non-qualifying persons.[8] No negative wording is used in the shareholder test under the US–Netherlands treaty. However, only under certain (exceptional) situations may the use of a positive wording lead to qualification under the shareholder test, where the use of negative wording would result in disqualification.[9]

In addition, to qualify under the shareholder test, a base reduction test must be satisfied; the latter test is similar to the base reduction test in the Dutch treaty.[10]

D. Tests for persons who are not qualified persons

1. Activity test

This test is similar to the activity test included in the US–Netherlands treaty, although less elaborate because of the lack of a safe harbour rule (and the accompanying "ratio tests").[11]

A person that satisfies the requirements of the activity test is only entitled to treaty benefits as expressly provided for in Article XXIXA(3), i.e. income derived from the United States that is connected with or incidental to a US trade or business. The activity test under the US–Netherlands treaty has a more extensive impact: if the taxpayer meets the requirements of this test then he is entitled to all benefits under the treaty.[12]

2. Derivative treaty benefits test

This test deserves particular attention because it is unprecedented in US (LOB) treaty history. Roughly, it provides that a company that is a resident of Canada will be entitled to the lower treaty rates imposed on dividends, interest and royalties if more than 90 percent of the company (vote and value) is owned directly or indirectly by persons who:

- are resident of a country with which the United States has concluded a comprehensive tax treaty and are entitled to all of the benefits provided by the United States under that treaty; and

5. See Art. 26(1)(c)(ii)(B) and(iii)(C) of the US–Netherlands treaty.
6. On 11 October 1994, the IRS issued proposed Treasury regulations concerning conduit financing arrangements pursuant to a grant of authority under Sec. 7701(l) of the IRC. Sec. 7701(l) was enacted as part of the Revenue Reconciliation Act of 1993 and is an anti-abuse provision that permits the US Secretary to issue regulations that recharacterize "multiple-party financing transactions". Basically, the proposed regulations provide that the IRS may recharacterize a conduit financing arrangement by treating an intermediate entity as a conduit entity, which is ignored for purposes of determining Federal income taxation, when (i) the participation of the intermediate entity reduces the tax imposed by Sec. 881 (dealing with US taxation of passive US source income, such as interest and royalties, earned by foreign corporations), and (ii) the intermediate entity's participation is pursuant to a "tax avoidance plan" (as described in the Regulations), and (iii) either the intermediate entity is related to the financing entity or financed entity or the (unrelated) intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity (including the situation whereby the financing entity guarantees the financed entity's obligations). Generally, a financing transaction is any advance of money or other property in exchange for debt and includes any lease or licence (equity investments are excluded).
7. Assume, for example, a UK company lends funds to a Dutch company. The latter company onlends the funds to its US subsidiary. Both the US–Netherlands treaty and the US–UK treaty provide that interest paid to a resident of the other country is exempt from US withholding tax. Accordingly, the Dutch company will not be disregarded under the proposed anti-conduit regulations because of the absence of a "tax avoidance plan" (see *supra* note 6).
However, treaty benefits may still be denied under the US–Netherlands treaty. Assume that the Dutch company meets the indirect stock exchange test under the US–Netherlands treaty but for the fact that it is a conduit company for purposes of that test (i.e. a company that makes payments of interest in an amount equal to or greater than 90% of its aggregate interest receipts). If the Dutch company is unable to satisfy one of the other tests under the LOB, the United States is allowed to withhold its 30% statutory tax rate on the interest paid.
8. See Brian J. Arnold, "New Protocol to Canada–US Treaty Addresses Estate Tax Issues, Limitation on Benefits, and Mutual Assistance", *Tax Notes International* (19 September 1994), at 859.
For instance, the situation whereby a company ("Taxpayer") is directly owned 45% by a non-qualifying person ("NP") and 55% by a qualified person ("QP", e.g. a company satisfying the direct or indirect stock-exchange test). If NP also owns 40% of QP, then Taxpayer is ultimately owned more than 50% by NP. Using negative wording would prevent qualification under the shareholder test.
9. Notwithstanding the negative wording of the shareholder test and Taxpayer's disqualification under that test, however, in the example above Taxpayer would still be a qualified person under the indirect stock exchange test since Taxpayer is a company the shares of which are owned more than 50%, directly, by five or fewer persons ("QP") qualifying under the (in)direct stock exchange test. Only in the exceptional case where the shares are held by six or more qualifying persons could Taxpayer be disqualified under the indirect stock-exchange test. This can be illustrated by the following example:
Each of six QPs (qualifying either under the direct or indirect stock exchange test) owns 9% of Taxpayer, owning in aggregate 54%; NP owns the other 46% of Taxpayer. In addition, NP owns 49% of two of the QPs, as a result of which NP's interest in Taxpayer (directly and indirectly) exceeds the 50%. Under these circumstances, Taxpayer would only be able to invoke treaty protection under a shareholder test that employs positive wording.
10. See Art. 25(5)(d) of the US–Netherlands treaty.
11. See Art. 26(2) of the US–Netherlands treaty.
12. Art. 26(2)(a) of the US–Netherlands treaty states: "[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 ..."

- would be qualified persons or would meet the activity test if these persons were resident of Canada; and
- would be entitled to a rate of US tax under the tax treaty between their country of residence and the United States not exceeding the rate applicable under the US–Canada treaty.

In addition, a base reduction test identical to the base reduction test under the shareholder test should be met.

The reader's first impression might be that the United States has been generous to taxpayers residing in Canada (and their foreign shareholders) since the United States has not yet granted the pleasure of such a "derivative treaty benefits" test to other treaty partners. If one takes a closer look at this test, however, the gesture turns out to be less generous than would appear at first sight. This can be illustrated by the comments to the following hypothetical situation:
Assume a foreign parent company owns all of the stock of its Canadian subsidiary. The Canadian subsidiary derives income from US sources. The Canadian intermediate company does not satisfy one of the "regular" LOB tests and therefore wants to explore whether it can invoke the benefits of the treaty under the test at issue. The following issues may arise:

(a) A literal reading leads to the conclusion that the 90 percent ownership requirement cannot be satisfied if the shares are owned by *one* person (see "persons" in paragraph 4(a)). There appears to be no valid reason for such a restriction.

(b) The foreign parent company should be a resident of a country with which the United States has concluded a "comprehensive" income tax treaty (paragraph 4(a)(i)). Comprehensive probably means that it should be a "general" income tax treaty, as opposed to e.g. a navigation treaty the scope of which is restricted to the avoidance of double taxation with respect to income derived from shipping and/or air transport.[13]

(c) Under the comprehensive income tax treaty the foreign parent company should be entitled to "all" benefits provided by the United States under such treaty (paragraph 4(a)(i)). In this respect, if the foreign parent were a resident of the Netherlands and would satisfy the "EU shareholder test" under the US–Netherlands treaty (i.e. entitled to treaty relief only in respect of dividends, interest, royalties and branch profit tax) it would not be entitled to "all" treaty benefits.[14]

(d) The foreign parent company should (also) qualify for the benefits under paragraph 2 or 3 "if he were a resident of Canada" (paragraph 4(a)(ii)):

(1) *Qualification under the direct stock exchange test*
Article XXIXA(5)(a) lists the recognized stock exchanges. As mentioned above, thus far only US and Canadian stock exchanges are treated as "recognized". The shares of the foreign parent company should therefore be traded substantially and regularly on a US and/or Canadian stock exchange. This restriction will be eased when other stock exchanges are added to the list.

(2) *Qualification under the indirect stock exchange test*
More than 50 percent of the shares (vote and value) of the foreign parent company should be owned by five or fewer persons, each of which is listed on a recognized stock exchange and is a "qualified person". As to the latter requirement, a person is a "qualified person" only if he is a resident of Canada. This will generally not be the case. Therefore, the foreign parent company is unlikely to qualify under this test for purposes of application of the treaty derivative benefits test.

(3) *Qualification under the shareholder test*
The taxpayer will encounter the same problem as described in the previous paragraph. The foreign parent company will generally not be a resident of Canada, so the treaty derivative benefits test cannot be satisfied.

(4) *Qualification under the activity test*
For the purpose of this (sub)test under the derivative treaty benefits test, the foreign parent company is not only deemed to be a resident of Canada, but its business is deemed to be carried on in Canada.

(e) In respect of the particular class of income for which benefits are claimed under the US–Canada treaty, the foreign parent company should be entitled to a tax rate under the treaty between its country of residence and the United States that is "at least as low" as the rate applicable under the US–Canada treaty (paragraph 4(a)(iii)). If this condition is not fulfilled, the full statutory US tax rate will be imposed on the income paid to the Canadian subsidiary, and not a lower rate applicable for that particular class of income under the other treaty.

The conclusion is that where a taxpayer is unable to claim treaty benefits under one of the "regular" LOB tests, he will have a hard time finding treaty protection under the derivative treaty benefits test.

E. Miscellaneous

1. Discretionary relief

Where a resident of Canada is not entitled to the benefits of the treaty under one of the tests discussed above, a request can be made to the US competent authority to grant treaty benefits.

2. No other tests

The US–Canada treaty does not include a headquarters company test, or a separate test for shipping and air transport companies.[15]

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13. See in this respect Art. 30(6)(d) of the new US–France tax treaty, where the term "comprehensive income tax treaty" is defined implicitly. It can be derived from that provision that a general income tax treaty can qualify as a "comprehensive" tax treaty, regardless of whether it contains an LOB.
14. On the other hand, a Dutch parent company allowed treaty benefits under the "competent authority" provision (Art. 26(7) of the US–Netherlands treaty) seems to be a qualifying shareholder for purposes of the test at hand. In any event it will often require considerable time and effort to establish with certainty that the foreign parent company "is" entitled to the benefits of the treaty between the country of which it is a resident and the United States.
15. See Art. 26(3) and (6) of the US–Netherlands treaty.

III. US–FRANCE TREATY

A. Introduction

On 31 August 1994 the United States and France signed a new income tax treaty that replaces the 1967 treaty (and the 1970, 1978, 1984 and 1988 Protocols to that treaty). The treaty includes a complex LOB (Article 30), although it is not as detailed as the LOB in the Dutch treaty.

B. In general

The LOB includes the following tests: direct stock exchange test, indirect stock exchange test, EU indirect stock exchange test, shareholder test, investment entity test, activity test, EU shareholder test and a headquarters company test. Moreover, a "triangular case" provision is included in the LOB.

For purposes of the LOB, any person that is entitled to the benefits of the treaty pursuant to the direct, indirect or EU indirect stock exchange test, shareholder test or investment entity test is considered a "qualified person".

C. Qualified person[16]

1. Direct stock exchange test

A company that has substantial and regular trading in its principal class of shares on a recognized securities exchange is a qualified person when it is listed on such a stock exchange in either the United States or France. Rather than "recognized stock exchange" the treaty uses the term "recognized securities exchange", a definition of which is set out in paragraph 6(e). It includes the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Sydney, Tokyo and Toronto. The treaty does not contain a definition of the term "principal class of shares".

2. Indirect stock exchange test

The indirect stock exchange test is similar to the one under the US–Canada treaty, meaning that this test is not accompanied by an anti-conduit test. A salient feature is that, in order to claim treaty benefits, the company can be owned directly or indirectly by "any combination of" companies meeting the direct stock exchange test, and/or by state-owned companies; a "five or fewer" restriction is not included in this ownership test.[17]

3. EU indirect stock exchange test

Apart from differences stipulated in the previous paragraph, the EU indirect stock exchange test is similar to that under the US–Netherlands treaty (i.e. 30 percent of the shares should be owned directly or indirectly by companies resident of one of the contracting states meeting the direct stock exchange test, and 70 percent of the shares should be owned directly or indirectly by companies resident of either contracting state or one or more member states of the EU, the shares of which are listed on a recognized stock exchange).[18]

Unlike the EU indirect stock exchange test in the US–Netherlands treaty, the application of which can only be invoked by companies resident of the Netherlands, the test at issue may provide treaty protection to companies resident of France (against US taxation) *and* the United States (against French taxation). Another difference between both tests is the definition of "resident of a member state of the European Union".[19]

4. Shareholder test

This test, including an accompanying base reduction test, is similar to the shareholder test under the US–Canada and US–Netherlands treaty.

5. Investment entity test

An investment entity referred to in Article 4(2)(b)(iii) of the treaty[20]is a qualified person if more than half of the shares in such entity is owned by qualified persons.

D. Non-qualified person

1. Activity test

This test is similar to the activity test included in the LOB of the US–Netherlands treaty except that it gives weight to business activities carried on in other EU member states that are a component part of or related to the business activities carried on in the country of residence.[21]

In order to establish whether the activity test is satisfied, the trade or business in the country of residence should be substantial in relation to the activity in the other state that generates the income. For that purpose a safe harbour rule is provided, giving a three-factor formula that compares value of assets, gross income and payroll expense in both countries. If the average of the three ratios exceeds 10 percent and each ratio exceeds 7.5 percent, the safe harbour test is satisfied. The ratios employed under this test are equal to those in the

16. Apart from companies meeting one of the tests described in this paragraph, individuals, contracting states or their political subdivisions, etc., and pension trusts or exempt organizations meeting certain requirements are also qualified persons for purposes of the LOB if, of course, they are considered residents.

17. See Art. XXIXA(2)(d) of the US–Canada treaty and Art. 26(1)(c)(ii) US–Netherlands treaty.

18. It is strange that the term "recognized stock exchange" is not defined in the treaty (but only the term "recognized securities exchange").

19. Compare Art. 26(8)(i) of the Dutch treaty with Art. 30(6)(d) of the French treaty. The definition under the latter treaty is not as restrictive as the Dutch treaty.
According to Violane Chassaing, Stephane Gelin and Thomas May, "The New France–US Income Tax Treaty: Far From Nothing New", *Tax Notes International* (24 October 1994), at 1313, there is a substantial deviation from the Dutch treaty by preventing privately held companies from qualifying under one of the indirect stock exchange tests. There is, however, no such deviation; compare Art. 30(1)(c) and (d) of the French treaty with Art. 26(1)(c) and (d) of the Dutch treaty.

20. In the case of the United States, a regulated investment company, a real estate investment trust and a real estate mortgage investment conduit; in the case of France, a "société d'investissement à capital variable" and a "fonds commun de placement".

21. Art. 26(2)(e) and (h) of the US–Netherlands treaty.

US–Netherlands treaty. Under the latter treaty it was held that the 10 percent average ratio reflects the fact that the economy of the Netherlands is substantially smaller than the economy of the United States.[22] This leads to the rhetorical question whether the economy of France and the Netherlands are substantially the same?

2. Headquarters company test

This test is the same as the test in the US–Netherlands treaty.

3. EU shareholder test

The scope of this test is restricted to income referred to in Articles 10 (Dividends, including Branch Tax), 11 (Interest) and 12 (Royalties). Both companies that are resident of France and that are resident of the United States may seek treaty protection under this test (in contrast with the US–Netherlands treaty where only companies residing in the Netherlands can claim treaty benefits under the EU shareholder test).[23]

E. Miscellaneous

1. Triangular case provision

Under this provision the United States is not bound to grant treaty relief for income derived by a company that is a resident of France if the income is exempt from French taxation because of attribution of the income to a permanent establishment situated in a third jurisdiction, unless the tax in the third jurisdiction is 60 percent or more of the tax that would be imposed if such income were not attributable to the permanent establishment.[24] If the 60 percent criterion is not satisfied, the United States will impose a 15 percent tax on the gross amount of any dividends, interest or royalties; any other income will be subject to tax under US domestic rates.[25]

The above-mentioned 15 percent tax will not be imposed if the income derived from the United States is in connection with or incidental to the active conduct of a trade or business carried on by the permanent establishment in the third jurisdiction.[26] In addition, an exception is provided for income derived from the United States by a French company the shares of which are more than 50 percent owned directly or indirectly by US shareholders.[27] Such an exception is not included in the Dutch treaty.[28]

Note that the triangular provision not only applies to interest and royalties derived from the United States (as under the Dutch treaty) but also to any other item of income derived from a US source.

2. Discretionary relief

The competent authorities may grant treaty benefits to persons who do not meet any of the tests under the LOB.

3. No other tests

The treaty does not include a separate test for shipping and air transport companies, nor does it contain a derivative treaty benefits test.

IV. US–SWEDEN TREATY

A. Introduction

The United States and Sweden signed a new income treaty on 1 September 1994, which replaces the 1939 treaty as amended by a 1963 Protocol. The treaty includes a less detailed LOB (Article 17) than those in the Dutch and French treaties.

B. In general

The LOB includes only three tests: a direct stock exchange test, a shareholder test and an activity test.[29] A person that does not satisfy one of these tests is not entitled to treaty benefits.

C. The three tests

1. Direct stock exchange test

A company that has substantial and regular trading in its principal class of shares on a recognized stock exchange is entitled to the benefits of the treaty. The treaty does not contain a definition of the term "principal class of shares".[30] The recognized stock exchanges are listed in paragraph 3, currently including only US stock exchanges and the Stockholm Stock Exchange.

22. Explanatory Memorandum prepared by the Netherlands Government to the 1992 US–Netherlands treaty, Parliamentary Report 23220, No. 3, at 49-50.
23. An important restriction included in the Dutch treaty but not included in the French treaty is that a resident of an EU member state may be taken into account only if the income paid to the Netherlands from the United States is not taxed at a more favourable rate than if this income would be paid to the shareholder's member state, see Art. 26(4)(b) of the US–Netherlands treaty).
24. Currently, corporation tax is levied in France at a rate of 33 1/3%.
25. Under the triangular case provision in the Dutch treaty (Art. 12(8) for interest and Art. 13(6) for royalties), the threshold is 50% instead of 60% of the general tax rate. As from 1 January 1998, however, a 60% threshold will apply, as is the case under the French treaty.
26. Other than the business of making or managing investments. For purposes of the Dutch treaty, the business of making or managing investments includes group financing (Art. III of the Agreed Minutes, 13 October 1993).
27. As a result, the French company will be a "controlled foreign corporation" subject to the provisions of Subpart F (Secs. 951-964) of the IRC. Subpart F requires US shareholders of a controlled foreign corporation to include certain items of income of that corporation in their taxable income in the year such income is earned, regardless of whether such income is actually distributed to the shareholders.
28. But see the letter of US Senator Paul S. Sarbanes to the US Treasury, *Tax Notes International* (19 September 1994), at 895, in which he asks for the Treasury's help in developing an appropriate remedy for this potential double taxation problem. In a response on 5 December 1994, the IRS announced that it will consider initiating competent authority proceedings for this problem, and that it will try to reach an agreement with the Dutch competent authority, according to which the United States will not impose the 15% withholding tax on interest that falls within the scope of Art. 12(8) of the Dutch treaty; see *Tax Notes International* (12 December 1994), at 1837.
29. Individuals residing in the United States or Sweden, the contracting states or political subdivisions or local authorities thereof, as well as certain not-for-profit organizations (including pension funds) that reside in Sweden or the United States, are fully entitled to the benefits of the treaty.
30. Unlike the US–Netherlands treaty; see Art. 26(8)(a).

2. Shareholder test

A company will satisfy this test if more than 50 percent of the number of shares of each class of the company's shares is owned directly or indirectly by persons entitled to the benefits of the treaty (not including persons entitled to treaty benefits solely by reason of satisfying the activity test or under discretionary relief granted by the competent authority). In addition, in order to qualify under the shareholder test, a base reduction test should be satisfied.

The shareholder test uses positive wording.[31] The shareholder test imposes no restriction on the number of qualifying shareholders (i.e. no "five or fewer" limitation).

In contrast to the base reduction tests included in the LOBs of the treaties discussed above, it is not necessary that less than 50 percent of gross income be used to make "deductible" payments. Instead, the treaty uses the wording "to meet liabilities", which may result in disqualification under the shareholder test regardless of whether the payments are tax deductible.

3. Activity test

A person is entitled to the benefits of the treaty if engaged in an active conduct of a trade or business in the state of which the person is a resident (other than the business of making or managing investments) and the income derived from the other state is derived in connection with or incidental to that trade or business.

A striking feature of this test is the far-from-voluminous text in comparison with the corresponding tests under the French and Dutch treaties. The reason is that the test does not contain the requirement that the trade or business be substantial in relation to the activity in the other state that generated the income. As a result, the activity test does not provide for detailed safe harbour provisions.

D. Miscellaneous

1. Discretionary relief

The competent authorities may grant the benefits of the treaty to persons who do not meet any of the tests under the LOB.

2. No other tests

The treaty does not include an indirect stock exchange test, a headquarters company test, a separate test for shipping and air transport companies or a derivative treaty benefits test. In addition, none of the tests anticipates Sweden's entry into the EU as of 1995 (e.g. by including an EU shareholder test as included in the LOB of the Dutch and French treaties).

V. US–PORTUGAL TREATY

A. Introduction

The United States and Portugal signed their first income tax treaty on 15 September 1994, completing the US's treaty network with EU member states. The treaty contains a LOB (Article 17) that is not as complex as the one in the Dutch treaty.

B. In general

The LOB includes the following tests: direct stock exchange test, indirect stock exchange test, shareholder test and an activity test. Consequently, when compared to the LOB of the Swedish treaty, taxpayers have been given one additional chance to qualify, i.e. under the indirect stock exchange test.[32]

C. The four tests

1. Direct stock exchange test

A company that has substantial and regular trading in its principal class of shares on a recognized securities exchange is a qualified person. A definition of "recognized securities exchange" is given in paragraph 4. For the time being, it only includes US and Portuguese stock exchanges. The treaty does not contain a definition of the term "principal class of shares".

2. Indirect stock exchange test

The indirect stock exchange test is similar to the one under the Canadian treaty. An important difference, however, is that the shares be owned directly by the shareholders meeting the direct stock exchange test (and not "directly or indirectly"). Further, as is the case under the French treaty, the taxpayer can be owned by any combination of companies meeting the direct stock exchange test, and/or state-owned institutions or organizations.

3. Shareholder test

Aside from minor details, this test, including an accompanying base reduction test, is identical to the shareholder test under the Sweden treaty.

4. Activity test

This test is identical to the activity test under the Sweden treaty but for the additional requirement that the trade or business be substantial in relation to the activity in the other state that generated the income. The treaty does not contain a safe harbour to determine whether the "substantiality condition" is fulfilled.

31. See *supra* note 9.
32. Also entitled to the benefits of the treaty are individuals, the contracting states and other state-owned institutions, and not-for-profit organizations and pension funds meeting certain requirements.

D. Miscellaneous

1. Discretionary relief

The competent authorities may grant the benefits of the treaty to persons who do not meet any of the tests under the LOB (paragraph 3).

2. No other tests

The treaty does not include a separate test for shipping and air transport companies, a headquarters company test, an EU shareholder test or a derivative treaty benefits test. Since Portugal is an EU member state, one might have expected the LOB to contain provisions which allow certain EU persons/shareholders and EU business activities to be considered in determining whether a Portuguese entity qualifies for treaty benefits. This expectation, however, has proved false.

VI. CONCLUDING REMARKS

First of all it should be noted that with respect to the new treaties discussed above, no official explanations, letters of understanding, etc., have been released thus far. Such official commentaries may give further guidance to the specific terms and expressions, used in the LOB of the treaty at issue, as well as explain the policy or reasoning for certain deviations in that LOB when compared with LOBs in treaties the United States concluded with other countries.

None of the LOBs discussed above is as lengthy and detailed as the LOB in the US–Netherlands treaty (although the French LOB comes close). Nevertheless, it might be expected that these LOBs will give rise to as many questions as is the case for application of the Dutch treaty LOB, and that they will significantly increase the compliance burden of companies seeking treaty protection for income from US sources.

In a nutshell, the noteworthy features are (i) the "derivative treaty benefits test" in the US–Canada treaty (hard to satisfy); (ii) the absence of an anti-conduit test under the indirect stock exchange test in the Canada, France and Portugal treaties (due to the proposed US anti-conduit regulations?); and (iii) the absence of any reference to shareholders residing in or business activities conducted in EU member states in considering the right to claim treaty benefits under the Swedish and Portuguese treaties.

CUMULATIVE INDEX – 1995

I. ARTICLES

SINGAPORE

OPERATIONAL HEADQUARTERS

Lee Fook Hong

Lee Fook Hong, MBA, FCIS, FAIA, ACIArb is the Principal Consultant of Lee Fook Hong & Co and an Adjunct Associate Professor in the School of Accountancy and Business, Nanyang Technological University, Singapore.

I. INTRODUCTION

In his recent tour of Australia, Singapore's Senior Minister, Mr Lee Kuan Yew commented that the Australian media's coverage of East Asia was poor. He urged the Australian media to inform and educate Australians about the realities of Asia.

Singapore's Prime Minister, Mr Goh Chok Tong during his recent visit to Germany and Britain, has also urged European firms not to see Asia as a threat, but as an opportunity to boost its own economic recovery. In his speech Mr Goh appealed to European companies to participate as insiders in Asia's growth and look to Singapore as a business architect.

Singapore is not only gearing up to attract investors into Singapore but also helping to service foreign investors to remain in Singapore and grow from Singapore by using Singapore as a springboard. As a consequence of the Prime Minister's recent visit to Britain, Singapore and the United Kingdom are setting up a Joint Business Council. The German–Singapore Business Forum, the Australian Business Council, the American Business Council and several others have been set up for many years.

To promote Singapore as a total world business centre, the Singapore Government is offering many tax and non-tax incentives to domestic and foreign companies. Tax incentives are available under the Income Tax Act and the Economic Expansion Incentives (Relief from Income Tax) Act. Tax incentive schemes such as the Approved Oil Trader Scheme, the Approved International Trade Scheme, the Approved International Shipping Enterprise Scheme and the Operational Headquarters Incentive Scheme are attractions to both domestic and foreign companies. This article focuses only on the tax incentive scheme for operational headquarters ("OHQs").

II. CHARACTERISTICS OF OHQ'S

The tax incentive scheme for OHQ was one of the recommendations of the Economic Committee set up in 1985 to promote Singapore as an international business centre for manufacturing and services.

For the purposes of the Operational Headquarters Incentive Scheme which is administered by the Economic Development Board, the term "Operational Headquarters" is defined as an entity incorporated or registered in Singapore (including legitimate branches of companies incorporated overseas) for the purposes of providing management and other headquarters-related services to subsidiaries and associated or related companies in other countries.

Companies that could qualify for the incentive will generally have a sizeable network of overseas companies in the region either wholly or partially owned by the Singapore-based OHQ, the parent company or its major home divisions. The OHQ may also be a branch of the parent company provided there is management control for the regional network. Although the OHQ is a Singapore-registered company and is expected to own equity of regional companies from its Singapore base, companies that have a corporate policy of owning equity only from the parent company may also qualify.

Companies seeking OHQ status for tax advantages must be well-established in their home country, industry or sector and the parent company must have attained a substantial size in terms of equity, assets and employees.

Although OHQ's status is intended for foreign companies, Singapore-owned companies also qualify for OHQ status if they meet the requirements of the Scheme.

III. ELIGIBILITY CRITERIA

Each application for OHQ status will be considered by the EDB on its own merits on a case-by-case basis. Upon approval of OHQ status, the applicant can enjoy tax benefits under the Scheme. The assessment process adopted by the EDB follows the quantitative and qualitative criteria.

A. Qualitative criteria

The OHQ is expected to be the regional control centre with clear-cut regional management and control from Singapore in terms of organization reporting structure at senior management levels. The number and quality of headquarters personnel are expected to be substantial, and their appointments should be of high level, such as regional chief executives, key professionals, technical personnel and other important support staff. HQ personnel are expected to be based in Singapore to service subsidiaries, associated or related companies in the region.

The OHQ must have a level of substantial operations in Singapore to support the OHQ's network in the region. Such operations may be classified into two areas – business-related activities and technical competence.

Business-related activities include administration and general management; business planning and coordination; procurement of raw materials and components; corporate finance advisory services; marketing control and sales promotion planning; regional training and personnel management; treasury and fund management; logistics services; and any other activities of economic benefit to Singapore.

Technical competence must be evident in R&D services and product development; regional technical support and maintenance; data processing and communication hub; and regional business development.

OHQs should not be letter box companies set up solely for the purpose of enjoying tax benefits. Subsidiaries, associated and related companies that form the network of the OHQ should be involved in commercial activities.

B. Quantitative criteria

For assessment under the category of quantitative criteria, applicants must ensure that the level of paid-up capital of the Singapore headquarters should be a minimum of S$ 0.5 million. The amount of total business spending per month in Singapore (i.e. operating expenses incurred by the Singapore operation) should be a minimum of S$ 2 million. The number of senior professional and management manpower should be no less than four or five persons. The OHQ should undertake a minimum of three headquarters-type activities related to its regional management and control functions. Lastly, but not the least important, the number of companies within the control and management of the OHQ in Singapore should be no less than three.

IV. BENEFITS OF OHQ

For companies which are granted the OHQ status, the tax benefits that are available include exemption from tax on dividends, and a 10 percent concessionary tax rate on management fees, interest, royalties and income from the provision of finance and treasury services and OHQ-related services. The tax relief period is five to ten years, with possible extension. Non-OHQ related income is subject to tax at the normal corporate tax rate of 27 percent.

A. Dividends

Where the OHQ in Singapore holds equity in subsidiaries and associated companies, dividends when paid into the OHQ in Singapore can be exempted from Singapore's corporate tax of 27 percent. Further taxes will not be levied when dividend income is distributed through Singapore to the parent company overseas. If the OHQ is owned by a holding company in Singapore, dividends can be distributed one level upwards to the holding company as tax-exempt dividend without any liability for further taxation. Where dividends are distributed from income which has been taxed at the concessionary tax rate of 10 percent, the same tax exemption benefit is also available to shareholder recipients.

B. Management fees

Income arising from the provision of management services to overseas subsidiaries, associated or related companies can qualify for concessionary tax at 10 percent. Where the OHQ network is structured such that fees paid by subsidiaries and associated or related companies to OHQ are at cost, a profit margin of 5 percent is imputed. Such income of the OHQ is subject to tax at 10 percent instead of the current corporate tax rate of 27 percent. The same 10 percent concessionary rate will also apply to fees paid by the parent company to the OHQ in Singapore.

C. Interest

Income derived from interest on loans raised by the OHQ through financial institutions in Singapore and extended to regional subsidiaries, associated and related companies can enjoy the concessionary tax rate of 10 percent.

D. Royalties

Where royalty payments from subsidiaries, associated and related companies arise from R&D work carried out from Singapore, such income can qualify for the concessionary tax rate of 10 percent. To qualify for this concessionary tax treatment, a manpower and development plan for substantial R&D work must be provided to the EDB for approval.

E. Finance and treasury services

Income arising from trading foreign exchange and offshore investments on the OHQ's own account is subject to tax at the concessionary rate of 10 percent instead of the normal rate of 27 percent. However, when such treasury functions are intended, it is necessary to include the treasury activities in the application for OHQ status for EDB's approval. This incentive for treasury functions will no doubt help to boost substantially the activities of OHQs and accelerate the development of Singapore as a regional financial centre.

V. EVALUATION OF BENEFITS AND PROBLEMS OF OHQS

Applications for the OHQ incentive scheme are processed by the EDB on a case-by-case basis because of the significant tax implications and differing needs of OHQs. When the OHQ incentive scheme was first announced, considerable interest was expressed by many groups of companies not only in the Asia Pacific Region but also from Australia, Europe and the United States. However, very few have obtained OHQ status as the qualitative and quantitative guidelines are applied on a case-by-case basis in determining whether or not the EDB would recommend that the Minister grant the OHQ status. To qualify for the OHQ status, the company applicant must comply with more than the minimum criteria. The more items a company can satisfy in relation to the qualitative and quantitative criteria, the greater are the chances of obtaining OHQ status. The test of substantiality is critically and objectively applied by the EDB in dealing with all applications for OHQ status.

While some companies are able to obtain OHQ status they are not keen to secure such a status because the tax incentives may not substantially benefit their operations. For example, some countries such as the United States and Australia have their own special tax legislation which may render OHQ incentives unattractive or less tax-efficient. Additionally, other countries with whom Singapore has treaties may be over-sensitive towards Singapore's OHQ tax incentive scheme. Consequently, difficult problems may be encountered in the tax jurisdictions of the parent company or the subsidiaries of the parent company. The OHQ benefits may appear attractive, but the net after-tax benefit to the whole group may not be substantial. A careful consideration of the incentive scheme for OHQ's should be carried out in consultation with professionals in the various jurisdictions affected by the scheme. The following questions may have to be considered:

- Are tax issues in the parent jurisdiction complex?
- Are there real benefits of OHQ status for the parent and subsidiary jurisdictions?
- Do any other commercial difficulties or problems exist?

When companies contemplate structuring or setting up an OHQ in Singapore, there is a need to consider, *inter alia*, government policies in the parent jurisdiction on foreign investments, the burden of stamp duty on transfers of assets and capital gains tax, restrictions on transfers of technology and royalty payments, foreign exchange controls, transfer pricing and other non-tax issues.

VI. CONCLUSION

In 1989, the EDB disclosed that six OHQs awards was the initial target in its drive to attract multinationals to use Singapore as their regional business centre. Among the first recipients of the OHQ award were the British food-based group Cerebos Pacific, US computer maker Data General, Asea Pacific, SKF(SEA) and the US oilfield engineering company Brown and Rood, Times Publishing Bhd and exhibition design firm Pico Art International. The latter two companies were the first local companies to have won the award. As most of the successful applicants for OHQ status prefer not to publicize their new status for competitive reasons, the exact number of OHQ companies to date has not been disclosed. Deutsche Telekom of Germany is perhaps the most recent awardee of OHQ status. Based on a rough estimate, there should be about 50 or 60 companies with OHQ status today.

Companies having the need to use Singapore for regional coordination and administration functions should seek opportunities for applying for OHQ status in Singapore. Whilst some problems may arise, the advantages which may be obtained from OHQ status may be considerable and they may outweigh the disadvantages if the OHQ is properly planned and structured.

Singapore's political stability, economic dynamism and extensive infrastructure are some of the specific advantages to foreign investors. Many MNCs are already involved in the Asia Pacific Region. Singapore has the necessary experience, information, connections and good business relationships with Thailand, Malaysia, China, Indonesia, India, Vietnam, Cambodia and Myanmar. Furthermore, Singapore has the ability to act as catalyst to foreign investors. Foreigners can profitably invest in Singapore as well as through Singapore in the wider Asia Pacific Region. The tax incentive scheme for OHQs will be an additional bonus to foreign investors if they plan and structure their OHQ in Singapore with care and prudence.

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PEOPLE'S REPUBLIC OF CHINA

DOMESTIC ENTERPRISE INCOME TAX

Jinyan Li

Faculty of Law, The University of Western Ontario, Canada; Tory Deslauriers & Binnington, Barristers & Solicitors, Toronto, Canada.

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The Chinese government implemented a sweeping tax reform at the end of 1993; its aim was to bring China's tax system in line with the rapid economic developments taking place in the country. One major part of tax reform was the introduction of a unified enterprise income tax law applicable to all domestic enterprises – the Domestic Enterprise Income Tax ("DEIT").[1]

This article discusses the rationale for the new tax, analyses its major provisions and examines the possibility of further reform. It should be of particular interest to those who have investments in Chinese enterprises or who do business with Chinese enterprises.

I. BACKGROUND AND NEED FOR REFORM

A. Background

The DEIT replaced three previous taxes: the State Enterprise Income Tax (1984),[2] the Collective Enterprise Income Tax (1985)[3] and the Private Enterprise Income Tax (1988).[4] Foreign investment enterprises (Chinese-foreign equity joint ventures, Chinese-foreign cooperative joint ventures, and wholly foreign-owned enterprises) and foreign companies doing business in China remain taxable under a separate tax – the Income Tax on Foreign Investment Enterprises and Foreign Enterprises (the "Foreign Enterprise Income Tax").[5]

1. Establishment of domestic enterprise income tax system

(a) State Enterprise Income Tax

Enterprise reform was the key to the success in China of the transition from a government-planned economy to a market economy. When the reforms started in 1977-1978, the Chinese economy was dominated by state-owned enterprises ("SOEs"). SOEs had little autonomy; their production, pricing and investment decisions were all subject to the central planning process. In addition, they transferred all surplus funds to the state budget and relied on the budget for subsidies to cover losses and grants for investment. Few incentives were available to workers or management; wages were set by centrally determined scales, and the management's main responsibility was to fulfil production quotas. The government controlled and managed SOEs through various ministries.

In order to turn SOEs into true enterprises responsible for their profits and losses, the government adopted various methods to "revitalize" SOEs. Some small SOEs were leased to individuals for management, or even sold; some medium or large SOEs were allowed to retain part of their profit and were made responsible for losses; still others began to pay income tax and retain after-tax profits.[6] In 1983, after some initial experimentation, the automatic profit transfers to the budget were phased out in favour of direct taxation. In 1984,

1. Provisional Regulations of the People's Republic of China on Enterprise Income Tax, promulgated by the State Council on 31 December 1993 (hereafter the "DEIT Law"); Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Enterprise Income Tax, promulgated by the Ministry of Finance on 4 February 1994 (hereafter the "DEIT Regulations").
Other taxes introduced during this reform include: a) the Individual Income Tax to replace two previous taxes on individual income tax with one applicable to foreign individuals and the other to Chinese citizens; b) the Value Added Tax, Business Tax and Consumption Tax to replace the previous value added tax, business tax and product tax applicable to domestic enterprises and the Consolidated Industrial and Commercial Tax applicable to foreign businesses in China; c) the Land Value Added Tax; d) the Natural Resource Tax.
2. Regulations of the People's Republic of China on State Enterprise Income Tax (Draft), promulgated by the State Council on 18 September 1984; Detailed rules for the implementation of the tax were promulgated by the Ministry of Finance on 18 October 1984. For a discussion of this tax, see Jinyan Li, *Taxation in the People's Republic of China* (Praeger 1991), chap. 4.
3. Provisional Regulations of the People's Republic of China on Collective Enterprise Income Tax, promulgated by the State Council on 11 April 1985 (hereafter the "CEIT Law"); Detailed Rules for the Implementation of the CEIT Law, promulgated by the Ministry of Finance on 22 July 1985.
4. Provisional Regulations of the People's Republic of China on Private Enterprises Income Tax, adopted by the State Council on 3 June 1988); detailed rules for the implementation of the tax were promulgated by the Ministry of Finance on 11 November 1987.
5. The Foreign Enterprise Income Tax law was adopted by the National People's Congress ("NPC") on 9 April 1991 and its implementing regulations were promulgated by the State Council on 30 June 1991 (hereafter the "FEIT Law" and "FEIT Regulations"). For further, see S. Nelson, "New Unified Tax Law Governing Foreign Investment Enterprises and Foreign Companies", *Tax Notes International* (June 1991), at 605 and "Detailed Rules for China's Unified Tax Law", (three parts), *Tax Notes International* (October 1991, December 1991 and February 1992); T. A. Gelatt, "China's New Tax Law for Foreign Business: a Rational System Emerges", *East Asian Executive Reports* (15 May 1991), at 13; J. Li, "People's Republic of China: The Implementing Regulations for the New Consolidated Income Tax on Foreign Investment", 46 *Bulletin for International Fiscal Documentation* (April 1992), at 170.
6. See Li *supra* note 2, at 70-73.

the State Enterprise Income Tax was introduced.[7] Large and medium-sized SOEs were liable to tax at the rate of 55 percent; small SOEs were liable to tax at progressive rates ranging from 7 to 55 percent.

There were two principal objectives of these reforms. The first objective was to promote the autonomy and accountability of enterprises. A formal tax system was seen as playing an important role in achieving these goals by establishing a framework of rules for payment of taxes by SOEs. SOEs were allowed to keep after-tax profits for investment, business expansion or workers' welfare. The second objective was to provide enterprises with access to their own funds (mostly profit retention and a part of depreciation funds) as a source of investment capital.

(b) Collective Enterprise Income Tax

Collective enterprises are not owned by the State, and have always had greater autonomy than SOEs. While SOEs must transfer all their profits to the State, collective enterprises paid income tax, namely the Industrial an Commercial Income Tax ("ICIT").[8] The ICIT was replaced by the Collective Enterprise Income Tax in 1985, which imposed tax on an eight-grade progressive rate scale rising from 7 to 55 percent.[9]

(c) Private Enterprise Income Tax

Until the beginning of the economic reforms in the late 1970s, private businesses were prohibited. Like collective enterprises, private enterprises were subject to the ICIT until 1988 when the Private Enterprise Income Tax was introduced. This tax was imposed at a flat rate of 35 percent.

2. Subsequent changes to the Enterprise Income Tax system

The structure and administration of the State Enterprise Income Tax and Collective Enterprise Income Tax were modified by subsequent changes (discussed below) to such degree that, by the end of 1993, the tax system bore little resemblance to the system introduced in 1984.

(a) 1984-86: ad hoc measures

Following the 1984 tax reform, the government introduced various measures that used the tax system to preserve the pre-reform financial situation of SOEs, provide relief to enterprises in financial difficulty and to regulate the activities of enterprises in the area of investment and employee compensation. These measures included: a surtax – the State Enterprise Income Regulatory Tax[10] – imposed on SOEs earning "excessive" profits; a proliferation of tax concessions to enterprises;[11] excessive wage taxes and bonus taxes on SOEs and collective enterprises;[12] and special taxes and levies on certain types of firms.[13]

(b) 1986: tax contract system

To further complicate tax administration, in 1986 the government introduced a "tax contracting" system for large and medium-sized SOEs.[14] Under the contract system, targets were specified for enterprises over a three- or four-year period for their performance, production quotas and financial obligations to the government (ordinary taxes and dividends). In effect, SOEs could negotiate with the government with respect to the amount of their tax liability. The amount varied from one firm to another in recognition of the different financial situations of the firm.

Although the contract system may have had a positive impact on the efficiency and autonomy of enterprises,[15] it undermined the tax system and had several serious policy implications. First, the national rate of 55 percent of the State Enterprise Income Tax was rarely applied, which encouraged enterprises to disrespect the tax law. The contract system was a step backward from the tax reform in 1984 that replaced full profit remittance by explicit income taxation. Moreover, contracts were negotiated for each enterprise and required a case-by-case determination of contractual terms. The approach was prone to produce anomalous results, since compromises were frequently necessary in order to reach agree-

7. During the same tax reform, new turnover taxes were introduced: a VAT on selected manufacturing products, product tax on other products, business tax on services and other businesses, a salt tax on salt.

8. Until 1980 when the Joint Venture Income Tax was introduced, the only tax on business profits in China was the Industrial and Commercial Income Tax introduced in 1958. While SOEs were exempt from income tax payments, collective enterprises had been subject to this tax until 1985. This tax was levied on business profits on a 21-grade progressive rates ranging from 5.75 to 34.5%. The rates were subsequently adjusted from time to time.

9. The same rates also applied to small SOEs.

10. State Enterprise Income Regulatory Tax Regulations, issued by the State Council on 18 September 1984. This tax was abolished as a result of the promulgation of the DEIT. The regulatory tax was imposed on large and medium-sized SOEs whose after-tax profits exceeded a "reasonable" amount of retained profits. It was based upon the amount of retained profits of the enterprise in 1983. Unlike other income taxes, there were no tax rates prescribed. The appropriate rate was determined according to the following formula:

$$\text{Tax rate} = \frac{\text{Base Year Profit} \times (1\text{-}55\%) - \text{1983 Retained Profit}}{\text{Base Year Profit}} \times 100\%$$

11. Chinese tax authorities and local governments had the discretionary power to grant tax reductions and exemptions. See Li *supra* note 2.

12. Provisional Regulations on State Enterprise Wages Regulatory tax, issued by the Ministry of Finance on 18 September 1985; Provisional Regulations on State Enterprise Bonus Tax, issued on 3 July 1985; Provisional Regulations on Collective Enterprise Bonus Tax, issued on 24 August 1985. These taxes were payable by enterprises, not by employees. The rates were adjusted from year to year. The rates of these taxes varied from 20 to 200%. Effectively, they formed a wedge between the wage cost and the wage benefit to employees.

13. For example, the natural resource tax, construction tax, energy and transportation fund. SOEs earning income from outside China were exempt from tax; Interim Regulations on the Levying of Enterprise Income Tax on State Enterprises Engaged in Contracted Projects in Foreign Countries, adopted by the Ministry of Finance on 11 March 1985.

14. At the same time, it introduced various forms of leasing arrangement for smaller SOEs, and to a very limited degree, the incorporation of joint stock enterprises. The contracting system was designed for the purpose of adjusting relative enterprise profit retention to the levels existing prior to the introduction of the State Enterprise Income Tax. The system was fairly simple at the beginning, but evolved into a complex system having several other objectives, such as revitalize SOE performance, enhance SOE autonomy and enable the State to claim returns on investments in SOEs in addition to income tax collection.

15. Large and medium SOEs in China were under the jurisdiction of several levels of government. The management and operation of these SOEs could be subject to various forms of official interference, sometimes contradictory. The contract system was used to reduce such interference, since the execution of contracts would require reaching agreement on explicitly stated targets, responsibilities, and rewards for the SOEs in advance. Once a contract is executed, the SOE is free of government interference during the term of the contract.

ment by all parties involved in the negotiation process. The use of enterprise-specific contracts with a validity of several years made it difficult to appraise relative economic performance among SOEs. Finally, the multi-year duration of contracts gave rise to systemic rigidity, impairing the inherent anti-cyclical properties usually associated with an income tax system. The income tax system became inelastic and tax revenue decreased while enterprise profits increased.[16]

(c) 1988: shareholding system

The development of the enterprise income tax system was further shaped by two other policy objectives. The first objective was that the role of the State as tax collector should be separated from that of the owner of capital in SOEs. In 1988, the government began to allow some SOEs to be restructured into shareholding enterprises;[17] for the first time, individuals and other enterprises could become shareholders of SOEs. This change was revolutionary in that the State began to divest itself of SOEs.[18] The shareholding system provided for a clear separation of ownership from management of SOEs and was, therefore, a way of restructuring the traditional relationship between the State and SOEs. Because the State had assumed both the role of investor and tax collector, SOEs that have been restructured into shareholding enterprises were required to pay tax separately from the remittance of after-tax profits (dividends). The tax rate of 55 percent was lowered to 30 percent, 33 percent or 35 percent to enable SOEs to have sufficient funds to pay dividends.[19]

The second policy objective was that the tax system should promote competition among domestic enterprises to increase productivity. Some local governments, such as Shenzhen, were allowed to introduce measures to adopt uniform tax rules for all domestic enterprises and to levy income tax at the rate of 15 percent with respect to foreign investment enterprises.[20]

(d) New types of business organization

During the 1980s, new types of business entities emerged, including joint operation enterprises, enterprise groups, limited liability companies, joint stock companies, partnerships and investment companies. In order to deal with the new types of enterprise, interim measures were issued with respect to the taxation of joint operations between enterprises of different ownership,[21] enterprise groups[22] and shareholding enterprises.[23]

B. Need for reform

The former enterprise income tax system suffered from several major defects which are briefly discussed below.

1. Unfair taxation

Under the former tax system, the tax structure for enterprises was based on the form of ownership, reflecting the government's belief that the form of ownership of enterprises should vary in terms of national importance and social desirability. Large SOEs were taxed at 55 percent (a lower rate for shareholding enterprises); small SOEs and collective enterprises were subject to progressive rates ranging from 10 to 55 percent; and private enterprises paid tax at a flat rate of 35 percent.

The tax burden for large and medium-sized SOEs was much greater than for other enterprises. In addition to income tax, SOEs paid various other taxes and special funds, including the enterprise income regulatory tax,[24] energy and transportation fund,[25] budgetary adjustment fund,[26] investment direc-

16. Before the tax contract system, 45% of the enterprise profits were transferred to the government in the form of tax payment and profit remittance. In 1988, the ratio was 27%. See Jiang Yonghua and Zhao Huaitan, eds. *Caizheng Shuishou Xinzhidu Xiangjie (Detailed Explanations to the New Finance and Tax System* (Enterprise Management Press, 1994), at 61-62.

17. Shareholding enterprises refer to enterprises with "legal person" status that can raise capital through the issue of shares. Those that issue shares to the general public are known as "joint stock companies". The financial liability of the shareholders is limited to the value of their shareholding in the company.

18. The shareholding system has several advantages: a) it facilitates the separation of government ownership from management; b) it mobilizes and rationally allocates financial resources; and c) it provides greater financial and decision-making autonomy so that enterprises can become more efficient and respond dynamically to changing market opportunities.

19. Interim Provisions with respect to the Taxation of Shareholding Enterprises, issued by the State Tax Administration and State Institutional Reform Committee on 12 June 1992.

20. Interim Provisions on Standard for Computing Enterprise Income in Shenzhen Special Economic Zone, issued by the Shenzhen People's Government on 29 May 1992. The text was published in *International Tax* (July, 1992), at 6-9.

21. For example, Notice Concerning Joint Operation Enterprises Carrying on Business in Shenzhen, Zhuhai, Shantou and Xianmen Special Economic Zones, issued by the Ministry of Finance on 28 May 1986; Notice Concerning the Payment of State Enterprise Income Tax by Enterprises Carrying on Business in more than one Economic and Technology Development Zones, issued by the State Tax Administration on 23 January 1992; Notice on the Applicable Rate for Joint Operation Enterprises in Shanghai New Pudong Area, issued by the State Tax Administration on 15 May 1992; and Provisions Concerning Financial Affairs of Domestic Joint Operation Enterprises, issued by the Ministry of Finance on 23 April 1986 and supplementary provisions were issued on 29 August 1990.

22. Interim Provisions Concerning the Financial Affairs of Enterprise Groups on An Experimental Basis issued by the Ministry of Finance on 3 August 1992; and Trial Measures on the Management of Financing Companies of Enterprise Groups issued by the Ministry of Finance on 26 January 1991.

23. Interim Provisions on Taxation of Joint Stock Enterprises on An Experimental Basis issued by the State Tax Administration and State Institutional Reform Committee on 12 June 1992; and Interim Provisions on the Financial Affairs of Joint Stock Enterprise on An Experimental Basis issued by the Ministry of Finance and State Institutional Reform Committee on 6 June 1992.

24. *Supra* note 10. This tax had no parallel in the tax systems of developed countries. It was at odds with the stated goals of the Chinese tax reform, and cancelled many of the benefits that would ordinarily be associated with a move toward a formal income tax system. In particular, the level of the tax differed from enterprise to enterprise.

25. Measures on the Collection of State Energy and Transportation Fund issued by the State Council on 15 December 1982; Detailed Rules for the Implementation of the Measures on the Collection of State Energy and Transportation Fund issued by the Ministry of Finance on 17 January 1983. The purpose of this levy was to divert funds from enterprises into investment in public infrastructure.

26. Measures on the Collection of State Budgetary Fund issued by the State Council on 17 February 1989; Detailed Rules for the Implementation of the Measures on the Collection of State Budgetary Fund issued by the Ministry of Finance on 24 April 1989. This levy was introduced in 1989 in the face of a revenue shortfall from the enterprise income tax. This shortfall seemed to have resulted from a number of factors, including the use of fixed tax contracts, discretionary tax reliefs, and the deduction of the principal repayments on loans.

tion tax,[27] and excessive wage and excess bonus tax. The energy and transportation fund and the budgetary fund were levied at a combined rate of 25 percent of after-tax profits and depreciation funds. Combined with the income tax rate of 55 percent, they resulted in a combined statutory tax rate of 66.25 percent, well in excess of the rate applicable for other enterprises in China and the corporate income tax rate in other countries. Furthermore, the effective burden of these additional levies was greater for enterprises with higher levels of depreciation and after-tax profits; they were biased against profitable enterprises, enterprises in more capital-intensive industries, as well as enterprises with assets with more rapid rates of depreciation.

The differing tax treatment of domestic enterprises was justified when the State had strict control over the operation of SOEs and restricted the business scope of private firms. At present, however, all these enterprises compete openly on the market. The discriminatory tax system became an obstacle to competition and discouraged enterprises of different types to form enterprise groups or joint ventures.

2. Complexity

The former enterprise income tax system was extremely complex and confusing. There were several sources of complexity. First among these was the different rates and rules for computing taxable income for different enterprises. Under this system, some firms could claim depreciation for certain assets, others could not; losses could be carried forward for private enterprises and SOEs, but not collective enterprises;[28] and different accounting systems applied to different types of firms. The second source of complexity were the changes to the tax structure described above which resulted in tax rates varying from one region to another and from one enterprise to another. A third source was the levy of a combination of income tax, quasi-income taxes and various adjustment taxes on enterprises, and the attempt to tailor each levy to the situation of each enterprise. Fourth was the difficulty in fitting the new business forms into the traditional definition of "state enterprises", "collective enterprises," and "private enterprises." The "mixed" private, state and collective entities gave rise to complexity in tax administration.

Another source of complexity was the different treatment of SOEs. For example, medium- and large-size SOEs were subject to tax at the rate of 55 percent, whereas small SOEs were subject to progressive rates ranging from 10 to 55 percent. Because the 55 percent rate was considered excessive, even among large SOEs, various compromises were negotiated between the government and enterprises. For example, under the tax contract system, some enterprises undertook to pay a prescribed amount of revenue to the government during the term of the contract. The amount of the payment varied with the size of the government's investment, technology, location, market share and the level of profitability of the enterprise. Some enterprises received tax concessions due to financial difficulty or for other reasons. SOEs that had been restructured into shareholding enterprises paid income tax at the lower rate of 30 or 35 percent.

3. Erosion of revenue and inelasticity

A serious erosion in the revenue base took place under the previous enterprise income tax system. The ratio of SOE budgetary contributions[29] to the gross national product ("GNP") fell from 12.2 percent in 1981-84 to 4.1 percent in 1989.[30] The decline was attributable to the tax contract system and the policy of allowing SOEs to deduct the repayment of loans in computing income. The widespread use of tax contracts was bound to lead to low revenue elasticity, especially when contracts failed adequately to take into account economic growth and inflation. Even when the contractual terms accurately anticipated subsequent economic developments, they were enforced with a degree of discretionary flexibility that resulted in an inherent bias toward under-fulfilment of contracts in the aggregate. For example, while SOEs that performed better than expected rarely remitted more than the amount stipulated in their contracts, those that performed worse than expected frequently had their contracted remittances reduced.[31]

Under the previous tax system, both the interest and principal of loans used by SOEs for acquiring fixed assets were deductible.[32] The deduction of repayments of principal effectively allowed a double deduction of the capital cost of assets purchased by borrowed funds. This reduced the cost of these investments relative to investments funded from other sources, such as equity or retained earnings. The predictable response of enterprises was rapidly to expand their borrowing, leading to unanticipated reductions in government revenue.[33]

The complexity and confusion under the previous tax system also encouraged enterprises to manipulate costs and incomes in order to reduce their tax liabilities. Tax evasion and avoidance caused great losses of revenue to the government. Some empirical studies indicated that the effective tax rate was much lower than the nominal rate; the effective rate was 32.56 percent for SOEs, 28.26 percent for collective enterprises and 32 percent for private enterprises.[34]

27. Provisional Regulations of the People's Republic of China on Fixed Assets Investment Direction Adjustment Tax promulgated by the State Council on 16 April 1991. Detailed rules for the implementation of this tax were issued on 18 June 1991. This tax was intended to influence the aggregate level of investment and the allocation of investment by levying different tax rates on different forms of investment.
28. CEIT Regulations, Art. 12, *supra* note 3. Subsequent measures were introduced to permit loss carry-forward by collective enterprises.
29. The revenue contributions from SOEs to the budget took several forms: remittance of profits and tax payments.
30. See Jiang and Zhao, *supra* note 16.
31. *Id.* at 53-62.
32. The deduction was intended to provide relief to SOE that relied on government loans to purchase fixed assets. Under the previous system, all government loans were interest-free or at nominal interest rate. During the economic reform, government banks were required to become profit-making entities and started to charge market interest rate. If the repayments of loans were not deductible, many SOEs would not have sufficient after-tax profits to repay the loans.
33. As a result of the deduction of loan repayments, the ratio of retained earnings of SOEs increased from less than 45% in 1984 to 70% in 1988. See Jiang and Zhao, *supra* note 16, at 60.
34. Wu Jianguo and Pang Lei, "Basic Thoughts on Enterprise Income Tax Reform," *Shuiwu Yanjiu (Tax Study)*, 1993, No. 3, 37-42, at 39 (in Chinese); Zhou Xiaochuan and Yang Zhigang, *Zhongguo Caishui Tizhi de Wenti yu Chulu (Problems and Solutions to China's Finance and Tax System* (Tianjin People's Press, 1994).

4. International compatibility

The previous enterprise income tax system was not compatible with international practice in such areas as: the tax contracting system with respect to SOEs; deduction of loan repayments in computing income; the various quasi-tax levies on enterprises; the separate tax system for domestic enterprise based on ownership; and the different tax systems for domestic and foreign investment enterprises.

Until recently, the Chinese economy was closed to the international market and therefore there was little need to establish a tax system compatible with international norms. All that has changed in the past few years. China needs foreign investment and ranked second in the world in attracting investment by multinational corporations in 1993.[35] In addition, the Chinese government wants to joint the General Agreement on Tariffs and Trade in the near future.[36] Since the establishment of stock exchanges in Shanghai and Shenzhen in 1990 and 1991, foreign investors have been allowed to invest in shares of Chinese companies; more than 30 large SOEs have been permitted to issue shares at the stock exchanges in Hong Kong, New York, and other places. In order to have their shares listed, SOEs must adopt an internationally-accepted accounting and tax system.

To bring the Chinese tax system within international norms, the Chinese government has planned to adopt a uniform enterprise income tax system for both domestic and foreign-invested firms on the basis of the Foreign Enterprise Income legislation.[37] Consolidating taxes for domestic enterprises is the first step towards that goal.

II. MAJOR PROVISIONS OF THE NEW TAX

The DEIT legislation consolidated three earlier taxes applicable to domestic enterprises and incorporated various interim regulations and a body of administrative rulings and practices.[38] It appears to have been modelled on the Foreign Enterprise Income Tax.

Compared with existing taxes, several important changes are reflected in the DEIT: the adoption of uniform rules for all domestic enterprises; replacement of the multiple-rate structure with a single rate; broadening of the tax base by prohibiting the deduction of loan repayments; the introduction of a foreign tax credit mechanism to avoid international double taxation; extension of the loss carry-forward period from three years to five years; and the clarification of tax incentive measures.

A. Taxpayers

The DEIT applies to SOEs, collective enterprises, private enterprises, joint-operation enterprises, joint-stock enterprises and other business entities. The DEIT legislation does not define the meaning of each of these enterprises. There is no general enterprise law in China, although companies are governed by the newly promulgated Company Law.[39] In order to carry on business, enterprises must register with the State Adminstration of Industry and Commerce and obtain a business licence. The business licence generally identifies the type and business scope of the enterprise.

1. State-owned enterprises

SOEs represent public ownership by the whole people, under which the State owns the means of production on behalf of all the working people.[40] Despite the recent growth in the number of collective and private enterprises and of foreign enterprises and Chinese-foreign joint ventures, the Chinese economy remains dominated by SOEs. In 1992 SOEs generated 48.1 percent of the national industrial output, employed 35.5 percent of the total workforce, possessed 74.6 percent of the total fixed assets and 65.5 percent of the total capital, and contributed 62.5 percent of the total budget revenue.[41]

SOEs are legal persons under Chinese law and may possess, use and legally dispose of property which they have been authorized by the State to operate and manage.[42] SOEs take

35. See World Investment Report 1994, published by the United Nations Conference on Trade and Development; *The Globe and Mail*, 31 August 1994, B5.
36. Ding Biqun, "Rejoin GATT and Our Country's Tax Reform", *International Tax* (May, 1994), at 11-13.
37. The FEIT legislation has been the most comprehensive tax legislation in China since 1949. That legislation is consistent with international tax norms and has been well received by foreign investors. See Li *supra* note 5.
38. Previously issued regulations or administrative rulings are still in effect unless they have been officially cancelled or are inconsistent with the provisions of the new legislation.
39. Company Law of the People's Republic of China, promulgated by the National People's Congress for implementation as of 1 July 1994. No implementing regulations have been issued. Companies will soon become a dominant form of doing business in China.
40. State-owned enterprises are called in Chinese as *guo you qiye*, i.e. state-owned enterprises or *guo ying qiye*, i.e. state-run enterprises. The full name for this type of enterprises is, however, *quanmin suoyouzhi qiye*, i.e. enterprises owned by the whole people).
41. Total industrial output, employees, capital and contribution to national budget by different types of enterprises:

	Industrial Output	Employees	Capital	Contribution to budget	Fixed assets
SOEs	48.1%	35.5%	65.5%	62.5%	74.6%
COEs	38%	45.8%	26.4%	31.1	19.9%
POEs	6.8%	16.2%	1%	2.6%	–
Others (including FIEs)	5.6%	2.5%	7.1%	3.8%	–

SOEs: state-owned enterprises
COEs: collectively-owned enterprises
POEs: privately-owned enterprises
Source: *Zhongguo Gongye Jingji Tongji Nianjian (China Statistical Yearbook on Industry and Economy)* (China Statistics Press, 1993), at 3-7.
42. Assets owned by the State must be registered with the administrative departments in charge of state-owned assets according to the Trial Measures for the Registration and Administration of Property Rights of State-Owned Assets" issued by the State Administrative Bureau of State-Owned Assets, the Ministry of Finance, and the State Administration of Industry and Commerce ("SAIC") on 11 May 1992.
The general manager of an SOE has decision-making power and runs the enterprise with the assistance of a management committee and an employee representative assembly. The general manager can be directly appointed by the relevant government department or appointed upon the recommendation of the employee representative assembly. The general manager is subject to the supervision of the assembly. See Law of the People's Republic of China on State-Owned Industrial Enterprises, promulgated by the First Session of the Seventh National People's Congress on 13 April 13, 1988 (hereafter the "SOE Law"), Arts. 44-48.

full responsibility for their profits and losses and practice independent business accounting. As is the case with other enterprises, SOEs may declare bankruptcy or merge with other firms.[43]

Where SOEs have been restructured into shareholding enterprises,[44] the financial liability of shareholders is limited to the value of their shareholding in the company. The extent of State participation in a shareholding company depends on the type of industry in which the company operates. In certain priority sectors, which include those characterized by market failures or that produce goods deemed to be of national strategic importance, companies remain wholly owned by the state; some small companies engaged primarily in commercial activities may be privatized; enterprises in between these two groups may be controlled by the State. Where the State is a minority or majority shareholder of an enterprise, the State participates in the decision making only to the extent of its representation.

2. Collective enterprises

There are two main types of Chinese industrial enterprises: SOEs and collective enterprises. Collective enterprises represent public ownership, under which the means of production are owned collectively by the people working in the enterprise.[45] Collective enterprises have grown rapidly in China; the number of industrial collective enterprises has grown from 264,7000 in 1978 to 384,500 in 1992.[46] These enterprises employed 45.8 percent of the total workforce, generated 38 percent of the total value of industrial output and contributed 31 percent of the national budget revenue.[47]

Collective enterprises take a variety of forms, ranging from small partnerships to relatively large concerns which are incorporated. The majority of collective enterprises are in rural regions and were previously operated by people's communes. Since the late 1970s, as restrictions affecting nonagricultural activities were progressively rolled back, rural collective enterprises sprang up, absorbing surplus rural labour and contributing to rising foreign exchange earnings.

The essence of a collective enterprise is that it is collectively-owned, rather than state-owned. Collective enterprises can retain profits and achieve significant productivity gains through reinvested earnings. In addition, they were initially given tax concessions, supplemented by access to credit from the rural credit cooperatives. The rapid growth of collective enterprises, however, is also attributable to the fact that they must be competitive on the market. Unlike SOEs, collective enterprises have no "captive" markets for their products or inputs and face significant financial pressures. They do not have the resources to support failing enterprises; the banks would similarly be disinclined to extend credit in the absence of government financing.

3. Private enterprises

Private businesses are operated either by sole proprietorships[48] or in the form of private enterprises.[49] A private enterprise may take the form of a partnership, sole proprietorship, or limited liability company.

Compared to SOEs and collective enterprises, private enterprises are small in scale. The majority of private enterprises are in rural areas and are concentrated in labour-intensive trades, such as industry, handicrafts, transportation and communications, and construction. Very few private enterprises engage in manufacturing, and their equipment and technology are generally backward.

4. Joint operation enterprises

Joint operations are an important form of business organization in China. They are formed by enterprises from the same or different regions and industries,[50] and usually take the form of partnerships or separate legal persons. Where a joint operation is created as an independent business entity and meets the requirements of a legal person, it may acquire legal person status upon the approval of and registration by the competent authority.[51] Where a joint operation does not satisfy the requirements of a legal person it is treated as a partnership. Profit sharing in a joint operation is flexible and depends primarily on the provisions of the joint operation agreement. Parties may distribute profits in accordance with their capital contribution and may also share the products produced by the joint operation. In principle, however, parties are required to share profits in proportion to the capital contribution.

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43. Regulations on Transforming the Management Mechanisms of State-Owned Industrial Enterprises, promulgated on 23 July 1992 by the State Council.
44. Measures for Share Enterprises Pilot Projects, issued by the State Commission on the Restructuring of the Economic System, the State Planning Commission, the Ministry of Finance, the People's Bank of China and the Production Office of the State Council on 15 May 1992. A state enterprise may be restructured into a company under the relevant company regulations, such as the Company Law of the People's Republic of China, promulgated for implementation on 1 July 1994; Measures for the Restructuring of State Enterprises in The Shenzhen Special Economic Zone Into Joint Stock Companies or Limited Liability Companies, promulgated by the Shenzhen municipal government on 17 August 1993.
45. Regulations Concerning Urban and Township Collective Enterprises, promulgated by the State Council on 21 June 1991.
46. *China Statistical Yearbook on Industry and Economy, supra* note 41, at 24.
47. *Id.*
48. They are commonly referred to as "individual industrial and commercial households". An individual industrial and commercial household is generally owned and managed by one member of a family or by the whole family. One or more "assistants", but not more than seven, can be hired if hands are needed. Such a household business may engage in small-scale industrial and commercial activities as well as services, in particular retailing, repairing, catering and consultancy. The relevant regulations are: Provisional Regulations on the Management of Individual Industrial and Commercial Households in Urban and Rural Areas, promulgated by the State Council on 5 August 1987; and Detailed Rules for the Implementation of the Provisional Regulations on the Management of Individual Industrial and Commercial Households in Urban and Rural Areas, promulgated by the SAIC on 5 September 1988.
49. Provisional Regulations on Private Enterprises of the People's Republic of China, adopted by the State Council on 3 June 1988, promulgated on 25 June and effective as of 1 July 1988.
50. A joint operation may be established according to the Interim Procedures for Administration of Registration of Joint Economic Organizations, issued on 31 March 1986. These regulations require the articles of association to set forth, among other things, the purpose, name and address of the new organization, capital contributions, profit and liability sharing, rights and obligations of each party, conditions for participation and withdrawal and organizational structure. The parties may then apply to the SAIC for a business licence.
51. Art. 114 of the Civil Law of the People's Republic of China adopted by the 4th Session of the 6th NPC on 12 April 1986.

For the purposes of the DEIT, a joint operation enterprise in the form of a legal person must pay income tax separately from the participating enterprises; a joint operation enterprise in the form of a partnership may not be a separate taxpayer if no independent accounting system is established. If the joint operation enterprise is a taxpayer, profits cannot be distributed before the payment of DEIT.

5. Shareholding companies

Under the Company Law, there are two types of companies, limited liability companies and joint stock companies.[52] Shareholding companies may be controlled solely or jointly by individuals, collectives or the State. The Company Law requires the State to retain a controlling interest in companies involved in energy, transportation and communications, and other sectors of key importance to the national economy. SOEs involved in national security, national defence and military sectors may not be restructured into companies without special approval.

Under the Company Law, the structure and management of shareholding companies are similar to those of companies in the West: shareholders' liability is limited to their equity in the company, the highest decision-making body is the board of directors, and dividends must be paid out of retained earnings.

6. Other business entities

For the purposes of the DEIT, other business entities registered with the government to conduct business activities are also taxpayers. "Other business entities" refers to research or educational institutions and social organizations that are engaged in business activities.

Partnerships[53] are not taxpayers under the DEIT. Where the partnership is formed between individuals, they are treated as private enterprises; where the partnership is formed by enterprises, if a separate entity is created with the status of a legal person, the partnership is treated as joint operation enterprises; in other cases, income derived by the partnership is taxed in the hands of partners.

B. Taxable income

1. General accounting rules

The accounting system in China has progressed from a single-entry accounting system to a double-entry accounting system based on internationally-accepted accounting principles.[54] A clear distinction is made between capital and revenue expenditures. Inventory must be taken at least once a year. Inventory is valued at actual cost, which is determined according to one of four methods: first-in first-out ("FIFO"), moving average, weighted average, or last-in first-out ("LIFO").[55] Once a method is chosen, a taxpayer may not change it without approval of the tax authorities.[56]

Income tax is imposed on a taxpayer's taxable income. Taxable income is computed annually and is the amount of revenue less costs, expenses and losses. A "taxation year" is the calendar year. A short taxation year is permitted where the taxpayer commenced or terminated its business in the year, or in the case of reorganizations.[57]

Income is calculated on an accrual basis for purposes of DEIT. Income is deemed to be realized where goods are sold or services rendered, regardless of the time of payment. Taxpayers may defer the recognition of income where payments for goods and services are deferred to future years, or where the manufacturing of goods or provision of services lasts more than one year.[58]

2. Inclusions in income

Article 1 of the DEIT Law provides that enterprises are taxable on their income from production, business and other income derived from both inside and outside China.

(a) General

Article 2 of the DEIT Regulations defines "income from production and business" to include income from manufacturing, farming, transportation, commodity trading, services and other income. "Other income" includes dividends, interest, rent, gains from the transfer of property (such as fixed assets, securities and land-use rights), fees for the use of proprietary rights (such as patents, proprietary technology, trade-marks, copyrights) and non-operating income. "Non-operating income" refers to income from fines, deposits, and forgiveness of debt.[59]

(b) Intercorporate dividends

Unlike the Foreign Enterprise Income Tax legislation, the DEIT does not provide for the receipt of intercorporate dividends on a tax-free basis. In order to avoid double taxation of income earned by one enterprise and distributed by way of dividends to another enterprise, Article 42 of the DEIT Regu-

52. Joint stock companies are subject to FEIT if foreign ownership of shares exceeds 25%.
53. Chinese law recognizes two forms of partnerships: general partnerships and limited partnerships. For example, Partnership Regulations introduced by Shenzhen on 20 April 1994. With respect to general partnerships, partners jointly contribute capital to and operate the partnership, and bear unlimited, joint and several liability for the debts of the partnership. With respect to limited partnerships, partners jointly contribute capital, with more than one partner bearing unlimited, joint and several liability for the debts of such partnership and with the other partners bearing liability to the limit of the amount of capital contributed by them.
54. General Principles on Enterprise Financial Affairs, promulgated by the Ministry of Finance on 30 November 1992; Standard Rules on Enterprise Accounting, promulgated on 30 November 1992.
55. DEIT Regulations, Art. 35.
56. *Id.*
57. DEIT Regulations, Art. 52.
58. In the case of instalment payments, sales revenue may be recognized when goods are delivered, when the invoice is issued or when payment becomes due. Where a construction, installation or assembly project, or provision of services lasts more than one year, or the processing or manufacturing of machinery, equipment or vessels lasts more than a year, revenue may be realized according to the portion of work completed during the year. See *Xin Shuizhi Nashui Zhinan (Tax Guide for the New Tax System)* (Haitian Press, 1994, at 155-56.
59. DEIT Regulations, Art. 7.

lations indicates that a dividend tax credit may be available to the recipient.[60]

(c) Capital gains

Gains from the transfer of property, such as fixed assets, securities and other property, are taxable as income. The term "other property" is not defined, but presumably includes land-use rights and intangible property.[61] The legislation provides no specific rules with respect to the computation of capital gains. Capital gains are taxed in the same manner as income from business and property.

For purposes of the DEIT, capital gains include gains from the liquidation of a business, which is the net asset value of the remaining property (i.e. the balance of all the taxpayer's assets net of all debts and losses) to the extent that it exceeds the amount of the paid-up capital.[62] Also taxable are foreign exchange gains and losses that are earned or incurred by a taxpayer in the course of preparing or carrying on production or business operations.[63]

3. Deductions

In computing income, taxpayers may deduct expenses incurred in the course of carrying on business, such as the cost of goods sold, sales and property taxes, and marketing and administration fees.

(a) Non-deductible items

Article 7 of the DEIT Law prohibits the deduction of certain expenses. These include capital expenditures, fines and penalties, losses from natural disasters or accidents which are indemnified by insurance, gifts and donations to charitable organizations in excess of the limits imposed by the government, and expenses unrelated to production and business operations.

(b) Current expenses

Interest expense is deductible if the amount of the interest is computed according to the market rate[64] and the money is borrowed for the purpose of earning business income. The market rate refers to the rate charged by financial institutions for ordinary commercial loans. Interest expenses incurred for acquiring fixed assets or intangible assets are not currently deductible, but can be added to the cost of assets and amortized.

Wages and welfare benefits are deductible. For the purposes of the DEIT legislation, "wages" includes salaries and wages, bonuses, subsidies and various fringe benefits.[65] Contributions to pension funds and unemployment funds are also deductible. Furthermore, Chinese law requires enterprises to pay union dues, employees' welfare contributions and fees to the employees' education fund. These payments are deductible at a prescribed portion of the total wages: 2 percent for union dues, 14 percent for employees' welfare contributions and 1.5 percent for employees' education fund.[66]

Enterprises that incur leasing fees may deduct the fees if the lease is an operating lease. Fees paid for financing leases are generally not deductible, although the interest component of the payment is deductible[67] and the remaining portion is depreciated during the prescribed useful life of the leased assets.[68]

Taxpayers engaged in financing, leasing or providing trade credit may claim a reserve for bad debts.[69] Some enterprises may also deduct a reserve for price reductions for commodities.

Entertainment expenses appear to be deductible, and no limitations are imposed on the deductible amount.[70] Enterprises may deduct gifts and donations to charities, relief funds, and other organizations for public benefits up to 3 percent of their taxable income.[71]

(c) Capital expenditures

The cost of acquiring capital assets may either be depreciated, or amortized according to detailed statutory rules.[72] Capital assets include both fixed assets and intangible assets. Fixed assets include all tangible capital assets, such as buildings, machinery, equipment and transportation vehicles. Assets worth less than RMB 2,000 that have a useful life of less than two years are deemed not to be capital assets. Depreciation is based on the "original cost"[73] of the assets less residual value[74] (normally 5 percent of the original cost) and is computed according to the straight-line method over the prescribed useful life of the assets. Depreciation may be

60. This article provides that where the dividends received by one enterprise from another enterprise and income tax was paid by the payer enterprise, the recipient may, in computing its tax payable, make appropriate adjustment for the tax paid by the payer enterprise.

61. The Constitution prohibits the transfer of land which is owned by the State or collectives.

62. DEIT Regulations, Art. 13, which is similar to the treatment under FEIT Regulations.

63. DEIT Regulations, Art. 24.

64. DEIT Law, Art. 6(1). Where interest is paid on loans from non-financial institutions, the amount of deduction is limited to the amount of interest computed according to the rate charged by financial institutions for similar loans.

65. DEIT Regulations, Art. 11.

66. DEIT Law, Art. 6 (3).

67. DEIT Regulations, Art. 17.

68. DEIT Regulations, Art. 30(4).

69. DEIT Regulations, Art. 18.

70. Under the FEIT Law, the deduction of entertainment expenses is limited to 0.3 to 1% of gross revenue of the taxpayer. For example, taxpayers engaged in manufacturing, construction and farming may deduct 0.5% of annual sales up to RMB 15 million; where the sales exceed RMB15 million, the deduction is limited to 0.3%. Taxpayers carrying on services and transportation businesses may deduct 1% of business revenue up to RMB 5 million; where the business revenue exceeds RMB 5 million, the deduction is limited to 0.5%.

71. DEIT Law, Art. 6(4).

72. DEIT Regulations, Part III; Accounting System for Enterprises in the People's Republic of China, passed by the Ministry of Finance on 24 July 1992.

73. The original cost is determined as follows:

a) for purchased assets, the purchase price plus freight, insurance, installation expenses and other related expenses incurred before they are put into use;

(b) for fixed assets manufactured by the taxpayer, the cost of production;

(c) for assets leased under an financing lease arrangement, the cost of the lease;

(d) for fixed assets acquired as a gift, the reasonable appraised price; and

(e) for assets contributed by investors as capital contribution, the market value of the assets.

Cost of improvement or expansion of fixed assets is considered part of the original cost. See DEIT Regulations, Art. 30.

74. If a taxpayer wishes to have a lower or no residual value, approval from the local tax authorities must be obtained. See DEIT Regulations, Art. 31(2).

claimed once the assets are put into use.[75] The useful life of fixed assets is 20 years for buildings, ten years for transportation vehicles, machinery and equipment and five years for tools and furniture.[76]

The cost of acquiring intangible assets may be amortized. "Intangible assets" include know-how, patents, trade marks, and the right to use a site. The amortization period is prescribed to be five years for start-up costs,[77] and ten years in other cases.

4. Deemed profit

If taxpayers are unable to submit complete and accurate evidence of their costs and expenses, their taxable income may be assessed according to a deemed profit rate or other method.[78]

5. Losses

Current losses are deductible by taxpayers in computing net income. Losses incurred in a taxation year may be carried forward for five years, but may not be carried back.[79] No distinction is made between capital losses and ordinary business losses, since capital gains are taxed as ordinary income. The legislation provides no special rules for the treatment of losses when enterprises are reorganized or where there is a change in control.

C. Rate

The income tax rate is a proportional rate of 33 percent. This rate is the same as the rate under the Foreign Enterprise Income Tax, and is close to the rates applicable to joint stock enterprises and other SOEs which make separate income tax payments and profit remittances to the government. The 33 percent rate would facilitate any future consolidation of the Foreign Enterprise Income Tax and the DEIT.

The 33 percent rate under the DEIT differs from the rate under the Foreign Enterprise Income Tax in that the latter designates 30 percent of the tax rate to be national and 3 percent to be local. Revenue sharing between national and local governments is governed by separate regulations.

D. Foreign tax credit

Enterprises are subject to the DEIT on their worldwide income. In computing their tax payable, taxpayers may claim a credit for foreign income taxes paid on foreign-source income. The credit is limited to the amount of Chinese tax otherwise payable on the foreign-source income.[80] Income from a foreign country is computed in accordance with Chinese laws; costs, expenses and losses may be deducted if they are attributable to the foreign-source income. Foreign-source income and foreign income taxes paid are computed on a per-country rather than a per-item basis. There is no requirement that the foreign tax be a direct tax. Underlying corporate taxes paid in a foreign country may also be eligible for the credit.[81] Any unused foreign tax credit can be carried forward for five years.[82]

E. Tax incentives

The DEIT legislation has consolidated various tax incentive measures under the previous taxes. Some tax concessions provided under previous laws and regulations remain in force.[83]

1. Incentives for special regions

Provincial governments may grant concessions to enterprises in the minority autonomous regions.[84] Enterprises pay tax at a lower rate of 15 percent if they are located in Shenzhen, Zhuhai, Shantou, Xianmen and Hainan special economic zones, Shanghai New Pudong area[85] or advanced technology development zones.[86]

2. Incentives for special industries

Tax is reduced or waived for certain types of enterprises, such as new- and high-technology enterprises, tertiary industrial enterprises, enterprises that carry out technology transfers, new enterprises engaged in labour employment services, factories established by schools, production enterprises for the handicapped and enterprises that produce non-staple foodstuffs.[87]

3. Incentives for small enterprises

Under the previous system, small SOEs and collective enterprises paid tax at progressive rates ranging from 10 to 55 percent. In order to minimize the increase in tax burdens on small firms, as a temporary measure, the tax authorities permit small firms to pay income tax at a lower rate of 18 percent if the annual taxable income of the firm is below RMB 30,000, or at the rate of 27 percent if the annual taxable income is between RMB 30,000 and RMB 100,000.[88]

75. The DEIT legislation does not specify the term of the useful life and refers to other regulations. DEIT Regulations, Art. 31(3).
76. Jiang and Zhao, *supra* note 16, at 206.
77. Start-up costs incurred from the date on which approval is granted for preparation of the enterprise, such as incorporation costs, expenses connected with conducting feasibility studies, and legal fees, may be amortized for five years after the commencement of production and business operations. See DEIT Regulations, Art. 34.
78. DEIT Regulations, Art. 47.
79. DEIT Law, Art. 11, and DEIT Regulations, Art. 28.
80. DEIT Law, Art. 12.
81. DEIT Regulations, Arts. 39-40.
82. DEIT Regulations, Art. 41.
83. See *supra* note 38.
84. DEIT Law, Art. 8.
85. For further, see B.X. Sang, "Pudong: Another Special Economic Zone in China? Any Analysis of the Special Regulations and Policy for Shanghai's Pudong New Area", 14 *Northwestern Journal of International Law & Business* (1993), at 130.
86. Jiang and Zhao, *supra* note 16, at 209.
87. Ministry of Finance and State Taxation Administration Notice on Several Preferential Policies on Enterprise Income Tax, 25 April 1994.
88. Ministry of Finance and State Taxation Administration Notice on Several Preferential Policies on Enterprise Income Tax, 25 April 1994; *Zhongguo Shuiwu (Chinese Taxation)*, 1994, No. 3, 14-15, at 15.

4. Lower rate for enterprises with overseas investors

Nine Chinese enterprises obtained approval from the Chinese government to issue shares at the Hong Kong stock exchange in 1993. With the approval of the Chinese government, another 22 enterprises will issue shares at the Hong Kong and New York stock exchange in 1994. The nine enterprises that issued shares in Hong Kong in 1993 pay income tax at the rate of 15 percent. However, enterprises that issue shares overseas in 1994 and thereafter will pay tax at the standard rate of 33 percent.[89]

F. Transfer pricing

Under Article 10 of the DEIT Law, affiliated enterprises must deal with each other on an arm's length basis. If the price charged between affiliated firms is different from the arm's length price, the tax authorities have the power to adjust the income of the enterprises.

The terms "affiliation" and "arm's length price" are not defined under the DEIT legislation. For purposes of the Foreign Enterprise Income Tax, the meaning of these terms seems to have been applied by reference.[90]

The term "affiliate" is broadly defined as any company, enterprise, or other economic organization that has direct or indirect control in the capital, business operations, sales and purchases of taxpayer, that is controlled by the same third party as the taxpayer, or that has any affiliate relationship with the taxpayer arising from mutual interests.[91] In practice, a company is considered an "affiliate" of a taxpayer where:
- the company directly or indirectly owns 25 percent or more of the shares of the taxpayer;
- a third party directly or indirectly owns at least 25 percent shares of both the company and the taxpayer;
- the taxpayer's debt to the company accounts for 50 percent of the taxpayer's total capital, or 10 percent of the taxpayer's debt is guaranteed by the company;
- more than half of the directors or high-level managers of the taxpayer are appointed by the company;
- the taxpayer's business operations depend on the use of the company's proprietary technology;
- the company controls the taxpayer's supply of raw materials and spare parts and the sale of products; or
- the company controls the taxpayer's business operations in other ways (for instance, the owners or managers of the two companies and the taxpayer are related).

An arm's length transaction refers to a business transaction between non-affiliated enterprises conducted at fair prices and according to common business practice. For instance, with respect to the sale of goods, the arm's length price is determined by internationally accepted methods, such as the price of a comparable transaction between unaffiliated parties, the profit margin from resale to an unaffiliated party, the cost-plus method or any other reasonable method.[92]

G. Tax administration

Tax administration is generally governed by the Law on Tax Administration and Collection.[93] Enterprises must file annual tax returns and accounting statements with the local tax authorities.[94] Tax is paid by monthly or quarterly instalments.

Enterprise groups cannot file consolidated tax returns. An enterprise must pay tax to the tax authorities in the jurisdiction where its actual management and operation is located. The head office of enterprises carrying on business in railway transportation, civil aviation, post and communication sectors must pay tax to the tax authorities in the jurisdiction where the head office is located.

III. EVALUATION OF THE NEW TAX

This part of the article evaluates the DEIT from the perspective of tax fairness, revenue yield, economic efficiency and international compatibility.

A. Fairness

The new tax makes the domestic enterprise income tax system more equitable and easier to implement by applying the same rules to enterprises with different forms of ownership; as a result, domestic enterprises will compete on a level playing field. State enterprises, especially large ones, are no longer required to pay taxes or quasi-taxes in addition to income tax payment; the new tax system will thus be less distortive to the market allocation of resources.

B. Revenue

Revenue yield from the new tax is likely to be equal to or to exceed the revenue from the old taxes, despite the fact that the new tax rate of 33 percent is much lower than the nominal rate of 55 percent applicable to SOEs and large collective enterprises. The reason for this is that the rate of 33 percent is close to the effective tax rate applicable to these enterprises. Under the new tax system, revenue yields may increase as a result of the elimination of various local tax concessions, the prohibition of deducting repayments of loan capital in computing income and the improvement in tax compliance.

C. Economic efficiency

The new tax system is more compatible with a decentralized economic setting in China than was the previous system. Economic reforms in China have been successful in several respects:

89. *Tax Notes International* (July 11 1994), at 90.
90. Jiang and Zhao, *supra* note 16, at 208.
91. FEIT Regulations, Art. 54.
92. *Id.*
93. The Law of the People's Republic of China on Tax Administration and Collection, promulgated on 4 September 1992 by the 27th Session of the 7th NPC (hereafter the "ATC Law"). The implementing regulations for the ATC Law were promulgated by the State Council on 4 August 1993.
94. DEIT Regulations, Art. 48.

- a market, although still limited, has been established for capital and labour;
- the price of most goods and services is no longer controlled by the government;
- private property rights are now recognized under law; and
- economically non-viable firms may be closed under bankruptcy laws and company laws.

Under the new tax system, enterprises, especially SOEs, are treated as independent economic entities and are not required to make fiscal contribution to the government other than in the form of tax payments and, in the case of SOEs, dividend payments.

D. International compatibility

The DEIT legislation, although rudimentary by Western standards, has moved the tax system for domestic enterprises closer to the Foreign Enterprise Income Tax, and thus closer to international tax norms.

IV. ISSUES FOR FURTHER STUDY IN CHINESE ENTERPRISE INCOME TAX REFORM

The Chinese government plans to introduce a uniform enterprise income tax system in a few years. Some issues must be studied further before the next step in reform is taken.

A. Taxation of corporations

Corporations will soon become an important form of business organization in China. The enterprise income tax law should incorporate some of the special features of corporate taxation in other countries.

1. Relief from double or multiple taxation of income earned through corporations

Corporations are legal entities separate from their owners-shareholders. Corporations are legal persons under Chinese law and are liable for their own debts and liabilities. Corporations are taxed separately from shareholders, resulting in double taxation of income earned through corporations.

(a) Intercorporate dividends

Under the DEIT, corporations must include dividend income received from other corporations in computing their income; the recipient corporation may claim a credit for the corporate income tax paid by the payer corporation in respect of the dividends. The effect of the credit is to allow the recipient corporation to receive inter-corporate dividends tax-free.

Since all corporations are subject to a 33 percent tax rate under the DEIT, it is simpler to provide an exemption for intercorporate dividends. Where the tax rate is reduced under a particular tax incentive measure, the Government may exempt the inter-corporate dividends from the recipient's income in order to preserve the effect of the incentive. Given the sophistication of tax administrators and taxpayers, the exemption method is simpler than the credit method. In many cases, a simple system will achieve many of the goals of integration without imposing a significant compliance burden on taxpayers and administrators.

(b) Integration of individual and enterprise income taxes

Integration generally refers to the integration of taxation of income at the corporate and shareholder level so as to avoid double taxation of the same income. The integration issue arises because corporations are taxed separately from their shareholders, and income earned by the corporation may be more or less heavily taxed than if the income had been earned directly by the shareholder.

Is there double taxation of income earned through corporations in China? The answer is clearly "yes". Under the current tax system, corporations are taxable on their income at a rate of 33 percent, and individual shareholders are taxable on dividends under the Individual Income Tax ("IIT')[95] at a flat rate of 20 percent of the gross amount.[96] The aggregate tax burden is, therefore, 46.4 percent (100 x 33 percent plus 67 x 20 percent). If the corporate income is business income and is earned directly by an individual, the top marginal rate under the IIT is 35 percent; if the corporate income is interest and the interest is earned directly by an individual, the rate under the IIT is 20 percent of gross payments; if the corporate income is rental or royalty income, the rate under the IIT is 20 percent of the amount net of expenses.[97] Therefore, the combined tax rate of 46.4 percent is much higher than the rate under the IIT if the income is earned directly by the individual.

Is the problem of double taxation serious enough to merit relief at the individual income tax level? The answer is "no", at least for the moment and for several reasons. First, the higher tax burden on distributed corporate profits implies that income earned and retained in corporations will benefit from tax deferral. The benefit of tax deferral will encourage corporations to use the retained earnings for reinvestment instead of paying dividends. Reinvestment of profits in business activities is more beneficial to the Chinese economy than using the funds for personal consumption.

Second, there is no evidence that wealthy individuals are using corporations to defer their tax liability indefinitely. Less than two percent of China's industrial enterprises are owned by individuals.[98] Moreover, equity investment by Chi-

95. Individual Income Tax Law of the People's Republic of China, adopted by the 4th Session of the Standing Committee of the 8th NPC on 31 October 1993 and promulgated by the President on the same date (hereafter the "IIT Law"); Implementing Regulations for the Individual Income Tax Law of the People's Republic of China, issued by the State Council on 29 January 1994 (hereafter the "IIT Regulations").
96. IIT Law, Art. 3. The IIT does not allow any deduction for carrying charges and other costs of earning such income. Dividends paid to foreign investors by a joint venture or wholly foreign-owned enterprise are exempt from tax under the Foreign Enterprise Income Tax; FEIT Law, Art. 19.
97. IIT Law, Art. 3.
98. See *supra* note 41, at 3.

nese individuals has been mostly in corporations controlled by the State; individual shareholders cannot dictate a corporation's dividend policy.

Third, in view of the fact that an individual income tax has been in effect in China since 1980, and that less than 10 percent of the population are subject to the tax, introducing a dividend tax credit system to prevent double taxation will complicate tax compliance and administration. If an exemption method is used to exclude dividends from the tax base, investors would be attracted to invest in stock; the tax system would create a distortion to investment decisions between debt investment and equity investment.

This is not to say, however, that China should not consider integration issues. As China begins to develop corporations and the ownership of corporations by individuals, it will need to develop rules to avoid double taxation. Integration will become an important issue when closely-held enterprises become more common and create more opportunities for tax deferral and greater costs from double taxation. In the meantime, badly implemented integration may lead to complexity in the tax system and create opportunities for tax avoidance, especially where the corporate income tax rate is lower than the individual income tax rate. Therefore, if the Chinese government intends to introduce integration, the system should be able to minimize both double taxation and tax avoidance.

2. Reorganizations

The DEIT legislation contains no rules to deal with the tax consequences of reorganizations. Corporate reorganizations in the form of mergers, divisions and dissolutions[99] are recognized under the Company Law and enterprise laws. A SOE may also be restructured into a company. For example, under the Company Law, a company may merge or consolidate with another company or be divided into two or more companies. The merger of companies may take one of two forms:

- merger by absorption, whereby one or a number of companies joins another company, and the joining parties are dissolved while the party absorbing them survives; or
- merger by new establishment, whereby two or more companies merge into a new company and the original enterprises or companies are dissolved. The surviving or newly established company succeeds to all the claims and debts of the merging enterprises or companies.[100]

The Chinese government should consider rules to allow tax-free reorganizations. At present, where an enterprise is restructured into a corporation, the assets of the enterprise must be evaluated, and market value is generally used as the basis to determine the value of the stock. Any gains or losses resulting from the evaluation must be recognized for income tax purposes. In some situations, where a foreign investment enterprise is incorporated into a joint stock company, rollover treatment may be available if the company does not bump up the cost base of the assets to market value.[101]

3. Corporate groups

In general, the DEIT legislation does not permit a group of enterprises[102] to file consolidated tax returns. As a temporary measure, however, 55 enterprise groups have been permitted to consolidate the income and losses of the member enterprises.[103] The parent or core enterprise within each group must provide relevant information to the local tax authorities with respect to the place of tax payment, name and address of the parent enterprise and enterprises controlled by the parent enterprise.

If the Chinese government intends to use the income tax system as a tool to encourage the development of enterprise groups, it should incorporate rules into the DEIT to deal with the definition of "enterprise groups" and consolidation of income and losses among the members of the group.

B. Limit the use of tax incentives

1. Reasons for the widespread use of tax incentives

The income tax system is frequently used by the Chinese government to influence economic activity. Special treatments, in the form of low tax rates or accelerated write-offs, are allowed for certain types of activity; special areas qualify for reduced rates of tax and tax holidays;[104] and there are special tax incentives for foreign investment enterprises.[105] Some of tax incentives have been introduced as policy choices (such as the incentives for foreign investment enterprises); others were introduced on an *ad hoc* basis to meet the immediate demands of economic development (such as the lower rate of tax for shareholding enterprises) or a particular type of enterprise (such as incentives for enterprises doing business outside China).

Although the DEIT legislation has consolidated the rate structure and rules on computing income and losses for all

99. The Company Law, *supra* note 39, for example, sets forth situations in which a company may be dissolved and liquidated. These situations include:
- the occurrence of events stipulated in the company's articles of association as reasons for dissolution,
- a decision by the shareholders' general meeting for dissolution,
- the closure of the company due to violation of laws or regulations or injury to the public interest; or
- the declaration of bankruptcy of the company.

100. Regulations on Transforming the Management Mechanisms of State-Owned Industrial Enterprises, promulgated on 23 July 1992 by the State Council.

101. According to an interpretation notice issued by the State Tax Administration, where a foreign-investment enterprise ("FIE") is restructured into or merged with a joint stock company, any gains or losses realized by the transfer of the FIE's assets to the company must be reflected as gains or losses of the FIE.

102. The Chinese government has encouraged the formation of large enterprise groups with the aim of rationalizing the industrial structure by taking advantage of economies of scale and promoting the optimum use of resources. Unlike many former centrally planned economies, China's economy was highly cellular, as each locality was encouraged to be fully self-reliant during the pre-reform period. Furthermore, enterprises within one industry were normally not allowed to diversity into related fields. As a result, from a national perspective, there was much duplication, a lack of specialization and strong local barriers to interregional trade.

103. Notice on Income Taxation of Large Enterprise Groups, issued by the State Tax Administration on 8 February 1994.

104. For example, the Special Economic Zones, Economic and Technology Development Zones, Open Coastal Areas, New- and High-Technology Zones, etc; *supra* notes 84-90.

105. These incentives take the form of lower rates, tax holidays and tax refund. See FEIT Regulations, Part 6.

domestic enterprises, discretion and flexibility remain, especially in the area of granting tax incentives. There seem to be three reasons for this. First, the administration of tax policy in China is influenced by multiple objectives. At the central government level, tax policy is made with a view to meeting the needs of budgetary revenue and for ensuring fairness in tax treatment. However, tax policy and tax rules are administered in China by the provincial and local governments whose actions are often guided more by the need to encourage local economic activity and employment or to improve the overall welfare of local population.[106] As a result, the administration of tax policy is often affected by a mixture of local economics and politics.

Second, multiple agencies are involved, in one form or another, in influencing taxes borne by enterprises, especially SOEs. For example, local tax bureaus and local finance bureaus work closely to determine the amount of tax payable by local enterprises. Similarly, the State Tax Administration, Ministry of Finance and the supervising department of the individual enterprise controlled by the central government generally determine whether special tax relief should be given to certain enterprises. Finally, the government attempts to maintain the after-tax profit level of enterprises.

It may take some time before the uncertainty caused by the widespread use of discretion and flexibility is eliminated from the Chinese tax system.

2. Policy implications of tax incentives

The use of tax incentives in China as regulatory tools had some negative consequences. Tax incentives reduced the revenue stability of the tax system. It is difficult to estimate the revenue impact of a tax incentive because of the numerous tax incentives which interact in unanticipated ways, and the lack of a sophisticated data collection and processing system. It seems clear, however, that tax incentives can lead to revenue shortfalls, which in turn require higher statutory tax rates to attain revenue goals (the budgetary adjustment fund is a case in point). Higher tax rates generally increase the problems associated with tax incentives.

Second, the use of tax incentives encouraged local governments and enterprises to compete with each other for more incentives. It also gives a great degree of discretionary authority to local tax authorities. This can lead to the loss of control of the use of tax incentives by the Central Government and loss of tax revenue. Tax incentives have been used in China as form of government subsidy, especially for enterprises in poor financial situation. The efficiency of the incentives is highly questionable. The incentives were intended to compensate for market imperfections and that would hinder the economic reform process. Achieving the appropriate mix of tax incentives in the face of a complex and dynamic market was impossible in China.

Tax incentives, by their nature, attempt to distinguish among different taxpayers and different activities, and cause complexity in tax administration and compliance. Moreover, incentives often lead to tax avoidance activities and result in revenue loss.

Tax incentives may be warranted in a limited number of instances. One situation is where the social rate of return exceeds the private rate of return and enterprises would therefore tend to under-invest in the activity. For example, research and development and tax relief for certain foreign investment should be encouraged though the tax system.

3. Tax relief for foreign investment

At present, various types of income tax relief are provided to foreign investors. The use of this relief has been justified in the past to encourage initial investments by foreign corporations, which was seen as necessary, given the high statutory tax rate in China. It is not clear that tax relief is an important factor in attracting foreign capital.[107] Access to the Chinese market, the cost and availability of resources and labour, adequate infrastructure, the ability to repatriate capital and stability in government are more important factors than taxation, provided the tax system is within international norms. Special tax relief may be retained for special enterprises, such as high-tech enterprises, export-oriented enterprises and firms investing in less developed regions in China; other types of relief should be phased out over time. The goal should be to have a common income tax system that applies equally to both foreign and domestic enterprises.

C. Revenue sharing between national and local governments

1. Unitary tax system

China is a unitary country, with the national government having the sole legislation power. All tax laws are enacted by the National People's Congress, by the State Council or a ministry under the State Council under the authority delegated to it. Even legislation governing local taxes is generally promulgated by the national government for local implementation.

2. Revenue sharing

Tax revenues are shared between national and local governments according to decisions of the State Council.[108] Revenue from the DEIT is shared as follows: tax paid by enterprises controlled by the Central Government[109] and banks and

106. China is in the process of establishing a national tax administration system under which all tax bureaus administering national taxes are under the direct control of the central government. Once that process is completed, uniform tax administration may be accomplished. The impact of the change is unclear yet.
107. Yu Po, "Thoughts on Foreign Tax Incentives", *International Taxation* (February, 1990), at 11; Hu Zhenfang and Jiang Shengjian, "Discussion of Several Issues on Foreign Tax Incentives", *International Taxation* (January, 1992), at 19; Shen Jingzhang and Mao Jing, "China's Foreign Tax Incentive Policy Must be Adjusted", *International Tax* (June, 1992), at 33.
108. State Council Decision with respect to the Implementation of A Tax Assignment and Fiscal Management System, *Guofa*, (1993) No. 85.
109. In China, SOEs have been established by both the central and local government. SOEs established by the Central Government are controlled by ministries under the State Council and are generally enterprises in key industries, such as transportation, banking, insurance, foreign trade and steel manufacturing.

other financial institutions belongs to the Central Government;[110] income tax paid by other enterprises belong to local governments.[111] In other words, income tax from SOEs is retained by the level of government which owns them, and income tax from collective enterprises and private enterprises is retained by local governments.

This practice has been the source of much of the special tax relief and discretionary adjustments, with serious implications for the revenue elasticity of the tax system. Local tax officials have been particularly vulnerable to influence and pressure from local governments to provide aid to local enterprises.

3. Reform the revenue sharing system

The revenue sharing system should not be based on ownership of the enterprise; taxes collected from all enterprises in a region should be shared by different level of government according to a prescribed formula. For example, 30 percent of DEIT collected from all domestic enterprise can be national revenue, and 3 percent can be local. The local tax rate could vary depending on the fiscal situation of the local government.

With respect to multijurisdictional enterprises, the amount of revenue attributable to a particular jurisdiction should be determined by applying a formula on the basis of the proportion of sales, payroll, assets, etc. located in that jurisdiction.

Furthermore, tax administration must also be free of interference from local governments. The State Tax Administration should have direct control over tax authorities at the local level in administering national taxes.

V. CONCLUSIONS

The DEIT legislation has improved both equity and efficiency in China's tax system and has made the tax system much easier for compliance. It is hoped that when the DEIT is consolidated with the Foreign Enterprise Income Tax in the near future, the issues identified in the last part of the article can be addressed.

110. Other fixed tax revenues of the Central Government include tariff, customs duties, sales taxes collected by the Customs, Business Tax paid by the national railway enterprises, banks and insurance companies. See State Council Decision, Part III, Sec. 2, *supra* note 109.

111. Other local revenues include Business Tax paid enterprises other than banks and insurance enterprises whose taxes are paid by the head office, IIT, Urban Land Use Tax, House Property Tax, Vehicle and Vessel License Tax, Stamp Tax, Slaughter Tax, Agriculture and Husbandry Tax, Deed Tax and Land Value Added Tax. See State Council Decision, Part III, Sec. 2, *supra* note 109. For a discussion of some of these taxes, see Li, *supra* note 2, chapter 7. Revenues from the Value Added Tax, Resource Tax and Securities Transaction Tax (to be introduced later) are shared between the Central and local government; 75% belongs to the Central Government and 25% belongs to local governments.

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Supplemented: annually.
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Supplemented: once per year.
Publication containing the texts of the law on motor vehicles and an article by article commentary thereto. Various examples of motor tax return forms are included.

– No. 8. Gemeentelijke belastingen e.a. waarin opgenomen de onroerend goedbelasting, provinciale belastingen, waterschapsbelastingen en milieuheffingen. Edited by P. de Bruin; J.P. Kruimel, assisted by J.W. Ilsing and J.A. Monsma.
Supplemented: four or more times per year.
Publication in five binders providing information on municipal taxes, including the real estate taxes. Regional and environmental taxes and other levies. Included are texts of the law, commentaries thereto, decrees, regulations, cases and historical surveys.

FISCALE ENCYCLOPEDIE "DE VAKSTUDIE"
Edited by D.B. Bijl; J.A.C.A. Overgaauw; L.G.M.Stevens and others.
Deventer, Kluwer.
– Vol. 1. Algemeen deel, bevattende de algemene wet bestuursrecht, (AWB), algemene wet inzake rijksbelastingen (AWR) en de wet op de internationale bijstandsverlening bij de heffing van belastingen (WIB) en de wet administratieve rechtspraak belastingzaken (wet ARB).
Original editor: M.K. Kamperman, continued by L.A. de Blieck; Ch.J. Langereis; J.B.H. Röben and others.
Supplemented: six or more times per year.
Publication in six binders dealing with general management law, general tax law, international mutual assistance law and tax appeal procedures. The work provides an explanation of each section of the law, the text of the law and connected by-laws. References to case law and important literature are appended.

– Vol. 2. Wet op de inkomstenbelasting 1964. Edited by J.A.C.A. Overgaauw and H.B.A. Verhoeven, assisted by R.C.J.M. Arts, E.B. Jaspers and others.
Supplemented: more than 20 times per year.
Publication in 14 binders dealing with the individual income tax law of 1964. The work provides an explanation of each section of the law, the text of the law and connected by-laws. The income tax tables for a number of years are also included. References to case law and important literature are appended.

– Vol. 3. Wet op de vermogensbelasting 1964. Original editor: T.J. Korthof, continued by C. Schaap.
Supplemented: quarterly.
Publication in three binders dealing with the net wealth tax law of 1964. The work provides an explanation of each section of the law, the text of the law and connected by-laws. References to case law and important literature are appended.

– Vol. 4. Wet op de loonbelasting 1964. Edited by F.H. Lugt and J.P.F. Slijpen; assisted by J. de Blieck and J.P.F. Slijpen.
Supplemented: monthly.
Publication in seven volumes dealing with the wage tax law of 1964. The work provides an explanation of each section of the law, the text of the law and connected by-laws. Wage tax tables, the instructive guide on the wage tax, social security premiums, and saving and profit schenes for employees are dealt with. References to case law and important literature are appended.

– Vol. 5. Wet op de vennootschapsbelasting 1969. Edited by H. Smit and F. Zevenhuijzen, assisted by H.K.C. Bakker, H.N. van der Kolk, J.M. Schellekens, R.L. van de Water and others.
Supplemented: monthly or bi-monthly.
Publication in eight binders dealing with the corporate income tax law of 1969. The work provides an explanation by section of the law, the text of the law and connected by-laws. References to case law and important literature are appended. Other subjects dealt with are dividend taxation, standard conditions, double taxation and juridical mergers.

– Vol. 6. Wet op de omzetbelasting 1968. Original editor: L.F. Ploeger, continued by D.B. Bijl; M.E. van Hilten; G.D. van Norden; J.B. van der Zanden.
Supplemented: four or more times per year.
Publication dealing with the value added tax (turnover tax) of 1968. The work provides an explanation by section of the law, the text of the law and connected by-laws. Lists in alphabetical order of products with subject to the reduced rate are included. VAT in six other EU-countries is also referred to. References to case law and important literature are appended.

– Vol. 7. Successiewet 1956. By A.C. Gorren, continued by L.M. Holdert and C.M. Lambregtse.
Supplemented: quarterly.
Publication in two volumes dealing with the death duties and gift tax of 1956. The work provides an explanation by section of the law, the text of the law and connected by-laws. Included are the Royal decree on avoiding double taxation, an extract of the "Natuur schoonwet", and the interest rates on tax debts and claims. References to case law and important literature are appended.

– Vol. 8. Personeelsvoorschriften. By E.W. Nijgh.
This publication contains the national conditions of service, labour agreement decree, the general civil servant pensions act and the civil servant unemployment regulations. The salary scales and the travel and subsistance regulations are appended.

– Vol. 9. Investeringsregelingen. Edited by J.A. M. Klaver; J.H. Krefeld; P.C. Maris and L.G.M. Stevens and assisted by P.A.Th. van Agtmaal; P.M.F. van Loon and various others.
Publication containing a survey of the basic investment premium scheme, general survey of regulations, the Law on Investment Regulations (WIR) (no longer in force), investment premium scheme and regional, shipping, research and development stimulation measures.

– Vol. 10. Invorderingswet 1990. By J.A.C.A. Overgaauw; A. van Eijsden; J.C.E. Gronski and C.J. van Noord.
Publication containing the text of the law concerning the collection of taxes and commentaries thereto. The implementing decree and amendment, the collection costs, parlimentary history of the 1990 law and instructions for collection.

– Vol. 11. Jaarverslaglegging. By E. Bos Ra; R.P. van den Dool; H.M.M. Smeets and others.
Loose-leaf publication dealing with the fiscal and commercial rules concerning the annual report, including those described under title 9, book 2 of the Civil Code and title 11, book III, Civil Claim Law (Rv), with commentary per paragraph and a number of EC-directives. The text of the relevant laws, including the annual account law, are appended.

– Vol. 12. Accijnzen. Waarin ook opgenomen de verbruiksbelastingen van alcoholvrije dranken en andere produkten.
Loose-leaf publication in two binders containing the excise duties act of 1991, the introductory guide concerning excises, the text of harmonization regulations of excise taxes in the EU, the texts of the unification of excise taxes in the Benelux, and the rate scheme on the excise duties on mineral oils. The text of the law
of the consumption tax on alcohol-free drinks and some other products and the introductory law thereto are included in a separate section.

– Vol. 13. Lokale belastingen en milieuheffingen. By P. de Bruin and J.P. Kruimel, assisted by P. van Berg; E.G. Borghols and others.
Loose-leaf publication in two volumes dealing with provincial, semi-govermental organizations and local enviromental taxes. The relevant laws and the important levies are included. Comments on the law on municipalities authorizing them to impose certain local taxes and the new regional law are to be included in the future.

– Vol. 14. Wet op de belastingen op rechtsverkeer en registratiewet 1970. By H.S.A. van Gils.
Loose-leaf publication in one binder dealing with transfer tax, formation tax, insurance tax and registration procedures. The appendix contains statutes, examples of filing return forms and an explanation of the laws.

– Vol. 15. Belastingheffing van motorrijtuigen, Wet op de motorrijtuigenbelasting 1992, Wet op de belasting van personenauto's en motorrijwielen 1992. By L.A. Blieck; G.J. van Es; R.E. van Pomeren and J.B.H. Röben.
Loose-leaf publication in one binder containing the text of the law of taxation of motor vehicles of 1992 and the texts of the special consumption tax on cars are included. Coming supplements will contain commentaries to those laws. The introductary guide to the special guide and texts of traffic regulations are published in the appendix.

FISCALE WETTEN
Serie Nederlandse Wetgeving (Series Netherlands Legislation)
By Ch.P.A. Geppaart; A. Meering and C. van Soest. Compiled by G.J.L. Seesink.
Deventer, FED/Kluwer.
Supplemented: six times per year.
Publication in two volumes containing compendium of texts of relevant tàx laws imposed in the Netherlands. Publication dealing with the Value Added Tax Act of 1968. The work provides an explanation per section of the Law. The text of the law and connected by-laws.

FISCALE MODELLEN
Met inleiding en toelichting. Edited by E. Chaudron; F.W. Imhof; P.C. van Maris; assisted by G.H.Th. van de Bult; G.D.Th. van de Bult and others.
Deventer, Kluwer.
Supplemented: twice per year.
Loose-leaf publication of forms in two binders for tax practitioners providing information on tax procedures, illustrated by samples of letters to the tax inspector. Relevant text of statutes with explanation is appended. All fiscal models in the book are also published on a floppy disk, which is updated two times a year and are included in the subscription, and only available for subscribers.

FISCALE WETTEN
Serie Nederlandse Wetgeving (Series Netherlands Legislation). By D.B. Bijl, Ch.P.A. Geppaart. Compiled by A.J.M. Timmermans
Deventer, FED/Kluwer.
Supplemented: six or more times per year.
Publication in six volumes containing compendium of text of all tax laws imposed in the Netherlands. Included are the wage tax and individual income tax tables, old tax laws and the Dutch texts of the treaties to avoid double taxation.

FISCALITE EUROPEENNE: PAYS BAS
By Pierre Fontaneau.
Nice, Les Cahiers Fiscaux Européens.
Supplemented: quarterly.
Publication in two volumes containing information on the corporate income tax, individual income tax, value added tax, net wealth tax and succession and gift taxes in the Netherlands.

HANDBOEK VOOR IN- EN UITVOER
Edited by P.J. Vogelaar; J.P.G. Koedijk and D.G. van Vliet.
Alphen a/d Rijn/Deventer, Samsom/Kluwer.
Publication providing information on import duties, other taxes and levies. Information on formalities and supervision on the import and export of goods. As EU regulations are dominant in the field of international trade and are changing rapidly the contents of this publication is regularly adapted to keep up with the current situation. The series is divided in the following four parts:

– Vol. A. Intracommunautaire transacties. By J.W.M. Gulickx; J.W. Taken and C. Verwey.
Supplemented: regularly.
Contains information on the levies at importation, such as customs duties, turnover taxes and excise duties. The refund of import taxes, exemptions, customs value of good, etc.

– Vol. B1. Gebruikstarief. By A.B. Roltink.
Supplemented: regularly.
Contains the import and value added tariffs of goods as listed in the Brussels nomenclature. Included are regulation, certificates, forms, etc.

– Vol. B2. Gecombineerde nomenclature. By H. de Pagter and I.H.J. Wind.
Supplemented: eight times per year.
Gives an explanation of all items of the combined nomenclature and for a number of subdivisions the official explanation, as agreed in the EU or other international organizations.

– Vol. C. Algemene wetgeving inzake douane. By C.C.M. Gijsbers; P.H. Jacobs; L. Ruseler.
Publication describing and providing information on the general provisions of the Customs Law.

KLUWERS FISCAAL ZAKBOEK
By E. Eikelboom.
Deventer, Kluwer.
Supplemented: six or more times per year.
Survey of tax developments in the Netherlands. Almost all fiscal problems are considered. Problems occurring by the application of tax laws are explained with practical examples. Description of the main principles of double taxation and some commentaries to double taxation agreements are included.

KLUWERS SUBSIDIEBOEK
Subsidies en financieringsregelingen van de overheid.
By P.J.A.M. Snels and his colleagues of the subsidy-advisory team of Deloitte & Touche.
Deventer, Kluwer.
Supplemented: six or more times per year.
Publication in four binders explaining subsidies and financing regulations enacted by the government which affect businesses. Apart from an overvieuw of the incorporated regulations, these are treated all the same way to make them more understandable.

KLUWERS TARIEVENBOEK
By E. Eikelboom.
Deventer, Kluwer.
Supplemented: six or more times per year.
Publication in three binders containing the income tax tables, wage tax tables, company tax tariffs, net wealth tax tariffs, social security levies, information on labour conditions, business price regulations, fees, schedules of free professions, telephone and post tariffs, etc.

LEIDRAAD BIJ DE BELASTINGSTUDIE
Original editors: C. van Soest and A. Meering, continued by H.M.N. Schones, assisted by H.S.A. Gils; R.L. van de Water and others.
Arnhem, Gouda Quint.
Supplemented: five times per year.
This publication in two binders is designed as a guide for studying the Dutch tax system. It describes the basic principles, taxation laws, avoidance of double taxation, and important tax cases.

MODELLEN VOOR DE RECHTSPRAKTIJK
By W.J. Slagter; W.J. Kleyn; M.J.A. van Mourik and others.
Deventer, Kluwer.
Supplemented: three or four times per year.
Loose-leaf in five volumes containing more than 1,100 forms for legal practice. Current forms in accordance with the new Civil Code are included.

NEDERLANDSE JURISPRUDENTIE INZAKE INTERNATIONAAL BELASTINGRECHT
Directe belastingen van internationaal opererende ondernemingen.
Amsterdam, IBFD Publications BV.
Supplemented: one or two times per year.
A thorough analysis of the Dutch case law regarding important international tax law topics, including: residence of companies, permanent establishnents, permanent representatives and the fixed base, arm's length dealings between domestic and foreign group companies and procedural aspects. With regard to each subject, the case law is analysed and all cases are summarized. The book also contains texts of relevant laws and treaties, general jurisprudence, list of resolutions and the applicable articles. This publication is an update of a report compiled by the Tax Section of the Faculty of Law of the University of Groningen under the chairmanship of professor A. Nooteboom in 1986.

NEDERLANDSE REGELINGEN VAN INTERNATIONAAL BELASTINGRECHT
By C. van Raad; H. Born, D. Hund; M.P. Bongard; B.P. Dik; M.J. Ellis; W.F. Wijnen and B.J.J.M. Lucas Luijckx.
Deventer, Kluwer.
Supplemented: two or more times per year.
Publication in 10 volumes exclusively designed to provide a compendium of the text and comment on each of the Netherlands provisions on international tax law. The full text of all the comprehensive double taxation treaties on income/capital and death duties concluded by the Netherlands with other countries, as well as limited treaties on income from shipping and airline operation enterprises are published. Implementing provisions thereto both from Netherlands and foreign tax administrations are appended. In addition, an introduction to international tax law and a comment on each comprehensive double taxation treaty on income/capital and death duties is provided. References to case law and important literature are appended. The annual pocket edition of the Dutch double taxation treaties is included in the subscription.

NEDERLANDSE WETBOEKEN EN AANVERWANTE WETTEN
Editors J.A. Borman; C.J. van Zeben and others. Compiled and edited by H.J.M. Bredt and L.E. van Doorn.
Serie Nederlandse Wetgeving, Part B.

Deventer, Kluwer.
Supplemented: six times per year.
Publication in five volumes containing text of Dutch civil laws.

NOORDUYN BELASTINGWETGEVING
Original editor J.H. Christiaanse.
Arnhem, Noorduijn, P.O. Box 1148, Arnhem.
This extended commentary to the various tax acts of the Netherlands is divided in seven volumes mentioned below:

– Vol. 1. Algemene wet inzake rijksbelastingen/Wet administratieve rechtspraak belastingzaken. By W.P. van Sikkelerus and J.B.H. Roben.
Supplemented: two or three times per year.
Publication containing text and comment per article of the Dutch General Tax Code, which is intended to codify the general provisions applicable to all taxes in so far as they concern formal law and penal law. The text of and comment on the law concerning administrative procedure in tax affairs, the regulations to avoid double taxation, the fiscal regulations between the countries of the Netherlands and the Royal Decree to avoid double taxation are included.

– Vol. 2. Wet op de inkomstenbelasting 1964. By T. Blokland and G. Bout and others.
Supplemented: five times per year or more if necessary.
Publication providing text of and comment on the individual income tax law of 1964 in six binders, containing the commentary to the articles of the law, the proposals for the life assurance and annuities law (Brede Herwaardering), Commentaries to the taxation of dividends and the taxes on games of chance, the profits from a company and the levying of premiums by assessment are dealt with.
References to case law and important literature are appended.

– Vol. 3. Wet op de vermogensbelasting 1964. By L.A. de Blieck and J. Wieten.
Supplemented: once per year.
Publication in three binders providing text of and comment on the net wealth tax law of 1964. Decrees, regulations and notices and the text of the "natuurschoonwet" are included.
References to case law and important literature are appended.

– Vol. 4. Wet op de loonbelasting 1964. By J.A. Rouwenhorst and J. Meulenbeld, continued by A.C.H. Hengeveld-Beereboom and M.G.B. Scholten.
Supplemented: six times per year.
Publication in three binders providing text of and comment on the wage tax law of 1964, including the regulations. Apart from the text of the law it contains the guide wage tax and social contributions, survey of the social security system and extracts of relevant social security agreements. References to case law and important literature are appended.

– Vol. 5. Wet op de vennootschapsbelasting 1969. By A.H. Boekhoudt; P.A.M. Daalmans; C. van Raad and others.
Supplemented: once or twice per year.
Publication providing the text of and commentary on the Corporate Income Tax Law of 1969. The relevant articles of the Individual Income Tax Act the standard conditions Art. 14 and 15, and comments to the taxation of dividends are included. A commentary dealing with the influence of the corporate tax on the international activities of companies is included. References to case law and important literature are appended.

– Vol. 6. Wet op de omzetbelasting 1968. By R.C. Tuk, with cooperation of A. Geering and J.D. Roomer.
Supplemented: three times per year.
Publication providing text of and comment on the Turnover Tax Law of 1968 (value added tax). In Article 34 of the law a branch-information list is appended, its classification system can easily be used to find the turnover taxes levied in the Netherlands. The relevant directives of the EC on value added tax are included. References to case law and important literature are appended.

– Vol. 7. Successiewet 1956. By G. Laeijendecker.
Supplemented: once per year.
Publication in two binders providing the text of and commentary on the Death Duty Law of 1956. An extract of the "natuurschoonwet", Royal Decree avoiding double taxation double taxation treaties and the interest percentages of the Collection Tax Act are included.
References to case law and important literature are appended.

OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF
By D.B. Bijland and E. Eikelboom.
Arnhem, Gouda Quint.
Supplemented: five times per year.
Publication in two volumes containing text and comment on the turnover tax (tax on value added) with emphasis on free profession and business activities. Not only tax liability but also administrative aspects of bookkeeping are dealt with.

RECHTSPERSONEN
Deventer, Kluwer.
Supplemented: about six times per year.
Publication entitled "Legal Persons" dealing with Book Two of the new Civil Code. Commentaries are given article by article, including the relevant court decisions and the related literature. Taxation problems in relation to the company law are also considered. The notifications of the department are treated in a separate chapter. Included are the Works Council Law; the European Company Law and European Corporate Tax Law Directives.

SOCIALE VERZEKERINGSWETTEN
Edited by J.J.M. Veraart.
Deventer, Kluwer.
Supplemented: 10 times per year.
Publication in 12 parts, in various binders, dealing with the Netherlands social security laws, social security contributions and their organization, prepared by various authoritative authors. The EU-regulations and bilateral and multilateral treaties are included.

STAATS- EN ADMINISTRATIEFRECHTELIJKE WETTEN
Editors J.A. Borman; C.J. van Zeben and others. Compiled and edited by H.J.M. Bredt and L.E. van Doorn. Serie Nederlandse Wetgeving, Part A.
Deventer, Kluwer.
Supplemented: six times per year.
Publication in five volumes containing the texts of public and administrative laws of the Netherlands.

Norway

JAROY, Jacob.
Norsk skattelovsamling 1993/94. Utfyllende regnskapsregler.
Skien, Jacob Jaroy. 1994, pp. 165.
A companion booklet to the annual compilation of tax law. It contains practical accounting rules with reference to the pertinent Norwegian law and practice and the EC corporate accounting directives.
(B. 114.030)

JAROY, Jacob.
Supplement 1994 til Norsk skattelovsamling 1993/94.
Skien, Jacob Jaroy. 1994, pp. 48.
Supplement to the main volume of tax legislation for the years 1993 and 1994. The supplement contains new and amended legislation enacted during the first seven months of 1994.
(B. 114.030A)

Spain

FISCALIDAD-93. IMPUESTO SOBRE sociedades 1992.
Madrid, Ernst & Young.
Cinco Dias, Vols. 2-8, 1993, pp. 420.
Volumes 2-8 of the series Cinco Dias on Spanish corporate taxes.
(B. 113.702)

United Kingdom

TOLLEY'S TAX PLANNING 1994-95.
Volumes 1 and 2. Edited by Glyn Saunders.
Croydon, Tolley Publishing Company Ltd. 1994, pp. 1850. £ 66.50.
Comprehensive guide to practical taxation strategies. This updated annual edition contains three completely new chapters. (The current year basis – sole traders and partnerships; Enterprise investment schemes; Unit trusts and collective investment schemes.) The chapter on trading overseas has been completely rewritten.
(B. 114.074)

TINGLEY, K.R.
Tolley's roll-over, hold-over and retirement reliefs. 4th Edition.
Croydon, Tolley Publishing Company Ltd. 1994, pp. 262. £ 37.95.
The book provides a clear, concise explanation of the calculation and operation of the three main capital gains tax reliefs. This revised and updated edition includes the provisions of the Finance Act 1994 dealing with the enhanced rollover relief on reinvestment in shares (entrepreneurial relief), indexation losses and transitional relief, and the considerably increased retirement relief limits.
(B. 114.075)

PRICE WATERHOUSE
Tolley's Estate Planning 1994-95. A comprehensive guide to practical taxation strategies. 6th Edition.
Croydon, Tolley Publishing Company Ltd. 1994, pp. 493. £ 31.95.
This revised and updated edition takes account of the legislative provisions of the Finance Act 1994 and includes new chapters on the important topics of marriage breakdown and national heritage property. It also includes a new introductory chapter on trust law.
(B. 114.044)

UNITED KINGDOM NATIONAL ACCOUNTS.
The CSO Blue Book. 1994 Edition. Editor Simon Humphries.
London, HMSO. 1994, pp. 175. £ 15.95.
(B. 114.052)

INTERNATIONAL

THE PUBLIC INTERNATIONAL LAW
of Taxation. Text, cases and materials. Edited by Asif Hasan Qureshi.
London, Graham & Trotman Limited. 1994, pp. 623. £ 110.-
In this book various problems of international taxation are treated: from the point of view of international community, where double taxation may undermine the free flow of trade in goods and services and national fiscal measures may undermine international trade liberalization; from the regional point of view, fiscal harmonization and formation of the economic union; from the national point of view, where the protection of the national fiscal base from tax evasion and avoidance is of a particular significance. Other subjects: direct bearing on the taxpayer, discriminatory fiscal practices, administrative burdens, etc. The book is intended to orient tax practitioners to the issues of international taxation from the perspective of public international law.
(B. 114.076)

TAX TREATY INTERPRETATION.
The International Tax Treaties Service. Editor: Michael Edwardes-Ker.
Dublin, In-Depth Publishing, Alton House, Herbert Street, Dublin 2, Ireland. 1994.
This loose-leaf publication is a companion to the International Tax Treaties Service and analyses the basic principles which should govern the interpretation of tax treaties.
(B. 113.906)

STRUNK, GÜNTHER.
Wettbewerbswirkungen unterschiedlicher Betriebsprüfungssysteme. Ein internationaler Vergleich – U.S.A., Japan, Grossbritannien, Frankreich und Deutschland.
Baden-Baden, Nomos Verlagsgesellschaft. 1994.
Schriften des Instituts für Ausländisches und Internationales Finanz- und Steuerwesen der Universität Hamburg, No. 23, pp. 305. 78.- DM.
Effects of different investigation systems of the Inland Revenue on competition. The author compares the effects of the different methods of investigation used by the Inland Revenue in the USA, Japan, the United Kingdom, France and Germany. He discusses topics such as basic principles of investigation of the tax authorities, effect on the situation of an enterprise in competition, protection of the taxpayer, equal treatment of taxpayers, burdens caused by the investigation.
(B. 113.856)

GUIDE TO GATT LAW AND
practice. Analytical index. 6th Edition.
Geneva, GATT General Agreement on Tariffs and Trade. 1994, pp. 1082. 150 Sfrs.
This volume presents a guide to the legal interpretation and application of the General Agreement and GATT practice and drafting history, including decisions, panel reports and discussions between contracting parties. It is updated to the end of March 1994.
(B. 114.080)

THE INTERNATIONAL GUIDE TO
taxation of life insurance and mutual funds.
London, IBC Financial Publishing, 57-61 Mortimer Street, London W1N 7 TD, England. 1994.
This loose-leaf publication contains the rules for the taxation of life insurance contracts and mutual funds in the EU countries, Nordic countries, Australia, Singapore, South Africa, Canada, the USA and Japan. Covered are the occasions in the life of a financial product when tax could be relevant. These include: effecting the product – taxes and relief, income and gains arising both to the investor and the product provider, relevant anti-avoidance legislation (if any), changing the underlying investment, partial and full encashment of the investment, assignments and gifts, wealth tax assessments, and death of the investor (inheritance and succession duties).
(B. 114.007)

LATIN AMERICA

Mexico

TAXATION AND INVESTMENT IN
Mexico.
Amsterdam, International Bureau of Fiscal Documentation. 1994. 400.- Dfl.
In the context of NAFTA, the International Bureau of Fiscal Documentation is developing a new series of publications giving detailed, accurate and practical information concerning the tax systems of Canada and Mexico. This volume focuses on the tax system in Mexico. The material covers the general rules applicable to the taxation of resident entities and individuals as well as the source-based rules applicable to non-residents. In addition, the taxation of special industries such as banking, construction and film production is described. Other tax and tax-like charges such as registration and stamp duties, payroll levies and social security obligations are detailed. Includes a chapter dealing with the creation of a company, expansion through subsidiary operation and the principle of group taxation, tax incentives for particular investments, inflation, reorganization and liquidation. The volume concludes with a description of tax procedure and administration, transfer pricing adjustments.
(B. 18.852)

ZARAGOZA, Luis Alberto Sanchez.
El dictamen fiscal. Elementos para su integración y revision en el impuesto al valor agregado.
Guadalajara, Indetec. 1994, pp. 190.
The book analyses the issues related to the fiscal opinion in the financial statements that accountants have to issue with respect to the impact that the fiscal opinion has on certain taxes, especially the value added tax.
(B. 18.850)

GARCIA LEPE, Carlos; HERNANDEZ SALCEDO, Ricardo.
Procedimientos de actualizacion de creditos fiscales en el IVA.
Guadalajara, Indetec. 1994, pp. 139.
This booklet updates the procedures for taking an input tax credit under the Mexican VAT law.
(B. 18.849)

DE LA TORRE FERREIRA, A.; LOMELIN MARTINES, A.; MARQUEZ CRISTERNA, O.
Compilación de tratados tributarios. Tomos I y II.
Mexico, Dofiscal Editores, Avenida Mexico 203, Hipodromo Condesa, 06100 Mexico, D.F. 1994.
Compilation of tax treaties in two loose-leaf volumes. Volume I deals with general aspects of international taxation, economic impact of the international multiple taxation, double taxation relief, model conventions on tax matters, international taxation, double taxation treaties and mutual assistance in the field of taxes on income and capital. Volume II deals with methods for the avoidance of double taxation.
(B. 18.857)

ANALISIS DE LA DETERMINACION DE
obligaciones fiscales. (Liquidación).
Guadalajara, Indetec. 1994, pp. 170.
Analysis of the assessment of tax obligations.
(B. 18.848)

MIDDLE EAST

THE WORLD OF INFORMATION
Middle East Review 1995. 20th Edition. The Economic and Business Report.
London, Kogan Page Limited, 120 Pentonville Road, London N1 9JN, England. 1994, pp. 150.
Annual edition of economic and business report dealing with general topics concerning the Middle East and a country-by-country description of the major events in the country involved by various authors.
(B. 58.013)

NORTH AMERICA

Canada

STIKEMAN INCOME TAX ACT.
Annotated. 23rd Edition. Editor Richard W. Pound.
Scarborough, Carswell Thomson Professional Publishing. 1994, pp. 2316.
This edition incorporates the Income Tax Act, Income Tax Application Rules, Income Tax Conventions Interpretation Act, Canada–US and Canada–UK tax treaties, Interpretation Act consolidated as of 31 July 1994 (re-enacted effective 1 March 1994 as R.S.C. 1985 (5th Suppl.) and including Bill C-2, Bill C-9, Bill C-15, Bill C-27, as enacted) with Proposed Draft Legislations up to 1994; Press releases and other tax proposals; Income Tax Regulations and Draft Regulations to 15 July 1994.
(B. 114.032)

THE PRACTITIONER'S INCOME TAX ACT.
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FRANCE

Corporate Income Tax: Recent Developments in the French Territorial Approach

Philippe Juilhard

Avocat, Bureau Francis Lefebvre, London; member of the New York Bar.

French corporate income tax ("CIT") is based on a strict principle of territoriality, embodied in the French Tax Code ("FTC") under Section 209 I, whereby profits realized in France, whether by French or foreign companies, are taxable in France and profits realized from operations outside France escape French CIT. Although this principle is subject to provisions in France's tax treaties, the territorial scope of French CIT is recognized by all French treaties. It is also subject to certain exceptions which aim either at furthering worldwide development of French business or at combating tax evasion.

This article analyses the French territorial principle in light of recent developments and changes brought about in France by the French tax authorities and the courts, particularly with regard to the territorial scope of CIT, French CFC rules and French transfer pricing rules.

I. BACKGROUND

A. General principle

Section 209 I FTC provides, *inter alia*, that: "profits subject to corporate tax are determined ... taking into account only the profits realized by enterprises operating in France and those for which the right to tax is granted to France by a tax treaty relating to double taxation".

Under this principle French companies are only subject to CIT on profits realized from French operations. Profits realized from operations outside France are not subject to French CIT, but losses incurred on operations abroad may not be utilized in France to offset profits taxable in France. As a corollary, foreign companies are only subject to CIT if they operate an enterprise in France.

French law does not provide for a definition of the concept "enterprise operating in France". However, the French Administrative Supreme Court *(Conseil d'Etat)* has held that it means the "habitual exercise of a commercial activity". Habitual exercise of a commercial activity arises in three situations:

- when a foreign company has a business establishment in France, i.e. an autonomous installation with a certain element of permanence;
- when a foreign company acts in France through representatives who have no professional personality distinct from that of the enterprise, e.g. an official responsible for carrying out a commercial activity on behalf of the enterprise;
- when a foreign company, although not established in France, operates a "complete business cycle detachable from the enterprise's other operations".

For purposes of the French territorial principle, France includes metropolitan France and Overseas Departments, i.e. Guadeloupe, Martinique, French Guyana and la Réunion. French Overseas Territories (New Caledonia, French Polynesia, Wallis and Futuna Island, the Indian Ocean Islands, and the French Atlantic and Oceanic Territories) are not considered part of France for purposes of CIT, and business operations in such territories are considered as being performed abroad.

Tax treaties entered into by France follow the territorial principle by providing, along the lines of Article 7 of the 1992 OECD Model Treaty, that profits of an enterprise in a contracting state are taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment ("PE") situated therein, and by electing for the exemption method as the means to eliminate double taxation (Article 23A OECD Model Treaty).

B. Exceptions

The territorial principle of the French CIT allows for two categories of exceptions: those intended to promote French business development worldwide, and those intended to combat tax evasion.

1. Tax incentives for foreign development

As regards the first set of measures, French tax law provides for a derogatory worldwide consolidation regime (Section 209 quinquies FTC) and certain incentives for setting up abroad (Section 39 octies FTC).

(a) *Worldwide consolidation*

Under Section 209 quinquies FTC, certain companies (specifically authorized by the French Finance Minister) may include in their taxable result in France the overall profits and losses from their direct and indirect operations in France and abroad. Such a regime, the effect of which is to incorporate into French taxable results all results realized abroad, enables the limited number of companies which benefit from this regime to utilize extra-territorial losses in France. In return, profits realized outside France are subject to French CIT. Double taxation is avoided by granting a credit for tax paid abroad.

(b) *Other tax incentives*

Under Sections 39 octies A and B FTC, French companies that set up operations abroad may book a special tax reserve which corresponds, to a certain extent, either to the losses incurred abroad or to the cost of such investment. The tax allowance regime differs depending on whether the investment is of a commercial or an industrial nature, and whether or not it takes place within the EU. The benefit obtained from this regime is in any event only temporary, as the reserve so credited must be added back at maturity. The draft Finance Law for 1995 extends the scope of this incentive to services.

2. Anti-avoidance provisions

As regards the second set of exceptions, tax evasion is targeted by French CFC legislation (Section 209 B FTC), French transfer pricing rules (Sections 57 and 238A FTC), and more recently, a provision aiming at transfers by French companies to foreign trusts or similar entities (Section 238 bis OI FTC).

(a) *CFC legislation*

Under Section 209 B FTC, where a French corporate tax company operates an enterprise outside France, or directly or indirectly holds at least 10 percent of the shares, interest, financial or voting rights in a company or a group of companies established outside France, or holds in such company or group of companies a participation whose acquisition price is equal to or higher than FRF 150 million, and where such company or group of companies enjoy a privileged tax regime within the meaning of Section 238 FTC (see below), the company is subject to French CIT on any profits, whether or not distributed, realized by the foreign company or establishment, by reason of its participation.

As the threshold for application of this provision was reduced from 25 to 10 percent by the Finance Law of 1993, structures existing as of 30 September 1992 whose range of control by a French company is between 10 and 25 percent will only be subject to this new regime as from 1 January 2003. The same applies to branches existing as of 30 September 1992.[1]

Profits and losses are determined in accordance with French regulations and are assessed and taxed separately, which prohibits foreign losses from being offset against French profits and vice versa and leads to tax being paid on local profits even though the French company is in a loss position.

Under paragraph II of Section 209, however, the qualifying French enterprise may be excluded from the scope of this section if it can demonstrate that its foreign subsidiary mainly carries out an effective industrial or commercial activity, and it mainly carries out its operations in the local market (i.e. more than 50 percent of its turnover comes from locally realized operations).

(b) *Transfer pricing rules*

Under Section 57 FTC the income directly or indirectly transferred by a French corporate taxpayer to a foreign dominant or controlled enterprise, either through an artificial increase or decrease in transfer prices or via any other means (e.g. excess royalties, reduced interest loans, waiver of claims, etc.) may be added back to the French company's taxable income. The same procedure is available to the tax authorities for companies that are controlled by an enterprise or group of enterprises that control enterprises located outside France.

The concept of control for purposes of this section is not defined by law. According to the tax authorities, one enterprise controls another when it owns more than 50 percent of voting stock or a dominating interest in the capital of the dependent enterprise. However, control also exists when the enterprises have interlocking contractual or financial arrangements between each other (de facto control).

In principle, the tax authorities have the burden of proof and must establish that income was transferred to a related enterprise through an increased or decreased transfer price. However, under case law, it has been recognized on occasion that when the tax authorities have been able to prove that the French company had entered into abnormal transactions, the burden of proof shifts to the taxpayer who then must demonstrate that the transaction was bona fide and the price normal.

Under Section 57 when the transfer benefits an enterprise located in a tax haven the tax authorities need not prove dependence or control to have a case for transfer pricing.

(c) *Payments to tax havens*

Under Section 238 A FTC certain payments made by French companies to individual entities domiciled or established in a country or territory where they are subject to a privileged tax regime are not allowed as deductible expenses in France, unless the taxpayer establishes that the payments relate to a true and bona fide transaction and that they were not excessive.

Under this provision a taxpayer is considered to be subject to a privileged tax regime in the relevant state or territory when he is exempt from tax or subject to tax which is notably lower than that which would have been paid in France. According to the tax authorities, a privileged tax regime is deemed to exist when the tax paid is one-third less than that which would have been due in France on the same income. This rule is a mere presumption and the characterization of a privileged tax regime requires that all relevant circumstances be taken into account.

The scope of Section 238 A is particularly broad. It covers all interest, late payments, royalties of any kind for the licensing

1. Art. 107 of Law No. 92-1376 of 30 December 1992.

or sale of patents, trade marks or know-how, compensation payments such as salaries, fees and commissions and payments made on an account in a financial institution established in a tax haven.

(d) *Transfer to trusts or similar entities*

Introduced in 1992 Section 238 bis OI FTC,[2] applies to any enterprise which, directly or indirectly, transfers or has transferred outside of France, certain of its assets to a trust or similar entity, with a view to having them managed in its own interest or to undertaking on its behalf a current or future commitment. Such an enterprise must include in its taxable income the proceeds resulting from the management or disposal of such assets or from any such asset acquired thereafter.

Certain transfers are expressly outside the scope of this provision, notably agency arrangements and insurance contracts. This provision also only applies to transfers outside of France, so that domestic transfers are not within the scope of Section 238 bis OI FTC.

The taxable results must be determined according to the same rules as apply to the enterprise in France, but separately from the results from its other activities. The taxable income so determined is then aggregated with the income of the French enterprise for purposes of determining the overall CIT due by the French company. The French enterprise may therefore offset profits and losses during a tax year. This is a major difference from Section 209 B FTC. Whilst Section 209 B FTC provides for separate taxation of the profits only, Section 238 bis OI provides for aggregate taxation of both profits and losses.

This may be explained by the fact that whilst Section 209 B aims to combat tax evasion by imposing a sanction on the French company, Section 238 bis OI is designed not as a penalty but rather as a neutral mechanism, whereby the French company remains in the same tax situation as if the transfer had never taken place.

The question arises under this regime as to whether the assets transferred to the trust should be held for at least two years in order to benefit from the reduced long-term capital gains tax regime. The same question arises with respect to the benefits of the French parent-subsidiary exemption for dividends if the assets transferred are shares (the benefit of this regime is conditioned on the commitment by the holder to keep the shares for at least two years). Given that the purpose of Section 238 bis OI FTC is to neutralize the transfer and tax the French company as if the transfer never took place, there is a strong argument for concluding that the holding period should be computed as from the date the assets were originally recorded in the books of the French company until the assets are finally disposed of by the trust or similar entity, the transfers to the trust being treated as a non-event from a French tax perspective. However, the fact that distinct accounts are to be established by the trust and that the computation of taxable income is to be determined separately militates on the contrary for a computation of the holding period of the assets as from the time they are actually transferred to the trust.

The French tax authorities have not yet commented on this provision, and at this stage one may only hope that they will follow the full neutrality goal of this provision.

II. RECENT DEVELOPMENTS

A. Section 209 B FTC

1. New disclosure requirement

The regulations for application of Section 209 B FTC are embodied in Articles 102 S–102 Z of Appendix II FTC. These regulations were modified by Decree No. 94282 of 5 April 1994, which reinforced the burden of compliance for companies that consider themselves outside the scope of French CFC legislation under paragraph II of Section 209 B FTC.

Under Article 102 Z of Appendix II French companies claiming entitlement to paragraph II exemption for their foreign subsidiaries had to file with the tax authorities a list of all their subsidiaries that came within the scope of Section 209 B FTC. This was necessary to protect the French parent company from any penalty and/or late payment interest under Section 1732 FTC if it was later determined that a subsidiary was not eligible for the above-mentioned exemption.

Since its amendment by the 1994 Decree, Article 102 Z of Appendix II now requires that, in order to qualify for protection under Section 1732 FTC, the French company must file with the French tax authorities not only a list of all such subsidiaries (with their full identity, percentage of ownership and details of their activities), as was previously the case, but also a balance sheet and a profit and loss statement, drawn up according to French principles.

In addition to the fact that the requirements of the new Decree impose an extra burden on French companies, there is a further problem in that it is questionable whether Section 1732 FTC actually requires the French company to file these additional documents. This provision grants French taxpayers protection if they expressly indicate in the tax return, or any deed or appendix thereto, the legal or factual reasons for omitting, partially or entirely, certain items from their tax computation. It should, therefore, arguably be sufficient for a French company to provide, with the list of its subsidiaries and their identities, the reasons why it does not consider a foreign subsidiary to come within the scope of Article 209 B FTC. The nature of the subsidiary's activity and the percentage of the activity realized on the local market, which are criteria for exemption specifically mentioned in the law, should be sufficient in this respect.

2. Section 209 B FTC – tax treaties and EC law

2. Art. 55 of Law No. 92.1476, dated 31 December 1992.

Whether or not the French tax authorities may apply Section 209 B FTC when the foreign subsidiary is located in a treaty country has given rise to considerable tax literature in France.

In March 1992 the tax authorities specified in a statement of practice that Section 209 B FTC was compatible with both treaties and EC law.[3] Interestingly enough, however, the tax authorities, in the France–Mexico treaty of 7 November 1991, felt the need to mention in the Protocol that the treaty provisions do not prevent France from applying Section 209 B FTC.[4]

Unless one takes the position that paragraph 13 of the Protocol to the Mexico treaty or Article 24 I e (iii) of the new France–US treaty are meaningless, a solution which is impossible under the general principle of interpretation of law, then it should follow that Section 209 B FTC may only apply in a treaty context when the applicable treaty specifically authorizes it. At the very least these specific provisions for treaty compatibility show that, notwithstanding the affirmation of March 1992, the tax authorities have doubts about such compatibility.

Further, the need for the tax authorities to preserve the application of domestic anti-avoidance provisions in their double taxation agreements is also recognized by the 1992 OECD Model Treaty.[5]

Notwithstanding the strength of this argument the conclusion that Section 209 B should not apply in a treaty situation unless the treaty so provides requires further analysis, notably depending on whether the presence in the low tax jurisdiction is through a subsidiary or a mere PE, and whether it is in an EU or a non-EU Member State.

3. Subsidiary versus PE

Although Section 209 B FTC applies under domestic law to both subsidiaries and PEs, the compatibility of this provision with treaty law requires the two situations to be distinguished.

As regards subsidiaries, the 1992 statement of practice (which is of course silent as regards PEs since the scope of Section 209 B FTC was only extended to PEs by the Finance Law for 1993) made it clear that the tax authorities did not consider Section 209 B FTC to be contrary to treaty law for three reasons. First, one of the purposes of tax treaties is to combat tax fraud and treaties could not be interpreted as precluding contracting states from applying their domestic legislation aimed at that objective. Second, application of Section 209 B is not contrary to treaty principles since it does not give rise to juridical double taxation (since two entities are involved and the foreign entity is not taxable in France in the absence of a PE), nor does it give rise to economic double taxation (since Section 209 B FTC provides for a credit mechanism).

Although the first argument of the tax authorities could still be used in the context of a PE, we believe that the combination of treaty rules on the taxation of PEs and the French territoriality principle (see above) should prevent the French tax authorities from applying Section 209 B FTC where a PE is located in a treaty country with a low tax regime.

Tax treaties aim to avoid juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one state, which is necessarily the case when Section 209 B FTC applies to a French company with a foreign PE, since the foreign PE is by law the same legal person as the French company. Application of Section 209 B FTC in the case of a PE is therefore contrary to treaty principles.

4. EU versus non-EU jurisdiction

The use of Section 209 B against foreign PEs or companies may also depend on whether they are located in an EU or a non-EU jurisdiction.

If the foreign entity is in a non-EU jurisdiction, then the only argument available to defeat a Section 209 B FTC assessment would have to be based on treaty provisions and the potential conflict between French domestic law and treaty law (see above). If, however, the subsidiary or the foreign PE in respect of which the French tax authorities attempt to apply this provision is located in an EU jurisdiction, then the French taxpayer may, in addition to the treaty arguments, have certain arguments based on EC law.

In this respect it is interesting to note that while the 1992 statement of practice argues for the compatibility of Section 209 B FTC with tax treaties, the compatibility of said provision with EC law is merely stated, without further comment.

As regards certain European tax regimes, such as Irish IFSCs or Belgian coordination centres, it is worth mentioning that these privileged tax regimes have been implemented to attract foreign investments in certain zones considered by the EC Commission to be priority zones, and have also been considered by the Commission to be in conformity with the Treaty of Rome, particularly with Articles 92 and 93. Further, these regimes are generally subject to a certain time limit and are subject to stringent conditions.

Should Section 209 B FTC be applied in respect to such types of vehicles the tax advantages granted to such investments would be entirely recaptured by France, thereby removing the tax advantages of locating one investment in these zones. The French recapture of such incentives could be considered contrary to EC law and particularly to Article 5 of the Rome Treaty.

Section 209 B FTC could also be considered contrary to the principle of free establishment of Article 52 of the Treaty of

3. 4H-9-92.
4. A similar provision was included in the Protocol to the tax treaty with Venezuela of 7 May 1992 and more recently in the new treaty with the United States of 31 August 1994 (not yet in force).
5. Para. 7 of Art. 1 of the OECD Model reads as follows:

> ... taxpayers have the possibility, double taxation conventions being left aside, to exploit the differences in tax levels as between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter possible manoeuvres. *Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.* (emphasis added).

Rome. Although this article has thus far been interpreted as imposing a legal obligation on the host country rather than on the country of origin, it could be argued that for tax purposes and CFC legislation, the principle of free establishment also imposes an obligation on the country of origin, under which it should not recapture the advantages of establishing in another member state by applying domestic anti-avoidance provisions.

The intrinsic contradiction of Section 209 B FTC and EC law has been raised in the 13th report by the French Tax Council issued in October 1994, notably for commercial and industrial investments. Although the Tax Council emphasizes the political contradiction more than the legal one, it should be noted that Section 209 B FTC, as an anti-avoidance provision, could be considered to contradict the general principle of mutual trust among member states.

B. Continental Shelf

Under Article 15 of Law No. 68.1181 of December 1968 relating to the exploration of the continental shelf and the exploitation of its natural resources, products extracted from the continental shelf must, for tax purposes, be considered as having been extracted from metropolitan France.

In a recent decision the Paris Administrative Court of Appeal held that services performed by a French company on a boat over the continental shelf were not within the scope of French CIT under the 1968 law.

In this instance the tax authorities considered that the studies, drilling and geophysical studies performed by a French company on a boat on the Iroise Sea over the French continental shelf characterized the activity of an enterprise carried out in France and therefore the results of such activity were to be subject to French CIT under Section 209 I FTC. The French tax authorities argued that this resulted from Article 2 of the Continental Shelf Convention of 29 April 1958, which provides that "the Coastal State exercises over the Continental Shelf sovereign rights for the purpose of exploring it and exploiting its natural resources".

The court held to the contrary – that such activities were outside the scope of French CIT and that the law of 1968 only refers to products extracted from the continental shelf. This decision is based on a strict reading of the 1968 legislation which, in incorporating the 1958 Convention, limited the scope of French taxation to extractions, leaving exploration over the Continental Shelf outside the scope of French CIT.

Interestingly enough, the new tax treaty between France and the United States provides in Article 5 that a ship used for exploration or to prepare for the extraction of natural resources will constitute a PE if the ship is in use for more than 12 months. This treaty provision is no doubt designed to avoid the consequences of the administrative decision in the France–US context. However, it should be noted that it may only impact on US companies operating and exploring over the Continental Shelf and not on French companies exploring the French Continental Shelf, which may still argue on the basis of Article 15 of Law No. 68 1181 of December 1968 that their activities are outside the scope of French CIT.

Whether the new US treaty provision will be sufficient to attract taxation of US companies exploring the French Continental Shelf from ships for a period of more than 12 months is a moot point. Although under Section 209 I FTC profits of which the right to tax is granted to France by a tax treaty must be taken into account in determining the profits subject to French CIT, one could argue that if the treaty attributes the right to tax such exploration profits to France, such activities, under domestic law, remain outside the scope of French CIT by reason of the law of December 1968. The rationale for such an argument is that under French international principles a treaty may not aggravate or increase the domestic tax regime. Although this "non-aggravation principle" is supported by a number of authors in France, it has not been clearly established by case law, and may be considered contradictory to the language of Section 209 1 and Article 55 of the French Constitution.

C. Transfer pricing

An early 1994 decision of the French Administrative Supreme Court offers an interesting insight into Section 57 FTC and the compatibility of this provision with treaty provisions.[6] This case concerned a French company marketing kitchen equipment in France, whose production and assembly were actually subcontracted to a Swiss company.

Having considered that the price paid by the French to the Swiss company for this equipment was excessive and that the two companies were inter-dependent, the tax authorities, under Section 57 FTC, added back to the French company results, that part of the price paid for the equipment which was considered as having been unduly transferred abroad.

First, the court confirmed that Article 9 of the tax treaty between France and Switzerland is compatible with Section 57 FTC. In this respect, the court followed the reasoning of Mr Philippe Martin, *Commissaire du Gouvernement*, according to whom the scope of both provisions is identical, and the concept of direct or indirect participation in the management, control or capital of a company of Article 9 of the treaty is compatible with that of the juridical or de facto dependence under Section 57 FTC.

The court, however, took a restrictive approach to Section 57 and held that because the links between the French and the Swiss company were solely economic, the links were sufficient to characterize the dependency relationship required under this provision.

The *Commissaire du Gouvernement* mentioned that the fact that the French company and its chairman held patents on some of the equipment manufactured by the Swiss company was not sufficient to prove juridical or factual dependency.

6. CE 18.3.94 No. 68799 – 70814.

The court went further and held that Section 9 of the treaty, which allows the profits transferred abroad between associated companies to be added back, could not prevent such adding back when the two companies are not related. Although the court actually refused in this case to follow the French tax authorities, in the absence of sufficient evidence, it actually agreed that French domestic legislation could apply without any restriction when a situation is not within the scope of Article 9 of the treaty.

Another interesting 1994 case is a Paris appellate court decision[7] on the scope of Article 238 A FTC. The appellate court refused to apply Section 238 A to payments made by a French company to a Venezuelan company by way of a bank account of the beneficiary in the Bahamas, on the grounds that the tax authorities had not demonstrated that the beneficiary benefited from a privileged tax regime in Venezuela. This decision is surprising, since the third paragraph of Article 238 A provides that the principle of this provision also applies to any payment made to a bank account of a financial institution established in a country with a privileged tax regime, as was presumably the case here. The tax authorities have appealed against this decision and the *Conseil d'Etat* will have to decide whether or not this type of scheme falls within the scope of Article 238 A.

D. Waiver of claims to foreign subsidiaries

The deduction of waivers of claims by French companies, which raises a number of difficulties when the subsidiary is a resident of France, is even more problematic when the beneficiary is a subsidiary located in a foreign country, since in such a case it may result in utilizing foreign losses which would otherwise not be allowed as a deduction under the territoriality principle.

As a general rule French law distinguishes between commercial and financial waivers. While the former are generally deductible for the granting company provided it furthers its own interest and does not amount to mismanagement, the deductibility of the latter is only recognized to the extent of the negative net worth of the shareholding in the subsidiary.[8]

For a while the French Administrative Supreme Court took the position that although they were made in furtherance of the French company's own interest, regular subsidies granted to foreign subsidiaries could not be deductible from the company's taxable income since this would amount to using foreign losses in France, which is contrary to French territorial principles.[9]

According to the court French companies may only grant deductible subsidies to their foreign subsidiaries in exceptional circumstances, when the latter experience major difficulties at a particular time, provided such subsidies prove to be in the normal management of the French company and that they do not increase the value of shares in the subsidiary.

This restrictive position has now been relaxed. In 1987 the court held that when the commercial interest of a French company leads it to help its foreign subsidiary (regardless of the nature of the help, i.e. subsidies, waiver of claims, etc.), such help must be deemed normal and allowed as a deduction, provided the French company receives sufficient quid pro quo for its French activities.[10]

According to this decision subsidies granted by French companies to maintain their sales in foreign markets are in principle deductible

Some doubts remained, however, with regard to the deductibility of financial waivers. For certain commentators and authors, financial waivers could only have an impact on the value of the shares of the subsidiary but not on the business carried on in France, and therefore were not deductible in France. The Administrative Supreme Court recently put an end to those hesitations and held that financial waivers granted to foreign subsidiaries are deductible in France to the extent of the negative net assets value of the subsidiary, provided they are granted as normal management of the French company in furtherance of the interests of the enterprise carried out in France.[11]

Following this decision it may be said, as a rule, that subsidies given to foreign subsidiaries are in principle deductible from the taxable income of the parent when the decision conforms to the commercial or financial interests of the French company.

If waiver of claims could in theory fall within the scope of Section 57 FTC, it appears that the specific condition of normality for the deduction of the waiver implies that it may not amount to a wrongful transfer of profits.

7. CAA Paris 1 February, 1994 Nos. 92-1221, 3rd Ch. Sté Arthur Loyd RJF March, 1994 No. 533.
8. CE 30 April 1980 No. 16253 RJF 6/80 No. 467.
9. CE 14 March 1984 No. 33188 RJF 584 No. 590.
10. CE 30 March 1987 No. 32754plein, SA "Labo Industries": RJF 5/87 No. 489.
11. CE 11 February 1994 No. 119726 8th and 9th ss.

NETHERLANDS

Reduction of Dutch Withholding Tax for Pass-Through Dividends

Robert Rouwers

Tax lawyer Loyens & Volkmaars Amsterdam; lecturer on tax law at the University of Leiden, Netherlands.

I. INTRODUCTION

On 1 January 1995 a law entered into force that provides for a reduction of Dutch dividend withholding tax ("DWT") for certain pass-through dividends. This law forms part of an ongoing effort to improve the investment climate in the Netherlands. It is relevant not only to Dutch (intermediary) holding companies, but also to all Dutch companies receiving dividends from foreign subsidiaries to which the participation exemption applies. A Dutch company cannot credit any foreign withholding tax on these dividends against Dutch *corporate income tax* as these dividends are not taxable in the Netherlands under the participation exemption; as from 1 January 1995 it can credit the foreign DWT against Dutch DWT.

Generally, reduction of Dutch DWT is available only if dividends are received by a Dutch company from a subsidiary resident in a tax treaty country, if a local DWT of at least 5 percent was withheld and Dutch DWT is withheld on the redistribution of these dividends by the Dutch company.

With regard to redistributed qualifying dividends, the Dutch company does not have to pay the full amount of DWT withheld on the redistribution to the Dutch tax authorities. Instead a reduction of 3 percent of the amount of redistributed qualifying dividends is applied – 2.5 percent for 1995 and 1996. The law applies to foreign dividends received as from 1 January 1995.

II. REQUIREMENTS

The following conditions must be met to obtain the reduction:

A. the participation exemption (for purposes of corporate income tax) applies to dividends that a Dutch company receives from a foreign subsidiary;
B. this subsidiary is resident in a tax treaty country which imposes a DWT of at least 5 percent;
C. the Dutch company owns alone, or together with related Dutch companies, at least 25 percent of the nominal share capital or, if the tax treaty with the country where the subsidiary resides applies this criterion, 25 percent of the voting rights;
D. the qualifying dividends received by the Dutch company are passed through to its shareholders by way of a dividend distribution in the calendar year concerned or in the next two calendar years;
E. the latter redistribution is effectively subject to Dutch DWT.

These conditions are discussed further below.

A. Application of the participation exemption

The first condition is that the dividends paid by the foreign company are exempt from Dutch corporate income tax under the participation exemption. Generally, the participation exemption applies to dividends received from a foreign subsidiary if:

- the participation amounts to at least 5 percent of the nominal paid-up capital of the subsidiary;
- the participation is not held as inventory or as a portfolio investment (the portfolio investment test does not apply to subsidiaries that meet the conditions of the EU Parent-Subsidiary Directive);
- the foreign corporation is subject to an income tax imposed by the Netherlands Antilles, Aruba or country in which it is resident.

It should be noted that although the participation exemption only requires a holding of 5 percent of the nominal paid-up capital, in order to obtain the reduction of DWT a 25 percent holding of either the nominal share capital or voting rights is required (see below).

B. Foreign DWT of at least 5 percent levied by a tax treaty country

1. Subsidiaries not resident in the EU

The reduction applies only if there is a tax treaty in force with the residence country of the subsidiary and the latter country imposed a final DWT of at least 5 percent. No reduction is granted if the foreign subsidiary has withheld a DWT which can be claimed back by the Dutch company and the effective DWT after the refund is less than 5 percent. The following chart shows the countries with which the Netherlands has concluded a tax treaty and the applicable general treaty rates on intercompany dividends.

General rates on intercompany dividends paid by a company resident in a tax treaty country to a Dutch company

Rate[1]	Treaty country[2]
0%	Czech Republic[3], Malaysia, Malta, Mexico, Norway, Poland, Singapore, Slovak Republic[3], Venezuela, Switzerland
5%	Bulgaria, Canada[4], Germany[5], Hungary[6], Japan, South Africa, United States, Yugoslavia[7], Zambia
7.5%	Netherlands Antilles[8], Surinam
10%	Bangladesh[9], China (People's Republic), Indonesia, Morocco, Pakistan, Philippines, Romania, South Korea, Sri Lanka, Thailand, Turkey, Zimbabwe
12.5%	Nigeria
15%	Australia, Brazil, India, Israel, New Zealand, republics of former Soviet Union[10].

1) Note that in specific situations a different rate could apply; a different rate could also apply to dividend payments made by Dutch companies to companies resident in these countries.
2) Not including EU-countries except for Germany.
3) The 1974 Netherlands–Czechoslovakia tax treaty applies both to the Czech and Slovak Republic. Negotiations are in progress with both countries to agree to new protocols.
4) According to the 3 March 1993 Protocol to the treaty the rate is 7% for 1996 and 6% for 1995. The 5% rate applies from 1995.
5) Germany may levy 5% DWT until mid 1996 as provided in the EU Parent-Subsidiary Directive.
6) Hungary changed its tax system as per 1 January 1995. It levies a supplementary tax on dividends at a rate of 23%. It is not yet clear whether this supplementary tax will qualify as a DWT.
7) The Yugoslavia–Netherlands tax treaty is applicable to the following republics: Croatia, Slovenia, Bosnia-Hercegovina and (probably) Macedonia. The application of the treaty is suspended with regard to Serbia and Montenegro. Please note that not all of the former republics of Yugoslavia levy a DWT.
8) The Netherlands Antilles does not levy a DWT.
9) This treaty will become effective on 1 July 1995 in Bangladesh and became effective on 1 January 1995 in the Netherlands.
10) The USSR treaty officially applies to Russia. Informally the treaty rates are in practice used by the former USSR states, except Kazakhstan. The situation with respect to withholding taxes in the Baltic States is unclear. Please note that not all of these states impose a DWT.

2. Subsidiaries resident in the EU

If the Dutch company receives dividends from a subsidiary resident in the EU, this country will normally not tax the dividends as a result of the implementation of the Parent-Subsidiary Directive. Therefore reduction of Dutch DWT will not apply to dividends received from EU subsidiaries. In special situations, however, the Parent-Subsidiary Directive allows EU countries to tax dividends, for example:

- the Dutch company has not maintained the shares/voting rights for an uninterrupted period of at least two years (a shorter holding period is applied in several EU countries)[1]; or
- the subsidiary and/or the parent do not have a legal form listed in the Annex of the Directive; or
- the subsidiary and/or the Dutch parent company are resident of a third country for tax purposes; or
- the subsidiary is a resident of Germany of Portugal;[2]
- an anti-abuse provision applies (France, Germany, Italy and Spain may refuse the nil rate if the parent company is controlled by non-EU residents).

Although the United Kingdom and Italy impose a withholding tax on ACT/*maggiorazione di conguaglio* refunded to a Dutch company, the Underminister of Finance stated that these taxes do not qualify as a DWT. This view could, however, be contested.

C. 25 percent nominal share capital or voting rights

The reduction is granted only if the Dutch company alone or together with Dutch "related companies" owns at least 25 percent of the nominal capital or – if the treaty applies a voting rights criterion – 25 percent of the voting rights. Generally, a Dutch company is related if it has a direct or indirect interest of at least one-third in another Dutch company.

The following chart shows which criterion is used in Dutch tax treaties on intercompany dividends paid to a company resident in the Netherlands.

Nominal capital and voting rights criterion on dividends in Dutch tax treaties that provide for a tax rate of at least 5% on dividends paid to a Dutch company.

Criterion	Treaty country[1]
nominal capital	Bangladesh, Bulgaria, Hungary,[2] Indonesia, Morocco, Netherlands Antilles,[3] Nigeria, Pakistan, Philippines, Romania, South Africa, South Korea, Sri Lanka, Surinam, Thailand, Turkey, Yugoslavia, Zambia, Zimbabwe
voting rights	United States
both criteria	Canada[4]
no criterion	Australia, Brazil, China (People's Republic), India, Israel, New Zealand, former republics of the Soviet Union
voting stock	Germany, Japan

1) Not including EU countries except for Germany.
2) It is currently uncertain whether the Hungarian tax on dividend distributions qualifies as a DWT.
3) The Netherlands Antilles does not levy a DWT.
4) In the treaty with Canada, Canada generally withholds 5% DWT if the Dutch company owns at least 25% of the capital of the Canadian subsidiary or if it owns at least 10% of the voting rights.

In tax treaties that have no criteria, the nominal capital will be used. Where tax treaties apply the voting *stock* criterion, it is unclear whether the nominal capital criterion and/or the voting *rights* criterion will apply.

1. Currently, the European Court of Justice is hearing three cases submitted by the Lower Court of Cologne disputing the one year requirement as implemented in Germany.
2. Germany may levy a DWT until mid-1996 and Portugal until 2000. The reduction, however, will not apply with respect to Portugal, since the Netherlands has not yet concluded a tax treaty with this country.

D. Redistribution within a certain period

The reduction applies only if the dividends that are redistributed by the Dutch company are received by this company in the calendar year concerned or in the two preceding calendar years (see III.B. for sourcing rules applied in this respect).

It should be noted that the calendar year period also applies if, for corporate income tax purposes, a book year other than the calendar year is used. The period in a multi-tier Dutch structure may be extended (see below example 7).

E. Dutch DWT

The distribution of dividends by the Dutch company must be subject to DWT. If the Netherlands does not levy DWT on the redistribution of the dividends, e.g. because the dividends are exempt under the EU Parent-Subsidiary Directive (parent company resident in the EU), or if the tax treaty with the country of the parent company provides for a nil rate, the reduction will not apply (for exceptions to this rule see III.C.).

The reduction of Dutch DWT applies regardless of whether the shareholders are resident or non-resident of the Netherlands, and regardless of whether they are companies or individuals.

III. HOW IT OPERATES

A. Reduction of DWT to be paid by Dutch company

As stated above the reduction amounts to 3 percent of the *gross* amount of qualifying dividends received – 2.5 percent for 1995 and 1996. The reduction is applied to the DWT that the Dutch redistributing company must *pay* to the Dutch tax authorities and not to the DWT this company must *withhold*.

Example 1
In 1997, an Australian company distributes 1000 dividends to its 100 percent Dutch parent company (BV). According to the Netherlands–Australia tax treaty, the Australian company withholds 150 DWT (15 percent) and consequently pays out a dividend of 850. In 1997 BV redistributes the net dividend of 850 to its 100 percent Netherlands Antilles parent company. According to the Tax Agreement for the Kingdom (the "tax treaty" between the Netherlands and the Netherlands Antilles), BV must *withhold* 5 percent[3] of 850 or 42.5 DWT. Of this 42.5 BV must *pay* 17 (42.5 -/- (*850* x 3% = 25.5)) to the Dutch tax authorities, which results in an advantage of 25.5 for BV.

As the reduction is calculated on the basis of the *gross* foreign dividend (i.e. before foreign DWT) and not on the *net* foreign dividend (i.e. after foreign DWT) BV can use 150 (the amount of Australian DWT in example 1) of its own profits to effectuate a full credit. Therefore if BV has no profits of its own and/or receives only qualifying dividends, it will lose part of the reduction that relates to the foreign DWT.

Example 2
As example 1, but BV now distributes a dividend amounting to 1000 in 1997: 850 relates to the net Australian dividend and 150 to other income. BV must withhold 50 (5% of 1.000) and must pay 20 (50 -/- (*1000* x 3% = 30)) to the Dutch tax authorities.

Since the reduction is applied on the amount that the Dutch company has to pay over to the Dutch tax authorities without affecting the amount it must withhold, the Dutch company has the benefit of the reduction. This company could of course decide to pay the amount of the reduction to its shareholders. The intention of this arrangement is that shareholders resident in a country that applies the credit method to avoid double taxation on foreign dividends, are entitled to a credit for the amount of the DWT *withheld* so that the benefit of the arrangement is for the Dutch company (see, however, V. below).

It is expressly provided that the DWT withheld by the Dutch company but not paid to the Dutch tax authorities does not form part of the taxable profits subject to corporate income tax. This issue may create a problem for countries (e.g. Japan) that require a certain level of taxation. The distribution of the reduction itself to the shareholders of the Dutch company will be liable to Dutch DWT.

B. Redistribution not within the same calendar year

If the Dutch company does not redistribute the foreign dividends within the same calendar year as it received them, the reduction will still be available if these dividends are redistributed within the following two calendar years. In this respect, the first-in first out (FIFO) method is applied.

Example 3
As example 1, but BV does not redistribute the 850 Australian dividends in the year it was received (1997). In 1998 the Australian subsidiary pays another 1000 dividends reduced by 15 percent DWT. In the same year BV distributes dividends amounting to 1500 to its Netherlands Antilles parent. For calculation of the reduction, this amount consists of 1000 of 1997 gross Australian dividends and 500 of 1998 dividends. A reduction for the remaining 500 Australian 1998 dividends will be granted if 500 dividends are distributed in 1999 or 2000.

If dividends are distributed that do not meet the conditions described in II. above (e.g. dividends paid out of own profits, dividends not liable to a DWT imposed by a tax treaty country or received from a subsidiary in a non-treaty country), it is assumed that the Dutch company will first redistribute the dividends to which the reduction applies.

3. The 5% rate is applied if the Netherlands Antilles company receiving the dividends has made an election to be taxed in the Antilles at the 5.5% rate corporate income tax. If the profits of the Netherlands Antilles company are taxed at the ordinary rate of 3 -2.4%, the Netherlands imposes DWT at a rate of 7.5%.

Example 4
As example 1, but in 1997 BV receives additional dividends amounting to 2000 from a subsidiary resident in Belgium. This is not a qualifying dividend since Belgium does not levy a DWT, in accordance with the Parent-Subsidiary Directive. If BV distributes 1000 dividends in 1998, the reduction amounts to the same as in example 2. It is assumed that the Dutch company first redistributes its qualifying 1997 1000 Australian dividends.

C. Dutch company with Dutch parent

If at least 5 percent of the shares of the Dutch company that receives the qualifying foreign dividends are owned by another Dutch company, the first Dutch company can redistribute the foreign dividends to the second Dutch company without any DWT as provided in the DWT Act 1965. This would have the unintended result that no reduction would be available, because the requirement that the redistributed dividends be subject to DWT is not met. Therefore, in such cases the first company is permitted to withhold 3 percent DWT on the redistributed qualifying dividends which it does not have to pay to the Dutch tax authorities.

Example 5
As example 1, but BV[4] (BV I) is a 100 percent subsidiary of another Dutch BV (BV II). The shares of BV II are held by the Netherlands Antilles company. BV I pays the net dividends received from the Australian subsidiary (850) to BV II and withholds 3 percent DWT or 25.5. If BV II redistributes 824.5 (850-/-3%) to its Netherlands Antilles parent company it must withhold 41.23 (5% of 824.5), but must pay 16.49 (2% of 824.5) to the Dutch tax authorities.

Example 6
BV I could of course decide to redistribute the amount of the reduction (25.5) to BV II. If BV II distributes the 850 received from BV I to its Netherlands Antilles shareholder, it must withhold 42.5 DWT (5% of 850) and pay 17 (2% of 850) to the Dutch tax authorities.

If the 3 percent DWT does not benefit the Dutch parent company (redistribution of the dividends by the parent company to its e.g. EU parent is not liable to Dutch DWT), the Dutch subsidiary may decide not to withhold the 3 percent. In this respect, the Dutch parent company is bound by the decision of its Dutch subsidiary.

It is possible to extend the two year redistribution period (see II.D.) in a multi-tier Dutch structure since the qualifying dividends received by the Dutch parent from its Dutch subsidiary are considered as qualifying dividends of the parent company.

Example 7
As in example 5, but 100 percent of the shares of BV II are held by another Dutch company (BV III). BV I must redistribute the gross 1000 Australian dividends in 1997, 1998 or 1999. If BV I redistributes the 1000 dividends in 1999 to BV II, BV II has to distribute 1000 dividends in 1999 - 2001. If BV II redistributes 1000 dividends to BV III in 2001, BV III must redistribute 1000 dividends in 2001 - 2003. Please note the sourcing rules applied in this respect (see II.B.).

IV. SPECIAL RULES

A. Branch profits tax

Under the Dutch tax treaties with Brazil, Canada, Philippines, Indonesia, Surinam, Turkey, United States and Zimbabwe these countries have the right to levy a branch profits tax. The DWT reduction rules also apply to branch profits of a Dutch company if these profits are exempt in the Netherlands according to the tax treaty as far as branch profits tax is or will be paid on these profits.

B. Dutch portfolio investments companies

The reduction applies only if the dividends paid by the foreign company are exempt from Dutch corporate income tax under the participation exemption. As Dutch portfolio investment companies ("fiscale beleggingsinstellingen", taxed at a rate of zero percent) are not entitled to the participation exemption, they are not entitled to the reduction.[5]

Dutch portfolio investment companies can request a full refund of Dutch DWT on dividends received from another Dutch company. Therefore if the latter Dutch company receives foreign dividends, it is not entitled to the reduction, i.e. the condition that the redistribution be effectively subject to Dutch DWT is not met. However, the law provides that a Dutch company receiving qualifying foreign dividends is entitled to the reduction if its shares are (partially) held by a Dutch portfolio investment company.

Example 8
The shares of a Dutch company (BV) are held by a Dutch portfolio investment company. The shares of the portfolio investment company are held by individuals resident in the Netherlands. In 1997 BV receives 850 net Australian dividends and pays a (gross) dividend of 1000 in 1998 to the portfolio investment company. BV can withhold 30 (3% of 1000) on this redistribution. If the portfolio investment company redistributes the 1000 (970 grossed) it must withhold 25 percent DWT or 250, but must pay 220 to the Dutch tax authorities. The Dutch individuals can credit the 25 percent withheld on the redistribution with their Dutch income tax.

4. If the Dutch subsidiary that receives the dividends forms part of a Dutch fiscal unity, the rules are applied as if the dividends are received by the Dutch parent of the receiving company. More detailed rules relating fiscal unities will be published in the coming months.
5. Different from companies to which the participation exemption applies, a Dutch portfolio investment company can generally credit foreign DWT on foreign dividends (Art. 6 BBI).

C. Redistributions to (non-)resident tax-exempt companies

If the shares of a Dutch company are held by a tax-exempt company, the latter company can request a full refund of Dutch DWT on dividends distributed. In this situation the condition discussed in B. above is not met. The law also provides with respect to tax-exempt companies that a Dutch company receiving the foreign dividends is entitled to the reduction if it:

- redistributes the dividends to a tax-exempt company resident in the Netherlands that owns *less* than 5 percent of the nominal paid-up capital of the distributing company; and/or
- redistributes the dividends to a tax-exempt company resident of a tax treaty country which can claim a full refund of Dutch DWT and that owns *less* than 5 percent of the nominal paid-up capital of the distributing Dutch company (e.g. see Articles 35 and 36 of the 1992 US-Netherlands tax treaty).

V. POSITION OF US AND JAPANESE PARENT COMPANIES

The reduction of Dutch DWT is applied on the amount of DWT that has to be paid to the Dutch tax authorities without affecting the amount it must withhold. If the local tax authorities in the country of the shareholder of the Dutch company apply a tax credit to the Dutch DWT withheld and not to the DWT paid to the Dutch authorities, the Dutch company will benefit from the reduction. If, however, the credit is applied to the amount paid to the Dutch tax authorities, foreign tax authorities will have the benefit. The Dutch Underminister of Finance "expects" that the United States will grant a foreign tax credit of 5 percent (tax withheld). However, it appears that under Reg. 1.901-2(e)(3), the reduction of Dutch DWT could be considered a "subsidy" which would result in a foreign tax credit of 2 percent (tax paid over). The same would possibly be true for Japan. Based on the information available, credit will be given in Japan for withholding tax actually paid to the Dutch tax authorities.

Since two-thirds of the total costs of the reduction of DWT for the Dutch Treasury relates to the United States and Japan, it is rather amazing that the Underminister could give not more certainty in this respect.

VI. CONCLUSION

The reduction of Dutch DWT improves the Netherlands as a location for holding companies. Unfortunately, for shareholders resident in the United States and Japan, it depends largely on local tax authorities whether such shareholders will benefit from the reduction. If, for example, the United States only grants a tax credit for DWT paid to the Dutch tax authorities, the reduction will not be beneficial to US shareholders of Dutch companies, but will constitute a "subsidy" from the Netherlands to the US Treasury.

Conference diary

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

MARCH 1995

101 estate planning ideas and traps for individuals, trusts and family companies, London, 22 March 1995 (English):

Vicki Goffin or Evie Kinane, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-71-637 4383, Fax: 44-71-631 3214.

Munich 1995 Tax Conference, Munich, 22-23 March 1995 (German):

Münchner Steuerfachtagung E.V., Rondell Neuwittelsbach 8, 80639 München, Tel.: 49-89-168 4820, Fax: 49-89-168 4835.

Current developments in VAT and Transfer Pricing, Brussels, 23 March 1995 (simultaneous translation into French, English and German):

The Confédération Fiscale Européenne (C.F.E.), Dechenstrasse 14, Postfach 1340, D-53115 Bonn, Tel.: 49-228 726 39 44 or 49-228 726 39 0, Fax: 49-228 726 39 52.

Course on expatriate taxation, Amsterdam, 23-24 March 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Twelfth Munich Symposium on exemption under international tax law, Munich, 24 March 1995 (German):

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FINLAND

FINLAND'S NEW CONTROLLED FOREIGN CORPORATIONS LEGISLATION

Ebel Magnin and Eero Rautalahti

Ebel Magnin is a tax partner with Loeff Claeys Verbeke in Amsterdam.
Eero Rautalahti is legal counsel with Outokumpu Oy, a Finland based international mining and metals company.

I. INTRODUCTION

Finland has enacted legislation designed to prevent Finnish taxpayers channelling their income to low-tax jurisdictions. The new Act on the Taxation of Shareholders in Foreign Intermediary Entities[1] ("the Act") and the Regulation[2] promulgated thereunder applies from the 1995 tax year.

The Act enables the Finnish tax authorities to tax the Finnish shareholders of a non-Finnish entity on their share of the income of such an entity, irrespective of whether the entity actually declares dividends, when the entity's effective tax rate in its country of residence is less than 3/5 of the Finnish corporate tax rate. The legislation has been modelled primarily on the controlled foreign corporations (CFC) legislation of Sweden and Norway.

The new legislation has been prompted by the increased mobility of capital and the need to curtail the evasion of Finnish taxation by means of channelling income to tax havens. With the abolition of exchange controls, the establishment of foreign subsidiaries is no longer reported to the Finnish authorities, and operations in tax havens have become available to individuals as well.[3]

Previous Finnish legislation did not allow the authorities to attack schemes involving tax havens. The profits of a foreign entity could be taxed in Finland only when the entity distributed dividends to its Finnish shareholders or a Finnish shareholder disposed of its shareholding. Case law has not supported the use of the general anti-avoidance provision[4] in such cases. Nor has there been any case law which has deemed a foreign corporation to be resident in Finland on the basis that its actual management was located in Finland.

The new Act represents an aggressive approach to tax haven operations. The income of a foreign entity becomes taxable in Finland merely on the basis that the entity is located in a low-tax jurisdiction – no intent to evade tax is required. The Act applies not only to foreign corporate entities, but also to trusts, foundations, funds and other separate asset entities. It also applies to all income of the foreign entity (whether passive or active in nature) and encompasses both individual and corporate Finnish taxpayers.

II. SCOPE AND APPLICABILITY OF THE ACT

Under the new Finnish CFC legislation, Finnish shareholders are taxed on the undistributed profits of a foreign entity when three conditions are met:

- at least 50 percent of the foreign entity is controlled, directly or indirectly, by Finnish residents (control test); and
- the taxpayer owns or controls, directly or indirectly, an interest in the entity of at least 10% (minimum ownership test); and
- the tax liability of the foreign entity is less than 3/5 of the tax that the entity would pay if it were resident in Finland (effective tax rate test).

The Act provides four specific situations in which a foreign entity is exempted from its scope:

- where the entity is located in a country included in the "white list" provided in the Regulation promulgated under the Act (white list exemption);
- where the entity derives the principal part of its revenues from industrial production activities in its country of residence (industrial activity exemption);
- where the entity derives the principal part of its revenues from another group company involved in industrial production activities in the same country (group function exemption); and
- where the entity derives the principal part of its revenues from ship-ownership (shipping exemption).

1. Laki ulkomaisten väliyhteisöjen osakkaiden verotuksesta, L 1217/94, issued 16 December 1994.
2. Asetus ulkomaisten väliyhteisöjen osakkaiden verotuksesta annetun lain 2 §:n 3 momentissa tarkoitetuista valtioista, A 1488/94, issued 30 December 1994.
3. The Bill to the Act (HE 155/94) ("the Bill") page 3. The Bill contains detailed discussion of the intentions behind the Act. (The bills presented to the Parliament by the Finnish Government include, in addition to the text of the proposed legislation, a detailed memorandum on the background to the proposed legislation, a description of the existing legislative position and detailed comments on the provisions of the proposed act. Although these bills are not considered to be binding on the courts, they are widely invoked to support interpretations of the legislation.
4. Sec. 56 Tax Procedures Act (Verotuslaki L 482/58).

When the requirements of any of the four exemptions are met, the foreign entity is entirely exempted from the operation of the Act, regardless of the effective tax rate to which it is subject.

A. Control and minimum ownership tests

The control test[5] aims to restrict the application of the Act to only those entities in relation to which the Finnish shareholders can effectively influence the distribution of profits. The control threshold has been set at 50 percent, that is the Act does not apply to a foreign entity unless at least half of its capital or the aggregate number of votes are controlled by Finnish taxpayers.

The Act envisages a wide variety of forms of control, including control arrangements by way of shareholders' agreements.[6] Control may be either direct or indirect (through other entities controlled by the same entity). Control is also deemed to exist when Finnish taxpayers are entitled to at least 50 percent of the profits deriving from of the assets of the entity (for example, in the case of a trust).

According to the Bill, whether control exists is determined by reference to the situation at the end of the foreign entity's accounting year, unless there are reasons to believe that the situation has been manipulated in order to avoid Finnish tax. The minimum ownership test[7] is designed to exclude from the operation of the Act small shareholders, who can neither influence the foreign entity nor obtain sufficient financial information concerning its operations to meet the administrative requirements of the Act. Accordingly, the Act applies only to Finnish shareholders who, directly or indirectly, control at least 10 percent of the capital of the foreign entity or are entitled to at least 10 percent of its profits.

In applying the minimum ownership test, the holdings of closely-related parties are aggregated with those of the taxpayer. Closely-related parties include near relatives in the case of an individual taxpayer, and affiliated entities and the shareholders of affiliated entities in the case of a corporate taxpayer.

B. Effective tax rate test

The effective tax rate test[8] is designed to compare the actual tax liability of a foreign entity with that of a Finnish corporate taxpayer. To achieve this, it is necessary to calculate in full what the foreign entity's tax liability would be if it were resident in Finland, and to compare this hypothetical tax liability with the actual amount of tax payable by the foreign entity in its country of residence.

If the actual tax payable amounts to less than $^3/_5$ of the tax that the entity would have to pay were it resident in Finland, the entity is caught by the Act. It should be noted that comparison of the statutory tax rates in Finland with those in the country of residence does not suffice – the test also takes into account other differences in tax treatment between the two countries.

Example:
A Finnish company has a wholly-owned marketing subsidiary in country A, where the corporate tax rate is 20 percent. However, country A's tax law allows for the creation of an inventory reserve, which, prior to 1993, was also permissible in Finland:

Revenues	1,000
Inventory reserve in country A	(400)
Taxable income	600
Corporate income tax @ 20%	120

Calculation according to Finnish tax law:

Revenues	1,000
Inventory reserve in Finland	0
Taxable income	1,000
Corporate income tax @ 25%	250

As the tax liability in country A is less than $^3/_5$ of the hypothetical Finnish tax liability, the Finnish parent company must declare the undistributed profits of its foreign marketing subsidiary as income.

One practical complication arising from the Act is that whenever the Finnish tax rate or tax base changes[9], the criteria for foreign entities also change, which introduces an element of considerable uncertainty into the foreign operations of Finnish businesses. The effective tax rate test also imposes a significant administrative burden on Finnish shareholders, who must present the Finnish tax authorities with detailed financial information concerning the foreign entity.

C. White list exemption

The Act is not intended to attack operations in a country with which Finland has concluded a tax treaty. In principle, such operations are exempt from the application of the Act. However, the legislator has decided to exclude from this exemption treaty countries which offer significant tax concessions not available in Finland.[10] To facilitate administration, the Regulation promulgated under the Act provides a "white list" designating treaty countries expressly exempted from the application of the Act:

5. Sec. 3 of the Act.
6. The Bill page 12.
7. Sec. 4 of the Act.
8. Sec. 2(1) of the Act.
9. Similarly, changes in the tax rate or base in the foreign entity's country of residence will have the same impact.
10. Sec. 2(2)(2) of the Act.

Australia	Latvia
Austria	Lithuania
Belgium	Luxembourg
Brazil	Morocco
Bulgaria	Netherlands
Canada	New Zealand
Czech Republic[11]	Norway
China	Philippines
Denmark and Faroe Islands	Poland
Egypt	Romania
Estonia	Russia
France	Slovenia
Germany	Spain
Greece	Sri Lanka
Hungary	Sweden
Iceland	Tanzania
India	Thailand
Indonesia	Turkey
Israel	Ukraine
Italy	United Kingdom
Japan	United States
Korea (ROK)	Zambia

It should be noted that the following treaty countries are *not* included in the white list:

Barbados	Portugal
Ireland	Singapore
Malaysia	Switzerland
Malta	

Ireland has not been included in the white list in view of the tax breaks granted to International Financial Service Companies; nor have Portugal, on account of Madeira, and Switzerland, because of the various tax concessions offered by certain cantons and municipalities.

It is envisaged that the white list will be changed if circumstances change: new countries may be added to the list if they abolish their tax concessions; conversely, countries may be removed from the list if they enact provisions granting tax concessions significantly different from those granted in Finland.

D. Industrial activity and group function exemptions

Unlike the CFC legislation of many countries, the new Finnish legislation takes no account of the motives behind locating a business operation in a particular country. Although, according to the Bill, the legislation is primarily directed at the channelling to low-tax jurisdictions of income which would otherwise be subject to Finnish tax, the scope of exemptions for income from legitimate business operations in a low-tax country is very limited. According to the Bill, this is due to administrative reasons and the desire to avoid difficulties of interpretation.

The principal exemption[12] applies to situations in which the Finnish-controlled foreign entity carries out industrial production in its country of residence. "Industrial production" is to be interpreted narrowly, and means primarily the mechanical or chemical transformation of inorganic or organic substances into new products, but also includes the assembling of products from prefabricated components.[13] This narrow definition clearly seems to exclude all commercial and support functions, such as marketing and research and development. It should also be noted that the industrial activity must take place in the entity's country of residence. Moreover, the Act expressly requires that the *principal part* of the entity's revenues must accrue from industrial production.

The exemption is expanded to apply, in addition, to affiliates of a foreign entity which derive the principal part of their revenues from payments from an entity involved in industrial production. Accordingly, a holding company of an entity conducting industrial operations is exempted from the Act, if the entity conducting the industrial operations itself qualifies for exemption. Presumably this group function exemption also extends to marketing companies, financing companies and real estate holding operations serving the industrial operations. The group function exemption is, however, subject to significant restrictions:

- the entity conducting the industrial operations and its affiliate must belong to the same group (as defined in the Finland's corporate legislation;[14]
- the entity conducting the industrial operations and its affiliate must be resident in the same country; and
- the affiliate must serve primarily only the needs of the entity conducting the industrial operations (as the principal part of the affiliate's revenues must be derived from the entity conducting the industrial operations).

The Act does not provide general exemptions for operations in the insurance sector or the financial services sector. Furthermore, except for revenues from industrial production activity, the Act applies to all revenues from legitimate business carried on in a low-tax jurisdiction, regardless of whether or not the business has been located there in order to avoid Finnish tax.

11. The Finnish foreign Ministry announced on 24 March 1994 that an agreement had been concluded between Finland and the Czech Republic, by way of an exchange of letters, to honour the tax treaty of 31 January 1975 concluded by Finland and the former Czechoslovakia. Regarding the Slovak Republic a similar procedure is currently in progress. In the meantime it is understood that the treaty with the former Czechoslovakia will also unofficially be applied to the Slovak Republic.
12. Sec. 2(2)(1) of the Act.
13. The Act does not define the term "industrial production activity". However, the Bill refers to the Act on the Temporary Investment Subsidy for Industrial Investments (Laki teollisten investointien väliaikaisesta investointituesta, L 444/94), where the same expression is used. The term is defined in the Bill to this act (HE 6/94) as follows: "Industry i.e. production means (in accordance with the nomenclature of economic activities issued by the Bureau of Statistics) primarily the transformation of anorganic or organic substances into new products. In accordance with the definition, the assembling of products (assembling) is also included in industrial activity". The Finnish nomenclature of economic activities (Teollisuuden toimialaluokitus 1995) is based on the standard nomenclature of the European Union Nomenclature Générale des Activités Economiques dans les Communautés Européennes (NACE Rev. 1, 1990), which all EU member states are to use for the statistical purposes under the Council Regulation 3037/90.
14. Chapter 1 Sec. 2 Finnish Companies Act (L 734/78) provides that two companies belong to the same group when there is at least 50 percent common ownership.

E. Shipping exemption

A further exemption was added to the Act during the parliamentary discussions[15] which fully exempts Finnish-controlled entities involved engaged in ship ownership. To qualify for this exemption, the foreign entity must derive the principal part of its revenues from ship ownership business. The group function exemption does not extend to the ship ownership businesses.

III. TAX TREATMENT OF THE FOREIGN ENTITY'S PROFITS IN THE FINNISH SHAREHOLDERS' HANDS

A Finnish shareholder of a Finnish-controlled entity within the scope of the Act must include its proportionate share of the entity's profits in its taxable income for Finnish tax purposes. Once the income has been taxed in Finland, it can be distributed to Finland free of tax during the following five years. Conversely, a Finnish shareholder is entitled to deduct its proportionate share of a controlled foreign entity's losses.[16] The deduction can be taken only against the subsequent profits of the same entity, the period for which a loss can be carried forward being restricted to five years. Losses cannot be offset against the profits of another entity.

A proportionate share of the taxes paid by a controlled foreign entity can be credited against Finnish tax payable on the same profits.[17] Credit is available for state income tax paid by the foreign entity in its country of residence or in another jurisdiction, but not for local, municipal or indirect taxes.[18]

Finnish taxpayers are required by the Act to report their deemed income from a controlled foreign entity and are also obliged to provide all necessary information regarding the accounts of the foreign entity.[19]

IV. ISSUES RAISED BY THE NEW LEGISLATION

A. GENERAL REMARKS

The intention of the Finnish legislator has been to draw up CFC legislation which is straightforward, simple to administer and liable to give rise give as few difficulties of interpretation as possible.[20] Although the Act clearly achieves these goals, it also seriously impinges on the entirely legitimate foreign operations of Finnish businesses, which are located in low-tax jurisdictions for reasons other than tax evasion.

Although the Act is designed to combat the channelling of Finnish taxable income to low-tax countries, it also attacks operations which are based in a particular country for logistical reasons, because of the availability of a skilled workforce or the need to serve the local customer base. For example, all Swiss financing, marketing and insurance operations of Finnish groups are affected by the legislation.

Against this background, the exemption for ship ownership businesses seems somewhat problematic. Given the fact that legitimate local business in a low-tax country is affected, it is surprising that shipping business, which can easily be transferred from one country to another, is excluded.

In general terms, the Act imposes a considerable administrative burden on Finnish multinational groups, which must now annually review the activities of all their foreign subsidiaries and, to the extent that those subsidiaries are caught by the Finnish CFC legislation, present potentially very extensive material to the Finnish tax authorities.

B. Possible conflict with European Community law

Since 1 January 1995 Finland has been a member of the European Union (EU), and accordingly must adapt its legislation to the requirements of the European Community (EC) legislation. Two other Member States of the EU, Ireland and Portugal, are not covered by the white list exemption and are therefore fully within the scope of the Act. A question arises as to whether the new Finnish CFC legislation could be said to restrict the free movement of capital or the right of establishment between Finland and these two other Member States, and thus be in conflict with the EC legislation.

Articles 3[21], 5[22] and 73B of the Treaty of Rome require Member States to refrain from any measures that restrict the free movement of capital between the Member States. Article 52 of the Treaty of Rome forbids the Member States to restrict the freedom of a national of another Member State to establish a business presence in that other Member State by setting up an agency, a branches or a subsidiary. The case law of the EC Court of Justice has further elaborated this principle in the "Avoir Fiscal case"[23] where the Court found that a Member State may not restrict the freedom of a national of another Member State to choose between the establishment of a branch or subsidiary by subjecting each of these forms of doing business to different tax treatment.

Arguably, the new Finnish CFC legislation can be regarded as restricting the ability of a Finnish company to choose between establishing a branch or a subsidiary in Ireland or Portugal. Branch profits generated in Portugal, for example, are exempt from tax in the hands of a Finnish company whilst the Act has the effect that profits generated by a Portuguese subsidiary are subject to tax in the hands of its Finnish parent.

It can also be argued that the new Finnish CFC legislation results in the situation that subsidiaries established by

15. Sec. 2(2)(1) of the Act.
16. Sec. 5 of the Act.
17. Sec. 6 of the Act.
18. It is unclear whether state tax paid under a federal system qualifies as creditable tax. The Bill refers to state income tax only (as opposed to municipal income tax), but gives no indication as to interpretation in a situation where the foreign entity pays tax at municipal, state and federal levels.
19. Sec. 7 of the Act.
20. The Bill clearly indicates this intention, for example on page 10 (chapter 4.4) in relation to the industrial activity exemption.
21. Article 3, sub c, of the EC Treaty.
22. Article 5, paragraph 2, EC Treaty.
23. Court of Justice EC 28 January 1986, case 270/83, ECR 1986, page 273.

Finnish companies in different EU Member States are subject to different tax treatment. This could be regarded as discrimination, albeit indirect discrimination, by Finland against its nationals on the grounds of the nationality of their subsidiaries in other Member States. No case law exists, however, to indicate that this sort of indirect discrimination contravenes Article 52 of the Treaty of Rome.

A Finnish company could possibly invoke the protection of Article 52 of the Treaty of Rome in the Finnish courts to claim that the Finnish CFC legislation must be overruled to the extent that it concerns subsidiaries incorporated in other Member States of the EU. The EC Court of Justice ruled in the "Kraus case"[24] that where a national of one Member State has made use of its right of establishment in another Member State, and is for that reason discriminated against by his own Member State, the national may invoke the protection granted under Article 52. In the light of the Avoir Fiscal and Kraus cases it seems possible that the courts could find that the new CFC legislation results in discrimination in contravention of Article 52 of the Treaty of Rome between branches of Finnish nationals established in Ireland or Portugal and subsidiaries established in those countries.

If such discrimination were found to be present, the courts would still need to evaluate whether the Finnish CFC legislation could be justified as a national measure taken in reasonable proportion to its objective. As discussed above, the objective of the Finnish CFC-legislation is to circumvent the avoidance of Finnish tax by Finnish taxpayers. The EC Court of Justice, however, ruled in the Avoir Fiscal case that the prevention of tax-avoidance is not sufficient justification for measures restricting freedom of establishment under Article 52. On the other hand, the Court of Justice has indicated in two cases (Bachmann[25] and Daily Mail[26]) that EC law should not be used as a tax planning tool, that is that legitimate tax measures introduced by a Member State should not be preempted by resorting to arguments based on EC legislation.

If these issues relating to Finland's CFC legislation were to be brought before the EC Court of Justice, it might be expected that the court would also have regard to the fact that the legislation results in the situation that operations in different Member States are treated differently for tax purposes. It should be noted that, while Ireland and Portugal are caught by the Act because of their special tax incentive regimes, some other EU Member States have been included in the white list notwithstanding their respective special tax regimes. Such incentive regimes exist, for example, in Belgium and Italy. The Finnish CFC legislation can, therefore, be regarded as giving rise to indirect discrimination not only between Irish/Portuguese branches and Irish/Portuguese subsidiaries of Finnish companies, but also between Irish/Portuguese subsidiaries of Finnish companies and their sister companies in other Member States. It seems highly unlikely, that the EC Court of Justice would consider this treatment to be in reasonable proportion.

The Act also applies in certain instances where tax concessions have been authorized by the EC to provide regional aid to underdeveloped areas within the EU under Article 92 of the Treaty of Rome. A notable example of this is the regime for companies established in the Ireland's Dublin Docklands. It seems inequitable that Finland should be able to seize the benefit of investments made by Finnish companies in such areas, effectively defeating the objectives of the EU in authorizing such incentives. It is also possible that in undermining the objectives of measures approved by the European Commission under Article 92, Finland may be infringing against Articles 5 and 92 of the Treaty of Rome.

24. Court of Justice EC 31 March 1993, case C-19/92, not yet reported.
25. Court of Justice EC 28 January 1992, case C-204/90, ECR 1992, page I-249.
26. Court of Justice EC 27 September 1988, case 81/87, ECR 1988, page 5483.

ISRAEL

FREE PROCESSING ZONE LAW

Leon Harris

Kost, Levary & Forer, Tel-Aviv.

In June 1994, the Knesset enacted the Free Processing Zone Law, 1994 (hereinafter the "FPZ Law"). The FPZ Law supplements the existing Eilat Free Trade Area provisions and heralds a new beneficial climate for companies establishing and managing the FPZ ("concessionaires") and for enterprises which choose to set up in the FPZ.

The FPZ Law creates attractive business opportunities in certain instances, especially for manufacturers that are not capital-intensive, and persons or entities providing services to overseas parties. These opportunities will be enhanced where businesses avail themselves of Israel's free trade agreements with the United States, the EU and EFTA.

Efforts are now under way to establish Israel's first FPZ near Beer Sheva. The following is a brief description of the FPZ Law and a review of the business opportunities that may arise.

I. OBJECTIVES OF THE FPZ LAW

The objectives of the FPZ Law are the promotion of production and development in Israel, creation of job opportunities, improvement of the balance of payments, economic growth, strengthening the competitiveness of Israeli exports, and attracting new investment into Israel.

Unlike some other countries, Israeli FPZ manufacturers will not be required to export all their output. Goods may also be sold on a wholesale basis to the Israeli market, although FPZ enterprises may not engage in retail sales nor conduct a business or activity outside a zone. In practice, export potential will presumably be taken into account when implementing the FPZ rules. Moreover, FPZ enterprises may be expected to maximize their advantage by seeking sales worldwide.

FPZ service enterprises will be limited to providing services to overseas parties, under the FPZ Law.

II. FREE ZONES COUNCIL

A Free Zones Council (hereinafter "the Council") has been established. It is comprised of six government officials and representatives of the relevant governmental Ministries.

The main responsibilities of the Council are as follows:
- to locate and propose locations for FPZs;
- to promulgate and administer the necessary regulations for the operation of FPZs in conjunction with the FPZ concessionaire;
- to approve requests for operating a business in an FPZ.

III. ESTABLISHING THE FIRST FPZ

The Council is currently arranging a tender inviting proposals to serve as the concessionaire for the first FPZ that is to be established, once a development agreement has been signed with the Israel Land Administration.

The first FPZ will be established at Likat near Beer Sheva, in a National Priority Region. The Government will finance infrastructure expenditures (roads, electricity, communications, sewerage, water, fuel, gas, waste disposal) in the designated FPZ. The first FPZ is not expected to be operational until 1996.

An FPZ concessionaire will be, among other things, a private sector entity with sufficient financial and organizational ability to establish and manage an FPZ and have the ability, know-how and qualifications to develop, manage and operate the FPZ. Tender participants are required to be registered as authorized dealers for Israeli VAT purposes and to produce letters of intent from businesses interested in operating in the zone, stating the estimated number of jobs that would be created.

IV. FPZ ENTERPRISES

The FPZ is aimed at entities that perform manufacturing activities or provide services to overseas parties, who are not engaged in retail sales in the FPZ or elsewhere in Israel. In addition, FPZ enterprises may not, directly or indirectly, conduct business or activities outside the FPZ.

Services of a financial institution, hire-purchase transactions and other financial services will not be recognized until such time as specific regulations are issued. The intent is to allow "offshore banking" activities after the formulation of preventive measures against the possibility of money laundering.

Requests for the establishment of enterprises in an FPZ should be submitted to the concessionaire for review. The concessionaire will then forward the application to the Council for authorization. The procedure for processing and granting authorization will be subject to various time limits (22-52 days under the Law).

V. TAX EXEMPTIONS AND BENEFITS

The FPZ concessionaire and FPZ enterprises will be entitled during the first 20 years of operation of the FPZ, and for any extension that may be granted, to a complete exemption from income tax, company tax, capital gains tax, property tax, land appreciation tax, real estate acquisition tax and all other direct taxes in Israel on business income accrued or derived in the FPZ. This exemption also extends to income of a non-resident from securities deposits and other deposits at a financial institution in the zone. Income from services rendered by one FPZ enterprise to another are not exempt.

A concessionaire or FPZ enterprise will not be granted any benefits or support from the state budget or government loan guarantees during the exemption period.

Withholding taxes and advance tax payments of 45 percent in respect of certain non-deductible expenses ("excess expenses"), relating to payments to Israeli residents, will apply in the FPZ.

Profits distributed from earnings that were accrued or derived in the FPZ will be taxed at a rate not exceeding 15 percent of the distributed profits.

During the exemption period, the concessionaire and FPZ enterprises will not be liable for indirect taxes (customs, purchase tax, excise tax, trade levies, etc.), except on private vehicles. Goods shipped to other parts of Israel (except to an FPZ) will be treated like imports and will be subject to indirect taxes. This will not apply to goods shipped temporarily for purposes of repair, renovation, enhancement, or organizing exhibitions or functions as per rules to be prescribed.

Goods imported by the concessionaire or an FPZ enterprise for use in a zone, except private vehicles, will be exempt from VAT. VAT at a zero rate will apply to goods and services exported abroad and to transactions between FPZ enterprises or with the concessionaire. Transactions with other Israeli parties will be liable to standard rate VAT – currently 17 percent.

Capital gains tax on the sale of shares in the concessionaire company or in an FPZ enterprise during the exemption period will be payable at a rate not exceeding 15 percent, subject to any applicable tax treaty.

The Income Tax Commissioner is empowered to defer collection of the tax for six months, but if during that period the sale consideration is reinvested in any FPZ enterprise, the capital gain will be exempt from Israeli tax.

During the exemption period, the concessionaire and FPZ enterprises will be exempt from stamp duty, municipal taxes, construction taxes, betterment levies, and consent fees and charges under the Law for Planning and Building. However, the concessionaire is free to establish rental fees and charges for services and facilities.

There will be no future tax levied in respect of the sale or acquisition of foreign currency.

Import and export licenses will not be required, except for specific limitations set forth in the FPZ Law (e.g. health and environmental rules). Imported goods designated for the FPZ will be brought directly from the port of entry to the FPZ under Customs supervision. Goods exported abroad from the FPZ will be similarly supervised. Israel will uphold its international trade agreements with respect to FPZ imports and exports of goods.

VI. OTHER EXEMPTIONS AND BENEFITS

Foreign residents employed in the FPZ will enjoy relief from Israeli foreign currency controls, and Israeli residents in the FPZ will be permitted to be party to such transactions, as if they were ordinary import-export transactions of goods or services.

Streamlined planning permission requirements will apply to new buildings in the FPZ.

Provisions governing terms of employment have been relaxed, and alternative arrangements may be approved by the Minister of Labour with respect to a significant part of Israeli labour legislation, including collective agreements.

The Interior Ministry may allow an FPZ enterprise or the concessionaire to employ foreign personnel in managerial and staff training functions, representing up to 3 percent of their personnel.

There will be no future price or profit controls in relation to the sale of goods, provision of services, and fixing of rental fees in the FPZ.

There will be an exemption from using public monopoly services such as power generation and telecommunications.

There will be no minimum requirements regarding equity levels or local participation.

VII. COMMENTS

The Council is expected to establish criteria for the authorization of enterprises in the FPZ. It is likely that manufacturing enterprises will be able to satisfy both the FPZ criteria and the criteria of the Investment Centre for obtaining approved enterprise status under the Law for the Encouragement of Capital Investments, 1959, outside the FPZ. Such manufacturing enterprises will therefore wish to evaluate the alternative options available to them.

Despite the generous tax benefits lasting up to 20 years or more for FPZ enterprises, operations in the FPZ will likely be less attractive for some entrepreneurs due to the necessity to forego investment and R & D grants, as well as other Government financial support and guarantees.

The main benefits which approved enterprises may enjoy, which are not granted to FPZ enterprises, are as follows:

- investment grants
  - 38 percent in National Priority Region A
  - 20 percent in National Priority Region B;
- tax holiday (outright exemption) on undistributed profits for up to ten years in National Priority Region A or up to six years for plants in National Priority Region B, and reduced company tax rates subsequently in Region B, for plants waiving entitlement to an investment grant;
- bank loans partially guaranteed by the government, ranging up to 70 percent for plants not receiving a grant, with eligibility for a tax holiday. Alternatively, it is possible to receive up to 25 percent as a fixed asset investment grant and the balance as a loan as stated above, but without a tax holiday;
- company tax at rates of only 10-15 percent for up to ten years for plants receiving a grant, as mentioned above, if they are 74-100 percent foreign owned;
- research and development grants from the Chief Scientist at the rate of 50-60 percent (although a royalty becomes payable if the R & D is commercially successful);
- marketing promotion grants from the Fund for the Encouragement of Overseas Marketing (although a royalty becomes payable if exports increase);
- grants for employee training;
- technology intensive companies tend to establish their plants adjacent to sources of skilled personnel.

In view of the above, it is reasonable to assume that some manufacturers potentially eligible to operate in the FPZ will opt to establish plants elsewhere in Israel with a view to enjoying "approved enterprise" benefits and other incentives.

On the other hand, the company tax exemption for up to 20 years and the other benefits available in an FPZ should encourage a number of enterprises to set up operations there. In certain instances, companies may also consider the seven year company tax exemption and related benefits available to authorized enterprises in the Eilat Free Trade Area. While Eilat is a port city on the Red Sea, its location on the southern tip of Israel must be taken into account. The FPZ near Beer Sheva will be closer to the centre of Israel.

On balance, FPZ tax and other benefits will represent an attractive option for consideration by some manufacturers, particularly those expecting to derive high profits from a relatively low initial capital investment. The efforts to minimize bureaucracy for FPZ enterprises may also prove attractive, and may even have a beneficial spill-over effect into the mainstream Israeli economy.

Moreover, businesses providing services to overseas clients may benefit substantially from the FPZ. Unlike manufacturers, service providers are not usually awarded "approved enterprise" status and benefits.

Nevertheless, the first FPZ in Israel is still only in the planning stages, and is not expected to be operational before 1996. Readers are advised to refer to the Law and to obtain appropriate professional advice in specific proposed instances.

LATIN AMERICA

TAXATION OF INVESTMENT INCOME IN SEVEN LATIN AMERICAN COUNTRIES

Miguel Massone

Non-resident Research Associate, International Bureau of Fiscal Documentation, Valparaíso, Chile.

I. INTRODUCTION

This article discusses the taxation of dividends, interest and royalty income paid by legal entities to residents and non-residents in seven Latin American countries, namely Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

A brief summary of the rules on the territorial scope of the countries is followed by a comparative analysis of the tax treatment of dividends, interest and royalties under domestic as well as treaty law. The concluding section offers a comparison of the domestic and treaty provisions for the avoidance of double taxation of inbound investment income.

II. TERRITORIAL SCOPE

Argentina, Chile, Colombia, Mexico and Peru rely on the worldwide principle of income taxation, as does Brazil in respect of income derived by individuals.

Venezuela relies almost exclusively on the territoriality principle, and Brazil applies the same principle in respect of income derived by legal entities.

III. TAXATION OF INVESTMENT INCOME

A. Dividends

Dividend distributions to residents are subject to final withholding tax in Brazil, are included in the taxpayer's taxable income in Chile (when distributed to individuals), and are generally non-taxable in Argentina, Chile (when distributed to legal entities), Colombia, Mexico, Peru and Venezuela. Foreign-source dividends received by resident taxpayers are included in taxable income in Brazil (when the recipient is an individual), Chile, Colombia and Mexico whereas they are not taxed in Brazil (when the recipient is a legal entity) and Venezuela; the situation in Argentina and Peru is unclear.

Dividend distributions to non-residents are subject to final withholding tax in Brazil, Chile and Colombia whereas in Argentina, Mexico, Peru and Venezuela such distributions are generally tax-free.

1. Argentina

Dividends paid to residents and non-residents, whether legal entities or individuals, are non-taxable.

After Tax Reform Law 24,073, published in the Official Gazette of 13 April 1992, it is not clear whether or not foreign-source dividends received by residents in Argentina are taxable. The income tax law does not make a distinction between dividends derived from domestic or foreign sources. Accordingly, based on current tax law dividend income seems to be non-taxable.[1]

Since outbound dividends are tax-free, the tax rate limitations for dividends in the Argentine treaty network are presently of no use.

2. Brazil

Dividends paid to residents and non-residents, whether legal entities or individuals, are subject to a 15 percent final withholding tax.[2]

Since Brazil applies the territoriality principle of income taxation to legal entities, foreign-source dividends received by a resident entity are not subject to income tax in that country.[3] In contrast, foreign-source dividends received by resident individuals are included in the recipient's taxable income and are taxed at progressive rates ranging from 15 to 35 percent in 1994.[4]

The only tax treaty which provides for a maximum tax rate below the rate established in domestic Brazilian law is the treaty with Japan. Under this treaty, the tax on dividends dis-

1. However, it should be noted that some local experts consider that foreign-source dividends should be considered taxable because of the introduction of the worldwide principle by Law 24,073. It is also important to take into account that no regulations have been issued after the tax reform that incorporated the worldwide principle; therefore, some questions still remain unanswered about application of this principle.
2. Taxation of dividends paid to resident taxpayers may change if the legislative branch confirms a provisional measure issued by the President.
3. However, foreign-source dividends received by legal entities are subject to a 10% "social contribution".
4. From 1995, the individual income tax schedule will range from 15 to 25%.

tributed to a resident of Japan cannot exceed 12.5 percent. Other treaties provide for a limit which is equal to the 15 percent tax rate applicable under Brazilian domestic law (treaties with Austria, Belgium, Canada,[5] China (People's Rep.), Czechoslovakia,[6] Ecuador, Finland, France, Germany, Hungary, India, Italy, Korea (Rep.), Luxembourg,[7] the Netherlands, the Philippines,[8] Portugal, Spain and Sweden[9]), or provide a limit which is higher than the 15 percent rate (treaties with Denmark, Luxembourg,[10] the Philippines[11] and Sweden[12]), or simply contain no limit (treaties with Argentina, Canada[13] and Norway).

3. Chile

Dividends paid to resident legal entities are exempt from corporate income tax. Dividends paid to resident individuals are subject to individual income tax at progressive rates ranging from 5 to 48 percent,[14] with the underlying tax being creditable against liability to the individual income tax.

Dividends paid by foreign corporations not doing business in Chile to resident legal entities are included in the recipient's business income and are subject to corporate income tax at a flat rate of 15 percent. Dividends paid by foreign corporations not doing business in Chile to resident individuals are subject to the 15 percent corporate income tax and additionally to the individual income tax at progressive rates ranging from 5 to 48 percent.[15]

Dividends paid to non-residents are subject to a final withholding tax of 35 percent, with the underlying tax being creditable against liability to the non-resident income tax (thus making an effective rate of 23.53 percent).[16]

No maximum withholding tax is stipulated in the only Chilean comprehensive income tax treaty (concluded with Argentina), and taxation of outbound dividends is governed entirely by domestic Chilean law.

4. Colombia

Dividends paid to Colombian legal entities or resident individuals are taxed only on that part exceeding either:

- 7/3 of the income tax liability of the distributing entity (this limit is increased for that part of dividends received by the distributing entity which is exempt under the same rules); or
- the after-tax business profits derived by the distributing entity.[17]

The tax on the excess is levied at a flat rate of 30 percent plus a 25 percent surcharge (thus making an effective rate of 37.5 percent) in the case of legal entities, and at progressive rates ranging from 0.14 to 30 percent plus the 25 percent surcharge (thus making a maximum effective rate of 37.5 percent) in the case of individuals.

Foreign-source dividends received by legal entities or individuals are included in the recipient's taxable income and taxed at the rates indicated above.

Dividends paid to foreign legal entities not domiciled in Colombia and to non-resident foreign individuals are subject to final withholding tax at a rate of 10 percent in 1994.[18]

No tax rate limitation for dividends paid to non-residents is stipulated in the Andean Group tax treaty for the prevention of double taxation of income between member countries (i.e. Bolivia, Colombia, Ecuador, Peru and Venezuela), which is the only comprehensive income tax treaty concluded by Colombia.

5. Mexico

Dividend distributions to residents and non-residents, whether legal entities or individuals, are exempt from income taxation when paid out of distributable profits,[19] but they are subject to corporate income tax at 34 percent when paid out of other resources. This tax, when applicable, is calculated on the dividend as multiplied by 1.515, thus making an effective rate of 51.51 percent.

Resident individuals may choose to include dividends distributed to them in their taxable income. For that purpose, the dividend received is multiplied by 1.515. If the individual includes the dividend in his taxable income, he may credit against his income tax liability a percentage of the taxable dividend, computed as above; this percentage is equal to the corporate income tax rate.

Foreign-source dividends received by resident legal entities or individuals are included in the recipient's taxable income and are subject to tax at a flat rate of 34 percent in the case of legal entities, and at progressive rates ranging from 3 to 35 percent in the case of individuals.

5. Only if dividends are paid to a company that holds at least 10% of the payer's equity.
6. Applicable to the Czech Republic and the Slovak Republic.
7. Only if dividends are paid to a company that holds directly at least 10% of the payer's equity.
8. Only if dividends are paid to a company (including a partnership).
9. Only if dividends are paid to a company (excluding a partnership).
10. Only if dividends are paid to a recipient other than a company that holds directly at least 10% of the payer's equity.
11. Only if dividends are paid to a recipient other than a company (including a partnership).
12. Only if dividends are paid to a recipient other than a company (excluding a partnership).
13. Only if dividends are paid to a recipient other than a company that holds at least 10% of the payer's equity.
14. From 1995, individual income tax rates will range from 5 to 45%.
15. Economic double taxation is alleviated by granting a credit against the individual income tax for the corporate income tax paid. From 1995, individual income tax rates will range from 5 to 45%.
16. The corporate income tax is not considered for the computation of the 23.53% effective rate.
17. As a corollary, dividends are exempt if paid out of income already subject to corporate income tax.
18. The rate is 8% in 1995 and 7% from 1996. Dividends reinvested in Colombia for five years are exempt. For dividends paid out of income from oil operations, the rate is 15% in 1994 and 1995 and 12% from 1996. Dividends paid out of income from investments in oil operations effected from 1993 are subject to a 12% rate.
19. Distributable profits are profits available for distribution which have already been subject to corporate income tax at the ordinary rate. More precisely, distributable profits are taxable profits net of the corporate income tax and non-deductible expenses (other than reserves). The distributable profits of each tax year and the dividends received from other resident legal entities are entered into a special account. Dividends and other distributions are deducted from that account.

Non-residents are not liable to Mexican tax on dividend distributions received. Liability to tax on dividends, when such a tax is appropriate, relies on the distributing entity. It must be noted, however, that virtually all dividend distributions to non-residents are not subject to tax because they are normally paid out of distributable profits.

6. Peru

Dividends paid to residents and non-residents, whether legal entities or individuals, are not subject to tax. After the last tax reform, it is not clear whether or not foreign-source dividends are taxable. The income tax law does not make any distinction between dividends from domestic and foreign sources. Accordingly, under current law dividend income appears to be non-taxable.

7. Venezuela

Dividends paid to residents and non-residents, whether legal entities or individuals, are exempt from income taxation. According to the source principle of income taxation adopted by Venezuela, foreign-source dividends are not subject to tax here.

B. Interest

In all seven countries interest payments to residents are included in the recipient's taxable income; Mexico, however, applies a final withholding tax in respect of interest paid to resident individuals.

As for payments to non-residents, all countries levy a final withholding tax on interest. However, the withholding tax applied by Venezuela on interest paid to non-resident legal entities is not a final one, i.e. such interest is subject to a withholding tax at progressive rates on a cumulative basis.

1. Argentina

Interest paid to residents, whether legal entities or individuals, is taxed as ordinary income. Thus in the case of legal entities, interest is subject to income tax at a flat rate of 30 percent, and in the case of individuals, interest is included in total income and is subject to progressive rates ranging from 11 to 30 percent.

Interest paid to non-residents is subject to a final withholding tax at an effective rate of 12 percent (i.e. 40 percent of gross interest is taxed at 30 percent). Interest paid for the financing of imported assets subject to depreciation is tax-free.

Practically all tax treaties concluded by Argentina provide for maximum withholding tax rates which are higher than the 12 percent effective rate applicable under Argentine domestic law (treaties with Austria, France, Germany,[20] Italy and Spain (effective from January 1995)) or simply contain no limit at all (treaties with Bolivia, Brazil, Chile and Sweden). Hence, the 12 percent rate applies to virtually all interest payments to non-residents.

2. Brazil

Interest paid to resident legal entities is normally included in business profits and is subject to an effective overall federal corporate income tax rate of 40.91 percent.[21] Interest paid to individuals is subject to individual income tax at progressive rates ranging from 15 to 35 percent in 1994.[22] However, interest from financial investments producing fixed returns is generally subject to a 30 percent final withholding tax.

Interest paid to non-resident individuals or legal entities is ordinarily subject to a final withholding tax of 25 percent.

Under treaty rules, the maximum withholding tax rate on outbound interest is limited to 12.5 percent in the case of the treaty with Japan, and 15 percent in the case of the treaties with Austria, Belgium, Canada,[23] China (PRC),[24] Czechoslovakia,[25] Denmark,[26] Ecuador,[27] Finland,[28] France,[29] Germany,[30] Hungary,[31] India,[32] Italy,[33]

20. A tax rate limitation equal to 10% applies in respect of interest paid in connection with the sale on credit of industrial, commercial or scientific equipment, or on a loan granted by a bank or in connection with the financing of public works.
21. The 25% corporate income tax is added with a 10% social contribution and a 10% additional tax on legal entities (15% for financial institutions), thus making an effective overall federal corporate tax of 40.91% in general (i.e. 9.09% effective social contribution + 22.73% effective corporate tax rate + 9.09% effective additional tax).
22. See *supra* note 4.
23. The limit applies on interest paid to a company. No limit applies on interest paid to individuals. The limit is 10% on interest paid to a Canadian-resident company in respect of loans guaranteed or insured by the Export Development Corporation of Canada for a minimum period of seven years.
24. Nil on interest paid to the Chinese Government or agencies thereof (including the Central Bank and financial institutions).
25. The limit is 10% for interest paid on loans and credits granted by a bank for at least ten years to finance industrial equipment, industrial or scientific units or public works. Nil on interest paid to the Czech Government and the Slovak Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government or agencies thereof (including financial institutions).
26. Nil on interest paid to the Danish Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government or agencies thereof (including financial institutions).
27. Nil on interest paid to the Ecuadorean Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government (including financial institutions).
28. Nil on interest paid to the Finnish Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government.
29. The limit is 10% for interest paid on loans and credits granted for a seven-year minimum period by banking institutions with participation from public bodies of specialized financing to finance equipment, industrial or scientific units or public works.
30. The limit is 10% on interest paid to a bank in respect of loans granted for a period of at least seven years to finance industrial equipment, industrial or scientific units or public works. Nil on interest paid to the German Government or agencies thereof (including financial institutions).
31. The limit is 10% for interest paid on loans and credits granted by a bank for a period of at least eight years to finance industrial equipment, industrial or scientific units or public works. Nil on interest paid to the Hungarian Government or agencies thereof (including the Central Bank and financial institutions).
32. Nil on interest paid to the Indian Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government or agencies thereof (including financial institutions).
33. Nil on interest paid to the Italian Government or agencies thereof (including financial institutions).

Korea (Rep.),[34] Luxembourg,[35] the Netherlands,[36] the Philippines,[37] Portugal,[38] Spain,[39] Sweden.[40] No limit is provided for in the treaties with Argentina[41] and Norway.

3. Chile

Interest paid to resident legal entities is included in gross income and is subject to corporate income tax at a flat rate of 15 percent. Interest paid to individuals is ordinarily subject to individual income tax at progressive rates ranging from 5 to 48 percent.[42]

Interest paid to non-residents is normally subject to final withholding tax at an ordinary rate of 35 percent. There are, however, several instances in which interest paid to non-residents is subject to final withholding tax at the reduced rate of 4 percent.[43]

No maximum withholding tax is provided for in the only Chilean comprehensive income tax treaty (concluded with Argentina), and taxation of outgoing interest is entirely governed by Chilean domestic law.

4. Colombia

Interest paid to residents is included in taxable income and subject to tax at a flat rate of 30 percent plus a 25 percent surcharge (thus making an effective rate of 37.5 percent) in the case of legal entities, and at progressive rates ranging from 0.14 to 30 percent plus the 25 percent surcharge (thus making a maximum effective rate of 37.5 percent) in the case of individuals.

Interest paid to foreign legal entities not domiciled in Colombia and to non-resident foreign individuals is subject to a final withholding tax at a rate of 30 percent plus a surtax on transfers of income abroad at a rate of 10 percent in 1994,[44] thus making an effective rate of 37 percent. The ordinary withholding tax is calculated on the gross amount of interest and the surtax is calculated on interest after deducting the amount of the ordinary withholding tax. Note, however, that there are certain items of interest which are not considered to be Colombian-source income and therefore are not subject to income taxation.[45]

No tax rate limitation on interest paid to non-residents is provided for in the Andean Group tax treaty.

5. Mexico

Interest payments to resident legal entities are included in the gross income of the recipient entity and are subject to tax at a rate of 34 percent. Interest payments to resident individuals are subject to a 20 percent final withholding tax calculated on the first 10 percentage points of the gross amount of interest. Interest payments to non-residents are subject to final withholding tax at different rates, 35 percent being the general rate. Other rates are: 4.9, 10 and 15 percent.

Under the treaties concluded by Mexico, the tax rate is limited to 15 percent for interest payments to a resident of Canada,[46] France,[47] Germany,[48], Sweden[49] and the United States.[50]

6. Peru

Interest paid to residents is included in taxable income and subject to tax at a flat rate of 30 percent in the case of legal entities, and at progressive rates of 15 and 30 percent in the case of individuals. However, interest paid to individuals in connection with the exercise of business activities is included in the individual's business income and is taxed at the flat rate of 30 percent.

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34. The limit is 10% for interest paid to a bank on loans granted for a period of at least seven years to finance industrial equipment, industrial or scientific units or public works. Nil on interest paid to the Korean Government or agencies thereof (including the Central Bank and financial institutions), unless arising from securities issued by the Brazilian Government or agencies thereof (including the Central Bank and financial institutions).
35. The limit is 10% for interest from loans and credit granted for a period of at least seven years by banks to finance capital assets, industrial or scientific equipment or public works. Nil on interest paid to the Luxembourg Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government.
36. The limit is 10% for interest paid to a bank on loans granted for a period of at least seven years to finance industrial or scientific equipment or public works. Nil on interest paid to the Dutch Government or agencies thereof (including financial institutions).
37. Nil on interest paid to the Philippine Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government or agencies thereof (including financial institutions).
38. Nil on interest paid to the Portuguese Government or agencies thereof.
39. The limit is 10% for interest paid on loans and credits granted by a bank for at least ten years to finance the acquisition of goods and equipment. Nil on interest paid to the Spanish Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government or agencies thereof (including financial institutions).
40. The limit is 25% for interest paid to individuals or partnerships. Nil on interest paid to the Swedish Government or agencies thereof (including financial institutions).
41. Nil on interest paid to the Argentine Government or agencies thereof (including financial institutions), unless arising from securities issued by the Brazilian Government or agencies thereof (including financial institutions).
42. See *supra* note 14.
43. E.g. interest paid on current accounts and term deposits in foreign currency if the deposit is placed in an institution operating in Chile which is authorized by the Central Bank to receive such deposits, and interest paid to foreign or international banks and to foreign or international financial institutions approved by the Chilean Central Bank.
44. The surtax is 8% in 1995 and 7% from 1996.
45. E.g. interest on loans to finance exports, interest on foreign credits granted to banks, and interest on credits for foreign trade transactions.
46. Nil on interest paid by, or paid to, the Government or publicly owned institutions, or when paid to a resident of Canada in respect of loans for at least 3 years which are granted or secured by the Canadian Export Development Corporation.
47. Nil on interest paid by, or paid to, the Government or publicly owned institutions, or when paid on loans for at least 3 years which are granted or secured by government export promoting institutions.
48. 10% on interest paid from 1 January 1999 to banks, insurance companies or pension funds. Nil on interest paid by, or paid to, a Contracting State or the Deutsche Bundesbank, or when paid on loans for at least three years which are granted or secured by government export promoting institutions.
49. Nil on interest paid by, or paid to, the Government or publicly owned institutions (including the Central Bank), or when paid on loans for at least three years which are granted or secured by government export promoting institutions. 10% on interest paid to banks as from 1 January 1998.
50. 10% (4.9% from 1 January 1999) for interest paid to a bank or insurance company and on interest paid on bonds or securities regularly traded on a securities market. 10% on interest paid as from 1 January 1999 by a bank to a person other than a bank or insurance company, or by the purchaser to the seller of machinery or equipment in a credit sale. Nil on interest paid by, or paid to, one of the Contracting States or a publicly owned institution, or paid to an exempt trust or company managing pension funds and other similar funds, or paid on loans for at least three years which are granted or guaranteed by the Export-Import Bank or the Overseas Private Investment Corporation.

Interest paid to non-residents is most commonly subject to final withholding tax at a rate of 30 percent. Nevertheless, interest is subject to a 1 percent final withholding tax if paid to legal entities on loans or financing specified by law. Also, there are instances where interest paid to non-residents is exempt.

No tax rate limitation applies by virtue of the Andean Group tax treaty or the treaty with Sweden, which are the only comprehensive tax treaties concluded by Peru.

7. Venezuela

Interest paid to resident legal entities is included in the entity's profits and is subject to corporate income tax at progressive rates ranging from 15 to 34 percent. Interest paid to resident individuals is taxed under general rules at progressive rates ranging from 6 to 34 percent.

Interest paid to non-resident financial institutions organized abroad and not being resident in Venezuela is subject to a final withholding tax of 4.95 percent. Interest paid to other non-resident legal entities is subject to withholding tax at progressive rates ranging from 15 to 34 percent on a cumulative basis. This tax applies on 95 percent of gross interest, provided the loan is used to produce taxable income (thus making a maximum effective tax rate of 32.3 percent). Interest paid to non-resident individuals is subject to a final withholding tax at a rate of 34 percent which is applied on 95 percent of gross interest, provided the loan is used to produce taxable income (thus making an effective tax rate of 32.3 percent).

Under the treaties concluded by Venezuela, the tax rate on interest paid to non-residents is limited to 5 percent in the case of the treaty with France[51] and 10 percent in the case of the treaty with Italy.[52] No tax rate limitation is provided for in the Andean Group tax treaty.

C. Royalties

All of the countries royalties paid to residents are included in the recipient's taxable income whereas royalties paid to non-residents are subject to final withholding tax. However, the withholding tax applied by Venezuela in respect of royalties paid to non-resident legal entities is not a final one; such payments are subject to a withholding tax at progressive rates on a cumulative basis.

1. Argentina

Royalties paid to resident legal entities are subject to corporate income tax as ordinary income at a flat rate of 30 percent. Royalties paid to individuals are also taxed as ordinary income and are subject to individual income tax at progressive rates ranging from 11 to 30 percent.

Royalties paid to non-residents are subject to final withholding tax at an effective rate of 24 percent[53] (i.e. 80 percent of gross royalties is taxed at 30 percent) in the case of patents and trade marks, and at an effective rate of 10.5 percent[54] (i.e. 35 percent of the gross royalties is taxed at 30 percent) in the case of copyrights provided certain conditions are met.

Under treaty provisions, withholding taxes on the gross amount of royalties paid to non-residents are limited to: 10 percent in the case of the treaty with Italy;[55] 15 percent in the case of the treaties with Austria[56] and Germany;[57] and 18 percent in the case of the treaties with France[58] and Italy.[59] In the treaty with Spain, Argentine withholding tax is limited to 3 percent for news; 5 percent for copyrights of literary, dramatic, musical or artistic works; 10 percent for patents; and 15 percent for trade marks. In the remaining cases, the limits exceed the effective rates applicable under Argentine domestic law, or no limit is provided in the treaty (treaties with Bolivia, Brazil and Chile).

2. Brazil

Royalties paid to resident taxpayers are taxed as ordinary income at an effective overall federal corporate tax rate of 40.91 percent in the case of legal entities,[60] and at progressive rates ranging from 15 to 35 percent in 1994 in the case of individuals.[61]

Royalties paid to non-resident taxpayers are subject to final withholding tax of 25 percent.

Under most tax treaties concluded by Brazil, withholding taxes on royalties paid to non-residents are limited to 15 percent in general and to 25 percent in respect of trade mark royalties (treaties with Austria,[62] Belgium,[63] Canada,[64] China (PRC), Czechoslovakia,[65] Denmark, Ecuador, Finland,[66]

51. Nil on interest paid by, or paid to, the government or agencies thereof, or by reason of financial agreements concluded between the contracting states.
52. Nil on interest paid by, or paid to, the government or publicly fully-owned financial institutions or agencies, or to other publicly owned financial institutions or agencies by reason of financial agreements concluded between the contracting states.
53. This rate is 27% (i.e. 90% of gross royalties is taxed at 30%) if the requirements of the Law on the Transfer of Technology are not complied with.
54. 15% for film royalties.
55. The 10% provided for in the tax treaty with Italy only applies to copyright royalties.
56. The 15% provided for in the treaty with Austria applies to patent and trade mark royalties.
57. The 15% provided for in the treaty with Germany applies to patent and trade mark royalties. The 15% rate also applies to "know-how" royalties (paid for the provision of information related to industrial, commercial or scientific assistance).
58. The 18% provided for in the treaty with France applies to patent and trade mark royalties.
59. The 18% provided for in the treaty with Italy applies to patent and trade mark royalties.
60. See *supra* note 21.
61. See *supra* note 4.
62. The tax rate limitation is 10% for copyright royalties (other than film and tape royalties).
63. The tax rate limitation is 10% for copyright royalties (including film and tape royalties).
64. The tax rate limitations only apply to royalties paid to a company.
65. The 15% tax rate limitation does not apply to royalties paid before 1 January 1996 to a person holding, directly or indirectly, at least 50% of the voting capital of the payer company.
66. See *supra* note 63.

France,[67] Germany, Hungary,[68] India, Italy, Japan,[69] Korea (Rep.), Luxembourg,[70] the Netherlands, Norway,[71] the Philippines,[72] Portugal,[73] Spain[74] and Sweden). No limit applies in the case of the treaties with Argentina and Sweden (in the later case only in respect of royalties paid to a beneficial owner not being a company).

3. Chile

Royalties paid to resident legal entities are added to business income and are subject to corporate income tax at a flat rate of 15 percent. Royalties paid to resident individuals are generally subject to the 15 percent corporate income tax and to the individual income tax at progressive rates ranging from 5 to 48 percent.[75]

Royalties paid to non-residents are subject to final withholding tax of 35 percent;[76] the rate is 15 percent for copyright royalties relating to work published as a book (including certain periodicals of a scientific, academic, or professional nature, as well as audio and visual materials which are accessory to books).

No maximum withholding tax is provided for in the only Chilean comprehensive tax treaty (concluded with Argentina), and taxation of royalties paid to non-residents is therefore entirely governed by the Chilean domestic law.

4. Colombia

Royalties paid to resident legal entities or individuals are included in taxable income and subject to tax at a flat rate of 30 percent plus a 25 percent surcharge (thus making an effective rate of 37.5 percent) in the case of legal entities, and at progressive rates ranging from 0.14 to 30 percent plus the 25 percent surcharge (thus making a maximum effective rate of 37.5 percent) in the case of individuals.

Royalties paid to foreign legal entities not domiciled in Colombia and to non-resident foreign individuals are subject to final withholding tax at a rate of 30 percent plus a surtax on transfers of income abroad at a rate of 10 percent in 1994;[77] the ordinary withholding tax is calculated on the gross amount of royalties and the surtax on royalties after deducting the amount of the ordinary withholding tax, thus making an effective rate of 37 percent. Royalties are exempt from the surtax on income remittances where they do not exceed 3 percent of the annual sales or production of the paying enterprise.

No tax rate limitation is provided for in the Andean Group tax treaty in respect of outbound royalties.

5. Mexico

Royalties paid to residents are included in the taxpayer's gross income and are subject to tax at a flat rate of 34 percent in the case of legal entities and at progressive rates ranging from 3 to 35 percent in the case of individuals.[78]

Royalties paid to non-residents are subject to final withholding tax at the following rates: 15 percent for copyright royalties (including film and tape royalties) and 35 percent for patent and trade mark royalties.

Pursuant to treaty rules, the Mexican tax on the gross amount of royalties paid to non-residents is limited to: 10 percent in the case of the treaties with Canada,[79] Germany, Sweden and the United States; and 15 percent in the case of the treaty with France. In addition, copyright royalties paid to a resident of Canada or France are not taxable in Mexico.

6. Peru

Royalties paid to residents are included in their taxable income and are subject to tax at a flat rate of 30 percent in the case of legal entities, and at progressive rates of 15 and 30 percent in the case of individuals. However, royalties paid to individuals in connection with the exercise of business activities are included in the individual's business income and are taxed at the flat rate of 30 percent.

Royalties paid to non-residents are subject to final withholding tax of 30 percent.

Under the Peru–Sweden treaty, Peruvian tax on royalties paid to a resident of Sweden is limited to 20 percent of the gross amount of royalties. No tax rate limitation is provided for in the Andean Group tax treaty in respect of royalties.

7. Venezuela

Royalties paid to resident legal entities are included in taxable profits and are subject to income tax at progressive rates ranging from 15 to 34 percent. Royalties paid to resident individuals are taxed under general rules at progressive rates ranging from 6 to 34 percent.

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67. See *supra* note 63.
68. The 15% tax rate limitation does not apply to royalties paid before 1 January 1996 to a person holding, directly or indirectly, at least 50% of the voting capital of the payer company.
69. In this case, the 15% tax rate limitation applies only to film and tape royalties. In addition, a 12.5% tax rate limitation is stipulated for royalties other than trade mark and film and tape royalties.
70. The 25% tax rate limitation is also applicable for film and tape royalties.
71. The 15% tax rate limitation provided in the treaty in respect of royalties in general (other than royalties on trade marks and film, television and radio broadcasting copyrights) no longer applies. Therefore, the 25% tax applicable under internal Brazilian law currently applies to any kind of royalty. A Protocol supplementing the Brazil–Norway treaty will re-establish the 15% maximum rate. This Protocol is not yet effective. Meanwhile, negotiations for a new treaty are ongoing.
72. See *supra* note 70.
73. In this case, the 25% tax rate limitation is not stipulated. A 10% tax rate limitation is applicable in respect of copyright royalties (including film and tape royalties).
74. *Id.*
75. See *supra* note 15.
76. Royalties which are considered unproductive or non-essential for the economic development of the country may be taxed at increased rates of up to 80%.
77. See *supra* note 44.
78. However, royalties paid to individuals in connection with the exercise of business activities are included in the individual's business income and are subject to corporate income tax at 34%. In this case, the individual may choose to pay only the corporate income tax on his business income or to include his business income multiplied by 1.515 in his income tax return and take a credit for the corporate income tax already paid.
79. The 10% tax rate limitation stipulated in the Mexico–Sweden tax treaty became applicable to the Mexico–Canada treaty by virtue of the most-favourednation clause in the Protocol.

Royalties paid to non-resident legal entities are subject to withholding tax at progressive rates ranging from 15 to 34 percent on a cumulative basis. This tax applies to 90 percent of gross royalties, thus making a maximum effective tax rate of 30.6 percent. Royalties paid to non-resident individuals are subject to final withholding tax of 34 percent which is applied on 90 percent of gross royalties, thus making an effective tax rate of 30.6 percent.

Under the treaties concluded by Venezuela, the tax rate on royalties paid to non-residents is limited to 5 percent in the case of the treaty with France, and 10 percent in the case of the treaty with Italy.[80] No tax rate limitation is provided for in the Andean Group tax treaty in respect of royalties.

IV. AVOIDANCE OF DOUBLE TAXATION

Most of the Latin American countries covered in this survey – except for Chile, Colombia and Peru – have been concluding more comprehensive tax treaties, most of which follow the OECD Model Convention. Accordingly, investment income (dividends, interest and royalties) normally may be taxed in the state of residence of the recipient, and the source country has the right to apply a limited withholding tax. Notwithstanding this, various treaties assign one country or the other exclusive jurisdiction to tax specified items of income.

Relief for double taxation of inbound investment income is granted either unilaterally or by treaty. The unilateral relief most widely used is the ordinary credit. The principal methods for the elimination of double taxation used in tax treaties are the ordinary credit method and the exemption method (exemption proper and exemption with progression). The indirect method is not widely used, albeit Mexico – one of the most active Latin American countries in the treaty scenery – adopts such a type of credit both as unilateral relief and by tax treaties.

A. Argentina

1. Domestic measures

As unilateral relief for the avoidance of double taxation, Argentina adopts the ordinary credit method. Under this method, a taxpayer subject to tax in Argentina on income from abroad which has already been taxed in the source country is entitled to have the foreign tax paid on that income credited against Argentine tax; the credit is limited to the increase of the Argentine tax originating from the computation of foreign-source income.

2. Treaty rules

As a rule, investment income may be taxed by both the recipient's country of residence and the source country. Noteworthy exceptions to this rule are the treaties with Austria, Bolivia, Chile and Sweden, which allocate the taxing power exclusively to the source country thus preventing double taxation of investment income (the later only with respect to dividends and interest).

The main methods used for the avoidance of double taxation are the exemption method (treaties with Brazil, France and Italy) and the exemption with progression method (treaties with Germany and Sweden).

B. Brazil

1. Domestic measures

Due to the territoriality principle of income taxation applicable in respect to legal entities, there is neither a credit for foreign income taxes nor deduction as an expense. For individuals, tax exemption or credit may be used provided reciprocal treatment is granted.

2. Treaty rules

Investment income may be taxed, as a rule, by both the recipient's country of residence and the source country.

As Brazil presently follows the worldwide principle of income taxation only with respect to individuals, measures to avoid double taxation of legal entities contained in the tax treaties are not discussed. In order to avoid double taxation of individuals, Brazil uses the ordinary credit method in all of its tax treaties and the exemption method (only in respect of dividends) in the treaties with India and Spain. Further, Brazil grants a matching credit in the treaties with Ecuador,[81] India,[82] Italy,[83] Korea (Rep.),[84] the Philippines[85] and Spain.[86]

C. Chile

1. Domestic measures

Taxpayers deriving business income are entitled to use as a credit against their corporate income tax the foreign tax levied on foreign-source dividends and income from the use of patents, trade marks and copyrights[87] which have already been taxed in the source country; the credit is limited to the lower of the Chilean corporate income tax assessed on foreign-source income and the foreign tax effectively paid or withheld in the tax period. The excess of the foreign tax over the Chilean tax is deductible as a business expense. The credit may be carried forward without limit.

80. 7% for copyright royalties (including film and tape royalties).
81. As a rule, Ecuadorean tax is deemed to have been paid at 25% of the gross amount of dividends, interest and royalties.
82. As a rule, Indian tax is deemed to have been paid at 25% in the case of interest and royalties.
83. Italian tax is deemed to have been paid at 25% of the gross amount of dividends.
84. Korean tax is deemed to have been paid at 25% in the case of dividends and, as a rule, at 20% in the case of interest and royalties.
85. As a rule, Philippine tax is deemed to have been paid at 25% in the case of dividends, interest and royalties.
86. Spanish tax is deemed to have been paid at 20% in the case of interest and 25% in the case of royalties.
87. No credit is granted for foreign taxes paid on interest.

2. Treaty rules

Chile's only comprehensive tax treaty (concluded with Argentina) follows the Andean Group Model Convention, which allocates the taxing power exclusively to the source country, thus preventing double taxation.

D. Colombia

1. Domestic measures

As double taxation relief, credit for foreign taxes may be claimed by Colombian taxpayers.[88] The credit is limited to the Colombian tax attributable to the foreign-source income.

2. Treaty rules

Under the Andean Group tax treaty, investment income originating from countries that are members of the Group is taxable only in the member country in which the source of such income is situated, thus preventing double taxation among member countries.

E. Mexico

1. Domestic measures

Mexico grants an ordinary credit as a unilateral measure for the avoidance of international double taxation. An indirect credit (i.e. underlying tax credit) is also available for dividends paid to legal entities, provided the recipient entity holds at least 10 percent of the registered capital in the paying entity. The credit may be carried forward for ten years.

2. Treaty rules

Under the effective treaty network, investment income may be taxed, as a rule, by both the recipient's country of residence and the source country. To avoid international double taxation, Mexico grants an ordinary credit in general and an indirect tax credit in respect of dividends paid to resident legal entities.

F. Peru

1. Domestic measures

As unilateral relief for double taxation, Peru grants an ordinary credit.

2. Treaty rules

Under both the Andean Group tax treaty and the treaty with Sweden, the source country is assigned exclusive jurisdiction to tax investment income, thus preventing double taxation. However, under the Peru–Sweden treaty royalties may be taxed in either of the contracting states. In this case, double taxation of royalties is avoided in Peru by granting exemption (with progression).

G. Venezuela

Due to the territoriality principle of income taxation adopted by Venezuela, there is no unilateral relief for the avoidance of double taxation and the measures for the avoidance of double taxation stipulated in the tax treaties concluded by Venezuela are presently not used.

88. Foreign taxpayers are not entitled to credit.

JAMAICA

US Limited Companies: Effective Vehicles for Reducing Withholding Taxes on Profits Derived by Foreign Companies

Dwayne E. Reid, J.D.

Dwayne Reid is currently a Senior Tax Manager with Price Waterhouse in Kingston, Jamaica. Mr Reid specializes in international taxation by servicing European, Jamaican and US multinationals.

I. INTRODUCTION

As Jamaica moves forward in the process of privatizing companies and developing its infrastructure, foreign companies often play significant roles by undertaking infrastructure projects either directly or indirectly. These often take the form of a local branch or subsidiary.

In many cases the foreign parent company is resident in a country which has not concluded a tax treaty with Jamaica. As a result, the foreign parent company will be exposed to a withholding tax rate which is significantly higher than rates provided in all of Jamaica's tax treaties.[1]

This article discusses the tax advantages of a foreign parent company interposing a US limited liability company[2] between itself and its Jamaican operation. Also discussed is the US tax treatment of US limited liability companies as investment vehicles.

II. OVERVIEW OF US LIMITED LIABILITY COMPANIES

The US style limited liability company was originally introduced into US law by the State of Wyoming. Since then, many other states, such as California, Delaware and New York, have adopted the concept and have codified it into law. The continued existence and importance of the limited liability company as an entity is primarily linked to the tax system of the United States.

Although a US limited liability company is a concept of state company law, and is indeed a corporation, for US tax[3] purposes, a limited liability company may be classified as either a partnership or an association (taxable as a corporation).[4] This treatment depends exclusively on the provisions adopted in the limited liability company's articles of organization or operating agreement as matched against the provisions of the Internal Revenue Code.

The criteria to be applied under the Internal Revenue Code[5] in determining the category in which a limited liability company belongs are:
- associates;
- an object to carry on a business and divide the gains therefrom;
- continuity of life;
- centralization of management;
- limited liability; and
- free transferability of interest.

The determination of whether a particular limited liability company is to be classified as a corporation is based on the presence or absence of each of these characteristics in its articles of organization or operating agreement.

While some of these characteristics are those of a corporation, some are those of a partnership. Characteristics common to partnerships and corporations are not material in distinguishing between a corporation and a partnership.[6] Because associates, and an objective to carry on business and divide the gains therefrom are common to corporations and partnerships, whether a limited liability company is to be treated for tax purposes as a corporation or a partnership is determined by reference to the other characteristics: continuity of life, centralization of management, limited liability and free transferability of interest.

If a limited liability company possesses more corporate characteristics than non-corporate characteristics, it constitutes a corporation, and vice versa.[7] In deciding between corporate

1. Jamaica has concluded bilateral income tax treaties with Canada, Denmark, Germany, Israel, Norway, Sweden, the United Kingdom and the United States. Jamaica is presently negotiating a treaty with France. Jamaica is also party to a multilateral tax treaty concluded among several Caribbean Basin countries.
2. Unless otherwise stated, US limited liability company refers to such companies incorporated under the laws of one of the states of the United States.
3. "US tax" as mentioned throughout this article refers only to federal income taxes as imposed by the Internal Revenue Code ("IRC") and the Regulations thereto.
4. Reg. § 301.7701-1(b).
5. Regs. § 301.7701-2 through 301.7701-4
6. Reg. § 301.7701-2(a)(2).
7. Reg. § 301.7701-2(a)(3).

treatment and partnership treatment, equal weight is to be given to each characteristic.[8] Where a limited liability company lacks a preponderance of the characteristics, it will be classified as a partnership for US tax purposes.[9]

Because of the flexibility granted by state company laws, limited liability companies can be specifically designed to be treated as partnerships for US tax purposes while maintaining a legal existence for company law purposes. If a limited liability company is designed to be classified as a partnership for US tax purposes, it is a transparent entity, and the income and expenses of the limited liability company will be attributed to the individual members, as is the case with partnerships.[10]

To the extent the members of the limited liability company are non-residents of the United States, they would only be taxed in the United States on their US source income.[11] The non-US members' foreign-source income will not be subject to tax in the United States.[12] Consequently, a limited liability company which is wholly owned by non-residents of the United States and which has foreign-source income will not be liable to tax in the United States.

III. JAMAICA'S TREATMENT OF US LIMITED LIABILITY COMPANIES

Jamaica has no codified or judicial rules with respect to limited liability companies. They are viewed entirely as a concept of the United States. Therefore, the treatment of US limited liability companies in Jamaica must be analysed under the laws applicable to corporations and partnerships in general.

Under Jamaican domestic law, a US limited liability company may only be classified as a partnership or corporation. The classification depends primarily on whether the limited liability company possesses the characteristics of a corporation or the characteristics of a partnership. The characteristics which distinguish a corporation from a partnership are limited liability and separate legal personality.[13] The distinguishing characteristic of a partnership is that one general partner must be personally liable for the debts of the partnership.[14]

If a US limited liability company possesses the corporate characteristics, it will probably be classified as a corporation in Jamaica, even though in the United States it is treated as a partnership for tax purposes. This follows from guidance provided by the Jamaica Revenue.

In a recently issued private letter ruling,[15] the Jamaica Revenue classified a US limited liability company incorporated in the State of Delaware as a corporation for purposes of the Jamaica–US tax treaty.[16] Jamaican Revenue for the first time had to address the tax implications associated with these companies in a case where they derived income from the Island. Essentially, the Jamaican Revenue had to consider, for purposes of allowing a reduced dividend withholding tax rate under Article 10(2) of the Treaty, whether the "Delaware limited liability company" was a partnership or a corporation. Such consideration was given in light of the fact that the limited liability company was treated as a partnership for US tax purposes.

Under Article 10(2), for a US limited liability company to benefit from the 10 percent withholding tax rate it has to meet three tests based on form, residence and ownership; that is, it must be a company (other than a partnership), a resident of the United States and the beneficial owner of at least 10 percent of the voting stock of the company paying the dividend. For purposes of this discussion, only the first test is addressed.

The term company (other than a partnership) seems to contemplate that "company" includes a partnership. However, the context of the term company (other than a partnership) excludes a partnership from being a company for purposes of Article 10(2)(a), the result being that a US limited liability company may not benefit from Article 10(2)(a) if it constitutes a partnership. It may, however, benefit from the article if it is a company but not a partnership. The question is whether a US limited liability company is partnership or company under the Treaty.

Article 3(1)(b) of the Treaty defines a company as a "any body corporate" (corporation) or any entity which is treated as a body corporate for tax purposes. The definition only requires that a company be either a body corporate or an entity which is treated as a body corporate for tax purposes. The company does not have to meet both tests.

The Treaty does not define body corporate. With respect to undefined treaty terms, Article 3(2) provides that, "as regards the application of the Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires and subject to the provisions of Article 26 (Mutual Agreement Procedure), have the meaning which it has under the laws of that State relating to the taxes which are the subject of this Convention".

Under Article 3(2), any term not defined in the Treaty is to be defined according to the tax law of the country whose tax is being applied. The question was whether Jamaica was applying the Treaty. Considering, in the light of the wording of the Treaty, both the decision made by the Jamaican Revenue and the US treatment of limited liability companies, it appears

8. Rev. Rul. 1979-1, C.B. 1.

9. It is worth noting that although the IRS accords partnership treatment to many limited liability companies for tax purposes, the various states may or may not accord the same treatment. A particular state may treat a limited liability company as a corporation for tax purposes, regardless of the approach taken by the IRS. Thus, consideration should be given to individual state tax consequences.

10. IRC Sec. 701(a).

11. IRC Secs. 871 and 872 for individual members, and Secs. 881 and 882 for corporate members.

12. *Id.*

13. See the Interpretation Act, Secs. 3 and 28.

14. Partnership (Limited) Act, Sec. 18.

15. Jamaica does not publish private letter rulings. As a caveat, the effect of such rulings is only binding on the parties to the ruling and should not be relied upon as precedent. However, it does offer guidance as to the thinking of the Jamaican Revenue.

16. Convention between the United States and Jamaica for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Income Taxes, 21 July 1980 (hereinafter referred to as the "Treaty").

that Jamaica in this instant case was of the opinion it was applying the Treaty[17] and that the Delaware limited liability company should be defined according to Jamaican law.

IV. BENEFITS OF JAMAICA'S TREATMENT OF US LIMITED LIABILITY COMPANIES

The foremost benefit of interposing a US limited liability company for purposes of direct or indirect investment into Jamaica lies in the opportunity for the non-US members to obtain a reduction in withholding taxes with respect to income streams from Jamaica.

Foreign companies doing business in Jamaica through a branch or a subsidiary are subject to a $33^1/_3$ percent corporate income tax rate on their net profits derived from the business. These companies are also subject to withholding tax at the rate of $33^1/_3$ percent when those profits are actually distributed to them.[18] This rate is normally reduced under a treaty. As discussed above, under the Jamaica–US treaty, the withholding tax rate may be reduced to as low as 10 percent where a US resident company owns 10 percent or more of the shares of a Jamaican company or where a US resident company has a branch located in Jamaica. In other cases, the reduced rate is 15 percent.

The rules of the Jamaica Treaty, however, serve to bar companies resident in third countries from availing themselves of the Treaty's benefits. Foreign companies carrying on business in Jamaica and being resident in countries which have not concluded a treaty with Jamaica are taxed on their distributed profits at the higher withholding tax rate of $33^1/_3$ percent. This rate coupled with the corporate income tax rate potentially could result in an overall effective tax rate of approximately 56 percent. This consequence may prove to be extremely costly to companies whose country of residence has substantially lower corporate tax rates and/or limits the use of foreign tax credits.

One recognized approach for overcoming this potentially high tax burden is for those companies to interpose a US limited liability company. By interposing a US limited liability company, non-US members resident countries having no treaty with Jamaica effectively might be able to obtain treaty benefits that otherwise would not be available to them.

As alluded to above the Jamaican Revenue is inclined to recognize US limited liability companies as corporations rather than partnerships.[19] Therefore, any profits distributed from a Jamaican to a US limited liability company will be treated as distributed to the limited liability company rather than to its members. Consequently, the distributions will be taxed at the lower Treaty rate of 10 percent or 15 percent[20] as opposed to the higher rate of $33^1/_3$ percent. Thus, the overall effective Jamaican tax rate can potentially be reduced from 56 percent to approximately 40 percent.

Where the Jamaican Revenue subsequently decides to treat US limited liability companies as partnerships, the non-US members would not be able to take advantage of the Treaty and would consequently suffer withholding tax at the rate of $33^1/_3$ percent in the case of corporations and 25 percent in the case of individuals. The use of the Treaty is limited to residents of the United States and Jamaica. In the case of a partnership, residence is determined by the status of the individual partners (members).[21]

Another benefit of interposing a US limited liability company is that the profit distributions as well as other foreign-source income will flow through to the non-US members without US tax consequences, to the extent the limited liability company is taxed as a partnership in the United States.[22] Non-US members of a US limited liability company are only taxable in the United States on US-source income.[23] Income derived by non-US members from non-US sources will not be taxed in the United States.[24]

Therefore, the non-US members' Jamaican-source income will not be subject to US taxation.

V. CONCLUSION

The potential tax savings associated with US limited liability companies makes them attractive vehicles for investing in Jamaica. US limited liability companies are particularly useful to companies whose country of residence has no treaty in force with Jamaica. US limited liability companies provide non-US members not otherwise eligible for relief under the Jamaica–US Treaty with the favourable occasion of obtaining relief under the Treaty. This benefit can be realized by many foreign companies doing business in Jamaica.

17. Had the Jamaican Revenue not applied Jamaican law, the only logical step would have been to apply US law. Had Jamaica applied US law it could not have concluded that a US limited liability company is a corporation for purposes of the Treaty, because this particular limited liability company was designed to be treated as partnership in the United States, and was so treated. In the United States, in determining whether a limited liability company is a partnership or corporation for US treaty purposes reference will be made to IRC Sec. 7701(a)(2) and the Regulations thereto which distinguishes corporations from partnerships. See US Treasury Department Technical Explanation of the US–Netherlands tax treaty, 18 December 1992. If an entity is treated as a partnership under the IRC, the IRC will also treat it as a partnership for treaty purposes.
18. Jamaican Income Tax Act (ITA), Secs. 34(10) and 38(1).
19. See *supra* note 15 and text.
20. See Art. 10 of the Treaty.
21. Under the Treaty, a resident means: (i) any person, other than a company, resident in the United States for purposes of US tax; but in the case of a partnership ... only to the extent the income derived by such partnership ... is subject to tax in its hands or in the hand of its partners. In the United States, the partners rather than the partnership are subject to tax. IRC Sec. 701(a).
22. IRC Sec. 701(a).
23. IRC Secs. 871 and 872 for individual members and Secs. 881 and 882 for corporate members.
24. *Id.*

INTERNATIONAL

THE OECD REPORT "ATTRIBUTION OF INCOME TO PERMANENT ESTABLISHMENTS": A COMMENTARY

Dr I.J.J. Burgers

Ms Dr I.J.J. Burgers is associate professor of tax law, tax department, faculty of law at the University of Groningen in the Netherlands. She is the winner of the 1992 Mitchell B. Carroll prize for her dissertation "Taxation and Supervision of Branches of International Banks".

I. INTRODUCTION

In early 1994 the OECD published its long-awaited report, the "Attribution of Income to Permanent Establishments".[1] The allocation of income to permanent establishments ("PEs") involves many complex issues. Different views exist not only amongst OECD member states, but also at national levels as to how the separate enterprise theory (as set forth in Article 7 of the OECD Model Treaty[2] and in most tax treaties) should be interpreted.[3] For example:

- should a transfer of goods, technology, trade marks, financial and other services be evaluated by reference to an arm's length price or at historic cost;
- on what basis should the financial structure of a PE be determined;
- what criteria should be used to determine which assets belong (for tax purposes) to the capital of the PE;
- should depreciation of such assets be taken at book value in the worldwide accounts or the actual value at the time of transfer to the PE;
- is a hypothetical "lease" possible;
- how should profits be allocated to a PE when other parts of the enterprise, in addition to the PE, participate in a transaction with a third party.

Diverging answers to these questions may result in economic double taxation or a gap.

Different interpretations in the following situations may also give rise to economic double taxation or under-taxation:

- when different methods for eliminating double taxation (i.e. the credit method or the exemption method) are used;
- when each country exercises its right to define profits earned abroad according to its domestic law;
- when different approaches are taken to determine the timing of the realization of a gain or loss, and for foreign currency translations.

Another issue relates to consolidation: how can over-taxation be prevented if a gain is attributed to a PE when the company as a whole realizes a loss, or alternatively if an exemption country takes into account losses suffered by overseas PEs without providing for a deduction of the PE loss from PE profits realized in future years. Finally, uncertainty arises in respect of the different treatment of PEs of foreign enterprises as compared to resident enterprises. This treatment may be discriminatory under Article 24 of the OECD Model Convention. Adequate reason exists for the OECD to try to clarify its intentions.

For the most part the Report discusses the interpretation of Article 7. Modifications to the 1992 Commentary to this article are proposed in respect of goods supplied for resale (new comment); goods supplied for temporary use in the trade (new comment); intangible rights (new comment); internal services (amendment to the previous comment); transfer of financial assets (new comment); capital endowment and allocation of debts (amendment to the previous comment), and an attempt is made to reconcile Articles 7(2) and 7(3) (see II.D.).

In respect of the other problems mentioned above the Committee examines the time lag that may exist between taxation in the PE country and exemption or credit in the country where the head office is located. Suggestions are made and modifications proposed to the Commentary to Article 7 to prevent over- or under-taxation. Considerable attention is paid to the consolidation issue. Finally, in respect of discrimination the Committee remarks that the "real nature of a PE" may justify different treatment. This issue, however, will be examined in the context of future work on the scope of Article 24.

This article examines the proposed amendments to the Commentary to Article 7.

II. INTERPRETATION OF THE SEPARATE ENTERPRISE THEORY

1. *Model Tax Convention: Attribution of Income to Permanent Establishments* (Paris: OECD, 1994) [hereinafter "the Report"].
2. Art. 7(1) provides that the business profits of an enterprise of one state may be taxed in another state but only to the extent that such profits are attributable to a PE situated in the latter state.
3. For an overview of statutory provisions, judicial decisions, regulations and rulings of tax administrations, see I.J.J. Burgers, *Taxation and Supervision of Branches of International Banks* (Amsterdam: IBFD, 1991) [hereinafter "Burgers"]; and I.J.J. Burgers and R. Betten (ed.), *The taxation of permanent establishments* (Amsterdam: IBFD) [hereinafter "Burgers and Betten"].

A. General application

Under the separate enterprise theory profits attributed to a PE are determined as if the establishment was a separate and independent enterprise. Under civil law concepts, however, a PE is not a separate distinct person from the corporate body to which it belongs. One of the main problems involved in the allocation of profits to PEs is that the separate enterprise theory used for this attribution may be approached in two ways, i.e. by using a functional approach or a territorial approach.

The functional approach is based on the theory that establishments which are part of an internationally operating enterprise are engaged in various activities within that enterprise. Profits are attributed to PEs on the basis of the attribution of functions to the different parts of the enterprise. Under this approach the PE is not fictitiously lifted out of the enterprise of which it is a part – rather it is treated as a sub-division of one enterprise. Under the territorial approach, however, profits of a PE are determined as though the PE was a separate and distinct legal entity, so that for tax purposes the PE is deemed a separate legal enterprise dealing independently with the enterprise of which it is a part.[4]

The different approaches to the separate enterprise theory can be further classified into three categories applicable to the functional approach and two categories applicable to the territorial approach. Each category has consequences for the allocation of profits to a PE.[5]

B. Functional approach

As stated above the functional approach analyses which business elements actually present in the worldwide enterprise belong to the PE;[6] assets and liabilities used for various activities must be allocated to the part of the enterprise that uses them.

The functional approach can be divided into a legalistic, a narrow and a broad functional approach.

The legalistic functional approach is based on the concept that in determining the fiscal profits of a PE, there can not be any fictitious agreements between the PE and the head office, since the PE is simply a part of a greater whole. This theory has its foundations in civil law which disallows contracts between two or more parts of one enterprise. Under the legalistic approach income and expenses are either attributed directly to a PE or apportioned. Internal transactions are taken into account at historic cost.

The narrow functional approach is based on the idea that internal activities are treated as arm's length activities if the enterprise has similar or identical transactions with third parties.

The broad functional approach assumes that the various parts of an internationally operating enterprise should be remunerated for their function within the enterprise. Contrary to the legalistic and narrow functional approaches all internal transactions are remunerated at arm's length prices.

C. Territorial approach

For the determination of profits, a PE is treated as a separate legal entity under the territorial approach. A narrow or a broad approach may be taken:

– Under the narrow territorial approach a PE is deemed to be a subsidiary for tax purposes, and the amount of income minus expenses that the PE would have derived or made had it been such a subsidiary is assumed to be the PE profit.

– Under the broad territorial approach the PE is deemed to be an unrelated third party, and the amount of income minus expenses that the PE would have derived or made had it been such a separate legal entity is assumed to be the PE profit.

D. No explicit choice made by the OECD

Neither Article 7 OECD Model and the 1963, 1977 and 1992 Commentaries to this Article, nor previous reports of the Committee referring to the allocation of profits to PEs clearly indicate which approach should be used. Although the wording of Article 7(2) (profits which it might be expected to make if it were a distinct and separate enterprise) appears to point to a broad territorial approach, Article 7(3) seems to refer to a legalistic functional approach since it appears to prohibit taking arm's length prices into account where other parts of an enterprise provide the PE with goods or services. This may give rise to confusion. Further, in analysing the Commentary to the 1963, 1977 and 1992 Models and the 1979 and 1984 transfer pricing reports contradictory views on the correct approach can be found. The following examples are illustrative:

(1) Paragraphs 17/19/20 OECD 1963/1977/1992 Models: While, on one view, to include a 'commission' figure in the profits" of every PE that has performed services other than for its own purposes could be looked at in theory as a consequential application of the separate enterprise theory, it would inevitably be cumbersome in practice". These paragraphs indicate a broad functional approach since arm's length remuneration can take place (therefore no legalistic functional approach) even if the enterprise does not have similar or identical transactions with third parties (therefore no narrow functional approach), and without addressing the issue whether the service would have been performed if the PE had been a separate legal entity (therefore no territorial approach).

(2) Paragraphs 15/17/18 OECD 1963/1977/1992 Models; paragraph 48, part II of the OECD Transfer Pricing Report, *Transfer Pricing and Multinationals: Three Taxation Issues* (hereinafter the "1984 Banking Report"): intrabank payments of interest should be taken into account in assessing the profits of PEs of a bank, since banks dealing indepen-

4. The text of Art. 7(2) seems to refer to this approach; however, Art. 7(3) refers to a legalistic functional approach.
5. For further explanation see Burgers, *supra* note 3, at 170-176.
6. See Burgers, *supra* note 3, at 171.

dently with third parties customarily pay interest to or receive interest from third parties as an integral part of their banking business. Internal interest is not taken into account for other types of enterprises because such enterprises do not have similar or identical transactions with third parties. These paragraphs therefore indicate a narrow functional approach.

(3) Paragraph 77 of the 1984 Banking Report: "It may also be argued that it would be inappropriate for the branch to pay interest since this kind of capital is akin to the capital which entitles the bank's shareholders to a share in the profit."
This paragraph points to a narrow territorial approach since a comparison is made with parent-subsidiary relationships.

After the promising description of the duality of approach problem set forth in paragraph 2b of the Report those who expect that the Committee will make a clear and unambiguous choice for either the territorial approach or the functional approach will be disappointed. No further references are made to the duality of approach in the Report, nor does the Committee reject one approach or the other. Closer study of the Report and the amended Commentary to Article 7 reveals that the Committee appears to adopt the broad functional approach for the following reasons:

- Paragraph 11 of the old Commentary to Article 7 is replaced by a modified paragraph 11 which clearly mandates applicability of the arm's length principle.
- Paragraph 9 of the Report refers to arm's length accounting and the role intended for application of this principle within a single legal entity. Apparently, the Committee's opinion is that the scope of the separate enterprise theory does not extend further than application of the arm's length price principle. The territorial approach is therefore implicitly rejected, since that approach requires not only the arm's length price principle to allocate profits to the PE, but the PE should be transformed into a separate legal entity. Thus all legal requirements which apply to separate legal entities (e.g. capital requirements) are deemed to apply to the PE.
- Paragraph 10 of the Report and new paragraph 12(1) of the Commentary further explain that internal agreements (even though they clearly cannot qualify as legally binding contracts) may be taken into account when goods or services transferred are essentially the same as those supplied to third parties by the enterprise as part of its principal activity (limited recognition of arrangements), as well as in all cases where such agreements are framed so that they reflect functions actually performed by the various parts and are disclosed consistently and symmetrically in the accounts of the various parts of the enterprise. The use of the word "function" seems to indicate a functional approach.

It can also be concluded from new paragraph 12(1) of the Commentary that, as internal agreements can be taken into account without any exception (so not only where goods and services transferred are essentially the same as those supplied to third parties by the enterprise as part of its principal activity), the Committee rejects the legalistic and the narrow functional approaches.

- It may be concluded from the use of the wording "remuneration of the financing function" in paragraph 20 of the Report that the Committee intends to apply a broad functional approach to the separate enterprise theory.

E. Reconciliation of Article 7(2) and 7(3)[7]

Fortunately, the OECD does explain the difference of principle that seems to be at the heart of Article 7(2), the wording of which refers to a broad territorial approach, and Article 7(3), the wording of which refers to a legalistic functional approach.[8] In the Committee's view there is no difference of principle between paragraphs 2 and 3 of Article 7. The Committee reconciled the two paragraphs in the explanation of the word "expenses" as used in Article 7(3): "expenses which are incurred for the purposes of the PE" include only those costs incurred by an enterprise for property or services which could not have been obtained from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In other cases – where independent enterprises will seek to realize a profit and when transferring property or providing services to each other will charge such prices as the open market will bear – a cost incurred by an enterprise on behalf of the PE should not be considered an expense of the PE but the relevant property or service should be considered, under the separate entity principle, to have been transferred between the head office and the PE at a price including an element of profit. In the Committee's view while paragraph 3 provides a rule applicable for the determination of PE profits, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

While this is a neat explanation, it is nevertheless somewhat far-fetched. Why did the Committee opt for a difficult to understand reconciliation by a limited interpretation of the word "expenses" used in Article 7(3) rather than simply explaining that the general principle is as follows:

- the functions of the PE should be remunerated;
- such remuneration should be at arm's length prices;
- in some circumstances arm's length may be equal to historical cost, i.e. when independent enterprises may agree to share the costs of an activity which is pursued in common for their mutual benefit or where a particular property or service could not have been obtained from an independent enterprise.

It would also have been preferable, as suggested by Van Raad[9] and this author,[10] to rephrase Article 7 so that it is unnecessary to resort to a Commentary to fully understand the general approach that is at the basis of the treaty articles.

7. Art. 7(2) requires that prices charged between the PE and its head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make if it were dealing with independent parties. Art. 7(3) provides that the deduction for expenses incurred for purposes of PEs should be the actual cost of those expenses, without adding any profit element.
8. Para. 14 of the Report and new para. 17(2) of the Commentary to Art. 7, which need to be read carefully.

III. BORDERLINE BETWEEN "DEDUCTION OF EXPENSES" AND "ARM'S LENGTH TREATMENT"

A. General

The Committee recognizes that it is difficult to make a distinction between circumstances where a particular property or service would not have been obtainable from an independent enterprise, or independent enterprises would not seek to realize a profit; and where a particular property or service is obtainable from an independent enterprise and independent enterprises would seek a profit.

Therefore the Committee formulated a question which may serve to draw the border (hereafter referred to as the "borderline question"). In paragraph 31 of the Report, this question is formulated as follows:

> Is the internal transfer of goods or services (whether temporary or final) one of the same type which the enterprise *might* in the ordinary course of its activity *be likely* to have offered to or be requested to supply by an independent third party at an arm's length price? (emphasis added)

Remarkably in paragraph 17(1) of the Commentary to Article 7 a somewhat different, one might even say narrower, formulation is chosen: whether the internal transfer of property and services, be it temporary or final, is of the same kind as that which the enterprise, in the normal course of its business, *would have charged* to a third party at an arm's length price, i.e. by normally including an appropriate profit in the sale price.

In paragraph 31 of the Report and 17(2) of the new Commentary to Article 7, the Committee offers an answer to the borderline question in two extreme situations.[11] According to the Committee, the answer will be in the affirmative if the expense was initially incurred in performing a function the direct purpose of which is to make sales of specific goods or services and to realize a profit through a PE. However, the answer will be negative if, on the basis of the facts and circumstances of a specific case, it appears that the expense was initially incurred in performing a function the essential purpose of which is to rationalize the overall costs of the enterprise or to increase its sales in a general way. Numerous internal transactions will take place where the situation is less clear. Perhaps the Committee thought it necessary to further consider the question separately and propose modifications to the Commentary on Article 7 in respect of goods, technology and trade marks, services and financial transactions.

An overview of the modifications of the Commentary with respect to these transactions and some comments to the changes is made below.

However, it should first be noted that the borderline question may restrict application of the arm's length principle more than the criterion formulated earlier in the Report, i.e. whether a similar property or service would have been obtainable from an independent enterprise this enterprise would seek to realize a profit. The question is not whether an independent third party would be willing to pay an arm's length price or would charge an arm's length price for a similar transaction, but whether the *enterprise* of which the PE is a part might, *in the normal course of its business*, be likely to have offered (or to have charged) a third party an arm's length price. Furthermore, the borderline question unfortunately creates new uncertainty as the phrase, "similar to one for which the enterprise, in the normal course of its business, would have charged", or "might in the ordinary course of its activity be likely to have offered to or be requested to supply by" is liable to dual interpretation, as explained below.

1. Transfer of assets from PE to head office or to another PE[12]

Paragraph 15 of the Commentary has undergone significant changes. In the old version[13] states were allowed to tax profits deemed to arise in connection with the transfer of an asset, other than trading stock, forming part of the business property of a PE to a PE or the head office of the same enterprise situated in another state. The amended version of paragraph 15 sets forth this principle for both trading stock and other assets. Further, the principle applies to both permanent and temporary transfers. Particular attention is devoted to the transfer of financial assets, goods supplied for resale and goods supplied for temporary use. Finally, the intentions of the OECD regarding the time lag problem have been added to this paragraph.

2. Transfer of financial assets[14]

Part II of the OECD's 1984 Banking Report dealt with the problems of multinational banking enterprises. This Report examined a number of issues such as the attribution of capital, why internal interest may be taken into account in the case of financial enterprises, and the attribution of income where more than one branch has performed economic functions in a transaction with a third party. The question whether a transfer from one part of a banking enterprise to another should be recognized for tax purposes, and if so at what value, was not addressed in the 1984 Report.

Paragraph 8 of the present Report and paragraph 15(2) and (3) of the amended Commentary examine this issue. The Committee recognizes that such a transfer should be recognized where it takes place for "valid commercial reasons"[15] or where it would have taken place between independent enterprises (e.g. where the PE bank is either opened or closed). In principle the transfer should be treated as taking place at the

9. C. van Raad, "The 1977 OECD Model Convention and Commentary - Selected Suggestions for Amendment of Articles 7 and 5", *Intertax* (November 1991), at 499.
10. Burgers *supra* note 3, at 498.
11. It may be queried which functions actually fall in this category.
12. Amended para. 15 of the Commentary.
13. Where reference is made to the old Commentary the reference is to the text of the Commentary on the 1992 model. The new version is the amended version as suggested in the Report.
14. New paras. 15(2) and 15(3).

open market value of the debt at the date of transfer (see IV.D. for exceptions).

3. Transfer of goods supplied for resale[16]

Previous Commentaries did not deal explicitly with goods supplied for resale. New paragraph 17(3) of the Commentary provides that it will normally be appropriate to apply the arm's length principle, but that exceptions exist. One would expect the Committee to give an example of exceptions concerning goods supplied for resale, but strangely enough the Committee includes an unsatisfactory example which concerns assets for temporary use in the production process rather than goods supplied for resale.

It is the Committee's opinion that it may be appropriate for the parts of the enterprise which share the use of materials to bear only their share of the cost of such materials, e.g. in the case of machinery, the depreciation costs that relate to its use by each of these parts.[17] The Committee does not further explain the circumstances where this may be appropriate, nor does it explain whether its conclusion results from application of the general principles laid down in paragraph 17(1) of the Commentary or from application of the borderline question. Consequently, the Committee creates new uncertainty.

For example, assume that computers owned by an enterprise and usually used at its head office are supplied for temporary use to its PE. Annual depreciation costs are 500. Similar computers are also leased by the enterprise from a third party at a price of 600 per annum. Under these circumstances would the Committee conclude that only depreciation costs should be allocated? The general principles in paragraph 17(1) of the Commentary would indicate that the computer is transferred between the head office and the PE at a price including an element of profit (600), as the independent third party realizes a profit on the similar transaction. If the borderline question is applied, the answer depends on whether the transfer is similar to one which the enterprise, in the normal course of its business, might be likely to have offered, or alternatively would have charged to a third party at an arm's length price. The phrase "in the normal/ordinary course of the business" may be interpreted in two ways.

One might argue that usually only costs (depreciation) should be allocated, as the internal transfer is not likely to be similar to a transfer which the enterprise actually provides to third parties in the normal course of its business (with the exception of enterprises whose business is to lease similar machinery to third parties). However, it is also arguable that the enterprise would have charged a price including an element of profit if it would have temporarily transferred similar machinery to third parties rather than to the PE in the normal course of its business, and therefore a price including a profit element should be allocated.

Indeed, the borderline question is not whether the enterprise actually charges a price including an appropriate profit in the normal course of its business, but whether it is likely that it might have offered or would have charged such a price if it transfers a similar computer in the normal course of its business to third parties. The Committee only states that "it may be appropriate" to allocate a share of the costs of the material (depreciation). Therefore it cannot be concluded from paragraph 17(3) that the Committee's view in this paragraph is based on the first interpretation of the borderline question. Whether depreciation or a price including an element of profit should be allocated remains uncertain.

B. Intangible rights[18]

Paragraph 18 of the old Commentary disallowed, without further explanation, the deduction of internal royalties. The new Commentary deals with intangible rights in paragraph 17(4). New paragraph 18 only covers internal interest. The changes are clearly an improvement of the Commentary. The Committee explains that practical reasons underlie the allocation of the actual costs of the enterprise without any mark-up for profits or royalties, as it is not possible to allocate legal ownership to any particular part of the enterprise, and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise.[19] However, some criticism is again warranted. Three factors in this paragraph are remarkable:

(1) Why does the Committee assert that it is not possible to allocate *legal* ownership whereas in paragraph 12(1) internal agreements may be taken into account even though they cannot qualify as legally binding contracts?
(2) Why does the Committee fail to answer the borderline question which would in most situations lead to the conclusion that the internal transfer is not similar to transfers which the enterprise in the normal course of its business would have charged to a third party, but that it would have either shared costs or have paid a royalty if it had provided a similar intangible right to a third party?
(3) Why is the alternative that was discussed and apparently not rejected by the Committee, i.e. to consider only the divisions that actually created the intangibles as the respective owners and therefore the parties entitled to a risk compensation, not included in paragraph 17(4) of the new Commentary? Indeed, in applying a broad functional approach to the separate enterprise theory this alternative should be given preference, considering that the separate enterprise theory is based on the principle of territoriality,[20] i.e. the State to which either taxable subject or taxable object (capital or productive activities – in this case the creation of the intangibles) has a geographic connection has the right to tax income.

15. Not for tax purposes, but for instance for supervisory or financial purposes. One example is where liquidity or solvency requirements must be fulfilled in the PE country. The bank wants to grant a new loan to a third party. At the express wish of the client the loan should be provided through the PE. If liquidity or solvency requirements are an obstacle, this may only be possible if another loan to a third party allocated to the PE is transferred to another part of the enterprise.
16. New para. 17(3) of the Commentary.
17. Para. 14(a) of the Report.
18. New para. 17(4) of the Commentary.
19. Para. 14(b) of the Report.
20. Not to be confused with the territorial approach to the separate enterprise theory.

C. Services[21]

Paragraphs 19 and 20 of the old Commentary made provisions for ancillary services (e.g. advertisement services performed by a PE) which can be summarized as follows. Although a cost plus commission would be charged in arm's length transactions, for practical reasons no notional "commission" should be included in the profits of a PE that has performed ancillary services for another part of the enterprise.

These paragraphs are not included in the new Commentary. Instead new paragraph 17(5) (paragraph 14(d) of the Report) deals with all aspects of internal services. The question whether "expenses" or a price including a profit element should be allocated is answered as follows:

- An arm's length rate should be charged where the trade of the enterprise, or part of it, consists of the provision of similar services.
- A profit margin may be included in the costs where the PE's main activity is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their cost represents a significant part of the expenses of the enterprise.
- Actual costs without profit mark-up should usually be allocated to the various parts of the enterprise where the provision of services is merely part of the "general managerial activity", e.g. where the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it.[22] This example in particular clearly shows that the general principle in paragraph 17(1) of the Report (i.e. that a price including an element of profit should be charged where independent enterprises would do so) is limited by the formulation of the borderline question, requiring an inquiry as to whether the internal service is similar to one which the enterprise itself, in the normal course of its business, might be likely to have offered, or alternatively would have charged to a third party at an arm's length price. Independent enterprises would probably charge the enterprise for similar services, but the internal transfer is not likely to be similar to a transfer which the enterprise actually provides to third parties in the normal course of its business. Further, it is regrettable that the Committee did not take the opportunity to define precisely "general managerial costs".
- In respect of ancillary services paragraph 13 of the Report explains that the provision of ancillary services does not deviate from what is expressed in paragraphs 19 and 20 of the 1992 Commentary.[23]

D. The problem of financing the PE[24]

Paragraph 18 of the Commentary, which addresses the question of how much interest should be allowed as a deduction from PE profits, has been changed completely. The old Commentary allowed only the deduction from PE profits of such a proportionate part of payments of interest, etc. to a third party made by the enterprise of which the PE is a part as related to the activities of the PE. Payments made under the guise of interest by a PE to its head office or vice versa could not be taken into account with the exception of financial enterprises. Further explanation was lacking.

In 1984 the OECD view of interest payments of financial enterprises was elucidated in Part II of the 1984 Banking Report. That Report explained that due to the nature of the banking business internal interest could be taken into account because:

- banks dealing independently with third parties commonly pay interest to, or receive interest from, third parties as an essential part of their banking business (compare the "borderline question" requiring the charge of arm's length prices in the normal course of the enterprise's business);
- the interest taken into account can be regarded as representing real outgoings or receipts of the enterprise as a whole.

In practice, the question of the financing structure of a PE to be taken into account for tax purposes remains perplexing. Both direct and indirect apportionment of total interest payments proved to be cumbersome. In the case of direct apportionment, the taxpayer may be able to control where loans are booked, so adjustments may need to be made to reflect economic reality. In the case of indirect apportionment, a distinction cannot be made between the different activities of a highly decentralized firm.

Paragraph 20 of the Report and amended paragraph 18 of the Commentary acknowledge this fact, and propose a different approach. An explanation for the approach is included. Remarkably, as was the case where internal royalties were considered, the explanation is not tied to the question whether the internal transfer (of funds) is of the same kind as those which the enterprise in the normal course of its business might be likely to have offered, or alternatively would have charged to a third party at an arm's length price.

Instead the Committee states that a capital structure appropriate to both the organization and the functions performed should be selected and the financing function should be fairly remunerated. The solution should be practical. Therefore, the Committee recommends continuing to apply the ban on deductions for internal debts and receivables. In respect of financial enterprises new paragraph 19 of the Commentary

21. New para. 17(5) of the Commentary.
22. Para. 14(c) of the Report.
23. The Report abusively refers to "paras. 18-19 of the existing Commentary on Article 7". Indeed in the 1977 Commentary in paras. 18-19 the provision concerning ancillary services can be found, but in the 1992 Commentary these paragraphs were renumbered to 19-20.
24. New paras. 18-18(3), 19 and 20 of the Commentary.

refers to the OECD Banking Report for an explanation as to why special considerations apply to payments of interest made by different parts of a financial enterprise to each other on advances, etc.

This is not to say, however, that in the case of non-financial enterprises deemed interest can never be taken into account. Paragraph 20 of the Report (which is referred to in new paragraph 18(3) of the Commentary) explains that if a PE is over-capitalized it should be entitled to deduct a fair amount for deemed interest. Therefore, the head office receives remuneration for its financing function which is only fair since the head office could have invested this amount in long-term loans rather than placing its own funds at the disposal of the PE. If a PE is under-capitalized, however, it may not deduct part of the interest payments. The head office country should avoid the risk of double taxation. Remarkably, this important passage is not included in the new Commentary.

It is also a pity that the Committee does not provide an example as it may be confusing that the Committee suggests continuing the ban on deductions for internal debts and receivables, but also recommends taking deemed interest into account in certain circumstances (e.g. over-capitalization of the PE).

How can this be reconciled? This author believes that paragraph 20 of the Report should be interpreted as follows: the entrepreneurial decision on the allocation of funds and third party liabilities to a PE as laid down in the PE's accounts should serve as a basis. Only if the allocated ratio of own funds/liabilities does not acceptably reflect what the PE would need to fulfil its function should the amount of interest to be taken into account in determining deductible interest be adjusted and either part of the third party interest payments not be deducted from PE profits or a deemed interest be taken into account in calculating PE profits. This approach fully accords with the broad functional approach taken in the Commentary.

The problem now, of course, is how to determine whether the PE is under- or over-capitalized. It is possible to compare the finance ratio of third party enterprises in the host to the PE. Nevertheless, the Committee has chosen not to recommend a method of comparison but rather to look to the rules and practice of the host country to determine whether a PE is under- or over-capitalized, unless there is a divergent mutual agreement under Article 25.

It should further be noted that the issue of how to determine the rate of deemed interest in the case of over-capitalization is not answered. Should this be an arm's length rate, or for example, should the average interest percentage paid by the enterprise as a whole or by the PE for liabilities allocated to it be applied?

IV. TIME LAG[25]

A. Introduction

The old Commentary to Article 7 did not consider the time lag problem which may arise when a transfer takes place at an arm's length price from a PE to the head office or another PE. If the market value of the assets transferred at the time of transfer exceeds the book value in the PE's accounts, a book profit will be realized at that time in the PE's accounts, even though the enterprise as a whole does not realize a book profit on this internal transaction at that time, and in fact may never realize a profit on the assets since they will not be sold to third parties.

The question is whether the PE country may nevertheless tax the profits realized on the internal transfer at the time of the transfer. Paragraphs 6-8 of the Report deal with this difficult question, which is further complicated by the two methods for eliminating double taxation, i.e. the exemption method and the credit method. Special attention is paid to the problem concerning the transfer of assets arising in relation to international banking. The Committee's views have been incorporated in the substantially extended paragraph 15 of the Commentary.[26]

B. Realization

The Committee states that realization of profits on goods depends mainly on the domestic law of each country. When the outward transfer country is the country where the PE is situated, this country should be allowed to impose tax upon the transfer since it cannot control what happens to goods once they leave the jurisdiction.

When the outward country is the head office country, however, deferral of taxation of the profits on the internal transfer should be allowed until they are actually realized regardless of whether the country uses the credit method or the exemption method, because a head office country can trace a transaction in its entirety by referring to the general accounts of an enterprise.

C. Time of exemption or credit

In respect of the time when an exemption or a credit should be granted where the outward transfer country is the PE country the Committee distinguishes between current assets and fixed assets.

1. Current assets

The Committee's views are best explained by an example:
Assume goods are being produced in December of year 1 by a PE in Country A. Cost of production is 2,000. The goods

25. New paras. 15(1) and 15(4) of the Commentary.

26. In previous versions this paragraph considered only whether a realization of a taxable profit upon transfer of an asset could be taken into account, and not at what time this profit might be taken into account.

are transferred to the head office in Country B at an arm's length price of 2,200. The goods are sold by the enterprise to third parties in year 2 at a price of 2,300. The enterprise as a whole realizes a profit of 2,300 – 2,000 = 300 in year 2. A profit of 2,200 – 2,000 = 200 is allocated to the PE.

Taxation in the PE country takes place in year 1. Should the exemption or credit be provided by the head office country in year 1 or in year 2? The Committee rightly remarked that the length of time between taxation on the transfer of goods and actual realization of the profit will be quite short. Therefore the Committee concluded that the taxpaying enterprise will not suffer any serious inconvenience since enterprises keep their accounts fairly flexible and if necessary will be able to move the dates of the two events closer together so that the transfer of goods and the realization of the profit accruing are disclosed in the same commercial year.[27]

2. Fixed assets

Realization by the enterprise of a profit accruing from a fixed asset that has been transferred from a PE to another part of the enterprise may take place several years after transfer of the asset. The PE country will tax the difference between the market value and the book value in the PE accounts upon the internal transfer.

Is it fair to the enterprise to require that it pays tax in the PE country without having realized a profit and without being allowed either an exemption or a credit in the same year? Here the interests of the taxpayer and the country of the head office clearly clash. Whose interests should be protected: the taxpayer or the tax receiver? This question is difficult to answer. Arguably, the taxpayer's interest should be given precedence for two reasons: not only will the (temporary) extra tax burden fall more heavily on the taxpayer than the (temporary) tax loss on a country receiving billions in tax, but more importantly it may be expected that total profits during the lifetime of an enterprise may be influenced in the negative if the enterprise has to pay taxes at a time when the enterprise as a whole did not realize any profit and liquidity may not be available. Thus the overall interests of the tax receiver may eventually be harmed more if the enterprise is not allowed an exemption or a credit on internal profits realized on internal transfer. As a result there is some merit for the view that the country of the head office should provide for exemption or credit in the same year that the PE country may tax the profit resulting in the PE accounts upon the transfer.

Unfortunately, the Committee does not explicitly advance the above considerations. It only indicates that it is up to the head office country to seek a bilateral solution with the outward transfer country where a serious risk of double taxation arises. It can only be hoped that head office countries will realize that it is in their own interest to reach such a solution.

D. Transfer of assets in international banking and time lag[28]

The problem of time lag may be even more acute where international banking enterprises are concerned. Debts are sometimes transferred from one part of an internationally operating enterprise to another. In principle, such a transfer should be made at the open market value of the loan at the date of the transfer. The value of the debt may be subject to high fluctuations in a relatively short period of time as the creditworthiness of the client changes and it is quite difficult to determine the probable value of the loan at the time of transfer. The actual loss to the bank can only be measured precisely at the time of disposal of the debt by the bank as a whole. The question may be raised whether under such circumstances relief should be granted for the loss suffered on final disposal of the loan rather than taking the market value into account at the date of the transfer.

The Committee feels that such relief should be granted where the transferee disposes of the loan after a very short time, or the transfer value at the date of the internal transfer was the result of mistaken judgement about the debtor's solvency.

The Committee stresses the importance of an agreement for a mutually consistent basis between the two countries for granting relief so that adequate relief for such a loss is granted. This is indeed essential. However, as long as binding arbitration is not provided for in tax treaties this recommendation will probably be without much effect.

V. CONSOLIDATION

Should a PE be allowed a deduction for any loss suffered by the rest of the enterprise of which it forms part, or should it be exempted from tax if the company to which it belongs realizes an overall loss? The Committee rightly answers this question in the negative.[29] The country where a PE is situated has an absolute right to levy tax on profits attributable to that PE, and this conclusion is fully compatible with one of the most important objectives of the separate enterprise theory, i.e. to make it possible in calculating PE profits to use information relating to the establishment which may be verified in the country where the PE is situated.[30]

VI. MUTUAL AGREEMENT PROCEDURE

The Committee stresses the importance of the mutual agreement procedure to avoid double taxation and arrive at a fair allocation of taxation rights between countries where the countries hold different views on the attribution of profits to a PE for preventing double taxation in the case of internal dis-

27. Para. 7 of the Report.
28. Para. 8 of the Report.
29. Para. 21 of the Report.
30. M.B. Carroll, *Taxation of foreign and national enterprises: Methods of Allocating Taxable Income* (Geneva: League of Nations, 1933), C. 425(b) 1933.II.A.

posals of technology and trade marks, internal services, under- or over-capitalization of a PE, and in all other cases where no clear distinction between "expenses" and "prices including an element of profit" exists.[31] No doubt the mutual agreement procedure may in certain circumstances be a useful tool to achieve this goal. However, it does not provide the taxpayer with certainty that double taxation will actually be avoided. Further, even if the tax authorities reach an agreement the taxpayer will have to wait considerable time before he receives this certainty.

It is unfortunate that the Committee does not make suggestions for a binding arbitration procedure or for what may be termed a "joint opinion procedure", where before drawing up the separate PE accounts and submitting the tax return, the taxpayer may request that both tax administrations reach a joint opinion on the allocation of assets, liabilities and profits to the PE.[32]

VII. CONCLUSION

The OECD Report and the Commentary to Article 7 as amended by the suggestions in the Report undoubtedly clarify the OECD's intentions in respect of the attribution of income to PEs. The main points are as follows:

- The arm's length principle should be used and internal agreements, even though they cannot qualify as legally binding contracts, may be taken into account to the extent that the trading accounts of the head office and the PEs are prepared symmetrically on the basis of these agreements and that they reflect the functions performed by the various parts of the enterprise.
- It offers a plausible explanation for the reconciliation of Articles 7(2) and 7(3), i.e. in the definition of "expenses incurred for the purposes of the PE". A particular cost can truly be considered an expense incurred for the purposes of the PE where property or a service would not have been obtainable from an independent enterprise or when independent enterprises may agree to share the costs of some activity which is pursued in common for their mutual benefit. In other cases, the relevant property or service should be considered, under the separate entity principle, to have been transferred between the head office and the PE at a price including an element of profit.
- Unlike the old Commentary an explanation is now given for the treatment of internal royalties (for practical reasons it is preferable to attribute the costs of creation of intangible rights to all parts of the enterprise which will make use of them) and internal interest (for practical reasons the ban on deduction for internal debts and receivables remains in force).
- All aspects of internal services, rather than only ancillary services, is considered in separate paragraphs.
- The OECD's view of the time lag problem is explained and included in the substantially expanded paragraph 15 of the Commentary.
- The OECD unambiguously lays down as a principle that the PE country has an absolute right to levy tax on profits attributable to that PE.

Nevertheless, as mentioned above, the Report unfortunately creates new uncertainty, which results from the borderline question formulated for making a distinction between circumstances where a particular cost incurred by an enterprise can truly be considered an expense under Article 7(3), and cases where the property or service should be considered to have been transferred between the head office and the PE at a price including an element of profit. Is the internal transfer similar to one for which the enterprise in the normal course of its business might be likely to have offered to or be requested to supply by (i.e. would have charged to) an independent third party at an arm's length price, i.e. by normally including in the sale price an appropriate profit. This question is subject to dual interpretation.

Further, it is regrettable that the OECD has apparently shrunk from reformulating the text of Article 7 so that it can unambiguously be concluded which of the five approaches to the separate enterprise theory should be followed in calculating the profits to be attributed to a PE.

Finally, it is doubtful whether the mutual agreement procedure suggested by the Committee for preventing double taxation in attributing profits to a PE in the case of internal disposals of technology and trade marks, internal services, under- or over-capitalization of a PE, and in all other cases where a clear distinction between "expenses" and "prices including an element of profit" will actually lead to results compatible with the underlying principles of double taxation agreements – the avoidance of economic double taxation and a fair allocation of taxation rights between countries – where countries hold differing views.

31. In the words of the Committee "between arm's length and cost allocation principles"; this terminology is as explained above less felicitous as in arm's length situations it is under circumstances possible that costs are shared and therefore the arm's length price may be equal to cost.
32. Burgers, *supra* note 3, at 500.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 48-52 of the January 1995 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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RUSSIA

SOME PROBLEMS OF COMPANY TAXATION

Dr Elena Markina

Lecturer, State Financial Academy (Moscow), currently working in the Tax Department, Faculty of Law, University of Groningen, the Netherlands.

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I. INTRODUCTION

In 1992 a new system of taxation of profits of enterprises was introduced in Russia, replacing a system suitable for a centrally planned economy, but not for a market economy.[1] Since 1992 taxation of profits has been regulated by the Act of the Russian Federation "Concerning Tax of profits of enterprises and +organizations" (hereafter "the Act"), as amended. This article gives an overview of the provisions included in the Act, compares the Act with existing systems in Western European countries, and concludes with some recommendations for further amendments.

II. DEFINITION OF TAXABLE SUBJECT

A. Situation in Russia from 1992

1. Taxable subject

The Act defines the following groups of taxpayers:

- enterprises and organizations (including budgetary organizations)[2] regarded as legal entities under Russian legislation;[3]
- branches and other similar subdivisions of Russian enterprises,[4] provided they have a separate balance sheet and bank account;
- foreign legal entities, defined as companies, firms and other organizations formed under the laws of foreign states and carrying on business activities through a permanent establishment in Russia.[5] Foreign legal entities are subject to profits tax to the extent they derive profits from sources of income in Russia. Foreign legal entities which do not have a permanent establishment in Russia but which derive dividends and interest from sources in Russia are subject to withholding tax at a rate of 15 percent; income from copyrights and licences and rental payments are subject to tax at a rate of 20 percent.

Finally, it should be noted that banks and legal entities, which carry on insurance activities were subject to a separate tax on income prior to 1994; they were subject to lower rates than the ordinary tax on profits, but disallowance of deductions of wages and salaries broadened the tax base. According to the Russian President's Decree of 22 December 1993 "Concerning some changes in the taxation and interrelations between the budgets of different levels", banks and legal entities carrying out insurance activities became subject to the ordinary tax on profits as from 1 January 1994.

2. Legal entities under Russian law

Before comparing the definition of taxable subject in Western European countries, some explanation should be given in respect of the definition of legal entities and the residence criterion. First, Russian tax law does not define the term legal entity but refers to the Civil Law. Both the Act of the Russian Soviet Federative Socialist Republic ("RSFSR")[6] "On Enterprises and Entrepreneurship in the RSFSR" of 25 December 1990 and the Fundamentals of Civil Legislation[7] provide for the following types of enterprises:

1. For a description of the main features of the new tax system, see E.V. Markina, "Results of Initial Implementation of Tax Reform", 48 *Bulletin for International Fiscal Documentation*, (June/July 1994), at 340.
2. Organizations wholly or partly financed from the State budget according to budget estimates of income and expenditure (e.g. schools, hospitals, scientific organizations, museums, etc.).
3. This group includes enterprises owned by foreign investors if they are established under Russian law and carry on business activities. Such enterprises are regarded as domestic legal entities.
4. Although these branches are not considered separate legal entities, they are treated as independent taxpayers. The concept of the "fiscal unit" is not recognized under Russian tax law.
5. According to Art. 1 of the Act, a permanent establishment is defined as a bureau, office, agency or any other place used for carrying out activities connected with the development of natural resources, carrying out of construction work, installation, adjustment or maintenance of equipment and other similar works, or an organization or physical person representing the foreign legal entity in the territory of the Russian Federation.
6. The former name of Russian Republic, which was part of the former USSR.
7. The new Fundamentals of Civil Legislation, which replaced the RSFSR Civil Code 1964, was adopted on 31 May 1991 by the USSR Supreme Soviet and was to enter into force on 1 January 1992. However, because of disintegration of the Soviet Union prior to this date, the Parliament of the Russian Federation adopted a Decree which provided that, before the adoption of a new Civil Code of the Russian Federation, the Fundamentals of Civil Legislation should be applied in the territory of Russian Federation insofar as it does not contradict the Constitution and other legislative acts of the Russian Federation adopted after 12 June 1990 (the date of the Declaration of Economic Sovereignty of the Russian Federation).

- state enterprises (enterprises belonging to the republic);
- municipal enterprises (enterprises belonging to a province, territory, city or district);[8]
- individual private enterprises;[9]
- cooperatives;
- different types of partnerships (general partnerships, limited partnerships);[10]
- joint stock companies, which can be open or closed.[11]

All of the above entities are considered legal entities under Russian Civil Law, except for individual private enterprises and general partnerships.[12] All legal entities must be registered with the local authorities and the tax authorities. As from the day of registration an enterprise is treated as a legal entity for commercial and tax purposes.

3. Residence

Tax legislation in Russia does not contain any provision concerning residence of a legal entity. The liability of the taxpayer depends on whether or not the entity is registered in the commercial register. Enterprises wholly[13] or partly owned by foreign investors (the former joint ventures), international associations and organizations incorporated under Russian law and registered in the Russian commercial register, are assumed to have their residence in Russia and are thus regarded as resident taxpayers. Foreign enterprises, recognized as legal entities under the law of the country in which their management is located, and foreign associations not registered in the Russian commercial register, are treated as foreign legal entities. Because the tax treatment of resident and non-resident taxpayers is different this distinction is of great importance. For example, foreign legal entities are not required to keep accounting records in Russia. If foreign companies do not keep accounting books to compute their profits, the profit is estimated on the basis of an agreement to be reached between the company and the tax authorities. The tax inspector may estimate taxable profits on the basis of gross income or expenses incurred, assuming a profitability norm of 25 percent. Furthermore, a foreign legal entity may enjoy a tax holiday, conditions of which are described below. It must pay tax on profits once a year; advance payments to which domestic taxpayers are subject, however, are not required. A foreign legal entity has a right to exemptions or reductions provided for in Russian double tax treaties.

B. Comparison with taxable subjects in Western Europe

1. Russian tax on profits as a tax on legal entities

At first glance not many differences seem to exist between subjects taxable under the Act and the corporate income tax laws in Western European countries. The groups of taxable subjects are mainly the same: companies or corporations with a capital divided into shares of both types (as public and private companies in the United Kingdom, NV and BV in the Netherlands, AG and GmbH in Germany), limited partnerships, cooperatives, different kinds of associations, foundations and entities governed by public law (so-called state and municipal enterprises). The concept of taxable subject for the corporate income tax ("CIT") in Russia differs from that in European countries mainly in that it is a tax on legal entities only. The list of taxable subjects is not properly defined in Russian tax law. Direct reference is made in the Act to the Civil Law, so that taxpayers are legal entities as defined under the Civil Law. In the tax law of Western European countries there is no direct connection between legal personality and liability to CIT. Some entities taxable for corporate income tax purposes are not legal entities, a typical example being a limited partnership which in the Netherlands, for instance, is not regarded as legal entity for company law purposes but in some circumstances can be recognized as a taxable subject for CIT. In Russia only legal entities are regarded as taxable subjects.[14] Limited partnerships, all kinds of cooperatives, foundations and associations, state and municipal enterprises are recognized as legal entities by the Civil Law.

2. Definition of residence

A second principal difference stems from a difference in the definition of residence. In Russia the place of residence can not be changed under any circumstances; if a company is incorporated under Russian law and registered in the commercial register it is deemed to be a resident of Russia. This is not the case in European countries. In Germany, France and Belgium, the only criterion of residence is the legal seat or place where central management is exercised. In the United Kingdom and the Netherlands, a company is treated as a resident if it is incorporated in the country, but other (foreign) companies which have their central management and control in the United Kingdom and the Netherlands, respectively are also treated as domestic taxpayers, having their fiscal residence in these countries.[15]

8. The meaning of this term in Russia is different than that in Western countries. Municipal enterprises are enterprises which are the property of national and administrative units of the Russian Federation (i.e. city, province, territory, district).
9. In Russian Civil Law this means enterprises which are carried on by individuals.
10. In a general partnership all general partners are jointly and severally liable for the debts of the partnership to the full extent of their net wealth. In other words, all members of a general partnership have unlimited liability. In a limited partnership general partners are liable for the debts of the partnership while limited partners are only liable to the extent of their capital contribution.
11. The main difference between an open and a closed joint stock company is that the shares of an open joint stock company may be offered to the public. In a closed company, fewer shareholders and less initial capital is required, possibilities for the transfer of shares are restricted (transfer is only allowed with the consent of the majority of the shareholders), and it has a simpler management structure. The Statute "On Joint Stock Companies", approved by the Government of the RSFSR by Decree No. 601 of 25 December 1990, Art. 7, 36, 109.
12. The latter are subject to individual income tax. Each partner of the general partnership is taxed on his share of profits.
13. According to the USSR President's Decree of 26 October 1990 "On foreign investments in the USSR" foreign companies were allowed to set up 100% owned subsidiaries in the USSR. Under Russian legislation, provisions enacted by the USSR are valid if they do not contradict provisions of the new Russian legislation.
14. In Russian literature a tax on profits of enterprises and organizations is also called a tax on legal entities.
15. *European Tax Handbook 1992* (Amsterdam: IBFD Publications BV), at 45, 95, 113, 231, 281, 416.

III. DEFINITION OF TAXABLE PROFITS

A. Situation in Russia as from 1992

1. Taxable base

The taxable base is defined in Articles 2, 3 and 4 of the Act (as amended, and supplemented by the Instruction issued by the Ministry of Finance concerning the application of the Act). The Instruction provides a more detailed interpretation of the provisions of the Act.

The taxable amount is gross profits, defined as the amount of profits from:

- the sale of goods or the provision of services, including sales of fixed and other assets of enterprises. Profits from the sale of goods or the provision of services is defined as the difference between turnover (exclusive of VAT and excise duties) and production and selling costs;[16]
- non-sale operations. Income from non-sale operations includes income from leasing property, dividends received, interest from bonds and securities and other income derived from a share participation in enterprises. The amounts of penalties and fines received or paid for breaching a supply contract are considered elements of profit (loss) from non-sale operations. Penalties levied by the tax administration are not deductible at all. These amounts must be paid from profits after tax.

2. Gross profits are in fact net profits

The term gross profits in Russia has a different meaning than in Western accounting standards. The word "gross" stresses only the fact that all types of profits and gains, of whatever nature, realized in the conduct of a business, are included in the computation of profits. However, taxable profits in Russia are in fact net profits, defined as the difference between gross receipts and all deductible business expenses, including both direct production costs and overhead expenses. Therefore, this definition coincides with the concept of profits in, for instance, the Dutch Income Tax Act where Article 7 IB 1964 defines profits as the amount of all types of gains under whatever name or in whatever form, derived from an enterprise.

3. Exclusions from taxable base

The following items of income are excluded from profits that are subject to an ordinary rate:

- dividends received, interest from securities and income received from a share participation in other enterprises;
- income from casinos and other gaming houses and other gaming business, video halls, video showing, rental videos and audio cassettes;
- profits earned from intermediary transactions;[17]
- profits from the sale of self-produced agricultural products with the exception of profits of industrial type agricultural enterprises.[18]

Such exclusions are necessary for the following reasons:

- Dividends received, interest and income from share participations in other enterprises are subject to a separate dividend withholding tax, also regulated by the Act. This tax is final and is levied at source at 15 percent. The enterprise which distributes the dividends and pays interest must withhold the tax and transfer it to the State budget.
- Different tax rates are still used for certain kinds of income, such as income from casinos, etc. and profits from intermediary transactions. Due to peculiarities of the transitional period, some activities are considered by the State as excessively profitable and are taxed at higher rates.[19] Income from intermediary operations and income from exchange and brokerage offices are taxed at 45 percent, income from casinos and gaming business at 90 percent, and income from video halls, rental videos and audio cassettes at 70 percent. Thus the concept of confiscatory withdrawal of profits earned from activities which have excessive profitability is still recognized under Russian tax legislation.
- Profits derived from the production and sale of self-produced agricultural products are completely exempt from taxation. Agriculture as a branch with a relatively low level of productivity and technology is supported by the State. Exemption from taxation of income is included in the State programme for the development of agriculture.

Furthermore, in some cases, a reserve fund may be formed. Contributions to the reserve fund may be deducted from gross profits in computing the taxable base. This fund is set up to cover future or contingent payments of enterprises and may also cover future business-related risks and maintenance of the liquidity of the enterprise. The fund is to be used primarily for covering losses of the enterprise. However, creation of this tax-free reserve fund is only allowed for enterprises specified in the legislation – currently enterprises wholly owned by foreigners, joint stock companies, banks and insurance companies. The reserve fund may not exceed 25 percent of the authorized capital of enterprises, and a donation to the fund may never exceed 50 percent of taxable profits.

Thus the concept of taxable profits is broad. Apart from a few exceptions, all types of income of whatever form or nature (including capital gains) are included in gross income. Capital gains realized on the disposal of fixed assets are treated as ordinary business profits. Profits of both domestic and nonresident taxpayers are determined only in roubles. Proceeds in foreign currency must be converted into roubles at the market exchange rate as established and published by the Central Bank of Russia in official newspapers (e.g. *Izvestiya*)

16. The term production and selling costs used in Russian financial accounting corresponds to the term "cost of goods sold" used in accounting of Western countries.
17. Intermediary operations include activities of enterprises which act as an agent or attorney under a commission agreement according to which the agent is obliged to carry out transactions in his own name (according to instructions of the client) but at the expense of the client in return for a fee.
18. The list of such enterprises is approved by the Government of Russia.
19. See *supra* note 1, at 346.

on the day the proceeds were received in an enterprise's bank account or its cash box.

B. Comparison with concept of taxable profit in Western European countries

1. No special accounts for tax purposes

In the majority of European countries two concepts of profits are known: profits used for commercial purposes and taxable profits. The two concepts are used for different purposes, i.e. commercial accounts aim at providing information to different groups of interested persons such as shareholders, employees, clients, the Government, etc. The concept of taxable profits is to determine tax liability.

A close link exists between the financial report (commercial accounts) and accounts used for tax purposes. However, the degree of closeness between financial and tax reports varies from country to country. In Denmark, Ireland, the Netherlands and the United Kingdom there is no formal link or the link is minor. In Belgium, France, Germany, Italy and some other European countries a company must use the particular accounting method adopted by the tax administration when preparing its financial reports. A major disadvantage is that the accounting policy in such countries is not based on proper accounting principles, but rather on the requirements of tax policy. This may alter the true valuation of the company's assets and liabilities and its financial position.[20]

No special accounts are used for tax purposes in Russia. Taxable profits are calculated on the basis of commercial accounts, although this does not mean that there is no distinction between commercial and taxable profits. Taxpayers are required to make a special computation of taxable profits.[21]

Taxable profits differ from commercial profits insofar as the latter include dividends subject to dividend withholding tax, other profit exemptions and donations to the reserve fund. However, it should be stressed that commercial profits as a basis for calculation of taxable profits is computed according to the accounting standards formulated by the State Tax Service. For instance, only the methods of valuation of fixed assets and inventory accepted by the tax administration are allowed when computing commercial profits.

2. System of profits calculation

The system of profits calculation in Russia is not in all respects in accordance with the concept used for tax purposes in market economies.

In the Netherlands, for instance, total taxable profit is computed under Article 7 of the Income Tax Act. The annual slices of taxable income are calculated in accordance with the principles of "sound business practice", i.e. the principles of matching, reality, prudence and simplicity. These principles are further interpreted by case law. Sound business practice leaves the taxpayer a level of freedom to choose his own system of calculation of profits.

In Russia taxable (and commercial) profits are calculated according to instructions issued by the Ministry of Finance concerning generally accepted accounting principles. A "Scheme of Accounts", defining a standard system of accounting implying detailed norms for accounting of different types of transactions and corresponding records, was adopted on 11 November 1991 by Order No. 56 of the Ministry of Finance, and came into force on 1 January 1992. This Order contains a list of accounts which all enterprises and organizations must use in accounting. All forms of financial statements and accounting documentation are fixed by the Ministry of Finance.

All taxpayers are required to present a computation of tax on profits (tax return) together with the balance sheet, on the basis of which a tax inspector verifies the tax return. Partly and wholly owned foreign enterprises must also submit an independent accountant's certificate regarding the validity of the balance sheet to the tax authorities. Commercial profits, as a starting point of the tax return, are reflected in the profit and loss account. They are computed as the difference between sales and production and selling costs, which are tax deductible, and hence reduce the profit before tax. Non-deductible costs only reduce the profit after tax, and are not recorded on the profit and loss account. A special account, the "use of profit", is provided for accumulation of non-deductible costs.

3. Deductibility of expenses

The general idea that all business expenses incurred for business purposes are deductible from taxable profits does not exist in Russia. A list of deductible expenses is established by a special Government Decree which was approved by Parliament. All enterprises are obliged to follow this regulation. Deviations are not allowed.

Verification of tax reports and balance sheets of taxpayers by the tax inspectors finds its basis in the Decree. If the inspector is of the opinion that an expense is incompatible with the Decree, either the full amount of hidden income must be transferred to the state budget or the taxpayer must pay tax on the amount of hidden income, and a penalty equal to the amount of tax.[22]

The above regulations have been criticized by Western researchers and domestic taxpayers for two reasons.

First, the method of computation of taxable profits is not defined by law. The Act merely refers to the statute "Concerning composition of expenditure relating to the cost of production (work, services)". This statute – rather than the Act – deals with deductible expenses and taxable profits. An appeal procedure against decisions of the tax inspector is not defined by law as is the case in all Western countries. Fur-

20. Leo G. van der Tas, "European accounting harmonization achievements, prospects and tax implications", *EC Tax Review* (March 1992), at 186.
21. Such a computation is analogous to a tax return in Western countries. However, as Russian tax law provides for advance payments of tax on profits in a tax year, taxpayers must make up quarterly computations of taxable profits. Furthermore, the final tax return should be filed after the tax year is over.
22. The tax inspector may choose between the two options in each case.

thermore, tax inspectors follow the directions of numerous letters of the Ministry of Finance and the State Tax Service which autonomously clarify the provisions of the tax law, statutes and accounting standards. Thus in Russia the tax administration has exceptional powers, which is not counterbalanced by checks of an independent court. This rudimentary element of the former centrally planned system leads to arbitrary decisions in many cases.

Secondly, the statute concerning the composition of expenses does not contain all expenses directly connected with the business. Some reasonable and necessary expenses must be charged to profits after tax; e.g. part of wages exceeding fixed normative amounts, research and development expenses, interest payments exceeding fixed normative amounts, business trip expenses exceeding the norms fixed by the Government, expenses on exploitation of cars used for business purposes exceeding the norms established by the Government, etc. Thus the statute indicates the distinction between deductible and non-deductible expenses. By means of such rules the legislator tries (implicitly) to limit the costs of production so that wages are deductible only up to a certain amount, conservative straight-line depreciation rates are used and unrealistic long useful lives of fixed assets are assumed. Such an approach contradicts the concept of profits prevailing in market economies. From an academic point of view costs are being taxed. Recognition of this fact, however, does not mean that it is automatically an unacceptable approach. The point is that specific economic development in the transition period necessitates some modification of the generally accepted taxation principles in order to restrain inflation and reduce the budget deficit.[23]

IV. SPECIFIC ISSUES RELATING TO THE DEFINITION OF TAXABLE PROFITS

A. Introduction

This section examines some specific issues concerning the definition of taxable profits in Russia compared with Western European tax systems, i.e. deductibility of wages, time of profit taking, valuation of assets, loss relief, tax incentives, etc.. Unlike the above sections the description of the provisions of Russian tax law and comparison with the Western model will not be dealt with separately. Since the Western reader has already been introduced to the basic elements of company taxation in Russia, a simultaneous description and comparison will be more convenient.

B. Deductibility of wages

In Western countries wages are deductible without limitation. According to Russian legislation enterprises which pay in excess of the normative amounts fixed by the Government must pay additional tax on the excess at the basic profits tax rate of 35 percent.[24] The procedure for determining the normative amount is established annually by Parliament on the basis of a proposal from the Government.

In 1992-1993, the normative amount initially equalled four times the minimum monthly wage for employees. This minimum monthly wage was revised periodically for inflation. In 1994 according to the above-mentioned President's Decree the normative amount was increased to six times the minimum monthly wage.[25] This measure was taken because average wages grew more than the normative wage amount, so that a greater part of the production costs of wages became subject to taxation. At the same time, according to the Decree all enterprises, regardless of whether they are exempt from tax on profits, must pay tax on the amount of the actual wages and salaries exceeding the normative amount. Before this amendment, enterprises which were exempt from this tax continued to use exempt profits for wages and salaries rather than capital investment, reconstruction, modernization, etc. This led to a new spiral of inflation and to the amendments. Currently, only some categories of taxpayers, such as agricultural enterprises and farmers, are released from the tax on excess wages provided the receipts from sale of their own agricultural production exceed 70 percent of total sale receipts. Partial deductibility of wages is a characteristic feature of the Russian tax system, distinguishing it from the Western model. However, it should be noted that measures aimed to prevent the growth of wages were undertaken by some Western European countries as well; for example, in the Netherlands "wage stop" measures were prescribed by the Government to employers. However, such measures are outside the scope of taxation rules.[26]

C. Time of profit taking

1. Cash method versus accrual basis method

In general, two methods of calculating amounts subject to CIT are commonly used: the cash basis method and the accrual basis method. Under the cash basis method gross revenue is recognized when cash is collected for the sale of goods, and expenses are deductible when paid. Under the accrual basis method gross revenue is recognized when an agreement for the delivery of goods or performance of services has to be concluded, and profit is deemed to be realized either when the goods are delivered or the services per-

23. See *supra* note 1, at 340-344.
24. According to the Russian President's Decree No. 2270 of 22 December 1993 "Concerning some changes in the taxation and interrelations between the budgets of the different levels", the basic rate of tax on profits was increased from 32 to 35%. This rate consists of 13% payable to federal budget and 22% payable to the budgets of autonomous republics, regions, municipalities, etc. Additionally, local government was granted power to increase the local rate up to a maximum of 30% for banks and insurance companies and up to 25% for other taxpayers. Thus in the regions that exercise this right the total tax rate may reach 43% for banks and insurance companies, and 38% for other enterprises.
25. According to the Russian Constitution, Parliament has legislative power, while the Government (Cabinet of Ministers) is an executive body. In respect of the tax on excess wages, the procedure for calculation of this tax is provided in the Act. However, under the Act the minimum normative wage which is revised periodically is to be defined by the government, and must be approved by Parliament. In 1993, during the political crisis, the deductible normative amount of wages was amended by Presidential Decree No. 2270 (see note 24).
26. During economic instability such measures would have no effect in Russia, so the provisions aiming at the restriction of wage inflation are provided by tax law.

formed, whichever is later, and the revenue is received either in cash or as a debt-claim. The time of delivery is therefore decisive. Expenses are taken into account when they are actually incurred rather then when they are paid.

The cash basis method is – with few exceptions – no longer used in Western countries as it contradicts to a certain extent one of the basic principles of sound business practice, i.e. the matching principle. This principle, which underlies the accrual basis method, provides that income and expenses should be matched to the year in which income is generated and costs are made, respectively. The primary advantage of the accrual basis method is that it eliminates the possibility of profit shifting by changing the time of receipt or payment of cash.

2. Methods of calculating taxable income in Russia

The question at what time profit should be taken is one of the most vexing issues in company taxation in Russia. Currently, Russian legislation permits both the cash method of calculating income and the accrual basis method. Before 1992 only the cash basis method was allowed – now enterprises may choose between the accrual method and the cash method. The cash basis method remains widespread for two reasons.

The accrual method requires trained accountants, experienced in particular in the valuation of, for instance, fixed assets, stock and debts. Moreover, there is no clear guidance as to how bad debts should be appraised or how the results of long-term contracts should be treated. This gives rise to conflicts between the taxpayers and the tax administration. This problem can be solved by training accountants.

A more important factor is the impetuous price liberalization process, strengthened by rapidly growing inflation. This causes the situation of "mutual insolvency of enterprises", where the insolvency of one enterprise frequently causes the insolvency of others mutually connected by agreements for the delivery of goods. Customers cannot pay for goods supplied because of shortages (or absence) of money in the bank account. According to the data of the Federal Department of Bankruptcy Affairs about half of Russian enterprises are on the brink of bankruptcy.[27] Under these conditions, adoption of the accrual method has aggravating consequences. For example, a supplier of goods, who has adopted the accrual basis system, delivered goods to a customer, having, as often is the case, no money in his bank accounts. On the basis of an invoice of delivery sent to the customer, gross revenue is to be included in the profit and loss account. According to the present procedure of tax collection, the supplier is obliged to make advance tax payments twice a month, but he often will not be able to make such payments if his customers have not paid their debts. The following paradoxical situation arises. The profit is recorded but the enterprise becomes the debtor of the government and its suppliers, as well as of its employees. A delay in payment of wages because of the lack of financial resources for two or three months is common practice in Russian enterprises.

To prevent this situation and to obtain realistic figures of taxable profits, accounting standards allow enterprises to create a reserve for doubtful debts. As explained below this possibility does not sufficiently diminish the harmful effect of using the accrual system for the enterprise in question. Under the present system a reserve for doubtful debts can be made on the basis of the assessment of the likelihood of each doubtful debt being collectible. Such a reserve may be formed at the end of the financial year and is deducted from taxable profits. If the reserve is not used during the next year, following the year in which it was formed, the unused part should be added to taxable profits of the current financial year. The problem, however, is that the payments to the reserve are deductible from profits for tax purposes only at the end of the tax year. Thus such a payment is taken into consideration only in the final assessment – it is not, even though it ought to be, taken into account in calculating advance payments to be made in a tax year. Although the excess of advance payments above the final tax assessment will be refunded, enterprises will in fact lose money because of high inflation. No adjustment provisions are provided for in Russian legislation. Therefore, although adoption of the accrual basis method is a critical transitional step from the old cash system to a system which is more in conformity with internationally recognized accounting standards, it should be recognized that during a period of economic crisis and instability, low payment discipline of enterprises and the absence of a mechanism to enforce the bankruptcy law, using the accrual system is very disadvantageous.

The accrual method is appropriate for a stable economic situation when a delay of payments under an agreement for the delivery of goods or performance of services is more the exception than the norm. The lack of stabilization of the economy and the size of the budget deficit create a barrier to this more advanced method of computation of taxable profits.

D. Valuation of assets

1. Fixed assets

In Russia, fixed assets are valued at historical cost which is the cost of acquisition plus additional expenses of construction or the cost of self-production. An increase in the book value of fixed assets is obligatory only in the case of reconstruction, rebuilding or re-equipment. Depreciation of assets is compulsory and must be applied whether the enterprise makes a profit or sustains a loss. Depreciable assets include all assets, tangible or intangible, which are used to carry on a business and which have a useful economic life of more than one year. Intangible assets were recognized as such with the adoption of the new "Scheme of accounts" in 1991. Thus, patents, licences, trade marks, etc. are considered business assets for tax purposes. They are valued in the balance sheet as the cost of acquisition, increased by expenses of bringing these assets to the condition where they can be used. Intangible assets may be amortized over the period of their useful lives.

27. Izvestiya (25 August 1994), at 1.

Although in principle revaluation of fixed assets is not allowed, a 1992 Decree required all enterprises to revalue their assets so as to adjust the value of fixed assets to the rate of rapidly growing inflation. A set of coefficients was established by the Government for this purpose – coefficients were provided for different kinds of fixed assets (buildings, machinery, etc.), the book value of which was increased on average by 20 times.

Contrary to common practice in Western countries where different methods of depreciation are permitted,[28] the straight-line method is the only method allowed in Russia. Annual depreciation is based on a fixed percentage of the cost of acquisition. The percentage is defined on the basis of the estimated useful life of the asset. Depreciation periods and the corresponding rates can not be established by taxpayers – depreciation rates are determined by a special Government Decree.

The main problem is, however, not whether depreciation rates are established by the Government, but rather their amount. Western taxpayers may establish rates themselves, but they must be accepted by the tax administration according to general tax practice. Despite the fact that there are no statutory provisions or official guidelines, "normative rates" (rates accepted by the tax authorities according to general tax practice) are used in most Western countries. In Germany the rates of depreciation are set out in officially recommended tables, classified by branch of industry. However, usually applied rates of depreciation are sufficient for timely recovery of capital. Russian tax legislation provides for excessively long useful lives of assets which are assumed in calculating of depreciation allowances. Some examples are given in the table:[29]

Rate of Depreciation

	Machinery		Building	
	SL*	DB**	SL	DB
Netherlands	10 to 20%	2 x SL	1,5 to 4%	-
United Kingdom	-	25%	4%	-
Germany	10%	3 x SL	2,5 to 10%	-
France	10 to 20%	1,5/2,5 x SL (max. 30%)	2 to 5%	-
Belgium	10 to 20%	2 x SL	3 to 5%	2 x SL
Russia	5 to 10%	-	0,7 to 2%	-

* SL-straight line
** DB- declining balance

Depreciation rates which are set too low constrain capital investments and impede cash flow. Thus under market conditions the "normative" depreciation rates should be revised taking into account the useful lives of assets which correspond to the real terms of their economic use. Another side of this problem is that the value of depreciation based on historic investment cost is eroded by inflation. The loss of real value of the depreciation allowances caused by inflation might be prevented by periodical adjustments of the depreciable base of assets in the form of indexation. Although this is complicated technically, it is necessary to stimulate the process of renovation of technology.

Since 1 January 1992 accelerated depreciation has been conceded principally through accounting standards. The system of accelerated depreciation in Russian tax law provides for the use of the straight-line method of calculating depreciation allowances on the basis of approved depreciation rates increased by a maximum two times.

Before 1 January 1992 actual use of this method was possible only after the enterprise obtained permission of the Ministry of Economy of the former Soviet Union or the Ministry of Economy of the relevant republic within USSR. These Ministries had to fix the rates of accelerated depreciation for every enterprise individually, but within two times the allowable straight-line rate. Since very few enterprises obtained permission, accelerated depreciation was more the exception than the norm. However, the newly issued President's Decree which contains the main trends of the tax policy empowers the Russian Government to adopt regulations regarding accelerated depreciation in high technology branches of industry. This step is necessary to provide an incentive for capital investments by reducing the tax payable in the early years of the useful lives of fixed assets. Currently, although accelerated depreciation is theoretically allowed, in practice it is not used by enterprises other than those that have already acquired permission.

2. Inventory

In respect of the valuation of inventory a large number of valuation systems have been developed in Western European countries. Not all of these systems are allowed for tax purposes, e.g. the method based on replacement value is not accepted. Taxpayers in Western countries have nevertheless much more freedom in the selection of a system of valuation (cost price, the lower of cost or market value, FIFO, LIFO, base stock system) than taxpayers in Russia.

Russian tax legislation does not provide any rules for the valuation of inventory. However, such rules are set forth in the Instruction of the Ministry of Finance, which contains valuation rules for all items in the balance sheet and clarifies rules for the use of the scheme of accounts. These rules must also be applied for tax purposes. Inventories are valued at acquisition cost, including incidental costs (commissions, legal fees, transportation costs, etc.). Neither adjustments for inflation nor the use of LIFO or any other valuation method is permitted. In times of inflation using the LIFO method results in higher reported costs of production implying lower

28. Report of the Committee of independent experts on company taxation (Ruding Committee). ECSC-EEC-EAEC, Brussels, Luxembourg 1992, at 52, 245.
29. Report of the Committee of independent experts on company taxation, at 245; G. Spenke and A.P. Lier, *Taxation in the Netherlands* (Deventer: Kluwer Law and Taxation Publishers, 1992), at 69; the Statute concerning a procedure of depreciation of fixed assets, approved by Decree No. BG-21-D of the State Planning Committee, the Ministry of Finance, the State Bank, the State Price Committee, the State Statistic Committee and the State Construction Committee of the USSR, of 29 December, 1990.

gross and net profits. Therefore, at the moment, in conditions of extremely high inflation and budget deficit the permission of the LIFO method would cause considerably decreased public revenues. From an economic point of view this measure is vital to ensure fairness of the tax system and the basis to further a sound enterprise system.

V. LOSS RELIEF

The concept of loss relief is completely new in Russian tax legislation. Prior to 1992 losses incurred in previous years could not be set off against profits of subsequent years. Under the former centrally planned system losses suffered by so-called planned loss-making enterprises[30] were subsidized by the Government. Actual losses suffered by planned profitable enterprises could be covered from the reserve fund of the ministry of the relevant branch of the economy to which the enterprise was subordinated, or from the state budget. The transition to a market economy necessitated changes in the treatment of losses. Although not provided for by tax law, the Instruction of the Ministry of Finance regarding the procedure for calculation of tax on profits permits a five-year carry-forward loss relief. However, loss relief is allowed only after the reserve fund has been completely used for covering losses, but the amount of losses still exceeds the amount accumulated in the reserve fund. The system of loss relief came into force for enterprises which incurred a loss in 1992. The amount of losses for which relief is provided must be allocated in equal portions over the following five years, so a loss amounting to 500,000 roubles in year 1 can be carried forward by allocating to each of the following five years an amount of 100,000 roubles.

Some criticism arises with respect to the system of loss compensation. First of all, a more liberal carry-forward system for initial losses has not been developed. Initial losses are treated as ordinary losses despite the fact that many new enterprises suffer losses in the first years of their existence. Some Western European countries allow initial losses to be carried forward indefinitely (as in the Netherlands).[31] This provision is based on the principle that the object of a company income tax is business profits realized during the entire life of an enterprise. This fundamental principle is not yet recognized by Russian tax law. A second criticism is the fact that there is no provision for a carry-back of losses to previous profit years.

Furthermore, since inflation is high, provision should be made for the adjustment of losses for inflation. Indexing losses would be realistic for the rate of inflation or for the index of revaluation of roubles to hard currency.

VI. TAX INCENTIVES

A. Analysis of tax incentives

One of the main features of the Russian tax system, distinguishing it from the Western model, is the numerous tax exemptions and tax privileges designed to promote goals which are considered by the State as paramount to further economic development.[32] Tax incentives provide for preferential tax treatment for certain branches of the economy, types of activities, certain investors, etc. Rather than enumerate all the tax incentives, groups of tax incentives and subsequent amendments will be analysed:

- By granting a tax exemption for profits used for capital investments, the State intends to stimulate capital investments. For the same reason, an unlimited deduction from taxable profits is allowed for interest paid on loans received from the bank for capital investments, whereas in other cases the deduction of interest is limited to the discount rate of the Central Bank of Russia.
- Considering the urgent necessity for stimulating scientific progress and renovation of obsolete technology in the majority of the former state enterprises, actual expenditure on scientific research is allowed as a deduction from taxable profits.
- Agricultural production has always been treated favourably in Russia (as is the case, for instance, in the Netherlands). Agricultural enterprises (with the exception of industrial type agricultural enterprises) are fully exempt from profits taxation. State financial support of unprofitable agriculture via subsidies and exemption from taxation remains one of the main goals of economic and tax policy. In addition, profits of any enterprise (non-agricultural) from its own agricultural production is deducted from the taxable base. Profits from the production of foodstuffs for children is also exempt from taxation.
- All kinds of charitable contributions to ecology and public health funds, funds supporting education and creative arts, children's and youth social associations and religious organizations, and amounts transferred to institutions of public health, public education, social security, culture, cinematography, sport, etc. are deductible from taxable profits up to 3 percent of taxable profits.

  Similar deductions are provided for in the tax legislation of European countries. In the Netherlands, for example, charitable and public welfare institutions and institutions promoting a general social interest are exempt from taxation. In Russia, in an economic crisis, the social motives of such exemptions become more significant. Although public welfare institutions are still supported by the State, the growing budget deficit has necessitated that subsidies be gradually reduced. Thus the State uses an indirect means to support social institutions by exempting from

30. Planned loss-making enterprises are enterprises whose loss was planned by the State and reflected in their financial plans (the balance of income and expenses). Under State control over prices of certain types of commodities (i.e. raw materials, consumer goods, etc.), expenses of such enterprises exceeded their incomes, so "planned loss" was subsidized.
31. Ruding Committee, *supra* note 28, at 242.
32. Tax legislation of Western countries provides for some exemptions as well. However, its number is very limited, covering primarily agriculture and institutions promoting a general social interest. The number of the incentives under Russian tax law exceeds 20. Their economic essence is explained in the text below.

taxation profits transferred by companies to such institutions. Further, tax policy has a pronounced social element to mitigate the lowering of the living standards and to avoid social tensions.

- For the same reasons, educational and cultural institutions are granted special tax treatment. Profits of the State and municipal education institutions, museums, libraries, theatres and circuses are exempt from taxation. In addition, enterprises which have their own public health, public education, culture and sport institutions[33] may deduct profits used for maintenance of such institutions from the taxable base.
- The legislation contains provisions to stimulate activities of enterprises relating to the Chernobyl disaster. Contribution to Chernobyl charitable organizations are deductible if they do not exceed 5 percent of taxable profits. Moreover, profits from activities ensuring the neutralization of the Chernobyl disaster consequences for enterprises which are located in zones that suffered from the catastrophe are not taxable.
- Enterprises, organizations and institutions in which at least 50 percent of total personnel are disabled persons are granted tax privileges. Their profits are exempt from tax, provided that not less than half of the profit earned is used for social needs of the disabled persons. Such social needs include medical assistance, health resort treatment, transport services, education, creation of new jobs, etc. If this requirement is not fulfilled another exemption, providing for a reduction of the tax rate by 50 percent, is granted if the disabled persons comprise more than 70 percent of the total personnel.
- As is the case in EU countries, where the Strategic programme for the internal market of the European Commission[34] (which sets out future developments in direct taxation) defines small and medium sized enterprises as generators of employment and provides some measures to stimulate small and medium sized business (including the possibility for unincorporated enterprises to be taxed as companies[35]), in Russia the stimulation of small business is considered a vital and immediate task. This stimulation is to be provided by tax incentives as well as other measures. Decentralization of the monopolized economy and encouragement of free enterprise and competition are the objectives. The law provides for a special category of taxpayers – so-called small enterprises, defined as enterprises with no more than 200 employees and in which share participation of the State and municipal ownership does not exceed 25 percent. Tax holidays are granted to such enterprises for the first two years of their business activities if they are involved in agricultural production, foodstuff production, production of consumer goods, medical equipment, medicine and construction of buildings. However, enterprises enjoy the exemption only if the proceeds from these activities exceed 70 percent of total proceeds. Enterprises which increase this amount up to 90 percent during the third and fourth years following commencement of their business activities pay tax on profits at the ordinary rate, reduced up to 25 and 50 percent of the basic rate in the third and fourth year, respectively. Accordingly, if the enterprise which enjoyed the above tax privilege ceases its activities within five years from the year of its registration the full amount of tax must be paid.

B. Efficiency of the tax incentives

It is clear from the above analysis that the Russian State focuses much attention on taxes and tax incentives in particular, as instruments of economic and social policy. Such an approach is justified to a certain degree by the difficulties of the transition period. The State is forced to use all available instruments (including tax measures) to avoid social tensions. But it should be borne in mind that economic neutrality and simplicity suffer from a host of tax incentives. The arguments against tax incentives are well known – they erode the tax base and distort an efficient allocation of resources within an economy. Preferential tax treatment makes a tax system more complex and expensive, while the real efficiency of many tax incentives might be questioned. For instance, implementation of tax reform in Russia demonstrates that tax incentives on their own did not have a significant impact on investment decisions. Enterprises do not hurry to invest profits exempt from taxation. Moreover, in times of economic crisis the tax factor is only one factor which influences investment decisions. Efficiency of capital investment depends to no small degree on credit and price policy. High bank interest, rapidly increasing prices for raw materials and equipment, and a rapid decrease of depreciation funds due to inflation create obstacles to capital investment. Thus the question whether tax incentives result in more investments (and therefore in the long run more tax revenue) than immediate loss in tax revenue cannot be answered unequivocally.

The Strategic Programme of the European Commission aims at development of the internal market through means which include the use of appropriate tax incentives. However, this programme stresses that the number of tax incentives should be kept to a minimum. The programme provides for tax incentives for the establishment and development of small and medium-sized enterprises, and in the area of research and environmental projection.[36] The European Commission recognizes that the actual economic impact of a system of tax incentives is very difficult to assess. Additionally, more direct forms of aid, such as targeted subsidies, are considered to have a more direct effect than tax expenditures.

In Russia a recently issued President's Decree[37] concerning the main trends of tax policy provides for a reduction in the

33. These institutions which belong to the enterprise (non-municipal) cover their expenses from the enterprise's profit.
34. COM(93) 632 def., Brussel, 22 December 1993.
35. P. Schonewille, "The Strategic Programme for the Internal Market and Direct Taxation", *EC Tax Review* (February 1994), at 59.
36. Dirk Albregtse and Edwin Heithuis, "Towards a Strategic Programme for the Internal Market: A Working Document of the Commission of the European Communities", *EC Tax Review* (January 1994), at 15.
37. President's Decree No. 1004 of 23 May 1994 "Concerning some questions of tax policy".

number of incentives due to a better understanding of certain negative effects of tax incentives. It confirms the need for Russia to follow the lead of Western European countries by broadening its tax base while lowering tax rates. This would protect the revenue base to ensure a more efficient allocation of resources and decrease administration costs of the tax system.

VII. RECENT TAX DEVELOPMENTS

A. Future tax policy trends

The initial legislation establishing a new tax system in Russia was amended in 1992-1994 to adapt it to changes in the economic situation. Further, a number of instructions and regulating letters interpreting the tax law were issued by the Ministry of Finance and the State Tax Service. Instability of the tax system is an important factor which deters investors and impedes business activities. However, due to the unpredictable economic development, the State was forced to change separate provisions of the tax law primarily to reduce the budget deficit and to stimulate private business. A package of recently adopted Presidential Decrees reflects new economic and tax policy trends.

Among these Decrees the most significant is Decree No. 1004 of 23 May 1994 "Concerning some questions of tax policy". This Decree defines the modification of tax policy to mitigate the tax burden for commodity producers and to limit inflation. According to the Decree, the Government was instructed to place a bill before Parliament, providing for the following:
- the tax system should be simplified by reducing the number of taxes levied;
- to stimulate commodity producers' activities the tax burden should be decreased by reducing the rates of tax on profits and value added tax by 10-20 percent. At the same time the forgone state revenues should be compensated by an increase in individual income tax and property taxation of legal entities and individuals;
- a reduction and revision of tax exemptions should be made to prevent erosion of the state tax base.

According to this Decree, the Government must adopt measures for accelerated depreciation of fixed assets in high technology branches of the economy. Tax holidays were also reinstated for foreign investors. Profits of "enterprises with foreign investments" which are engaged in material production and which are registered after 1 January 1994 are exempt from tax provided the share of the foreign participant in the authorized capital exceeds 30 percent and the equivalent value equals more than US$ 10 million. Additionally, the tax rates in the third and fourth year following the year commencing business activities are reduced by 25 and 50 percent of the basic rate. Although recognizing the necessity of an equal regime of profits taxation for domestic and foreign taxpayers, tax policy makers are compelled to infringe the principle of equal tax treatment in order to attract foreign investors. Currently, foreign capital is essential for restructuring the Russian economy and reconstruction and renovation of enterprises with obsolete technology resulting from the vast shortage of domestic sources of investment. Because of the unfavourable conditions prevailing during the transition period (such as high inflation, shortage of goods and raw materials, inadequate infrastructure, etc.) perhaps the only way to stimulate foreign investment under the present circumstances is an attractive tax regime which can be provided by tax holidays and reduced tax rates.

B. Measures against tax avoidance

The measures provided for another important Decree No. 1006 of 23 May 1994, "Concerning a complex of measures for timely and full payments of taxes and other obligatory payments to the budget", which aims to bolster state control over tax law compliance and to prevent tax avoidance. According to official data of the Ministry of Economy, between 30 and 40 percent of taxes are not transferred to the treasury.[38]

The following are the main measures designed to prevent tax avoidance and tax fraud:
- banks are permitted to open bank accounts for enterprises only upon presentation of the tax administration's confirmation of their registration;
- taxpayers are permitted to open only one bank account for their main activities;[39] they are required to report regularly to the tax administration about other bank accounts (aside from the account for their main activity), such as hard currency accounts[40] and deposit accounts;
- banks must transfer taxes from the taxpayer's account to the State budget. If there are no funds or insufficient funds in the enterprise's current account for the tax payment, the enterprise must transfer funds from the separate hard currency account by a conversion of hard currency into roubles in order to pay advance taxes on time and in full.

  Failure to fulfil such requirements will result in punitive measures, including administrative penalties or liquidation not only of the company, but also of the bank which did not comply with the measures. The Ministry of Finance also has the right to initiate bankruptcy proceedings against enterprises which have not paid taxes for more than three months.

Although such measures are unavoidable in the present situation where tax avoidance and tax fraud have become widespread, the new provisions, in particular the tax administration's right to compel conversion of hard currency into roubles, contradict market principles. The measures may be

38. Izvestiya (24 September 1994), at 1.
39. The tax practice of the last year testifies to myriad tax avoidance by means of allocation of financial resources of the enterprises to several bank accounts. Given the limited capability of the tax administration, this measure was undertaken to ensure stronger control over the accuracy of tax returns and to disclose hidden profits.
40. Such an account can be opened by enterprises engaged in foreign trade activities.

considered as a regressive step to the former state administrative management system. Other means to prevent tax avoidance would have been preferable, such as a reduction of the extremely high tax burden via a fair definition of taxable profits (where all expenses connected with a business are deductible).

VIII. CONCLUSION

By adopting a number of laws concerning profits taxation the Russian tax system has been brought more in line with Western models. However, the system is not yet complete; its progress is slow due to the instable economic development and peculiarities of the transition to a real market economy.

Experience of the past three years shows evidence of more understanding of policy makers of the need to amend the Russian tax system to Western standards. Such understanding is particularly reflected in the Decree concerning the modernization of tax policy. Mitigation of the tax burden for commodity producers by reducing the number of taxes and the rates of the tax on profits and VAT is recognized as a new direction in tax policy. Reducing the number of tax exemptions is targeted at making the tax system more transparent for all investors. The tax base will also be broadened and administrative costs will be reduced. Accelerated depreciation will allow the definition of profits to come in line with international accounting standards.

Nevertheless many problems remain. The main problem concerns the definition of the taxable base, which is still far from that used in Western European countries, because of the restriction in the deductibility of all expenses of earned income, especially deductibility of wages and interest payments. Depreciation rates should also be revised to ensure timely recovery of capital investment, and provision should be made for a system of adjustment for inflation. The absence of such a mechanism undermines confidence in the State and restrains investments. Adjustment for inflation by an indexation system would create many technical problems, but indirect adjustment through the use of the LIFO system of stock valuation and adjustment of depreciation funds might be provided for.

Equal treatment of different types of activities should be introduced. At present there are special, i.e. higher than basic, rates for branches considered to be more profitable. Thus some aspects of confiscatory taxation still exist in the legislation. Equal rates would promote neutrality of the tax system and the free flow of capital between different branches of the economy.

Lastly, the doubtful effects of tax incentives, which were already confirmed by the experience of both Western countries and Russia during the last three years of the tax reform, demonstrate the necessity of a clear examination of tax incentives from the point of view of their efficiency compared to losses in tax revenue. Only those incentives which stimulate investments and savings or which encourage small businesses should be retained. The present excessively complex tax system with preferential tax treatment for various taxpayers might be replaced by a simplified broad-based system with relatively low tax rates. The recent tax reforms undertaken in all Western countries show the positive results of such tax development, and undoubtedly Russia can not ignore this road.

AUSTRALIA

PART IV A: A CRITICAL EXAMINATION

Chris Ohms[1]

Chris Ohms has a B.Com., an LL B and an LL M (Hons) from the University of Auckland. Recently he was awarded a Ph.D. in Commercial Law also from the University of Auckland. He is a Senior Lecturer in Commercial Law specializing in taxation at the University of Auckland and also practises as a Barrister. Dr Ohms is a member of the International Fiscal Association and the Australasian Tax Teachers Association.

I. INTRODUCTION

The High Court of Australia in *FCT v. Peabody*[2] recently considered for the first time, Part IVA, the general anti-avoidance provision contained in the Income Tax Assessment Act (Cth).[3] Part IVA was introduced in order to remedy the deficiencies apparent in the previous general anti-avoidance provision, Section 260 of the Income Tax Assessment Act 1936 (Cth),[4] which was seen as failing in its primary purpose of preventing tax avoidance.

The effect of Section 260 had been severely curtailed by successive decisions of the High Court of Australia[5] led by the then Chief Justice, Sir Garfield Barwick,[6] who had displayed an intense dislike of the section ever since his defeat as Counsel at the Privy Council in *Newton v. FCT*.[7] It may be observed that the *Explanatory Memorandum* indicates that the general objective of Part IVA is to enact in legislative form the interpretation of Section 260 that emerged from the decision of the Privy Council in *Newton*.[8] It states:[9]

> Part IVA may be seen as effectuating in general anti-avoidance provisions of the income tax law a position akin to that which appears to emerge from the decision of the Privy Council in [*Newton*]. The essence of the views expressed in that case was that a tax avoidance situation covered by Section 260 exists only if it can be predicated from looking at an arrangement that it was implemented in that particular way so as to avoid tax.

Prior to *Peabody* commentators[10] were uncertain as to what judicial attitudes would ultimately prevail in the interpretation of the new general anti-avoidance provision. While, prima facie, accepting that the Part clearly gave the Commissioner a more powerful weapon to apply in tax cases, many still viewed the Part as being uncertain in application and containing some potentially major flaws.[11]

Unfortunately, the judgment delivered by the High Court of Australia in *Peabody* is somewhat obscure and suffers from undue brevity. But, be this as it may, when it is read *in pari materia* with that of Hill J in the Full Federal Court it is submitted the underlying intention of the *Explanatory Memorandum* has been advanced and the High Court has interpreted Part IVA to effectuate in the Part a position that was evident in the decision of the Privy Council in *Newton*. Although the High Court expressed no view on the matter Hill J had observed:[12]

> As pointed out in the Explanatory Memorandum...there were, in accordance with the jurisprudence then extant, four major limitations on the scope of the then Section 260....The proposed Part IVA was introduced to overcome these difficulties. The legislative purpose, as the Explanatory Memorandum makes clear, was to restore the law to what it was thought to be after the decision of the Privy Council in *Newton*...but subject to ensuring that the four problems, to which reference has been made, were overcome.

It is implicit in the judgment of Hill J that he felt that he was authorized by Section 15AB(1)(a) of the Acts Interpretation Act 1901 (Cth) to refer to the *Explanatory Memorandum* to discern the legislative policy underlying Part IVA, and confirm that the meaning of the provisions of the Part, was the ordinary meaning conveyed by the text of the provisions, taking into account the context or role of the Part in the Act and the purpose or object of the Part. It is submitted that this initial statement by the Full Federal Court essentially provides a context for the ensuing analysis of the Part by the High Court.

II. THE SCHEME OF PART IV A

Under Part IVA a taxpayer is prevented under the Act from obtaining a tax benefit that arises as a consequence of a scheme that has been undertaken with the sole or dominant object or purpose of obtaining the attendant tax benefit. Commensurately, the Commissioner is granted a power to negate the offending tax benefit.

More specifically, Section 177D occupies the central role of defining tax avoidance. Section 177D provides that Part IVA applies to any scheme[13] entered into or carried out that results in of a tax benefit,[14] and it would be concluded that the person who entered into or carried out the scheme did so for the purpose[15] of enabling the relevant taxpayer to obtain a tax benefit.

If the qualifying conditions of Section 177D are found to exist then it is open to the Commissioner to invoke the powers contained in Section 177F. Section 177F(1) has a reconstructive focus and allows the Commissioner to adjust the assessable income of a taxpayer so as to counteract any tax benefit that arises as a consequence of a scheme.[16] Where a prescribed scheme exists, the Commissioner may make adjustments either to include an amount in assessable income, or to disallow the whole or part of a deduction in order to deny the taxpayer the tax benefit.

III. THE FUNCTIONAL NATURE OF PART IV A

In *Peabody* the High Court determined that the operative elements of Part IVA were statutory concepts and did not depend upon the exercise of the Commissioner's discretion for their application. In this way the existence of a Part IVA scheme would be proven if, as a question of fact, the court was satisfied that the dominant purpose of the taxpayer was to enter into a scheme within the meaning of Part IVA giving rise to a tax benefit also as defined by the Part. This admittedly did differ from the approach of Hill J in the Full Federal Court who found that the existence of the elements of Section 177D was based entirely upon the Commissioner's discretion.[17] It is submitted that the approach of the High Court is consistent with the philosophy underlying the *Explanatory Memorandum* because the operation of Section 260 was held in *Newton* to be based on objective facts and not to be dependent on the Commissioner's discretion – the so-called "predication test".

IV. SCHEMES

A. The basic concept

The first component of Section 177D is the concept of a "scheme". Section 177A(1) defines a scheme[18] to be:

> (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
>
> (b) any scheme, plan, proposal, action, course of action or course of conduct.

It was the apparent legislative intention that the concept of a scheme should be analogous to the concept of arrangement which appeared in Section 260, and which, was described by Lord Denning in *Newton* in these terms:[19]

> Their Lordships are of opinion that the word "arrangement" is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable at law. But it must in this section comprehend, not only the initial plan but also all the transactions, that is, which have the effect of avoiding taxation, be they conveyances, transfers or anything else. It would be useless for the Commissioner to avoid the arrangement and leave the transactions still standing.

It is logical to assume that the concept of a "scheme" appearing in Section 177D, and, both globally in Section 177A(1), and specifically in Section 177A(1)(b), evinces an intention on the part of the legislature that the broad approach established in relation to Section 260 by the Privy Council in *Newton*[20] should be continued in Part IVA. This is consistent with the broad policy outlined in the *Explanatory Memorandum*.[21] If this position is accepted then it is implicit in the concept of scheme that it will be composed of a *temporal* dimension and a *static* or *segmental* dimension. In this sense it is submitted that it will be necessary for the court to, firstly, determine what steps have been undertaken to implement the overall structure that is intended to result in a tax saving, and, secondly, to ascertain the economic or end result. In the words of Kitto J in *Newton*[22] a scheme would consist of:

> Those consequences which are intended to form or in fact form the decisive or operative factors in bringing about ... [the end] result.

While traditionally the concept of a "scheme" connoted the whole series of transactions and steps by which it was put into effect, the one area of contention surrounding the concept concerns the actual extent of the final scheme which is subject to Part IVA. This is the next issue that arises for consideration.

B. The appropriateness of a "sub-scheme" approach

It has been suggested by some commentators that the concept might not focus on the whole arrangement but merely on the subsidiary part that yields the tax benefit.[23] The effect of adopting such an approach, and, effectively dividing the scheme into a number of sub-schemes, is that it removes the necessity of establishing an overall tax avoidance purpose to the entire scheme and allows any component of the scheme to be examined to see what its individual purpose is. In this way, even though the scheme as a whole may be actuated by non-tax purposes, any part which is inserted to obtain a tax advantage, may be isolated and found to be subject to Part IVA. It is submitted that the better view is that it is the entire scheme which is relevant under Part IVA and not just part of the scheme. Dabner[24] argues that the effect of adopting a sub-scheme approach is to displace the requirement of identifying a "dominant" tax benefit purpose in relation to a scheme as a whole by substituting a test that simply requires "any" tax avoidance purpose. Murphy[25] further suggests that pragmatically if a sub-scheme approach were to be adopted the Part would apply to a multitude of otherwise bona fide commercial or familial transactions that were structured tax efficiently. It was the apparent intention of the Part that a sub-scheme approach would not be appropriate. The *Explanatory Memorandum* would appear to support an approach similar to that developed by the Privy Council in *Newton*. It will be noted that the *Explanatory Memorandum* indicates that the requisite purpose is to be determined *having regard to the scheme as a whole*.

C. The approach of the courts to the concept of a scheme under Part IV A

Unfortunately, apart from the decisions of the Full Federal Court and the High Court in *Peabody*, there has been no real examination of Part IVA by the Federal Courts to date. Given the degree of ambiguity evident in the High Court judgment on this point, earlier decisions on Part IVA provide a useful guide as to the correct approach. The Administrative Appeals Tribunal has essentially considered the scope of Part IVA, and, more specifically the concept of scheme, in a relatively small number of cases. The only two decisions of any significance are *Case W58*[26] and *Case Y13*.[27]

In *Case W58*[28] the taxpayer was a computer and office equipment salesman who decided to shift with his family from Sydney to Hobart. A prospective employer, X Co, would only hire the taxpayer if he provided his services through a company. He therefore acquired a shelf company which entered into a consultancy agreement with X Co under which the shelf company provided the taxpayer's services in return for a consultancy fee. The taxpayer entered into an employment contract with the shelf company which also acted as a corporate trustee of a family trust established for the benefit of the taxpayer's spouse and children. Income earned from X Co was paid to the shelf company which distributed a portion to the taxpayer and the bulk to the beneficiaries of the family trust who derived the income at a lower rate of tax. Hartigan J, interestingly, rather than viewing the "scheme" as comprising the shelf company, family trust and associated contracts, preferred to separate it into parts or "sub-schemes".

Hartigan J found that the scheme could be divided into two individual sub-schemes. Viewed in this light his Honour felt that two steps were taken which ultimately had the effect of reducing what would otherwise have been the taxpayer's entitlement to income. Firstly, the taxpayer had established and maintained the corporate trustee with the attendant contracts between X Co and the taxpayer. Secondly, the taxpayer had created the discretionary family trust with the shelf company acting as corporate trustee and the taxpayer's family as beneficiaries. Hartigan J then examined both of these sub-schemes individually to assess what the dominant purpose was in each instance. While Hartigan J was prepared to find that the purpose behind the first sub-scheme was to enable the taxpayer to enter into the consultancy agreement with X Co, his Honour felt that the purpose behind the second sub-scheme, was to simply obtain a tax benefit. He noted:[29]

> On the evidence there was present no specific reason arising out of the taxpayer's or other circumstances for the creation of the trust....[The] rationale was to minimise the tax that is payable on the income generated by the taxpayer's exertions.

By ignoring the overall purpose behind the wider scheme, Hartigan J was able to focus on the second step and find that Part IVA applied because the only reason for the creation of the trust was to obtain a tax advantage.[30] The immediate problem with this approach is that it disregards the requirement that the purpose of obtaining a tax benefit be a dominant one. As Dabner[31] suggests, in this case, the taxpayer was found to have had three purposes in entering into the scheme as a whole (business, familial and tax considerations). The tax purpose was clearly associated with the establishment of the trust and resultant distributions. By selecting those two elements in isolation it was obviously much easier to describe the obtaining of a tax benefit as the dominant purpose.

In contrast, *Case Y13*, in a factual situation that was in all material respects the same as the previous case, the Administrative Appeals Tribunal adopted an approach that considered the scheme as a whole. In that case the taxpayer was an engineer who was approached by a number of clients to undertake consulting work in his spare time. The taxpayer set up a structure to undertake this work and established a discretionary family trust with a corporate trustee. The taxpayer was employed by the corporate trust which provided his services to the clients for a fee and which was then distributed to the trust beneficiaries at a lower rate of tax. Professor Grbich, by implication, considered the scheme to consist of the entire set of elements including the trust, the corporate trustee, the related agreements, and the yearly operation of the trust, stating that:[32]

> In the case before us we treat the trust and corporate trustee ... as an offending part of the scheme.

Further he noted:[33]

> Section 177D still cannot operate where a taxpayer simply chooses between equally plausible and recognised business or property holding vehicles on the basis of tax consequences. The mere fact that tax considerations are present in the decision to structure business or property arrangements is not the evil at which Section 177D is directed. The main focus is on the taxpayer's purpose of obtaining a tax benefit. The purpose under Section 177A(5) is the dominant purpose. The overwhelming focus, to repeat, is on inferences drawn from the objective steps in the transaction and on the content and limits of the core test applied to it.

That this was indeed the approach of Professor Grbich, is borne out by his observation that the relevant purpose under Section 177A(5) is the dominant purpose. This seems to suggest that he accepted that a dominant purpose test would only realistically apply to a global approach to a scheme. If a wider scheme with tax efficient components was divided into smaller parts, one being a step to simply reduce tax, a dominant purpose test would be unnecessary because the only purpose of the step would be to avoid tax. Professor Grbich was quite prepared to concede that a wider scheme actuated by non-tax reasons that contained tax efficient parts was not caught by Part IVA.

In *Case X90*,[34] which was factually similar to *Case Y13*, the Administrative Appeals Tribunal adopted the same approach as the latter case. Thompson DP found the scheme to consist of the corporate trustee and associated trust, the agreements between the corporate trustee and the former employer, the contract of employment between the taxpayer and the corporate trustee and the operation of the trust mechanism.[35] He stated:

> In the present case the course of action or course of conduct was the change from the status of employee with Z Co., the rejection of the offer of employment by the other company at a higher salary and the continuation of work for Z Co. on a contract basis through A Co. as trustee of the discretionary family trust.

While the issue was considered by both the Federal Courts and the High Court in *Peabody*, the analysis of both the Full Federal Court and the High Court is not completely satisfactory. Hill J approached the issue on the basis that the identification of a Section 177D scheme rested on the Commissioner's discretion. Whether his Honour's approach would have differed had this not been the case remains to be seen. Moreover, while the High Court ultimately rejected a sub-scheme approach some of the comments made in the course of the judgment do make the position somewhat unclear. To a certain extent one has to read between the lines of both judgments to extract a clear view. In *Peabody* a successful group of companies was being considered for a partial public floatation. The group was owned primarily by a family trust, the beneficiaries of which were the taxpayer and her two children. In 1985 the trust was contemplating floating 50 percent of the group, while retaining control of the remaining 50 percent. However, in order to do this, the minority shareholding in the group either had to be reduced or transferred to the trust. It was eventually decided to adopt the latter approach but the problem then arose that the trust would be liable on the eventual disposal of the minority shares. Under the former Section 26AAA of the Act which applied at the relevant time, if the trust acquired the minority shareholding and then on-sold it to the public within 12 months of purchase, the net capital gain would be assessable income. To avoid this eventuality the trust purchased a shelf company to purchase the minority shareholding. The shares were then converted into worthless "Z class" non-voting preference shares.[36] This left the trust with effectively 100 percent of the equity in the group and shortly thereafter 50 percent of the trust's shares were sold to the public. The result of the scheme was to avoid the receipt by the trust of an amount of approximately $ 2.69 million, which would have been assessed to tax, pursuant to Section 26AAA, either in the hands of the trustees or in the hands of the beneficiaries who were entitled to it. If the point about Hill J's conclusion that the identification of a scheme was a discretion vested in the Commissioner is ignored, arguably his Honour adopted an approach in accord with that developed by Lord Denning in *Newton*. His Honour analysed the concept of a scheme, as the expression was defined in Section 177A(1), in these terms:[37]

> [A scheme] encompasses, *inter alia*, non-enforceable arrangements or understandings as well as courses of action or courses of conduct. In a particular case a unilateral action may constitute a "scheme" for the purposes of the definition. In other cases, as identified by the Commissioner in the present circumstances, the scheme may consist of a series of steps or a course of action.

In the present case Hill J felt that the scheme included the purchase of the shelf company by the trust, the purchase of the shares from the minority shareholder, the conversion of the acquired shares into the Z class preference shares, and the ultimate sale of the remaining shares to the public. Having regard to the scheme of Section 177D, his Honour felt that it would be quite incorrect for the Commissioner to isolate one step in a collection of steps that constituted a wider scheme, and classify the individual step as a scheme. Hill J observed:[38]

> Reference in Part IVA to "part of a scheme" (cf. Section 177A(5)) suggests rather that, in the case where a series of steps constitutes a scheme, that whole series of steps is to be considered, the individual steps being seen as parts of the scheme rather than each step being capable of being seen as a scheme in itself.

In coming to this conclusion Hill J referred to the decision of the House of Lords in *IRC v. Brebner*.[39] In that case at issue was Section 28 of the Finance Act 1960 (UK), which applied, *inter alia*, to a *transaction in securities*.[40] This provision notably did not utilize a test based upon a discretion vested in the Commissioner. Lord Pearce rejected the suggestion that an entire scheme coming within the section could be divided into separate sub-schemes. He felt that the section, which utilized a dominate object test, would be deprived of all practical meaning if one had to isolate one part of the arrangement from the object of the whole arrangement. He stated:[41]

> And it would be quite unrealistic and not in accordance with the subsection to support that their object has to be ascertained in isolation at each step in the arrangements.

It will be noted that the approach of Hill J, in regard to the factual determination of the extent of the scheme, did differ from that of O'Loughlin J[42] at first instance. O'Loughlin J held that the scheme was unilateral in the sense that it was a course of action implemented by the trustees of the trust. His Honour did not consider that the scheme, which in his view consisted of the decision to convert the minority shareholding into "Z class" preference shares and certain consequential transactions, could be classified as a bilateral scheme because there was no other party at arms length who was involved in the scheme.[43] It is important to observe that his Honour would have been prepared to give the scheme in question a wider scope if the taxpayer had entered into a bilateral transaction, but, given the initial finding of fact, O'Loughlin J felt that it was not necessary to ultimately reach a conclusion on the matter.[44] Essentially, the difference in the approach of O'Loughlin J and Hill J, may be simply explainable as a question of fact.

The High Court prima facie rejected the sub-scheme approach when it observed:[45]

> But Pt IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself.

Unfortunately the High Court did not fully outline the indicia that would guide in the determination of a scheme and merely observed that a series of steps would not constitute a scheme "where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'."[46] In reaching this conclusion the High Court referred to the same passage in *Brebner* relied on by Hill J. Curiously, however, the cited portion of that passage was used in a different context by the High Court to that adopted by Hill J. While in *Brebner* Lord Pearce felt that Section 28 of the Finance Act 1960 (UK) would be robbed of all practical meaning were a sub-scheme approach to be adopted the High Court felt that a series of steps could not constitute a scheme if the series could not stand on its own without being robbed of all practical meaning. Most probably the High Court were simply emphasizing the fact that a scheme had to be self-contained in the sense that a series of steps could only constitute a scheme if the series standing alone would have been entered into in the normal course of events. Another difficulty with the approach of the High Court was the following statement made in the course of the judgment:[47]

> Before us the Commissioner sought to rely upon the narrower scheme identified by the judge at first instance and, in our view, he was entitled to do so.

This might be taken to mean that it was legitimate to adopt a sub-scheme approach, in this case, being the simple conversion of the "Z class" preference shares. However, it is submitted that the better explanation of this statement was that the High Court was simply stressing that the determination of a scheme was always a question of fact and that the Commissioner was entitled to argue that any particular combination of steps constituted a Part IVA scheme.

Apart from *Peabody*, which, it may be noted, is currently on appeal to the High Court of Australia, the only other decision of relevance is *Fletcher v. FCT*.[48] The High Court of Australia considered Part IVA primarily from a procedural viewpoint, although it did make some comment on the applicability of Part IVA itself, and the factual background of the case is worthy of consideration. In *Fletcher*, the four taxpayers were partners engaged in the business of subdividing and selling land on the central coast of New South Wales. The partnership's accountant suggested that it might enter into an "annuity investment" scheme to gain certain tax benefits that might be used to offset future profits from the partnership business. The scheme consisted of a partnership agreement, several annuity agreements, and several loan agreements interconnected in a complex series of "round robin" bill of exchange transactions. The taxation benefits to the taxpayers were ostensibly from the large deductions of interest made during the first five years of the arrangement. The partnership in the first year, 1982, made a net loss of $ 324,667, which was to be shared equally by the four partners and used to offset the profits made from the land development. The Commissioner applied Part IVA to disallow the deductions for the first year of the scheme and subsequent years.

Although in the Full Federal Court and the High Court the issues raised were principally procedural, there was some mention of the substantive application, of Part IVA. At first instance[49] the Administrative Appeals Tribunal found that Part IVA did apply. It was stated:

> This appears to be a case in which the taxpayers entered into the annuity schemes with the dominant purpose...of obtaining a tax benefit in connection with the scheme and that the scheme falls within Section 177D of the Act.

It was found that the scheme consisted of:[50]

> The agreements with [AIP Ltd]...the other agreements to implement the scheme and the annuity scheme itself.

The Full Federal Court[51] accepted the approach of the Administrative Appeals Tribunal that Part IVA was correct in law, and by inference agreed with the interpretation adopted in relation to the concept of "scheme" as the term is used in Section 177A(1). The High Court, although not expressing an ultimate view on the correctness of this finding, did infer that if the issue had been before it, that the decision would in fact have been upheld. By implication this would mean that the approach of both the Administrative Appeals Tribunal[52] and the Full Federal Court[53] was correct. The High Court did state:[54]

> It is arguable that a finding that the agreements [constituting]...the "scheme"....[were entered into with] "the dominant purpose of reducing the taxable income of [the taxpayers]."

It is significant that the Full Federal Court and the High Court chose not to redetermine the extent of the scheme by dividing it into a number of smaller "sub-schemes".

1. Unilateral schemes

It is to be noted that Section 177A(3) now includes a unilateral scheme. Section 177A(3) defines a scheme to mean:

> ...as including a reference to a unilateral scheme, plan, proposal, action, course of action or course of conduct, as the case may be.

This extended definition was placed in Section 177A to overcome difficulties caused by the interpretation of the term arrangement by the Privy Council in *Newton*,[55] where it was indicated that there might have to be two parties to a transaction before it could be seen as an arrangement.[56]

2. The scope of schemes – the relationship of Part IVA to other provisions

The final consideration in relation to the definition of a scheme is the extent to which that concept is limited by other provisions of the legislation. In this regard it is important to recognize the effect of Section 177B. Section 177B(1) holds, that subject to Section 177B(2), nothing in the provisions of the legislation[57] shall be taken to limit the operation of Part IVA.[58] Section 177B is a legislative mandate to overcome the position reached by the High Court of Australia in relation Section 260 on the same issue. The doctrine of "choice", as developed by the High Court, put serious limitations on the effect of the former general anti-avoidance provision. Under the doctrine, Section 260 was held to be, initially, subject to certain provisions in the legislation that offered tax concessions, regardless of whether the use of the particular provision was bona fide or not.[59] Subsequently, the choice concept was widened to include any situation where the taxpayer simply avoided the application of the legislation.[60] This essentially deprived Section 260 of any real effect. Section 177B(1) thus represents an attempt to prevent Part IVA from being read down or excluded by reason of other provisions of the legislation. There was no equivalent provision in Section 260 to Section 177B(1) and this was a deficiency that was clearly sought to be remedied when Part IVA was drafted. The *Explanatory Memorandum*[61] states:

> The basic principle of proposed Section 177B is to give to Part IVA a position of paramount force in the income tax law.

Speed[62] explains the effect of Section 177B in these terms:

> If a principal difficulty with Section 260 is its relation to the other provisions of the Act, this difficulty is not present with Part IVA to the extent that Section 177B(1) seeks to exclude any question of reconciling Part IVA with the other provisions of the Act. Part IVA is not limited by any other provisions... The situation has been reversed, and the difficulty is now to interpret each and every other provision of the Act so that there is no limitation on the operation of Part IVA.

Similarly Fayle[63] observes:

> Part IVA has probably avoided the "choice principle" although that is yet to be determined...it is no longer a simple matter to alter one's income earning status from sole trader to partnership or trust or to a company or a combination of these.

Although the function of Section 177B(1) seems quite clear, it is interesting that a surprisingly large number of commentators,[64] still believe that the choice doctrine will continue to be recognized by the courts in relation to Part IVA. Indeed, recently in the decision of the Federal Court in *Spotless Services Ltd v. FCT*[65] Lockhart J was ultimately not prepared to express a concluded opinion on the matter, despite the presence of Part IVA:

> Section 177C(2) and (3) exclude the operation of Part IVA where the tax benefit is derived from the making of a declaration, election, notice or option...expressly provided for by the Act. In my opinion, as presently advised, unless the exclusions of subs. (2) and (3) operate, the choice doctrine applicable by judicial decision to Section 260 is inapplicable to Part IVA. However, I have no concluded view on that question.

The continued support for the choice doctrine is thought to be found within the terms of Section 177C(2) where there is essentially an exception for schemes that occur:

> As a result of the making of a declaration, election or selection, the giving of a notice or the exercise of an option by any person being a declaration, election, selection, notice or option expressly provided for by [the] legislation.

It is submitted that there are two principal reasons why this interpretation of Section 177C(2) is essentially unsustainable. Firstly, the interpretation is in direct conflict with the express wording of Section 177B(1) which quite explicitly makes Part IVA paramount in relation to other provisions of the legislation.[66] Secondly, it is apparent that it was not the intention of the legislature that Section 177C(2) should preserve any form of the choice doctrine, but merely allows a taxpayer to exercise certain express options pursuant to a transaction that was not provoked by tax considerations.[67] A clear example alluded to in the *Explanatory Memorandum*[68] is the valuation of stock:

> For example, the amount to be included in assessable income in respect of the difference between opening and closing values of trading stock on hand will vary according to whether the taxpayer has opted to have the stock valued at its cost price, market selling value, or the price at which it can be replaced (sub-section 31(1)).

The only Administrative Appeal Tribunal cases to date that have considered this point are essentially *Case W58*[69] and *Case Y13*.[70] In *Case W58*[71] Hartigan J rejected any suggestion that Section 177C(2) preserved the former choice principle. He based this conclusion on the express wording of Section 177C(2), and the scheme and purpose of the legislation as a whole. The fact that Section 177C(2) only operated where the legislation had "expressly provided", indicated to Hartigan J that Part IVA would only be overridden when there was an express exception found in the legislation. He stated:[72]

> Subsection 177C(2) provides that where a tax benefit is obtained as the result of a choice (declaration, election or selection, the giving of a notice or the exercise of an option) expressly provided by the ITAA then any tax benefit obtained by the taxpayer is not a tax benefit for the purposes of Pt IVA of the ITAA. It is the escape hatch to Pt IVA. The lynch-pin of subsection 177C(2) is undoubtedly the words "expressly provided". The clear intention of those words and the structure of the ITAA itself is that it is not sufficient that the ITAA merely recognise that there are certain legal relationships which might produce an effect on the income of a taxpayer but rather, the ITAA must itself expressly give a choice which has the result, when taken advantage of, of producing a tax benefit. Examples of such choices can be found in sections such as Sections 26B, 26BA, 36(3), 36AAA, 36AA and so on.

In the present case it was not expressly provided that a taxpayer could utilize a trust to derive income at a lower rate of tax and therefore Section 177C(2) had no application. Hartigan J stated:[73]

> I accept the submissions on behalf of the respondent that to escape the operation of Pt IVA in this respect one would have to say not only was income splitting something that the Act contemplated but that there was an express provision in the Act that enabled a person to have a trust such as the TFT and to split the income of the trust according to the way in which that person wanted to arrange his affairs. The mere fact that the Act recognizes that there are such things as trusts, partnerships and so forth and then provides how those trusts and partnerships should be taxed does not mean that the mechanism is one expressly provided for by the Act for the purposes of Section 177C(2)(a)(i).

In *Case Y13* the Administrative Appeals Tribunal, although not considering the issue directly, appeared to retreat from the position reached in the previous case. Professor Grbich noted:[74]

> It might have been expected that the precise limits of this predication test would be severely tested in a scheme such as this. It hardly involves blatant, contrived and artificial arrangements. This scheme used a well recognized income-splitting device which is freely available to taxpayers with income from property sources. Indeed, it was conceded by the respondent that the provision did not apply in the case of the interest income in this case. Section 177D still cannot operate where a taxpayer simply chooses between equally plausible and recognized business or property holding vehicles on the basis of tax consequences. The mere fact that tax considerations are present in the decision to structure business or property arrangements is not the evil at which Section 177D is directed. The main focus is on the taxpayer's purpose of obtaining a tax benefit. The purpose under Section 177A(5) is the dominant purpose. The overwhelming focus, to repeat, is on inferences drawn from the objective steps in the transaction and on the content and limits of the core test applied to it. While the thrust of the provision is clear, the test is not spelt out in detail by the legislation in this critical area. The critical choice is delegated to bureaucrats, Tribunal members and to judges. It is necessary to develop an orderly set of criteria for the application of this critical test and it is on this task that future authority is likely to focus. It is necessary to spell out the minimum threshold for such annihilation.

However, it is probably correct to assume that in the latter case the Tribunal was simply referring to a choice of options that was open to a taxpayer who was pursuing a normal business or family dealing, rather than to a taxpayer who deliberately took advantage of a facet of the legislation solely with the object of avoiding tax. It is submitted that Professor Grbich was simply pointing to the fact that a scheme that was entered into, with a primary purpose other than that of obtaining a tax benefit, would be automatically outside the scope of Part IVA, and, it would be open to a taxpayer in such a case to exercise a choice as to various options that might be present in the legislation to gain a tax advantage.[75]

Although not explicitly considered in *Peabody* it is apparent that the High Court rejected the wider form of the choice doctrine that was advanced in *Mullens v. FCT*.[76] This must be the case because the High Court rejected the notion that a tax benefit could not be said to exist when a taxpayer simply took his affairs outside the scope of the legislation – such as converting income to capital. The High Court noted:[77]

> The difficulty faced by the Commissioner...was not in establishing that a tax benefit was obtained by reason of the conversion of the Kleinschmidt shares to "Z" class preference shares....

This statement reinforces the position laid out in the *Explanatory Memorandum* which recognized the choice doctrine was inappropriate in the context of Part IVA. It is obviously an improvement in the current drafting of Part IVA that the relationship to the rest of the legislation has been dealt with. It is submitted that it is a matter of policy, to establish the relationship of a general anti-avoidance provision to the rest of the legislation. A general avoidance provision may be paramount or subject to other provisions in the legislation, and, in the case of Part IVA, the intended policy was the former.

V. DEFINITION OF "TAX BENEFIT"

A. Scope of the concept

Part IVA will only apply if the second component of Section 177D has also occurred. This requires the taxpayer to obtain a "tax benefit". This is defined by Section 177C(1) to be either: (a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out;[78] or (b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out.[79]

It may be observed at the outset that Section 177D has adopted a new definition of the effect that is proscribed to that previously found in Section 260. However, it is submitted, that conceptually the two are analogous.

Section 260 applied, *inter alia*, to an arrangement that had the effect of "avoiding any duty or liability imposed on any person". This was interpreted by the Privy Council in *Newton*[80] to mean the avoidance of a future and non-existent liability to tax and was based on the assumption that a taxpayer would normally bear a "bench mark" liability to pay tax in respect of certain income.[81] As such the determination of whether a tax liability had been avoided, required a contrasting of the tax liability faced by the taxpayer if the arrangement in question was deemed effectual, and that which would in all likelihood have arisen if the arrangement in question had not occurred.[82] It is submitted that the definition of tax benefit envisages that a similar concept be utilized. The court under Part IVA will ascertain what would reasonably have occurred but for the scheme and compare that to the situation that has arisen as a result of the scheme. The *Explanatory Memorandum* states:

> A tax benefit will have been obtained by a taxpayer in connection with a scheme if, after applying the other provisions of the Principal Act to the taxpayer, either an amount is not included in assessable income of the taxpayer that might reasonably be expected to have been included if the scheme had not been entered into, or a deduction is allowable to the taxpayer the whole or a part of which might reasonably be expected not to have been allowable if the scheme had not been entered into. ....Specification of what constitutes a tax benefit ... is designed to eliminate the uncertainties associated with the use in Section 260 of less precise expressions, e.g. "altering the incidence of any income tax" and "defeating, evading or avoiding any duty or liability imposed on any person by this Act"....

The only real difference between Part IVA and Section 260 is that Section 177C focuses on a gross, as opposed to, a net result in determining whether tax advantage has arisen. Whereas under Section 260 the actual taxation liability of the taxpayer was used to ascertain whether a reduction had occurred (a net concept), it will be noted that under Part IVA, the focus shifts to elements that go to calculate a taxpayer's actual taxation liability, such as assessable income or deductible expenditure (a gross concept).[83]

The scope of the concept was considered in *Case Y13*.[84] In that case Professor Grbich analysed the definition of "tax benefit" contained within Section 177C, and concluded that it was an *ex post* concept that necessitated a comparison between what fiscally had arisen as a result of the scheme, and that which might have been expected to arise had the scheme not been undertaken. In this way, if a tax reduction was seen to have arisen, by reference to the omission of an item of assessable income or the incurring of expenditure, after this comparison was undertaken, then a "tax benefit" had occurred.[85]

> The definition of "tax benefit" has a clear purpose in the framework of the general anti-avoidance provisions. Attempts to dissect its words and take them out of context would undermine the clear rule being communicated by the legislation. The section works by comparing the actual tax result obtained from the steps in the scheme under review with the steps which might have been expected had the various tax avoidance steps not been undertaken. It involves an attempt to predict, based on all the evidence, what might reasonably have been done had tax considerations not been present. In the case before us we treat the trust and corporate trustee, conditionally and for the purposes of argument, as an offending part of the scheme. Had it not been carried out, the question is whether the consulting work would have been performed by the taxpayer personally and, if so, what the tax bill would be. The Tribunal is required to predict what steps would have been taken but for the tax avoidance purposes. In this case, I find on a balance of probabilities from all the facts that the consulting work, payments for business expenses would have been made had the scheme in question not been put into effect....same steps must be disregarded in the comparison demanded by Section 177C. The relevant comparison is between the steps relevant to the "amount not being included in the assessable income" and the statutory predicate about what might reasonably have been included.

It is significant that this approach was also adopted by both the Full Federal Court and the High Court in *Peabody*. In the Full Federal Court Hill J accepted that the concept underlying Section 177C required a comparison between what had happened as a result of a scheme and what would have happened had the scheme been absent. His Honour noted:[86]

> It will be seen that Section 177C requires the making of an hypothesis as to what might reasonably be expected to have happened had the scheme identified not been entered into or carried out.

Although not directly considering the issue the High Court implicitly accepted that the same conceptual basis underlay Section 177C. It was stated:[87]

> A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out....

Subject to some exceptions this similarly accords with the concept of "tax avoidance" as that term was used by Section 260 and interpreted by the Privy Council in *Newton*.[88]

B. Scope of Section 177C(1)(a)

A contention that has arisen in relation to the concept of "tax benefit" concerns the scope of the definition of "amount" which is referred to in Section 177C(1)(a). Some commentators[89] argue that this term does not include situations where the form of an item of receipt is altered, and only applies where the quantum is altered. Thus, an item received as non-taxable income, would not constitute "an amount" "not being included in assessable income" but would be "a receipt" "not being included in assessable income." For instance, take the observations of Hulme,[90] who suggests that:

> If one looks at Section 177C(1)(a)...one sees the description of the concept of obtaining a "tax benefit". As has been indicated, it is confined to...the omission of something from the assessable income...It does not apply to such matters as the form in which an amount does enter the assessable income, as for example whether it comes as a rebateable dividend or in a fully taxable form. That question of the form of assessable income is not within these provisions.

However, it is submitted that such an interpretation would not realistically be adopted by the court following the scheme and purpose approach now being followed by the Australian courts and mandated by Section 15AA of the Acts Interpretation Act 1901 (Cth).[91] At the outset it is likely that the court would find no ambiguity in the term "amount". This could well be taken to mean the way in which a receipt is derived as well as the quantum of a receipt.[92] Even if it is accepted there is ambiguity, and two meanings are possible, the wider meaning that might be given to the term would certainly be used. The clear intention of the *Explanatory Memorandum*[93] was that the non-inclusion of an amount in assessable income, meant the non-inclusion of any potential receipt. Certainly, the court might refer to the *Explanatory Memorandum*[94] to confirm this interpretation of Section 177C(1)(a) in one of two ways. If the court felt that the meaning of amount was unambiguous, and included the character of a potential receipt, as well as the quantum of a potential receipt, it might refer to the *Explanatory Memorandum* pursuant to Section 15AB91)(a) of the Acts Interpretation Act 1901 (Cth) to confirm this. Alternatively, if the court felt the issue was ambiguous it might directly refer to the *Explanatory Memorandum* and come to the same conclusion as mandated by Section 15AB(1)(b) of the Acts Interpretation Act 1901 (Cth). This exact issue arose for consideration in *Peabody* although it is interesting that Counsel for the taxpayer did not raise the point as a matter of substantive law. In that case a potentially assessable amount of approximately $ 2.69 million, which would have been assessed to tax pursuant to the provisions of Section 26AAA of the ITAA 1936 (Cth), was effectively converted into a capital gain.

At first instance O'Loughlin J[95] considered the issue of whether a tax benefit had arisen as a result of the scheme. His Honour observed[96] that the argument supporting the existence of a tax benefit rested on the assumption that it would "reasonably be expected" that, but for the scheme, the trust would have been assessable on the proceeds derived from the resale of the minority shareholding. In this sense O'Loughlin J implicitly accepted that the avoidance of the receipt which would have been assessable under Section 26AAA, and its conversion into a capital gain, could be described as the avoidance of an *amount* being included in assessable income. Although the finding by O'Loughlin J, that a tax benefit had indeed arisen, was subsequently overturned by Hill J in the Full Federal Court, it is submitted that the subsequent approach of Hill J does not contradict the conclusion that the transformation of an assessable receipt into a capital gain prima facie comes within the scope of Section 177C(1)(a). Hill J, recognized this was implicit in the finding of O'Loughlin J, when he observed:[97]

> [O'Loughlin J] formed the view that an expectation that Mrs Peabody might have, but for the scheme, received as assessable income one-third of the capital gain was reasonably based. Accordingly, his Honour held that Mrs Peabody had obtained a tax benefit in respect of the scheme.

Similarly the High Court noted:[98]

> The difficulty faced by the Commissioner...was not in establishing that a tax benefit was obtained by reason of the conversion of the Kleinschmidt shares to the "Z" class preference shares...

It will be observed that both Hill J and the High Court did not ultimately contradict the initial premise of O'Loughlin J, to the extent that the conversion of the potentially assessable receipt into a capital gain was, prima facie, within the terms of Section 177C(1)(a). Where they did differ from O'Loughlin J was the factual determination of whether it was reasonable to conclude that an assessable receipt would have arisen but for the scheme.

C. Scope of Section 177(1)(b)

Section 177C(1)(b) refers to a deduction being allowable to a taxpayer as a result of a scheme where the deduction or part thereof would not have been allowable or might reasonably be expected not to have been allowable. The operation of this part of the definition of a tax benefit should ultimately prove unproblematic although one could envisage an attack being mounted along similar lines to Section 177(1)(a). It could be argued that Section 177(1)(b) only operates where a completely new item of expenditure has been incurred as a result of a scheme, and not where the character of an existing item is merely changed, for instance, from capital to revenue. However, resort to the *Explanatory Memorandum* would ultimately resolve any ambiguity in favour of the wider interpretation.

D. Status of the antecedent transaction theory

Several commentators[99] have suggested that the concept of tax benefit is limited to situations where the scheme in question either avoids the derivation of a receipt, or creates a deduction in order to mask an antecedent transaction that had given rise to crystallized taxation consequences. As Dabner and Burton observe:[100]

> It is arguable that Section 177C enacts the "antecedent transaction test" as it appears to call for a comparison of the taxpayer's pre-scheme income with the post-scheme income. Thus, where the scheme comprises a new income earning activity of the taxpayer, Section 177C would appear to have no application.

The conceptual fallacy in this argument is simply that it misunderstands the basis of the "antecedent transaction" doctrine as it was developed by the High Court of Australia in *Mullens v. FCT*.[101] In that case Barwick CJ indicated that Section 260 would only apply to schemes that sought to cloak or mask an otherwise taxable situation by the operation of the subsequent transaction. However, rather than being based on the fact that it was only in such a case that a comparison could be made between the taxpayer's pre and post-scheme income, it was premised on a particular view of the first limb of Section 260 which referred to schemes which altered the "incidence" of tax. Barwick CJ felt that Section 260 could only apply to schemes that effectively cloaked an antecedent transaction because it was only in those cases that it could be said that the incidence of tax was altered. It is submitted that this interpretation of Section 260 would be totally inappropriate in the context of Part IVA for several reasons. Firstly, the concept of tax benefit as defined by Section 177C does not refer to schemes that alter the incidence of tax, indeed, the *Explanatory Memorandum*[102] specifically indicated that the "specification of what constitutes a tax benefit" was "designed to eliminate the uncertainties associated with the case in section 260 of less precise expressions, e.g. "altering the incidence of any income tax". Secondly, since the decision of the High Court of Australia in *Gulland v. FCT*[103] the analysis of Section 260 by Barwick CJ has largely been discredited. In fact in *Case Y13*,[104] Professor Grbich expressly rejected the application of the antecedent transaction doctrine in the context of Part IVA. He stated:[105]

> The argument that you need an antecedent transaction to avoid tax is adequately rebutted by Gummow J in *Bunting v. FCT* and the authority to which he refers in the context of Section 260....We need not go through a rerun of this argument in the context of the new general anti-avoidance provisions. It diverts our attention from more significant issues about the proper meaning and limits of the general anti-avoidance provisions at the core of Section 177D.

As submitted earlier, if the court was unsure about this issue, resort to the *Explanatory Memorandum*, as mandated by Section 15AB of the Acts Interpretation Act 1901 (Cth), would directly contradict any argument that the antecedent transaction doctrine was perpetuated in Section 177C. It does have to be conceded that Section 177C(2) specifically limits the definition of tax benefit by excluding certain circumstances.[106]

E. Practical application of the concept

It is submitted that the efficacy of the concept of a tax benefit may be demonstrated by considering how it might apply in relation to the three types of tax avoidance structure identified by Stiglitz.[107]

1. Application of Section 177D to income splitting arrangements

(a) *Alienation arrangements*

A scheme involving an alienation of income will create a tax benefit under Section 177C(1)(a) because it would result in "an amount not being included in the assessable income of [a] taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out". Parsons[108] supports this interpretation where it is stated:

> It is arguable that those words are satisfied if the scheme involves the cessation of some existing process of income derivation, as a result, for example, of the transfer of a business by a sole trader to a trading trust.

The application of the concept of a tax benefit to an alienation arrangement falling within Section 177C(1)(a) is now well supported by several decisions of the Administration Appeals Tribunal.[109] For instance, in *Case Y13*,[110] the taxpayer effectively transferred an income stream from himself to a family trust. In that case Professor Grbich found that a tax benefit had been obtained because income which would in all probability have been derived by the taxpayer was derived by the beneficiaries of the trust.[111]

(b) *Deduction arrangements*

A scheme involving a contrived deduction would create a tax benefit under Section 177C(1)(c) because there would exist "a deduction being allowable to [a] taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out."

Parsons[112] observes:

> It is arguable that those words are satisfied if the scheme involves the cessation of some activity involving outgoings or losses that are not deductible and the substitution of activity which involves outgoings or losses that are deductible.

In *Fletcher*[113] the Full Federal Court expressly held that such a deduction scheme created a tax benefit in terms of Section 177C(1)(b). In that case, it will be recalled, a highly complex series of transactions and flows of money created large interest expenses, which the taxpayers sought to deduct from their assessable income. The Full Federal Court held that:[114]

> It is enough to say that the term includes a deduction being allowable in the absence of the scheme.

This interpretation was not subsequently contradicted by the High Court.[115]

2. Application of Section 177D to conversion arrangements

If it is accepted, as previously discussed, that the conversion of a taxable receipt into a non-taxable receipt can constitute "an amount" not being included in assessable income, a scheme involving the conversion of income into capital would create a tax benefit (pursuant to Section 177C(1)(a)) because it would result in "an amount not being included in the assessable income of [a] taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out". This particular factual setting was considered by the Full Federal Court in *Peabody*. Although, ultimately Hill J found that a tax benefit had not eventuated, this was simply by reason of the fact that there was no reasonable expectation that the subject taxpayer would have derived an assessable receipt. There was no suggestion that a conversion scheme, *per se*, was not within the scope of Section 177C(1)(a). This was also the approach of the High Court as previously noted. Moreover, it will be observed that the Australian Tax Office regards such a scheme as creating a tax benefit. In *Taxation Ruling* No. IT 2456[116] it was stated that Part IVA could apply to a scheme where the nature of a receipt was changed in contrast to the quantum of a receipt being altered.

3. Application of Section 177D to deferral arrangements

A scheme which deferred the derivation of income would create a tax benefit because it would result in an "amount not being included in the assessable income of [a] taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out" pursuant to Section 177C(1)(a).

The same reasoning employed in the cases involving an alienation of income, such as *Case Y13*, would equally apply in this situation. In the situation where a taxpayer defers a taxation liability by the incurring of expenditure, a tax benefit would be created under Section 177C(1)(b) because there would be created "a deduction being allowable to [a] taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out". The decision of the Full Federal Court as affirmed by the High Court in *Fletcher* would support this interpretation.

F. Ascertaining whether there is a tax benefit

It is simply a question of fact whether there has been a tax benefit occurring as a result of a scheme. Practically, this will necessitate a comparison between the situation that has resulted from the scheme with a hypothetical situation which would have arisen but for the scheme. Unlike Section 99, Part IVA provides a guideline as to the degree of certainty required in assessing the hypothetical situation. The court must be "reasonably" satisfied that the situation would have eventuated had the scheme not in fact taken place and in this sense the test is objective. This point was expressly considered in *Case Y13*,[117] and *Peabody*.

For instance, in *Case Y13*, the taxpayer entered into a scheme utilizing a discretionary family trust and a corporate trustee. The taxpayer transferred his consulting business to the corporate trustee which employed him pursuant to a contract of employment. The effect of the structure was to enable the beneficiaries of the trust to derive the income at a lower rate of tax than the taxpayer. Professor Grbich, in applying the definition of tax benefit, found the test necessitated an attempt to predict (based on the evidence) what might reasonably have been done had tax considerations not been present. In the present case it required that the trust and the corporate trustee, conditionally, and for the purposes of the argument, be treated as an offending part of the scheme. The issue then became whether, had the scheme not been carried out, the consulting work would have been performed by the taxpayer personally, and, if so, what the tax liability would have been. Professor Grbich found on the balance of probabilities that the taxpayer would have derived the income personally. The Senior Member held that all that was required under Section 177C(1) was that it was "reasonably to be expected" that the hypothetical situation would eventuate. This required, on the balance of probabilities, that the situation would occur.[118]

A similar approach was adopted by Hill J in the decision of the Full Federal Court in *Peabody*.[119] In that case his Honour felt that a determination under Section 177C required a finding based on a reasonable expectation. In the particular context of Part IVA, this meant that the hypothetical situation required to be constructed, had to be one which would reasonably be expected to arise. Hill J applied the decision of the Full Federal Court in *AG v. Cockcroft*[120] and held that in the present context, it was necessary that the hypothetical situation constructed by the Commissioner in determining whether a tax benefit had arisen, be one that was reasonably probable of occurring, as opposed to being one that was a mere possibility. On the facts of the present case Hill J was not prepared to hold that there was a reasonable expectation that the subject taxpayer would in fact have derived an assessable receipt in the absence of the scheme. It will be recalled that the scheme in question ostensibly avoided the purchase and on-sale of certain shares, the profit on which, would have been assessable under the former Section 26AAA of the Act if distributed by the trustees of the trust to

Mrs Peabody. Hill J was ultimately not prepared to hold that there was a reasonable expectation that there would have been a purchase and on-sale by the relevant taxpayer giving rise to an assessable receipt that was subsequently distributed to the taxpayer. The approach of the High Court does not differ markedly from that of Hill J. It was found as a matter of construction that the finding of a Section 177C tax benefit was based on an objective test. Moreover, the High Court, applying *Dunn v. Shapowloff*,[121] held that a reasonable expectation required a prediction as to events which would have taken place if the scheme had not been carried out, and, that the prediction must be objectively reasonable. In other words, the prediction must be justifiable on the balance of probabilities or a similar standard.

VI. DEFINITION OF PURPOSE

It will be observed that Part IVA will apply if a scheme has been entered into with either the sole purpose,[122] or the dominant[123] purpose, of obtaining a tax benefit in connection with the scheme.[124] In this respect Part IVA is based on the position reached by the Privy Council in *Newton*[125] in relation to Section 260. As outlined by the *Explanatory Memorandum*,[126] the new provisions contained in Part IVA were designed to apply where, on an objective view of a particular arrangement and its surrounding circumstances, it was apparent that the arrangement was entered into for the sole or dominant purpose of avoiding tax.

A. Defining the mental element – the meaning of "purpose"

Section 177D differs from Section 260 insofar as the reference to "effect" has been omitted. The assumption must be that there is quite clearly a requirement of a mental state. There is, prima facie, no reason to suggest that the term "purpose" would be construed any differently from the way in which the Privy Council in *Newton* construed the similar term in relation to Section 260. It is submitted that the term purpose as it appears in Section 177D simply means the object, or actuating reason underlying a taxpayer's actions. In this way, it is exactly the same concept to that described by Lord Denning in *Newton*. Hulme states:[127]

> ...that looking at...Section 177D(b) one wonders where the difference lies....I would think that the scope of the Section 177D enquiry is precisely the same as the called for by Section 260.

Similarly, Fayle[128] states:

> Where any tax benefit is obtained, Section 177D requires the Commissioner to decide...whether, objectively, one might conclude that the arrangement was implemented for the dominant purpose of obtaining that tax benefit.

However, some confusion still surrounds the relationship of the criterion used by Part IVA to define the mental state, and the way in which that mental state is ascertained. It will be shown that Part IVA, like Section 260, uses an objective test to ascertain purpose, and does not place reliance exclusively on taxpayer evidence. Such an approach was formulated by the Privy Council in *Newton*, and simply held that oral evidence of the taxpayer was inadmissible in ascertaining the purpose of the arrangement in question. Unfortunately this evidential rule was explained in *Newton* in the following terms:

> The section is not concerned with the motives of individuals. It is not concerned with their desire to avoid tax, but only with the means which they employ to do it. It affects every "contract, agreement or arrangement"...which has the purpose or effect of avoiding tax. In applying the section you must...look at the arrangements itself and see which is its effect – which it does – irrespective of the motives of the persons who made it.

This has been taken by subsequent commentators[129] to mean that purpose refers not to the purpose of the taxpayer but to the purpose of the scheme. In this sense "purpose" is taken to mean an identifiable legal state existing independently of any conscious human action. Arnold and Wilson[130] observe:

> [Although] several commentators have argued that the purpose test in [Section 177D] is subjective and synonymous with motive and intention, and therefore requires an assessment of a taxpayer's state of mind... In our view....it is the purpose of the transaction, not the taxpayer's purpose, that is relevant.

This interpretation is also supported by Speed:[131]

> The enquiry is not about finding out the actual purpose of [the taxpayer]....The difference [is] between a purpose of the taxpayer and a purpose of a transaction....

This is apparently based on a distinction recognized in several decisions of the High Court of Australia including *FCT v. Students World (Australia) Pty. Ltd.*[132] where Aickin J said:

> I do not think the context of the whole of the sub-section permits the word 'purpose' to be construed as meaning the same as the words 'purpose or effect' in Section 260 of the Act. It seems to me to be clear that paragraph (c), dealing with a contract, agreement or arrangement, refers to the subjective purpose of the continuing shareholder and not with the objective effect of that which is done. It speaks not of the purpose of the contract, agreement or arrangement but of the purpose of entering into it, which must be the purpose of the person doing the relevant act."

However, the conceptual fallacy in this argument simply lies in the fact that purpose is a state of mind and must relate to an individual. The concept cannot exist independently as a function of a scheme. Trebilcock[133] made this point when he observed that:

> The significance of the rule in *Newton's Case*...is not easy to see, for the rule only lays down what in the nature of things must be the case: that a taxpayer's purpose in entering into an arrangement must be gathered from all the surrounding circumstances. The rule operates as a limitation upon the scope of the section only to the extent that it presumably excludes evidence *aliunde*, such as admissions, from circumstances to be looked at in the ascertainment of purpose.

In this light, purpose refers to the state of mind of the taxpayer but is ascertained using objective criteria. Grbich[134] explains the relationship between the concept of purpose and the evidential method used to ascertain its existence in these terms:

> Newton is authority for the proposition that such a purpose of the taxpayer is construed from the objective steps. It is from the nature of those steps that we draw inferences about whether the arrangement satisfies the badge of tax avoidance. Since the only purpose

> can be a human purpose, we use the actual steps in the transaction to construct a hypothesis that the taxpayer had the "purpose" of defeating the Act.

It is pertinent that this was confirmed by Hill J in the decision of the Full Federal Court in *Peabody*. In that case his Honour stated:

> It will be seen, from Section 177D, that the conclusion that is required to be drawn is not a conclusion with respect to the scheme itself, but a conclusion as to the purpose of a particular person.

There appears to have been fairly uniform acceptance of this interpretation of the term by both the Administrative Appeals Tribunal[135] and the Federal[136] courts. For instance in *Case Y13* Professor Grbich inferentially described "purpose" as "a moving factor". He stated:

> It is to be noted that under Section 177D the transaction is annihilated where "it would be concluded", having regard to a very wide range of objective factors about the scheme, its substance and its context, that the person who carried it out did so for the purpose of obtaining a tax benefit. Whilst it does not exclude subjective factors, inferences from objective facts are the primary focus of the legislation.

In *Peabody*, O'Loughlin J at first instance, was somewhat more cautious, in his approach. Counsel had referred to the presence of the same term in the former Section 260 and submitted that the interpretation of the word in that context, as epitomised by the decision of the High Court of Australia in *Gulland*,[137] might provide guidance in relation to Part IVA. O'Loughlin J felt that "some care should be taken before automatically applying decisions under Section 260 to the provisions of Part IVA".[138] His Honour was cautious for two reasons. Firstly, there was no statutory interpretation in Section 260 of "purpose" such is found in Section 177A(5) which sets the requirement of the degree of purpose under Section 177D. Secondly, Section 260 had a different effect upon a challenged arrangement in that it made a scheme absolutely void whereas Part IVA merely empowered the Commissioner to ignore a scheme and its consequences by permitting income to be included in, or, deductions not allowed against, the assessable income of a taxpayer. Despite these reservations O'Loughlin J appears to have still adhered to the traditional approach to the definition of purpose. Centring on the object or reason for the scheme, his Honour found that the scheme:[139]

> ...[had been] entered into...in order to avoid the provisions of Section 26AAA of the Act and it was a direct and intended consequence of that avoidance that [the trust]...would obtain a tax benefit.

On appeal to the Full Federal Court, despite the determination of Hill J, that in fact the dominant purpose of the scheme was commercial, there was no difference in the two approaches. Hill J felt that the issue was:[140]

> ...whether the participation of [a]...person was activated by that person's dominant purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with that scheme.

Unfortunately this issue was not examined by the High Court in *Peabody* although in *Fletcher*, the High Court appeared to have used the concept of purpose in the same sense as Section 260 and regarded it as the actuating factor behind a scheme.

B. Degree of purpose

It will be observed that Section 177D will apply if the sole purpose is to obtain a tax benefit,[141] or in the case of two or more purposes, the dominant purpose is to obtain a tax benefit.[142] Section 177D applies to two different situations. The first will be where a scheme has only one purpose and that is to obtain a tax benefit, and the second will be where a scheme has more than one purpose, and the dominant purpose is to obtain a tax benefit. In the second situation the purpose of obtaining the tax benefit must outweigh all other purposes in the aggregate.[143]

C. Evidentiary method under Part IV A

1. The basic test

It is submitted that the test under Section 177D to ascertain purpose, is objective. This preserves the approach adopted by the Privy Council in *Newton*[144] and is implicit in the scheme of Section 177D which states:

> *It would be concluded* that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme. [(emphasis added)]

It will be observed that most commentators[145] have accepted that the test is objective. In *Peabody* O'Loughlin J., in considering the evidential test mandated by Section 177D, inferred that an objective test was appropriate when he concluded that the purpose or purposes of a particular scheme were to be assessed "having regard to the eight subject matters that are identified in paragraph Section 177D(b)". This was also confirmed on appeal by Hill J in the Full Federal Court. He stated:[146]

> It will be seen that the determination of what schemes fall within Section 177D requires an objective conclusion to be drawn, having regard to the matters referred to in para. (b) of the section ...

Moreover, the High Court of Australia explicitly stated that the test was objective. Most Administrative Appeals Tribunal cases[147] to date have also followed this approach. In *Case X90* Thompson DP stated:

> When all [the evidence is] viewed objectively, I am satisfied that it must be concluded that the taxpayer entered into and carried out the scheme for the purpose of enabling him to obtain the tax benefit in connection with it.

Also in *Case Y13* Professor Grbich stated:

> The main focus is on the taxpayer's purpose of obtaining a tax benefit. The purpose under Section 177A(5) is the dominant purpose. The overwhelming focus, to repeat, is on inferences drawn from the objective steps in the transaction and on the content and limits of the core test applied to it. While the thrust of the provision is clear, the test is not spelt out in detail by the legislation in this critical area.

The uniform application of an objective evidential test by the Tribunal and Federal Courts indicates that the approach adopted by the Privy Council in *Newton*[148] will continue to apply under Part IVA.

2. The criteria of Section 177D

Unlike the former Section 260, Part IVA in Section 177D(b) specifies a range of matters that the court may have regard to ascertain the purposes of a scheme. There has been much debate over whether the criteria set out in Section 177D(b) are exclusive or exhaustive, or, whether the court may have regard to other evidence, such as oral testimony of the actual taxpayer. Some commentators[149] accept that the enquiry is limited to the eight factors listed in paragraphs (i) to (viii). Speed,[150] for instance, states:

> The only matters which it is relevant to consider are those contained in paragraphs (i) to (viii). No other matters are relevant.

Moreover, in *Peabody*, Hill J., came to a similar conclusion. His Honour was of the opinion that:

> It will be seen that...Section 177D requires an objective conclusion to be drawn having regard to the matters referred to in para. (b)...but no other matters. It is notable that the actual subjective purpose of any relevant person is not a matter to which regard may be had in drawing the conclusion.

The High Court did not consider the issue. It is, however, submitted, that the approach of Hill J is questionable, and, it is probably more correct to assume that the eight matters are not exhaustive. This was the apparent intention of the *Explanatory Memorandum* which states:

> In coming to a conclusion about the application of Part IVA in particular situations, it will be necessary to examine all relevant external evidence...it will require a [wide]...enquiry directed to finding, on objective grounds, what was the purpose of a person who entered into the arrangement.

As Binetter[151] observes, if the only matters that are to be taken into account, are those listed, Section 177D(b) would probably have specifically expressed such a limitation. He states:

> However, the enumeration of the eight matters to which regard is to be had and/or the use of the words "having regard to" do not as a matter of necessary construction mean that they are the only matters to be taken into account. The words in Section 177D(b) of the Act are "having regard to" and not "having regard only to".

Moreover, in *Case Y13*[152] Professor Grbich did imply that the criteria were not in fact exhaustive, and that, other evidence (for example, oral testimony), might be taken into account:

> It is to be noted that under Section 177D the transaction is annihilated where "it would be concluded", having regard to a very wide range of objective factors about the scheme, its substance and its context, that the person who carried it out did so for the purpose of obtaining a tax benefit. Whilst it does not exclude subjective factors, inferences from objective facts are the primary focus of the legislation.

The final point in relation to Section 177D(b) concerns the weighting to be given to the various enumerated items and any other evidence. There is no indication in Section 177D(b) itself and one expects it will be a question of fact in any case. In *Case W58* Hartigan J supported this view. He said:

> Section 177D(b) then sets out eight matters to which regard must be had by the Tribunal in ascertaining the purpose of the taxpayer. Those matters will not always all be of the same weight in particular cases. In every case it is necessary to consider the particular facts at issue.

Similarly, in *Peabody*[153] O'Loughlin J was not prepared to accept that there must be a finding that was adverse to the taxpayer in each of the eight inquiries prescribed by Section 177D(b). His Honour felt that it was sufficient that one of the factors pointed to an object or purpose of obtaining a tax benefit. A similar approach was adopted by Hill J on appeal to the Full Federal Court:[154]

> In arriving at his conclusion, the Commissioner must have regard to each and every one of the matters referred to in Section 177D(b). This does not mean that each of those matters must point to the necessary purpose referred to in Section 177D. Some matters may point in one direction and others may point in another direction. It is the evaluation of these matters, alone or in combination, some for, some against, that Section 177D requires in order to reach the conclusion to which Section 177D refers.

This is a reflection of the fact that the emphasis of Section 177D(b) is evidential or procedural as opposed to being substantive, such as, the definition of the term purpose contained in Section 177D or tax benefit under Section 177C.

(a) *The manner in which the scheme was carried out*

Section 177D(b)(i) directs that the manner in which the scheme was entered into or carried must be examined in determining the purpose or purposes of the arrangement. This test essentially focuses on the factual background relating to the scheme and the temporal element of the scheme, comprising, the individual steps that were undertaken, and the separate elements that form the entire scheme. Mannix[155] states:

> This test would seem to relate to the background of the scheme and the alternative purposes which could be attributed to the taxpayer in entering into it.

For instance, in *Case W58* the taxpayer formed a family trust with a corporate trustee to derive income at a lower rate of tax. Hartigan J considered that Section 177D(b)(i) directed him to examine the scheme comprising the trust, company, related contracts, and annual operations of the trust.

(b) *The form and substance of the scheme*

The test under Section 177D(b)(ii) focuses on two completely opposite concepts. In examining the form of the scheme, regard will be had to the legal effect of the entities and transactions which comprise it, while an examination of the substance of the scheme will, concentrate on the end result or economic effect that the scheme achieves. The former facet of Section 177D(b)(ii) in practice will overlap with the test mandated under Section 177D(b)(i), while the latter clearly directs the inquiry to the economic, as opposed to the legal, consequences of the scheme. Speed[156] notes:

> The reference in paragraph (ii) to the form and substance of the scheme ensures that the enquirer examines the economic consequences of the transaction and not simply the legal consequences.

The reference to economic substance seems to be directed at removing the trend in some cases under Section 260 to ignore the economic substance of an arrangement altogether.[157] In *Case W58* Hartigan J provided some insight into how might

Section 177D(b)(ii) applied. In that case the taxpayer had alienated income to a trust managed by a corporate trustee. The trust made distributions to the beneficiaries to enable them to derive the income at a lower tax rate. Hartigan J noted that the legal form of the transaction had already been examined under paragraph (a) but that the economic substance of the scheme was, despite the separate legal existence of the trust, that the scheme "essentially allowed the taxpayer to act in such a way as to attract to himself a lower incidence to personal tax."[158]

In *Peabody* O'Loughlin J had occasion to consider the scope of paragraph (i). In that case the economic result achieved by the scheme was to transfer value from one parcel of shares to another by altering the rights and liabilities attaching to the first parcel.

(c) *The time the scheme was entered into and carried out*

Section 177D(b)(iii) directs the attention of the court[159] to the time at which the scheme was carried out, and the period of time during which the scheme was carried out. This test essentially compliments the two previous tests by focusing attention on the overall temporal dimension of the scheme. In this way, paragraph (i) directs attention to the background steps and ultimate legal form of the scheme, paragraph (ii) to the economic substance, and paragraph (iii) to the period of its operation.[160]

(d) *The result achieved*

Section 177D(b)(iv) examines the result that would have been achieved but for the scheme. Mannix[161] states:

> This test relates to the results which would arise out of the normal operation of the Act, excluding the possible application of Part IVA, and would be considering the position of the tax benefit in relation to the position that would arise if the scheme had not been entered into.

To a large extent paragraph (iv) is "question begging" because a tax benefit must accrue if Part IVA is to apply at all. This test probably is intended to reinforce the fact that a tax benefit is a material evidential factor in determining taxpayer purpose.

In *Case W58*,[162] Hartigan J considered the effect of a corporate trust structure and found that the result of the scheme was to enable the taxpayer to reduce his incidence to income tax compared with that to which he would have otherwise been exposed, as a consequence of the services that he had rendered to with his former employer. The income generated by the taxpayer was split as a result of the scheme between the taxpayer and the members of his family through the corporate trustee and the trust mechanism.

(e) *Any change in the financial position of the taxpayer or any other person*

Section 177D(v) and (vi) indicate that regard must be had to the change in the financial position of the taxpayer or any other person. These tests relate to the financial benefit that the taxpayer and any connected persons might experience as a result of the payment of less tax. For instance, in *Case W58*, Hartigan J found that the trust structure as between the taxpayer and his family resulted in an overall reduction in the incidence of tax.

(f) *Any other consequence for the taxpayer or any other person*

Under Section 177D(b)(viii) any non-financial consequence accruing to taxpayers or any other person specified under paragraph (vi) must be taken into account. This would potentially include benefits flowing from a scheme that were non-tax orientated and would evidentially raise inferences as to other purposes behind a scheme. In *Case Y13* Professor Grbich considered that a corporate trust structure not only gave rise to a tax benefit but also improved the operating and managerial aspects of the taxpayer's proposed business.

(g) *The nature of any connection between the taxpayer and any other person*

Section 177D(b)(viii) examines the relationship between the taxpayer and any other person specified under paragraph (vi) whether connected by business, family, or other factor. This test simply focuses on the relationship of a taxpayer and a person who may benefit from the operation of a scheme.[163]

VII. THE RECONSTRUCTIVE POWER OF PART IV A – SECTION 177F

Section 177F(1) contains the power for the Commissioner to make adjustments to a taxpayer's income return after it has been decided that Section 177D applies. The section gives the Commissioner two powers:

- In the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income, the Commissioner may determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income.
- In the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in relation to a year of income, the Commissioner may determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income.

Section 177F(3) gives the Commissioner a complementary function where he has exercised his discretion under Section 177F(1). Where under Section 177F(1) the Commissioner has either included an amount in the assessable income of taxpayer or denied an allowable deduction to a taxpayer, the Commissioner may exercise a power to reconstruct the tax account of another taxpayer in such a way that will treat the taxpayer as not having derived income which under the scheme he has derived, or will treat him as being entitled to a deduction to which, under the scheme, he would not be entitled. The general effect of Section 177F was explained by the *Explanatory Memorandum*[164] in these terms:

> Where on the application of...the general provisions of Part IVA...it is found that a tax benefit has been obtained, the Commis-

> sioner of Taxation will be authorized, under Section 177F, to cancel the whole or (if the circumstances warrant it) a part of the tax benefit and, if it is fair and reasonable to do so, to effect corresponding tax adjustments in favour of the taxpayer or other persons concerned. In this way the particular "non-taxable" position sought for by the arrangement is annihilated and a taxable" situation appropriate to the case is reconstructed.

There has been no real disagreement amongst the commentators[165] that this aspect of Part IVA is effective in granting the Commissioner a power of reconstruction that was completely lacking in Section 260. Mannix[166] states:

> Section 177F introduces the major difference between Part IVA and the former Section 260. In many cases decided by the courts under Section 260 it has been pointed out that Section 260 was an annihilating provision and contained no power to rectify an agreement or an arrangement: see *Bell v. FC of T* (1953) 87 CLR 548; 5 AITR 462; *War Assets Pty Ltd v. FC of T* (1954) 6 AITR 1; AITL & P [260/16].

The reason for the presence of Section 177F was explained in similar terms in the *Explanatory Memorandum*:[167]

> [Section 260 did] not, once it [had]...done its job of voiding an arrangement, provide a power to reconstruct what was done, so as to arrive at a taxable situation ....Section 177F...aim[s] to overcome [this]...

The decisions on Part IVA to date have also reached a similar conclusion. A clear analysis of the function of Section 177F was provided by Professor Grbich in *Case Y13*:

> Under [Section 177F(1)] the Commissioner is given adequate basis so called "reconstruction" powers.

While in *Fletcher*, the Full Federal Court simply noted that:

> Section 177F gives to the Commissioner a discretion to cancel a tax benefit obtained by a taxpayer in connection with a scheme to which the Part applies.

O'Loughlin J in *Peabody*[168] provided a somewhat clearer analysis of the scope of Section 177F. His Honour observed that if the qualifying circumstances of Section 177D were found to exist, it was open to the Commissioner to invoke the power contained in Section 177F. Section 177F then empowered the Commissioner to ignore the consequences of the transaction, and reconstruct the tax accounts of the taxpayer so as to counteract the tax advantage. The same observation was made by Hill J in the Full Federal Court and the High Court.

The nature of the reconstructive power contained in Section 177F can be examined in relation to the three categories of income tax avoidance identified by Stiglitz.[169]

A. Income splitting arrangements

1. Alienation arrangements

In this case the Commissioner has power under Section 177F(1)(a) to include the income in the assessable income of the taxpayer. Where Section 177F(1)(a) has application, Section 177F(2) deems the amount to be included in the assessable income of the taxpayer by virtue of such provision of the legislation as the Commissioner determines. For instance, in *Case W58*[170] the taxpayer alienated income to a family trust. Hartigan J held that the whole of the alienated income could be included in the income of the taxpayer pursuant to Section 177F(1)(a).

2. Deduction arrangements

In this case the Commissioner has power under Section 177F(1)(b) to disallow the deduction, or part of the deduction to the taxpayer. In *Fletcher* the Full Federal Court approved the decision of the Administrative Appeals Tribunal when it utilized Section 177F(1)(b) to disallow a deduction paid under a complex tax avoidance scheme.

B. Conversion arrangements

In this case the amount that is capital under the scheme may be treated as included in the assessable income of the taxpayer under Section 177F(1)(a). Section 177F(2) will deem the amount to be included in the assessable income of the taxpayer by virtue of such provision of the legislation as the Commissioner determines. Although Part IVA was ultimately found by the Full Federal Court and the High Court not to have application in *Peabody*,[171] if one focuses on the decision of O'Loughlin J in the Queensland Federal Court, it is apparent, that an amount that would have otherwise been a capital receipt in the hands of a family trust was treated as income pursuant to Section 177F(1)(a).

C. Deferral arrangements

In this case the Commissioner has power under Section 177F(1)(a) to include the income, the derivation of which has been deferred, in the assessable income of the taxpayer. This would essentially be the same as a scheme involving alienation of income such as *Case W58*. Where Section 177F(1)(a) has application Section 177F(2) deems the amount to be included in the assessable income of the taxpayer by virtue of such provision of the legislation as the Commissioner determines. In the event of an expense being incurred it may be disallowed under Section 177F(1)(b), such as occurred, in *Fletcher*.

VIII. ADMINISTRATION

A. Assessments

Where the Commissioner decides that Part IVA has application, and determines pursuant to Section 177F(1) the tax consequences to the taxpayer, the consequential determination will form part of the normal assessment procedure pursuant to Section 166 of the Act. This is implicit in the scheme of Section 177F(1) which directs the Commissioner to "give effect" to his determination once completed. In this sense the Commissioner must give effect to the determination through the mechanism of the assessment procedure. It is to be noted that pursuant to Section 177G(1) any assessment may be amended at any time before the expiration of 6 years after the date on which tax became due and payable under the assessment if the amendment is for the purposes of giving effect to Section 177F(1).[172]

B. Compensating adjustments

Pursuant to Section 177(3) the Commissioner may make a compensating adjustment in favour of the taxpayer subject to Part IVA and any other taxpayer if he is of the opinion that it would be fair and reasonable to do so. Where the Commissioner determines that a compensating adjustment is needed then he is required to take such action as he considers necessary to give effect to such a determination.[173] Sections 177F(5) to (8) entitles a taxpayer to request that the Commissioner make a determination under Section 177F(3). Section 177F(5) allows the taxpayer to make a request at any time in writing for a determination to be made. It is important to observe that the Commissioner's power to make a determination under Section 177F(3) only arises if a determination has been made under Section 177F(1). This would tend to prejudice third parties who were not actually subject to Part IVA and a determination under Section 177F(1) but were nonetheless effected by a tax avoidance scheme.

C. Time of determinations

An issue that has arisen over the application of Part IVA, is whether the Commissioner may make a determination after a taxpayer's objection against a assessment has been disallowed and an appeal has been made to the Federal Court in circumstances where the assessment was based on provisions other than Part IVA.[174] In *FCT v. Jackson*[175] this issue was considered by the Full Federal Court. The Court held that where the Commissioner had more than one power to assess, and, in the course of making an assessment used a particular provision, but subsequently sought to justify that assessment on another provision, such as Part IVA, he would be limited to the provision used initially. The Federal Court held that the Commissioner would have to make an amended assessment if Part IVA was to be additionally relied on.

1. Objections and appeals

The objection procedure for a determination under Section 177F(1) is the same as any other assessment and would be authorised by Section 185 to object to any such determination. Further a taxpayer who wishes to object to a determination issued pursuant to Section 177F(3), has the right to object by virtue of Section 177F(8).

2. Onus

In any proceeding in which a taxpayer objects to a determination either under Section 177F(1) or (3), the burden of proof essentially lies with the taxpayer. Section 190(b) specifically places the burden of proof on the taxpayer. It will be noted that the burden of proof relates to questions of fact. Section 190(b) qualifies the general proposition that the burden shall be on the taxpayer, by specifying that the burden on the taxpayer shall relate only to proving that an assessment is excessive.

It will be noted that the High Court in *Peabody* did emphasize the requirement that the Commissioner supply the taxpayer with adequate particulars supporting a Part IVA assessment.[176]

3. Advance rulings

It will be noted that a new system of public and private rulings was introduced on 1 July 1992. It is beyond the scope of this chapter to examine this system fully, however, a few comments may be made. Under Part IVAAA and IVAA of the Tax Administration Act 1953 (Cth) public and private rulings can be legally binding on the Commissioner where they relate to arrangements that began or began to be carried out on or after 1 July 1992.[177] A scheme under Part IVA would clearly come within the scope of an "arrangement" as the definitions are identical.[178] Public rulings[179] deal with the way in which a tax law is to apply to any person or class of persons in relation to an arrangement or class of arrangements.[180] A public ruling may also deal with the exercise of a discretion under the legislation and in this sense would cover Part IVA.[181] Private rulings[182] deal with specific taxpayers who request them and in relation to an arrangement that is being carried out, is proposed to be carried out or has been carried out since 1 July 1992. A private ruling may be sought in relation to a discretion exercised by the Commissioner and as such would cover Part IVA.[183] Public and private rulings are legally binding on the Commissioner if they are favourable to a taxpayer which is held under the legislation to be a situation where an assessment to tax in accordance with the ruling results in a lower tax liability than an assessment in accordance with the law or another ruling.[184] While no right of appeal lies against a public ruling one does exist in relation to a private ruling.[185]

4. Penalties

If a determination is made under Section 177F, the taxpayer who would have received a tax benefit had Part IVA not applied is liable for a penalty equal to 50 percent of the tax sought to be avoided, reduced to 25 percent if it is reasonably arguable that Part IVA does not apply.[186]

IX. CONCLUSIONS

A few concluding observations are appropriate. It has been the underlying theme of this article that the appropriate approach to the interpretation of Part IVA is that stated in the *Explanatory Memorandum*. In this sense Part IVA should be interpreted to advance the general approach adopted by Lord Denning in *Newton* in relation to the former Section 260. If this approach is adopted, normal commercial or family transactions that contain a tax advantage will not be caught by Part IVA. It is the submission of this article that the approach of both Hill J in the Full Federal Court and the High Court in *Peabody* generally adopts this approach and recognizes a distinction between schemes that are driven predominantly by tax reasons (and which are caught by the Part) and those schemes that are normal or commercial or family dealings which are structured tax efficiently (that are not caught by the Part).

1. The basis for this article is relevant material derived from a dissertation submitted in fulfilment of a Doctorate of Philosophy in Commercial Law in the University of Auckland which was awarded in November 1994. I would like to express my appreciation to the Department of Accounting and Finance in the University of Western Australia and particularly to Richard Fayle for the thoughtful and encouraging support given when an abridged version of this paper was presented as a seminar in the Spring of 1992.
2. 92 ATC 4,585 (Fed Ct); 93 ATC 4,104 (Full Fed Ct); (1994) 68 ALJR 680.
3. Herein "Part IVA". Generally see: Income Tax Laws Amendment Bill (No 2) 1981 *Explanatory Memorandum* Government Printer; Binetter, M.T.R., "A Reflection on Part IVA", 21 *Taxation in Australia* (1987), at 404; Cassidy, J., "*Case W58*: Death Knell for Family Companies and Trusts?", 26 *Taxation in Australia* (1992), at 479; Dabner, J., "Tax Planning for Professional People – What Remains after the Unholy Trinity", 21 *Taxation in Australia* (1987), at 568; Dabner, J., "The First Part IVA Cases and Rulings – The Worst Fears Realized", 24 *Taxation in Australia* (1990), at 665; Dabner, J., Burton, M., "Part IVA: Walking the Dog", 26 *Taxation in Australia* (1992), at 609; Fayle, R.D., "Tax Planning and Current Thinking", 17 *Taxation in Australia* (1983), at 704; Ford, H.A.J., "Legislation Against Tax Avoidance: The Australian Experience", *British Tax Review* (1961), at 247; Forsyth, N.H.M., "The General Structure of Part IVA", 10 *ATR* (1981), at 132; Grbich, Y.F.R., "Section 260 Re-examined: Posing Critical Questions About Tax Avoidance", 1 *UNSWLJ* (1976), at 211; Gzell, I.V., "Taxation in the Eighties", 15 *Taxation in Australia* (1980), at 169; Hill, D.G., "*Commissioner of Taxation v. Galland* – Anatomy of a Saga", 21 *Taxation in Australia* (1987), at 565; Hulme, S.E.K., "The Place of Part IVA in the Income Tax Assessment Act", 10 *ATR* (1981), at 121; Madden, B., "The Revival of Section 260: Implications for Part IVA", 19 *Taxation in Australia* (1985), at 709; Munn, G.D., "Part IVA ITAA: A Practioners View", *The Australian Accountant* (October 1982), at 606; Murphy, T., "Part IVA: The Broadest Ambit", 25 *Taxation in Australia* (1990), at 53; Pape, B.R., "Misleading Cases: Misnomers or Mistakes", 25 *Taxation in Australia* (1990), at 449; Roach, P.M., "The Commissioner's Net Perceptions of Power", 27 *Taxation in Australia* (1992), at 21; Speed, R., "The High Court and Part IVA", 15 *ATR* (1986), at 186; Trebilcock, M.J., "Section 260: A Critical Examination", 38 *ALJ* (1964), at 237; Wilkins, D.C., "Tax Avoidance – Section 260 Replaced", *The Australian Accountant* (July 1981), at 403; Mannix, E.F., "Tax Avoidance 1981: the New Law", *Australian Federal Tax Reporter* (1981), at V.7 para. 81.250 ("AFTR").
4. Herein "Sec. 260".
5. See in particular *FCT v. Casuarina Pty Ltd* (1971) 127 CLR 62; *Mullens v. FCT* (1976) 135 CLR 290; *Cridland v. FCT* (1976) 135 CLR 330; *Slutzkin v. FCT* (1977) 140 CLR 314. Also see the comments of Barker J in *Challenge Corp Ltd v. CIR* [1986] 2 NZLR 513, 520, where his Honour felt that certain decisions of the High Court of Australia in the last years of Sec. 260 had shown a markedly relaxed approach to tax "avoidance" schemes. Speed, *supra* note 3, at 160, states that the different philosophies of two or three dominant judges have been responsible for widely differing interpretations of Sec. 260 which paid "scant regard to earlier" precedent.
6. See Marr, D., *Barwick* (1980), at 228-229. Marr notes that the defeat of Barwick in *Newton v. FCT* (1957) 96 CLR 578 (HC); [1958] AC 450 (PC), not only lost his clients a great deal of money after a six year legal battle but also gave the Australian courts a chance to reconsider the earlier decision *W P Keighery Pty Ltd v. FCT* (1957) 100 CLR 66 in which Barwick had successfully argued that Sec. 260 was subject to specific sections of the legislation that offered so-called "choices" to taxpayers in the way they ordered their affairs to save tax. Barwick was Chief Justice when the next major case came before the High Court, *FCT v. Casuarina Pty Ltd*, to test the same issue. Casuarina Pty Ltd has constructed an elaborate pyramid of companies which technically turned it into a public company which was not taxable on its undistributed profits. The High Court with the concurrence of Barwick CJ reaffirmed the concept developed in *W P Keighery Pty Ltd v. FCT*, and held that Casuarina Ltd had merely been exercising a choice in becoming a public company. Marr observes:
The Casuarina Case became the cornerstone of the tax avoidance industry in Australia and Barwick became the leading influence on the High Court's tax decisions which in time stripped Section 260 of almost all its remaining effect. How was it that the court could take a tough, all-embracing law against tax evasion and reduce it almost to nothing?
See also Lehmann, G., "The Income Tax Judgments of Sir Garfield Barwick: A Study in the Failure of the New Legalism", 9 *Monash ULR* (1983), at 115, 142, where he states that the decisions of Barwick CJ had the effect of creating "an elaborate exegesis of the section" which ostensibly is so removed from the words of Sec. 260 and earlier case law "that policy, rather than literalism seems to have determined the result".
7. (1957) 96 CLR 578 (HC); [1958] AC 450 (PC). In that case Lord Denning, 464, concluded that the submissions of Sir Garfield Barwick, if accepted, "would deprive the words [of Sec. 260] of any effect."
8. Cf. Dabner and Burton, *supra* note 3, at 608, who suggest that the Second Reading Speech to the Bill, op. cit., indicates that Part IVA is to apply only to "blatant, artificial or contrived" transactions. Utilizing the Acts Interpretation Act 1901 (Cth), Sec. 15 AB(1), the authors suggest that the court would utilize the second reading speech to resolve what the authors see as latent ambiguities in the drafting of Part IVA. They suggest that reference to the second reading speech would exclude from the scope of Part IVA those arrangements which could be characterized as in the ordinary course of commercial or family dealing notwithstanding that a significant outcome of the arrangement was to reduce a taxpayer's liability to tax.
9. See *supra* note 3, at 4.
10. See, for instance, the comments of Binetter, *supra* note 3, at 404. He actually regards Part IVA as being less general than Sec. 260; Dabner, "The First Part IVA Cases and Rulings – The Worst Fears Realized", *supra* note 3, at 672-673.
11. Such as the appropriate definition of tax benefit under Sec. 177C. See Hulme, *supra* note 3, at 122.
12. 93 ATC 4,104, 4,110 (Full Fed Ct).
13. Sec. 177A(1) defines scheme to be: (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and (b) any scheme, plan, proposal, action, course of action or course of conduct.
14. Tax benefit is defined by Sec. 177C(1) to be: (a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out (Sec. 177C(1)(a)); or (b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out (Sec. 177C(1)(b)).
15. Sec. 177D will apply if: (a) the sole actuating purpose is to obtain a tax benefit (Sec. 177); or (b) there are two or more actuating purposes, one of those purposes is a dominant purpose (Secs. 177D and 177A(5)).
16. The section gives the Commissioner two powers:
(a) in the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income the Commissioner may determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; and
(b) in the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in relation to a year of income the Commissioner may determine that the whole or a part of the deduction or of the part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income.
17. See *Avon Downs Pty Ltd v. FCT* (1949) 78 CLR 353.
18. It is to be noted that the scheme to which Part IVA applies must have been or is one entered into after 27 May 1981 or that has been or is carried out or commenced after that date (other than a scheme that was entered into on or before that date). Therefore if the "scheme" as determined by the court has been entered into before 27 May 1981 and is carried out after that date then prima facie Part IVA can have no application. The exception to this might be in the case of a unilateral scheme because there can be no "entering into" such a scheme. In this

case if the scheme was put in place before the operative date but commenced after that date Part IVA might well apply because the scheme would have been carried out or commenced after 27 May 1981 and it would not have been "entered into" before that date. See the comments of O'Loughlin J in *Peabody v. FCT*, noting the existence of the operative date.

19. [1958] AC 450, 465.

20. *Id.* See also the comments of Avery Jones, J.F., "Nothing Either Good or Bad, but Thinking Makes it So – The Mental Element in Anti-Avoidance Legislation I", *British Tax Review* 9 (1983), at 38. He notes that the Capital Gains Taxes Act 1979 (UK), Sec. 87(1), which applies to "a scheme or [arrangement] ... of which the main purpose ... is avoidance of tax", will encompass "a number of interrelated transactions". See also *IRC v. Payne* 23 TC 610.

21. It is of interest that the *Explanatory Memorandum* uses the term "arrangement" interchangeably with the term "scheme". It is stated "that "scheme" is to be defined in a way that covers the various forms in which tax avoidance *arrangements* may be found" (emphasis added). Commensurate with the Acts Interpretation Act 1901 (Cth), Sec. 15AB(1) the court would be entitled to use the *Explanatory Memorandum* to confirm the conclusion that the concept conveyed by *Newton v. FCT*, was apparent in the plain words of Sec. 177A(1) and (3).

22. (1957) 96 CLR 578, 598 (HC).

23. There has been no discernable trend in the cases concerning Sec. 260 in favour of a sub-scheme approach although in *Clarke v. FCT* (1932) 48 CLR 56 the High Court of Australia may have opted for this approach. In that case the taxpayer intended to grant a lease of his hotel to a tenant. The tenant agreed to pay the taxpayer a premium of £ 20,000 (payable in two instalments) and a weekly rental of £ 30. However, to avoid being assessed to tax on the first instalment of the premium (which amounted to £ 8,651 after deductions) the taxpayer entered into the following structure. A private company which the taxpayer owned was granted a lease for a term of five years at a rental of £ 30 per week. The company then transferred the lease to the tenant for a sum of £ 20,000 pursuant to the voluntary winding up of the company. The High Court examined the arrangement and appears to have focused on the interposition of the company as the material arrangement. This had no other purpose than avoiding the liability on the premium. However, the wider scheme consisting of the initial grant to the company, the transfer by the company and the subsequent liquidation was not considered to be the material arrangement. It is submitted that if this had been considered to be the arrangement the purpose of the taxpayer might simply have been found to be to grant the lease rather than avoid tax.

24. See "The First Part IVA Cases and Rulings – The Worst Fears Realized", *supra* note 3, at 671. Dabner suggests that this is necessarily so because once a purpose of obtaining a tax benefit is identified in relation to a sub-scheme that contains a tax saving transaction Part IVA will apply because this will not only be the dominant purpose but also the sole purpose of the sub-scheme. In this way the requirement of a "dominant" purpose is eschewed.

25. See *supra* note 3, at 534.

26. 89 ATC 524.

27. 91 ATC 191.

28. See generally *Cassidy*, *supra* note 3, at 483-484; Dabner, "The First Part IVA Cases and Rulings – The Worst Fears Realized", *supra* note 3, at 668-673; Dabner and Burton, *supra* note 3, at 609.

29. 89 ATC 524, 534.

30. See the comments of Cassidy, *supra* note 3, at 483. The author suggests that Hartigan J felt that the purpose underlying each step could be analysed separately, and, as long as one part was tainted by an illegitimate purpose, the whole scheme was so affected. She notes that Hartigan J relied on Sec. 177A(5) by inferring that the necessary purpose of gaining a tax benefit would exist if it was the dominant purpose for entering into the scheme or part of the scheme.

31. "The First Part IVA Cases and Rulings – The Worst Fears Realized", *supra* note 3, at 671. See the latter analysis of Dabner and Burton, *supra* note 3, at 609, where they suggest that the approach of Hartigan J is significant as it enables the Commissioner to isolate a particular part of a scheme in order to identify the dominant purpose of obtaining a tax benefit, notwithstanding, that the overall scheme did not necessarily have the dominant purpose of obtaining a tax benefit.

32. 91 ATC 191, 194. See the analysis of Dabner and Burton, *supra* note 3, at 610, where they acknowledge that the scheme "clearly embraced not only the trust arrangements, but also the income earning activities of the taxpayer".

33. 91 ATC 191, 197. Also see Roach, *supra* note 3, at 26. Roach discusses the decision in *Case X17*, where as a Member of the Administration Appeals Tribunal, he indicated that in the context of an otherwise bona fide deduction, the early incurrence of the expenditure to gain a timing advantage with respect to income tax, should not attract the operation of Part IVA. In this sense he appears to imply that a global approach to the concept of scheme is appropriate because the example of a scheme in the context of the case he discusses, consists of a bona fide deduction arising out of a contractual obligation and the incurrence of the expenditure. Cf. *Arthur Murray (NSW) Pty Ltd v. FCT* (1965) 114 CLR 314.

34. 90 ATC 648.

35. 90 ATC 648, 653. See the comments of Roach, *supra* note 3, at 25-27. In *Case X90*, the taxpayer was a draughtsman who had originally formed a partnership with his wife and provided his services to his employer as an independent contractor on behalf of the partnership. In 1981 the taxpayer established a discretionary family trust utilizing a corporate trustee. The taxpayer then entered into a contract of employment with the corporate trustee which provided his services to the former employer. Income was earned by the corporate trustee and distributed to the beneficiaries and taxed at a lower rate. The scheme was found to consist of the change in the status of the taxpayer to an independent contractor, the creation of the trust using the corporate trustee, the related contracts and the yearly distribution by the trust. Other cases to consider the concept of scheme are: *Case X17* 90 ATC 193; *Case Y4* 91 ATC 114; *Case Y28* 91 ATC 296.

In *Case X17*, the taxpayers were three companies in a large group of commercial interests involved in the fashion industry. One company manufactured clothing products and supplied them to the two other companies which marketed the goods extensively using the services of a particular advertising agency. It was decided to implement an advertising programme for the 1986 and 1987 income years. However, to reduce their taxation liability the two marketing companies attempted to accelerate the incurrence of the expenditure in relation to the two years by entering into forward contracts with the advertising company in 1985 and 1986 respectively. The manufacturing company entered into a similar agreement for the supply of raw materials in 1986 and 1987 and executed forward contracts in 1985 and 1986. In each case, a scheme was found to exist consisting of the relevant contract made between the company and the supplier and the subsequent claiming of the expenditure. Similarly in *Case Y28*, a scheme in all material respects the same as *Case X90*, was found to be within the scope of Sec. 177D.

In *Case Y4*, the taxpayer was a medical company incorporated by a general practitioner. The company borrowed $ 40,000 to purchase the practice of the doctor who used the proceeds to discharge a mortgage on his home. The structure had the object of converting a non-deductible interest payment on a domestic home into a deductible expenditure in the accounts of the taxpayer. It was found a scheme existed, that consisted of the incorporation of the company, the purchase of the practice and the borrowing by the taxpayer, the payment to the doctor and the subsequent repayment of the mortgage. Cf. Dabner and Burton, *supra* note 3, at 613, who suggest that the scheme in the latter case was simply the execution of the new mortgage.

36. Such as occurred in *Grimwade v. FCT* (1949) 78 CLR 199 and *Gorton v. FCT* (1965) 113 CLR 604.

37. 93 ATC 4,104, 4,111 (Full Fed Ct).

38. *Ibid.*

39. [1967] 2 AC 18.

40. The Finance Act 1960 (UK), Sec. 28(1), which stated:

Where ... (*b*) in consequence of a transaction in securities or of the combined effect of two or more such transactions, a person is in a position to obtain, or has obtained, a tax advantage, then unless he shows that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained, this section shall apply to him in respect of that transaction or those transactions ...

This would equally apply to Part IVA. See also the comments of Dabner and Burton, *supra* note 3, at 614. The authors submit that the definition of scheme in Part IVA engenders the problem of identifying the scope of the relevant scheme because it refers to both individual acts and broad courses of conduct. It is suggested that a "scheme" for the purposes of Part IVA should be viewed broadly. Only in this way is it possible to make sense to reference to parts of schemes in Secs. 177A(5) and 177D.

41. [1967] 2 AC 18, 27.

42. *Peabody v. FCT* 92 ATC 4,585, 4,594.

43. *Id.* His Honour also considered whether the scope of the scheme was in fact wider than the mere conversion of the shares to "Z class" preference shares. O'Loughlin J felt that it might in fact encompass the complex funding arrangements utilized to enable the shelf company to purchase the minority shareholding. However, O'Loughlin J noted that a wider view of the scheme would not necessarily prevent the application of Part IVA if the dominant purpose of the scheme was to obtain a tax benefit.

44. O'Loughlin J was prepared to accept that if the scheme was to be regarded as having wider scope the scheme would be considered in its entirety and the dominant purpose of the global scheme examined. He noted:

Whether the scheme should be classified as stopping with the conversion of the shares to Z class shares or whether it should be extended to include Loftway's issue of redeemable shares to fund their purchase is an interesting question, but it is one which it is not necessary to decide. Let it be assumed that the scheme did extend to the legitimate purpose of obtaining cheap fiance through the issue of redeemable preference shares; that will not save the relevant taxpayer if some other proscribed purpose existed that can properly be classified as the dominant purpose of the plan: (sub-sec. 177A(5)).

45. (1994) 68 ALJR 680, 685.
46. *Ibid.*
47. *Ibid.*
48. 88 ATC 113 (AAT); 88 ATC 4834 (Full Fed Ct); (1991) 173 CLR 1 (HC).
49. 88 ATC 113, 120-121.
50. 88 ATC 113, 120.
51. 88 ATC 4,834, 4,846. The Full Federal Court simply noted:

In our opinion the Tribunal did not err in law in holding, in the present case, that it had jurisdiction to determine under Sec. 177F that the deductions claimed by the applicants should not be allowable in the relevant year of income.

52. 88 ATC 113.
53. 88 ATC 4,834.
54. (1991) 173 CLR 1, 24 (HCA).
55. [1958] AC 450, 465. In that case Lord Denning seemed to indicate that an arrangement was "something in the nature of an understanding between two or more persons". Forsyth, *supra* note 3, at 133, suggests that the rationale for the inclusion of unilateral acts in the definition of scheme was to overcome the decision of the High Court of Australia in *Grimwade v. FCT* (1949) 78 CLR 199, 220, where Latham CJ and Webb J held that a "transaction" within the meaning of the Gift Duty Assessment Act 1941-42 (Cth), Sec. 4(f), had to be a transaction with some other person. Their Honours contrasted this concept with that of a mere "act" which they impliedly took to encompass a unilateral act. Cf. *Gorton v. FCT* (1965) 113 CLR 604, 622, per Barwick CJ and Taylor J.
56. Cf. Spry, I.C.F., *Section 260 of the Income Tax Assessment Act* (2nd ed., 1978), at 12. Spry makes the pertinent observation that it is possible to conceive of circumstances such as when a trustee declares complex trusts in favour of unborn children, where one person only is involved in a series of transactions directed at avoidance, and, that the definition of "arrangement" established by the Privy Council in *Newton v. FCT* must surely cover such an eventuality. See further, Roach, *supra* note 3, at 24, who notes that the concept of scheme extends to both unilateral proposals and actions.
57. This includes the Income Tax (International Agreements) Act 1953 (Cth).
58. Sec. 177B(2) excludes from the ambit of Part IVA Division 16C of Part III. Under Divison 16C of Part III a deduction is available for deposits made under the income equalization deposits scheme. A qualifying primary producer may be allowed a deduction for deposits that bear interest and is liable to have a repayment included in assessable income. Sec. 177B(3) effectively reflects the "last resort" character of Part IVA. The *Explanatory Memorandum* explained the effect of Sec. 177B(3) as being applicable where provisions such as Sec. 65(1), Secs. 75B(7) and 82KJ limit the deductibility of an amount that would be allowable but or apart from the particular provision. In this case the particular provision is to be read as covering a deduction that is allowable but for or apart from Part IVA and the reconstruction provisions of Sec. 177F. This means that the particular provision will have effect before Part IVA is applied. The *Explanatory Memorandum* illustrates this by reference to Sec. 65(1) which operates by allowing an expense to be deductible only to the extent the Commissioner considers it to be reasonable in amount where the expense, which would but for Sec. 65(1) be allowable as a deduction, is paid to an associated person. If the facts of a case indicated that both Part IVA and Sec. 65(1) can apply then Sec. 177B effectively means that the reference in Sec. 65(1) to the deduction that would "but for this sub-section" be deductible is to be read as though it said "but for this sub-sec. and sub-sec. 177F(1)". This means that the potential application of Sec. 177F must be considered after the application of Sec. 65(1). Sec. 177B(4) performs an identical function to Sec. 177B(3) in relation to provisions that limit deductions being otherwise allowable. Sec. 177N(5) and (6) are similar to Sec. 177B(3) and (4) and operate in relation to a Sec. 159TL rebate.
59. See *WP Keighery Pty Ltd v. FCT* (1957) 100 CLR 66; *Mullens v. FCT* (1976) 135 CLR 290; See the analysis of the choice doctrine by Grbich Y.F.R., "Section 260 Re-Examined: Posing Critical Questions About Tax Avoidance", 1 *UNSWLJ* (1976), at 211, 217-219. He observes that successive decisions of the High Court "allowed that branch of authority to continue as an anomalous growth".
60. See *Slutzkin v. FCT* (1977) 140 CLR 314.
61. See *supra* note 3, at 9.
62. See *supra* note 3, at 159. Speed supports his contention that Sec. 177B(1) does in fact negate the effect of the choice doctrine by reference to the interpretative approach the court would adopt in ascertaining the meaning of Sec. 177B(1); Sec. 15AB(1)(a) of the Acts Interpretation Act 1901 (Cth) expressly permits reference to the *Explanatory Memorandum*, *supra* note 3, to support or confirm an interpretation that emerges from the plain words of the legislation. Sec. 177B(1) is quite plain on the face of things. It holds that nothing in the provisions of the legislation shall be taken to limit the operation of Part IVA. This clearly gives Part IVA overriding effect which is confirmed by the *Explanatory Memorandum* which states that the basic principle of Sec. 177B is to give to Part IVA a position of paramount force in the income tax law. This is further reinforced by the fact that the *Explanatory Memorandum* specifically points to the severe limitations imposed by the choice doctrine on the former Sec. 260:

The "choice principle" is an interpretative rule according to which section 260 will not apply to deny to taxpayers a right of choice of the form of transaction to achieve a result if the Principal Act itself lays open to them that form of transaction. To do so does not alter the incidence of tax and this is so notwithstanding that the transaction in question is explicable only by reference to a desire to attract the operation of a particular provision of the Act and so achieve a reduction in liability to tax below what it would have been if that course had not been taken.

and then alludes to the fact that the new Part IVA is designed, *inter alia*, to overcome this difficulty with paramount force in the income tax law.

63. See *supra* note 3, at 711. See also the comments of Parsons R.W., *Income Taxation in Australia* (1985), at para. 16.30, who suggests that the express provisions of Sec. 177C(2) and (3), which give a limited expression to the choice doctrine, are likely to be construed as showing an intention that the choice doctrine is otherwise excluded. Dabner, "The First Part IVA Cases and Rulings – The Worst Fears Realized", *supra* note 3, at 670, submits that although Sec. 177C(2) contains a limited choice principle this must be expressly provided for in the legislation.
64. See the comments of Mannix, *supra* note 3, at para. 81. Mannix supports this contention on the basis that many of the options contemplated by the doctrine (such as the use of various forms of trading structure possibly a choice between a partnership or trust) are "expressly provided for". He obviously adopted a very wide interpretation to the words used by Sec. 177C(2) and essentially construes the mere presence of options in the legislation as being an *express provision*. Mannix, for instance, suggests that the factual pattern of *WP Keighery Ltd v. FCT* (1957) 100 CLR 66, would still not attract the operation of Part IVA. In that case the taxpayer company deliberately changed its status from a private to a public company to avoid excess retention tax on undistributed earnings. Mannix regards this as an example of an option "expressly provided for by" the legislation. Murphy, *supra* note 3, at 537, would tend to support this approach but on slightly different grounds. He suggests that if Part IVA is read so as to exclude the choice doctrine it is, tantamount to saying that all other things being equal, Part IVA will apply if the taxpayer chooses any structure which gives rise to other than the maximum tax liability.
65. 93 ATC 4,397, 4,418.
66. Such an interpretation could be supported by direct reference to the *Explanatory Memorandum*, *supra* note 3, at 9, which indicates that this should be the case. The Acts Interpretation Act (1901) (Cth), Sec. 15AB(1)(a), would permit the court to refer to the *Explanatory Memorandum* to confirm the plain meaning of Sec. 177B(1).
67. Cf. Parsons, *supra* note 63, at para. 16.41, where he suggests that if this position is accepted then Part IVA "lacks any rational justification". He argues that the presence of a purpose to enable a taxpayer to obtain a tax benefit may make sense in some cases where it is not within the policy of the law to grant that tax benefit but that it makes no sense to deny a benefit when it is within the policy of the law to grant it. He cites the example of *Mullens v. FCT* (1976) 135 CLR 290, where the status of an incentive provision designed to encourage investment in petroleum exploration companies was at issue. Parsons concludes that it makes no sense that the law should include incentive provisions such as that in *Mullens*, and then deny taxpayers the benefit of the provision through the operation of Part IVA. See also the comments of Harley G.J., "Structural inequities and concepts of tax avoidance" in McKay L., Prebble J., (eds) *Essays on Taxation* (1982) *VUWLR* 38, 50, who observes:

Tax incentives are inherently [purpose] ... oriented. The direction of anti-avoidance legislation against such ... provisions is a nonsense. It forces the courts to read down the express language Parliament uses because it does not mean what is says.

Harley submits that the only rational approach is to remove the "structural inequities" in the tax system so that avoidance opportunities are not present.

68. See *supra* note 3, at 10.
69. See *supra* note 26.
70. See *supra* note 27.
71. 89 ATC 524, 536. Hartigan J in support of his conclusion referred to the decision of the Full Federal Court in *Tupicoff v. FCT* 84 ATC 4851. In that case, the taxpayer had worked as an agent for an insurance company. The taxpayer formed a company and settled a discretionary trust nominating the company as trustee of the trust and himself, his wife and children as beneficiaries. The taxpayer resigned his agency and the company carried on the insurance business with the taxpayer as its principal employee. Fisher J, with whom Beaumont and

Pincus JJ agreed, rejected the contention that the taxpayer was simply exercising a choice forming the trust structure and did not agree that the legislation gave the taxpayer a choice as to the manner in which he conducted his business operations. Fisher J noted:

The taxpayer also contended that the Act gave him a choice as to the manner in which he conducted his business operations and that his decision to work as an employee of the trustee company was an exercise of that choice. In doing so he said he was choosing between the alternative arrangements open to him under Div. 5 (Partnerships), Div. 6 (Trust Income) and Div. 7 (Private Companies) of the Act.

However, his Honour was not prepared to view this as a situation where a choice existed for the taxpayer to avail himself of. Hartigan J also noted the remarks of Bowen CJ in *Gulland v. FCT* (1985) 160 CLR 55, 70, where the Chief Justice held that it was not a choice open to a taxpayer to have income from personal exertion taxed as though it were income derived by a trust and held for the benefit of a number of beneficiaries.

72. 89 ATC 524, 536-537.

73. *Ibid.*

74. 91 ATC 191, 197.

75. Similarly in *Case X17*, Senior Member Roach felt that it would be a strange interpretation of Part IVA to hold that non-tax saving elements were caught. He noted that many bona fide commercial decisions routinely lead to a reduction in taxable income such as the decision over the timing of the acquisition of a new plant which might qualify the purchaser for tax benefits (possibly depreciation). See also Roach, *supra* note 3, at 26, who cites the well-known decision of the High Court in *Brent v. FCT* (1971) 125 CLR 418. In that case the wife of the notorious Ronald Biggs (who took part in the Great Train Robbery) entered into an agreement with a newspaper to publish her life story for a total sum of $ 65,250. Payment was to be made in three parts. In the income year in question the taxpayer had only received an initial payment of $ 10,000 and had postponed the derivation of the remaining income. Roach suggests in this case an otherwise bona fide dealing should not attract the operation of Part IVA simply because it was structured tax efficiently.

76. (1976) 135 CLR 290.

77. (1984) 68 ALJR 680, 686.

78. Sec. 177C(1)(c) holds that the amount of the tax benefit is the amount that would have been or might reasonably be expected to have been included in assessable income.

79. Sec. 177C(1)(d) specifies that the amount of the tax benefit is the amount of the whole or the part of the deduction (as the case may be) that would not have been or might reasonably be expected not to have been so allowable. It is also to be noted that a tax benefit will be obtained where a Sec. 159TL rebate is allowable to the taxpayer in relation to a year of income and the whole or part of that rebate would not have been allowable or might reasonably be expected not to have been allowable to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out (Sec. 177C(1)(ba)). Sec. 177C(1)(e) holds that the amount of the tax benefit is the amount of the whole or the part of the rebate (as the case may be) that would not have been or might reasonably be expected not to have been allowable.

80. See the comments of Ford, *supra* note 3, at 252, who submits that it is clear from the opinion of the Judicial Committee that the concept of avoidance was not limited to a liability that had already accrued and that the meaning of "avoid" went beyond "displace".

81. Trebilcock, *supra* note 3, at 238.

82. *Id.*, at 239. See the suggested redraft of the forms Sec. 260 by Grbich, *supra* note 3, at 238-2;

A "taxation avoidance transaction" shall be any transaction...which has the effect of diminishing or postponing any liability imposed by this Act or any possibility of future liability which may be imposed by this Act....In this section diminishing includes lowering, avoiding, defeating or relieving, whether directly or indirectly, and whether wholly or in part ....

83. The focus is obviously on elements of the taxing formula that define taxable income as defined by the Income Tax Assessment Act 1936 (Cth), Sec. 6(1) which defines taxable income to be "the amount remaining after deducting from assessable income all allowable deductions. Further Sec. 17 specifies that income tax at the rates declared by Parliament is levied upon the taxable income derived during the year of income of any person. The formula set out in Sec. 17 may be represented as:

Taxable income (assessable income – allowable deductions) x Tax rates – (rebates and credits) = Tax payable.

Sec. 177C focuses on the first aspect of the formula whereas Sec. 260 looked at the later aspect.

84. Also see the analysis of O'Loughlin J in *Peabody v. FCT*, where his Honour adopted a similar approach. On the facts of that case, O'Loughlin J contrasted the situation that would reasonably be expected to arise but for the scheme (a receipt of assessable income) against that which had occurred (a capital receipt).

85. In the UK context see the formula used by the former Sec. 460 of the Income and Corporation Taxes Act 1970 (UK) defines tax advantage also by reference to a gross concept. It provides:

"tax advantage" means a relief or increased relief from, or repayment or increased repayment of income tax, or the avoidance or reduction of an assessment to income tax or the avoidance of a possible assessment thereto, whether the avoidance or reduction is effected by receipts accruing in such a way that the recipient does not pay or bear tax on them, or by a deduction in computing profits or gains.

It will be observed that the term "avoidance" is then defined to focus on gross items in that the "avoidance" may be effected "by receipts accruing in such a way that the recipient does not pay or bear tax on them" or "by a deduction in computing profits or gains". This formulation is extremely close to that utilized by Sec. 177C. Similarly to *Case Y13*, the interpretation of Sec. 460 was premised on the basis that there must be a pre and post-scheme comparison of the taxpayer's fiscal position in order to determine whether a tax benefit has arisen. In *IRC v. Parker* [1966] AC 144, Lord Wilberforce suggested that required the court to contrast:

... as regards the receipts between the actual case where these accrue in a non-taxable way with a possible accruer in a taxable way, and, unless this contrast exists, the existence of the advantage is not established.

His Lordship further felt that:

The paragraph ... presupposes a situation in which an assessment to tax, or increased tax, either is made or may possibly be made, that the taxpayer is in a position to resist the assessment by say that *the way in which he received what it is sought to tax* prevents him from being taxed on it; and that the Revenue is in a position to reply that if he had received what it is sought to tax *in another way* he would have had to bear tax. In other words, there must be a contrast.

It will be observed that Sec. 460 is more clearly drafted than Sec. 177C in that the former provision clearly indicates that a tax advantage is a net concept that may be further analysed according to the items that go to form assessable income and in this sense turn to a gross concept. It is unfortunate that Sec. 177C was not framed in similar terms. On the effect of Sec. 460 see further *IRC v. Cleary* [1968] AC 766; *IRC v. Brook* [1968] Ch 255; *Greenberg v. IRC* [1971] 3 WLR 386; *IRC v. Kleinwart Benson Ltd* [1969] 2 Ch 221. Carey, D de M., "The Stuff That Dreams are Made Of", *British Tax Review* (1970), at 28, 29,; Bretton, G.R., "Transactions in Securities", *British Tax Review* (1973), at 268, 269.

86. 93 ATC 4,104, 4,111, (Full Fed Ct).

87. (1994) 68 ALJR 680, 686.

88. The concept does not include the manipulation of rebates and credits or withholding taxes.

89. Hulme, *supra* note 3, at 122; Murphy, *supra* note 3, at 535; Binetter, *supra* note 3, at 412-413. Binetter suggests that a tax benefit will not arise for the purposes of Part IVA with respect to a scheme concerning the form in which an amount enters into assessable income. In this sense "amount" is construed to refer to a quantifiable receipt that is somehow then reduced by the scheme, such as might occur, in a scheme that utilizes a trust to derive income instead of the taxpayer. For instance, if Part IVA were to be considered in relation to the factual setting in *Slutzkin v. FCT* (1977) 140 CLR 314, which concerned a scheme that converted the retained earnings of a private company into a capital receipt by the sale of the underlying shares in a "dividend stripping" arrangement, Binetter argues that the concept of tax benefit would have no application, because an "amount" would not have been left out of assessable income.

Hulme also supports this interpretation for the same reasons. He regards the apparent omission of this type of tax avoidance scheme as reflecting an acceptance of the view that it is better to deal with matters of this kind by specific provisions rather than by stretching an already wide provision so as to try and make it universal. The obvious reply to this argument of course is that the concept of "tax avoidance" in paragraph (c) of Sec. 260 did not need to be so stretched and was found by the Privy Council in *Newton v. FCT*, to relate to the final liability to tax of a taxpayer (a net concept). The use of the final liability to tax as the basis for comparison between what happens with a particular scheme and what would have happened without the scheme is effective in its ability to overcome these types of arguments. It will be recalled that Lord Denning in *Newton v. FCT*, stated:

... the word "avoid" is used in its ordinary sense – in the sense in which a person is said to avoid something which is about to happen to him. He takes steps to get out of the way of it. It is this meaning of "avoid" which gives the clue to the meaning of "liability imposed". To "avoid a liability imposed" on you means to take steps to get out of the reach of a liability which is about to fall on you.

90. See *supra* note 3, at 122.

91. Quaere whether the court could not adopt such an approach even without resort to Sec. 15AA. Baxt, R., 9 *ABLR* (1981), 284, 290, notes the decision of the High Court of Australia in *Cooper Brookes (Wollongong) Pty Ltd v. FCT* (1981) 147 CLR 297 in which the High Court adopted a purposive approach to Sec. 80C of the Income Tax Assessment Act 1936 (Cth). Sec. 80C in that case would have

permitted the taxpayer company to utilize the tax loss provisions contained in the section because of a drafting error. The majority of the court examined the scheme of the relevant sections as a whole and concluded that, quite apart from Sec. 80C, to allow the taxpayer to succeed on a literal approach to the wording of the section would have been assisting to defeat rather than further the purpose or intention of Parliament. Baxt suggests that the Acts Interpretation Act 1901 (Cth) is unnecessary in the context of the definite change in attitude of the High Court to tax avoidance.

92. See Murphy, *supra* note 3, at 535.

93. See supra note 3, at 11. Murphy refers to the opinion expressed by the Commissioner in *Income Tax Ruling* No IT 2456 which relates to schemes where the composition of a taxpayer's assessable income is altered but its quantum is unchanged. The Commissioner, who is of the view that "amount" refers both to the quantum and character of a receipt, that the focus of Sec. 177C(1)(a) is not the reduction in the overall assessable income of the taxpayer but on the exclusion of an amount from assessable income. This is premised on the view that "an amount" refers to a receipt of a given character. This is itself supported by Sec. 6 which provides that assessable income means "all the amounts which under the provisions of this Act are included in assessable income." Murphy, however, suggests in the alternative that the focus on the section and Part IVA is on taxable income rather than the tax payable on the various forms of assessable income. Murphy thinks that this is apparent from the same definition of assessable income in Sec. 6 which is taken by him to refer to a monetary sum rather than a class of receipt. The court might confirm the view of the Commissioner reached on a plain reading of Sec. 177C(1)(a) and supported by the *Explanatory Memorandum* as mandated by the Acts Interpretation Act 1901 (Cth), Sec. 15AB(1)(a).

94. See *supra* note 3, at 11.

95. 92 ATC 4,585.

96. 93 ATC 4,104, 4,115 (Full Fed Ct).

97. *Ibid.*

98. (1994) 80 ALJR 680, 686.

99. See the comments of Dabner and Burton, *supra* note 3, at 609-610; Cassidy, *supra* note 3, at 480. Cassidy cites the decision of the Administrative Appeals Tribunal in *Case V160* 88 ATC 1,058 to support this conclusion. In that case a discretionary family trust was at issue. The Tribunal commented on the difficulty in establishing a tax benefit in cases involving discretionary trusts because in the absence of evidence indicating who would have, or might reasonably be expected to have, been subject of the exercise of the trustee's discretion, it might be impossible to identify a reasonable expectation as to the receipt of income. The conceptual fallacy in this argument is simply the fact that the trustee would either be liable for income tax on undistributed income or the beneficiaries will be liable for income tax on distributed income under Division 6 of Part III of the Income Tax Assessment Act 1936 (Cth).

100. See *supra* note 3, at 610.

101. (1976) 135 CLR 290.

102. The *Explanatory Memorandum* suggests that the doctrine of choice, which as an interpretation rule allowed taxpayers to undertake transactions notwithstanding that a particular transaction was only explicable by reference to a desire to achieve a reduction in liability to tax, because such a transaction did not alter the incidence of tax, was a shortcoming of Sec. 260 that was specifically sought to be overcome in the design of Part IVA. Therefore, it is extremely unlikely that the legislature intended the antecedent transaction doctrine to be given statutory recognition in Sec. 177C.

103. (1985) 160 CLR 55.

104. In *Peabody v. FCT* O'Loughlin J certainly did not feel that there must be a prior crystallized liability to tax, the incidence of which, the scheme in question sought to alter. In that case the scheme sought to avoid a prospective liability on a short term capital gain assessable under Sec. 26AAA of the Act. The gain had not accrued in the hands of the trust and was prevented from eventuating by reason of the scheme. There was clearly no antecedent transaction in issue but Sec. 177D still applied and a tax benefit was found to exist. As Carey, op. cit. at note 91, 29, observes that "[Tax] avoidance proceeds [sic] from the starting point of a charge to tax which is in some way prospect, and which would materialise if nothing was done about it ...".

105. 91 ATC 191, 195. Dabner and Burton, *supra* note 3, at 610, criticize the decision of Professor Grbich, *inter alia*, on the ground that although it was correct in the authors view to reject the application of the jurisprudence on Sec. 260 in the context of Part IVA, it was inappropriate, to automatically reject the antecedent transaction doctrine "simply because past cases have held that the rest is inapplicable to an entirely different provision (Sec. 260)".

106. These are: (a) where the non-inclusion of an amount in the assessable income of a taxpayer is attributable to the making of a declaration, election or selection, the giving of notice or the exercise of an option by any person, being a declaration, election, selection, notice or option expressly provided for by the legislation and the scheme was not entered into for the purpose of creating any circumstance or state of affairs which would enable the declaration, election, selection, notice or option to be made, given or exercised; (b) where the allowance of a deduction from an the assessable income of a taxpayer is attributable to the making of a declaration, election or selection, the giving of notice or the exercise of an option by any person, being a declaration, election, selection, notice or option expressly provided for by the legislation and the scheme was not entered into for the purpose of creating any circumstance or state of affairs which would enable the declaration, election, selection, notice or option to be made, given or exercised; (c) where the allowance of a Sec. 158TL rebate is attributable to the making of an election or the giving of a notice by any person being an election or notice expressly provided by the legislation and the scheme was not entered into for the purpose of creating any circumstance or state of affairs which would enable the election or notice to be made or given. The *Explanatory Memorandum*, *supra* note 3, at 12, explained the problem Sec. 177C(2) seeks to alleviate in these terms:

The Principal Act expressly provides in various provisions for taxpayers to exercise ... a choice as to the taxation consequences of designated transactions or states of affairs. For example, the amount to be included in assessable income in respect of the difference between opening and closing values of trading stock on hand will vary according to whether the taxpayer has opted to have the stock valued at its cost price, market selling value or the price at which it can be replaced (sub-sec. 31(1)). A taxpayer's deduction in respect of the cost of certain mining plant depends on whether the taxpayer elects for deprecation allowances instead of deductions under the mining provisions (Sec. 124AG).

Sec. 177C(2) is designed to limit the application of Part IVA in these circumstances by excluding from the definition of tax benefit the situation where an amount is left out of assessable income, a deduction allowed or a Sec. 158TL rebate allowed as a result of a scheme and it is attributable to an option expressly provided by the legislation. This will be so only if the scheme was not entered into for the purpose of creating a state of affairs that gave rise to the ability to exercise the option granted by the legislation.

107. Stiglitz, J.E., "The General Theory of Tax Avoidance", 28 *Nat Tax J*, at 325.

108. See *supra* note 63, at para 16.34.

109. See *Case W58* 89 ATC 524, 536; *Case X90* 90 ATC 648, 653.

110. Professor Grbich found in the present case that had the scheme not been carried out the consulting work would have been undertaken by the taxpayer. He further stated that there was a reasonable expectation that the taxpayer would have derived the income of the trust and this constituted "the amount not being included in the assessable income" of the taxpayer pursuant to Sec. 177C(1)(a).

111. *Ibid.* Cf. Dabner, "The First Part IVA Cases and Rulings – The Worst Fears Realized", *supra* note 3, at Dabner suggests that *Case V160* 88 ATC 1,058, indicates a different stance might be adopted. Dabner notes that the case concerned a complicated series of transactions designed to avoid taxation on certain trust income. The scheme rested on validity of a resolution by a corporate trustee. Ultimately, the Tribunal held that the resolution was ineffective and the whole arrangement a sham. However, as Dabner observes the Commissioner had argued Part IVA in the alternative. The Tribunal, in a brief consideration of these submissions, stated that Part IVA did not apply at all comfortably in a trust situation, especially where there were numerous beneficiaries. Dabner suggests that the difficulty is in identifying the existence of a tax benefit because the discretion vested in the trustee makes it difficult to say that there is an amount not included in the income of a particular taxpayer where that amount "would have been included or might reasonably be expected to have been included" but for the scheme. Moreover he submits that the resolution of this issue was not in any way assisted by the existence of a default clause which took effect upon the annihilation of the scheme because it could not be said that the default beneficiary was the taxpayer who was to obtain the tax benefit arising from the scheme. The Tribunal in fact concluded that:

... it is ironic that the born-again, or what came to be born-again, Sec. 260, so often found wanting in times past, was put to sleep only to be replaced by a provision the greater complexity of which can give rise in some circumstances to problems at least as great as those that occurred in relation to its predecessor.

Dabner concludes that "this case illustrates a major defect that appears in Part IVA".

112. See *supra* note 63, at para 16.36.

113. 88 ATC 4,834, 4,846.

114. *Id.*

115. (1991) 173 CLR 1, 24.

116. In the ruling the Commissioner considers the issue of whether a tax benefit might arise under Sec. 177C(1)(a) where an amount is not included in the assessable income of the taxpayer being an amount that might reasonably be expected to have been included if the scheme had not been entered into but the scheme still included an amount in assessable income by virtue of a different provision or description (such as an item attracting a rebate of tax) instead of being in a non-rebateable form. The Commissioner is of the opinion that, although a

scheme may not result in a reduction over all in assessable income of the taxpayer (and perhaps the assessable income might even be greater under the scheme), a tax benefit for the purposes of Part IVA may arise. Dabner, "The First Part IVA Cases and Rulings – The Worst Fears Realized", *supra* note 3, at 667, suggests that this view has potentially very wide application and would essentially mean that the definition of tax benefit in Sec. 177C(1)(a) would move closer to the net concept adopted in relation to para (c) of Sec. 260 in *Newton v. FCT* [1958] AC 450, 464. See also Richards, R., "Part IVA – Tax Avoidance", *Australian Accountant* (1988), at 65.

117. A related question that arose in the case concerned the status of the so-called "new source" rule in relation to Part IVA. Professor Grbich rejected that the application of Part IVA was limited to situations where there was income from an existing source. He noted that in the recent decision of the Full Federal Court in *Bunting v. FCT* 89 ATC 5,254 the same approach had been adopted in relation to the former Sec. 260. In that case a taxpayer without a previous employment history in Australia set up a corporate trust structure and earned fees from his work as a computer consultant through the corporate trustee rather than personally. The Full Federal Court rejected the notion that this was a new source of income for the taxpayer and applied Sec. 260. Professor Grbich applied that approach in the present case and rejected outright that a tax benefit could only relate to existing sources of income. The Senior Member appears to have rationalized the rule simply as one of evidence. If (in the case of a new source of income) there was no reasonable expectation that income that had been diverted to another taxpayer, would have been derived by the taxpayer who was seeking the tax benefit, then there would be no tax benefit within the meaning of Sec. 177C(1)(a). It would be otherwise if there was a reasonable expectation that the income would have been derived but for the scheme. Cf. Roach, *supra* note 3, at 27, who remains in relation to *Bunting v. FCT*, "at a loss to understand how a purpose of tax avoidance is to be found in circumstances whereby an unemployed person, without a previous employment history ...secures his first employment ... as an employee of a company he controls ...".

118. Professor Grbich noted that the test did not require certainty because the relevant test was "reasonably to be expected". This was based on the balance of probabilities or on something less. The Senior Member referred to the judgment of Sheppard J in *AG v. Cockcroft* (1986) 64 ALR 97, 109-112, where the Full Federal Court had occasion to consider the meaning of the Freedom of Information Act 1982 (Cth), Sec. 43(1)(c)(ii), which exempted from disclosure certain information the disclosure of which "could reasonably be expected" to "prejudice the future supply of information". Sheppard J held in relation to this statutory formula that the degree of certainty was possibly not as high as the balance of possibilities but certainly required that there be "real and substantial" grounds for a particular decision. See further Munn, G.D., "Part IVA I.T.A.A.: A Practioner's View", *The Australian Accountant* (1981), at 606, 607. Munn suggests that reference might also be made to the decisions of the courts in the United Kingdom which considered a similar test in relation to Sec. 33(3) of the Finance Act 1944 (UK). Sec. 33(3) required analysis of "the main benefit which might have been expected to accrue from the transaction ...". Munn, observes that in *Crown Bedding Co Ltd v. IRC* [1946] 1 All ER 452 the Court of Appeal adopted the view that a "main benefit" meant that which in the opinion of the tribunal ultimately deciding the question, might have been expected by a person surveying all the facts and knowing all the law on the subject at the time of the transaction. See also *Ackland & Pratten Ltd v. IRC* [1960] 3 All ER 367.

119. His Honour referred to the decision of the Full Federal Court in *FCT v. Arkley* 89 ATC 4,563. In that case the Federal Court was concerned with the meaning to be given to the expression "circumstances existed by reason of which it was reasonable to expect" which appeared in Sec. 82AAS(2)(a) of the Act. The court observed:

We are of the opinion that the phrase with which we are concerned in the context of Sec. 82AAS of the Act requires a determination whether or not circumstances exist by reason of which the decision-maker is able to expect on reasonable grounds that superannuation benefits would be provided as stipulated in the section. That test is an objective one. However, in applying the test the decision-maker, in considering the circumstances, should have regard to any relevant matters concerning the taxpayer personally. Put another way our understanding of the meaning of the expression is one which involves the application of an objective test, but, as on of the concomitant elements of that test, the subjective intentions of the taxpayer may be relevant.

O'Loughlin J felt that this meant an objective test was appropriate under Sec. 177C. As Munn, *supra* note 3, at 607, submits in determining whether a tax benefit has arisen under Sec. 177C it seems necessary to inquire what an observer with a knowledge of the facts of the transaction and knowing the income tax law on the subject might have expected. There is a tax benefit if an amount is not included in assessable income where, on an objective analysis, the amount would otherwise be likely to have been included in the assessable income of the taxpayer but for entry into the scheme or alternatively, if an mount is allowed as a deduction where the amount would otherwise be likely not to have been allowed as such but for entry into the scheme.

120. (1986) 64 ALR 97.
121. [1978] 2 NSWLR 235.
122. Sec. 177D.
123. Secs. 177D and 177A(5).
124. Currently Sec. 177D does not require that the person who obtains a tax benefit is the taxpayer that has the purpose of obtaining the tax benefit. The *Explanatory Memorandum* explains this feature of Sec. 177B on the basis that it should be irrelevant whether or not the person who entered into or carried out the scheme with the relevant purpose is the taxpayer or one of the taxpayers.
125. [1958] AC 450, 465, where Lord Denning stated "The word 'purpose' means ... the effect which it is sought to achieve – the end in view."
126. See *Case X17* and *Case Y13*.
127. See *supra* note 3, at 124.
128. See *supra* note 3, at 711. See further Munn, *supra* note 3, at 607; Binetter, *supra* note 3, at 409; Cassidy, *supra* note 3, at 480, possibly gives the clearest support to this conclusion when she states:
It is submitted that the test introduced by Sec. 177A(5) and Sec. 177D is not unlike the "predication test" used in the application of Sec. 260.
Certainly the Commissioner felt that this was the case when Part IVA was first introduced. See Munn, *supra* note 118, at 608.
129. For instance, see Arnold B.J., Wilson J.R., "The General Anti-Avoidance Rule-Part 1", 36 *Can Tax J* (1988), at 829.
130. *Ibid*, at 1157-1158.
131. See *supra* note 3, at 164.
132. (1978) 138 CLR 251, 274. See also *Cooper Brookes (Wollongong) Pty Ltd v. FCT* (1981) 147 CLR 297; *McClelland v. FCT* (1969) 118 *CLR* 353 (HCA); (1970) 120 *CLR* 487 (PC). Avery Jones, *supra* note 28, at 22, notes:
The most likely explanation of the Australian and New Zealand cases is that the purpose of a transaction can be different from the purpose of the person carrying out the transaction. In both countries this is a well-recognized distinction ...
Avery Jones seems to confuse purpose and intention. He suggests that the example of whether a taxpayer is trading in terms of Case I of Schedule D of the Income and Corporation Taxes Act 1986 (UK) illustrates the point that a transaction may have a "purpose". He indicates that a person may be found to be trading without having the purpose of doing so if the facts have all the characteristics of trading: *IRC v. Incorporated Council of Law Reporting* (1888) 22 QBD 279. This, however, confuses intention with purpose. Intention is the relevant criterion under Case I of Schedule D and the taxpayer's purpose is irrelevant.
133. See *supra* note 3, at 242.
134. See *supra* note 63, at 216. Grbich observes that it is only human beings that have purposes. It is the distinguishing mark of living organisms that only they are capable of goal-directed activity [See Sommerhoff G., "The Abstract Characteristics of Living Systems", in Emery F.E. (ed) *Systems Thinking* (1969) 147, 150-151]. Grbich submits that when the authorities state (such as the comments of Williams J in the High Court of Australia decision in *Newton v. FCT*) or imply that a transaction or any other inanimate object has a "purpose" they are talking about inferences they draw about the taxpayer from the relationship between the elements of that transaction and from the whole context. Conceptually Grbich, similarly to Trebilcock, suggests that because evidence of the taxpayer's desire to minimize his tax bill is both unreliable and uninstructive, inferences drawn by the court from the specific steps are likely to be the best evidence of this "purpose".
135. See *Case W58* and *Case X17*.
136. See *FCT v. Jackson* 70 ATC 4,990, 4,994.
137. (1985) 160 CLR 55, per Gibbs CJ at 80, per Brennan J at 105, and per Dawson J at 110.
138. 92 ATC 4,585, 4,598.
139. *Id.*
140. 93 ATC 4,104, 4,113 (Full Fed Ct).
141. Sec. 177D.
142. Secs. 177D and 177A(5). Sec. 177A(5) states:
A reference in this part to a scheme or part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for two or more purposes of which that particular purpose is the dominant purpose.
143. Reference can be made to Binetter, *supra* note 3, at 409. Dalton, *supra* note 3, at 103, suggests that in either case the determination of a sole or principal purpose is in many cases an extremely difficult task. He suggests that it may be impossible to determine either type of purpose on purely objective grounds, presumably, because the ascertainment of a sole or dominant purpose is more easily done with recourse to the oral statements of the taxpayer concerned. It is submitted that this difficulty is not as great as Dalton imagines. As far as the first situation is concerned (a sole purpose to obtain a tax benefit), it is submitted that in

practice it will be a relatively simple task to ascertain whether the tax benefit is objectively the only reason for the transaction. Take an example in the New Zealand context. In *Challenge Corp Ltd v. CIR* [1986] 2 NZLR 513, 529 (CA), the Court of Appeal was faced with a scheme to purchase an otherwise moribund tax loss company. The only reason for the purchase was to utilize the accumulated tax losses and it was fairly evident that objectively there was no other reason for the purchase. Objectively the company had no tangible assets and there was no suggestion that the company would carry on business after the change of ownership. On these facts it was reasonable to conclude that the sole purpose of the arrangement was to avoid tax. Cooke J noted:

It is apparent on the face of the agreements that a purpose ... was to obtain [a tax advantage] ... this was indeed its sole purpose.

In terms of the second situation (a dominant purpose to obtain a tax benefit) it does have to be admitted that this is somewhat harder in that it requires the ascertainment of the weighting to be given to the tax purpose when compared with the other purposes. However it is submitted that the test should not in practice prove onerous. A dominant purpose is to be regarded as a purpose that outweighs all others. The *Explanatory Memorandum* states:

... by reason of sub-sec. 177A(5) the expression is in the case of a scheme with more than one purpose to include also a dominant purpose, i.e. a purpose that outweighs all other purposes put together.

In earlier decisions of the High Court of Australia, regimes under consideration which used equivalent criteria, such as the Income Tax Assessment Act 1936 (Cth), Sec. 26(a), did not appear to present problems in the application of, a primary purpose test. For instance in *Evans v. DFCT (SA)* (1936) 55 CLR 80, Starke J equated "dominant" with "substantial". As Speed observes, *supra* note..., at 169, normally the only area of disagreement would be confined to the weight to be given to different purposes.

144. Where Lord Denning held that the court must examine the overt acts by which the arrangement was implemented.

145. Binetter, *supra* note 3, at 409; Hulme, *supra* note 3, at 123; Roach, *supra* note 3, at 25.

146. 93 ATC 4,104, 4,113 (Full Fed Ct).

147. See *Case W58*, where Hartigan J noted that Sec. 177D set out criteria "to be taken into account in determining whether the taxpayer entered into and carried out the scheme for the purpose of obtaining a tax benefit." Also *Case Y4*, per Deputy President Gerber, "Sec. 177D sets out the *criteria* for ascertaining whether ... Part IVA applies."

148. For instance Munn, *supra* note 118, at 607, submits that Sec. 177D imposes an objective assessment of what is the purpose of entry into a scheme. It requires an objective determination of a subjective purpose by reference to certain matters.

149. See Munn, *supra* note 118, at 607, who concludes that Sec. 177D:

... requires an objective determination of a subjective purpose by reference to certain matters, none of which curiously requires consideration of the actual purpose of those who entered into the scheme. There is no direct opportunity to ask or inquire of those who entered into the scheme what was in fact their purpose ...

150. See *supra* note 3, at 164.

151. See *supra* note 3, at 410-411. Deputy President Gerber in *Case Y4* 91 ATC 114, 118, was similarly prepared to receive taxpayer testimony. In that case, one Dr Kildare was found to have given a "clear and honest admission ... that the [scheme] ... was undertaken for the dual purposes of obtaining the tax deductions of the additional superannuation payments and the interest on the capital borrowing."

152. Professor Grbich noted that while the thrust of Sec. 177D was clear, the test was not "spelt out in detail" by the legislation. He suggested that it was "necessary to develop an orderly set of criteria for the application of this criteria test ...".

153. For instance, in the present case the criterion set out in Sec. 177D(b)(ii) and (v) when applied to the facts of the case, were, without more sufficient to bring about an adverse conclusion.

154. 93 ATC 4,104, 4,113-4,114 (Full Fed Ct).

155. See *supra* note 3, at para 43. Similarly in *Case X90*, Deputy President Thompson in a similar factual setting found that the factors to be considered included the discontinuation of the taxpayer's contract of employment with his employee, the formation of the family trust utilizing a corporate trustee and the continuation of work on a contract basis through the corporate trustee.

156. See *supra* note 3, at 164.

157. Such as *Slutzkin v. FCT* (1977) 140 CLR 314.

158. Similarly Professor Grbich in *Case Y13*, saw the corporate trust structure as being in substance a "well recognized income-splitting device".

159. See the comments of Cassidy, *supra* note 3, at 480, note 26, where it is submitted that this criterion focuses on any antecedent transaction existing before entry into the subject scheme and its relation to the state of affairs that arises as a result of the scheme.

160. For instance, in *Case W58*, Hartigan J, in the case of a corporate trust structure, noted that the taxpayer had initially become an employee of the corporate trustee whereas previously he had been employed by the entity that was now contracting directly with the corporate trustee. Hartigan J noted that the taxpayer continued to generate income by reason of his own personal exertions after his employment by the corporate trustee as he had done before as an employee of other employers.

161. See *supra* note 3, at para 43.

162. In the New Zealand context useful reference may be made to the decision of the Court of Appeal in *Hadlee v. CIR* 3 [1991] NZLR 517. In that case the taxpayer also adopted a corporate trust structure. Instead of transferring his business operations to the trust (which was not possible because he was a partner in a firm of chartered accountants) the taxpayer assigned a proportion of the "capital units" he owned in the partnership to the trust. The actual tax saving in proportion to the consideration paid was immense. In the first year of the scheme the trust received a return of 120% on the purchase price of the units while in the second year the return was 159%. Although not decisive this was certainly indicative of a tax avoidance purpose. Eichelbaum CJ noted that "the potential tax benefits were too significant and obvious".

163. For instance, in *Case Y13*, Professor Grbich had regard to the fact that a taxpayer had shifted his income earning structure to a family trust, the beneficiaries of which, were the taxpayer's spouse and children. Grbich noted with approval the decision of the Full Federal Court in *Bunting v. FCT* 89 ATC 5,254, where in not dissimilar circumstances, Gummow J held that the fact that the taxpayer's family were beneficiaries under a discretionary trust provided a strong indication that the object of arrangement was to avoid tax. Gummow J observed "... what was done is not fairly explicable without an inference being drawn that a purpose ... was to effect a [splitting] ... of the income ...".

164. See *supra* note 3, at 5.

165. See Hulme, *supra* note 3, at 125; Murphy, *supra* note 3, at 539.

166. See *supra* note 3, at para 56. See the comments of Denning LJ in *Newton v. FCT* where in relation to the former Sec. 260 he stated:

This question then arises: What is the effect of Sec. 260 on that arrangement? It is quite clear that nothing is avoided as between the parties but only as against the commissioner. As against him the arrangement is "absolutely void" so far as it has the purpose or effect of avoiding tax. This is not a very precise use of the words "absolutely void". Ordinarily, if a transaction is absolutely void, it is void as against all the world. In this case what is meant is that the commissioner is entitled completed to disregard the arrangement – and the ensuing transactions – so far as they have the purpose or effect of avoiding tax. In the words of the courts of Australia, it is an "annihilating" provision – the commissioner can use the section so as to ignore the transactions which are caught by it.

167. See *supra* note 3, at 3-5. The court could also resort to the *Explanatory Memorandum* if it wished to confirm the position: Acts Interpretation Act 1901 (Cth) Sec. 15AB(1)(a).

168. His Honour also explained the scope of Sec. 177F in similar terms. He suggested that if the qualifying circumstances of Sec. 177D were found to exist, it was then open to the Commissioner to invoke the powers contained in Sec. 177F.

169. See *supra* note 107.

170. Similarly in *Case Y13*, Grbich SM held that the Commissioner might assess the income to taxpayer who had alienated it to a family trust under Sec. 177F(1)(a).

171. An interesting question that arose for consideration in this case was the calculation of the net tax benefit. Sec. 26AAA of the Income Tax Act 1936 (Cth) brought into assessable income any profit arising from the sale of an asset and any profit was ascertained after deducting costs of acquisition and sale (including all holding costs such as interest on borrowed moneys). O'Loughlin J had to consider the quantum of the tax benefit that arose. His Honour had to deal with the contention advanced by Counsel for the taxpayer that notional financing costs should be deducted in calculating the net capital gain. The hypothesis was advanced that if the trust had purchased and on-sold the relevant shareholding the financing would most likely have been by bank bill borrowing. O'Loughlin J rejected this contention and was not prepared to take such notional costs into consideration. Quaere whether actual costs, such as floatation and professional expenses, would be deductible.

172. It is to be noted that there is an element of doubt over whether the procedure adopted under Sec. 177F(1) is discretionary or mandatory. Reference can be made to the *Australian Federal Tax Reporter*, *supra* note 3, at para. 81.382, where the editors suggest that the issue is not clear cut. Although the word "may" is normally permissive it can in an appropriate context be mandatory: *Ward v. Williams* (1955) CLR 496. In the *Explanatory Memorandum* it is assumed that Sec. 177F(1) "effectively calls on the Commissioner to make a formal determination as to how much of the identified tax benefit is to be cancelled". The editors of the *Australian Federal Tax Reporter* suggest otherwise given the impression that Sec. 177F(1) is permissive and that it was intended by

the Legislature in Sec. 177A to 177E that certain schemes otherwise coming within the terms of those provisions would be only annulled at the discretion of the Commissioner. The conceptual fallacy in this argument really lies in the fact that the context of the Part as a whole would indicate that the power of reconstruction is indeed mandatory. Part IVA is intended to be a general anti-avoidance provision designed to prevent tax avoidance. It would seem strange that the Legislature would introduce such a provision yet ultimately leave it up to the Commissioner's discretion if it is in fact to apply. The better view is that the use of the word "may" is mandatory and indicates that if Part IVA applies the Commissioner has the power and obligation to reconstruct the tax accounts of the taxpayer concerned.

173. It will be noted that the same problem arises with the use of the word "may". It is probable that this is mandatory as well. Sec. 177F(4) further provides that where the Commissioner has made a determination under Sec. 177F(3) by virtue of which an amount is allowed a deduction, that amount, is deemed to be allowed as a deduction by virtue of any provision of the legislation as the Commissioner determines.

174. *Australian Federal Tax Reporter*; *supra* note 3, at para. 81.382.

175. 90 ATC 4,990.

176. See *Baily v. FCT* (1977) 136 CLR 214.

177. Commerce Clearing House, *1994 Australian Master Tax Guide* para. 23-004.

178. See the Taxation Administration Act 1953 (Cth), Secs. 14ZAAA and 14ZAA(2).

179. See the Taxation Administration Act 1953 (Cth), Secs. 14ZAAA-14ZAAL.

180. See the Taxation Administration Act 1953 (Cth), Secs. 14ZAAE-14ZAAG.

181. See the Taxation Administration Act 1953 (Cth), Secs. 14ZAAC-14ZAAD.

182. See the Taxation Administration Act 1953 (Cth), Secs. 14ZAA-14ZAZC.

183. See the Taxation Administration Act 1953 (Cth), Secs. 14ZAD-14ZAE.

184. See the Income Tax Assessment Act 1936 (Cth), Secs. 170BA-170BF. See, however, *CTC Resources NL v. FCT* 94 ATC 4,072.

185. See Taxation Administration Act 1953 (Cth), Part IVC.

186. See the Income Tax Assessment Act 1936 (Cth), Sec. 226.

Conference diary

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

APRIL 1995

Course on international tax planning techniques, Amsterdam, 10-11 April 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

International Trust and Estate Planning, Geneva, 27-28 April 1995 (English):

Euro Forum, 14 Bowden Street, London SE11 4DS, Tel.: 44-171-582 2423, Fax: 44-171-793 8544.

MAY 1995

Current problems regarding the application of tax treaties, Munich, 5 May 1995 (German):

Internationales Steuerseminar Zürich, z.Hd. Frau Salzberg, CH-8022 Zürich, Tel.: 41-1-219 2399, Fax: 41-1-219 3583.

Course on cross-border finance, Amsterdam, 8-9 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Course on new financial products, Amsterdam, 10 May 1994 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

V.A.T. sans frontières, Brusselles, 11 May 1995 (simultaneous translation into French and English):

Francis Lefebvre Formation Europe, Avenue E. Mounier 5, B-1200 Brusselles, Tel.: 32-2-775 2111, Fax: 32-2-770 4780.

The 8th East-West Tax Conference, Warsaw, 15-16 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Die Methoden zur Vermeidung der Doppelbesteuerung, Wien, 24 May 1995 (German):

Institut für Finanzrecht, z.Hd. Frau Gabriele Bergmann, Wirtschaftsuniversität Wien, Althanstraße 39-45, A-1090 Wien.

Insurance for tax planning, London, 17 May 1995 (English):

IBC Financial Focus Ltd., Attn: Nicola Stephens or Katie Gwyn-Williams, DX 122100 Mortimer Street, London, Tel.: 44-171-637 4383, Fax: 44-171-323 4298.

Course on US Taxation & § 482 Compared to OECD Transfer Pricing, Amsterdam, 18-19 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Methods for the Avoidance of Double Taxation, Vienna, 24 May 1995 (German):

Institut für Finanzrecht, Attn: Frau Gabriele Bergmann, Wirtschaftsuniversität Wien, Althanstrasse 39-45, A-1090 Wien.

JUNE 1995

Course on international tax audit, Amsterdam, 1-2 June 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Corporate Finance Centres and Tax Havens, Geneva, 2-3 June 1995 (English):

Vicki Goffin or Kate Roberts, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

Meeting of the International Tax Planning Association, Amsterdam, 8-9 June 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-1732-762 910, Fax: 44-173-2 763 762.

Course on permanent establishments, Amsterdam, 15-16 June 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

AUGUST 1995

Course on the principles of international taxation, Amsterdam, 21 August through 2 September 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1995

Meeting of the International Tax Planning Association, Monte-Carlo, 19-20 October 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-1732 762910, Fax: 44-1732 763762.

NEW ZEALAND

Update on the New Binding Rulings Regime and Amendments to the Entertainment Tax Regime

Adrian J. Sawyer

Com (Hons), LL B, A.C.A., Barrister and Solicitor of the High Court of New Zealand. **Adrian Sawyer** is a lecturer in taxation and business law in the Department of Accountancy, Finance and Information Systems at the University of Canterbury, Christchurch, New Zealand. He specializes in tax compliance and administration, and effective tax rate research, as well as company and insolvency law. He is a New Zealand correspondent for the *Bulletin*.

I. INTRODUCTION

In an earlier article by this author,[1] the proposed binding rulings regime was critically examined, with the overall impression being favourable for taxpayers, subject to certain exceptions. As part of the consultation process, for which the earlier discussion document was the first stage, submissions on the discussion document's proposals have been considered and revised draft legislation has been introduced as part of the Taxation Reform (Binding Rulings and Other Matters) Bill ("the Bill").

Two principal changes were made as a result of consultation on the discussion document: removal of the requirement that private rulings be published; and the creation of a third class of binding rulings to be known as *product rulings*. The revised draft legislation forms part of a tax reform package, where changes to the Goods and Services Tax, Entertainment Tax and the Binding Rulings regimes are included, along with technical and minor corrections to other aspects of tax law. This article reviews the changes to the Binding Rulings proposals, and the revisions to the severely criticized entertainment tax package which came into force on 1 April 1993.

II. MAJOR CHANGES TO THE BINDING RULINGS REGIME

The purpose of the regime remains as set out in the discussion document. Inserted clause 91A of the Bill sets out the purpose of the regime:

"91A. Purpose of this Part – The purpose of this Part is to –
(a) Provide taxpayers with certainty about the way the Commissioner [of Inland Revenue] will apply taxation laws; and
(b) Help taxpayers to meet their obligations under those laws,
– by enabling the Commissioner to issue rulings that will bind the Commissioner on the application of those laws, while recognizing the importance of collecting the taxes imposed by Parliament and the need for full and accurate disclosure by taxpayers."

Inherent within the scheme is the intention to provide certainty to taxpayers about the manner in which the Commissioner will apply taxation laws and to assist them in satisfying their obligations under those laws. However, the draft legislation fails to succinctly define what each of the three types of binding rulings are; taxpayers are left to surmise and draw their own conclusions from the resulting documentation and the provisions of the draft legislation.

The creation of a third type of binding rulings is unique to New Zealand's proposed regime. The product ruling, a hybrid private ruling in effect, may be issued by the Commissioner concerning a particular arrangement which is independent of the taxpayer's tax status. Subject to certain other criteria, product rulings have the same effect and application as private rulings.

Previously private rulings were to be published in a "sanitized" form. This departure from overseas practice was criticized by the writer and other commentators as creating extreme difficulties to ensure anonymity is preserved and facilitate compliance with privacy law requirements. Nevertheless it was recognized in the course of the discussions that publication would assist in ensuring that the "public good" value in private rulings could be utilized to some degree by other taxpayers. Nevertheless, discussion on the likely form of publication did not receive attention in the discussion document.

A. Product rulings

Product rulings may be issued by the Commissioner on arrangements provided three criteria are satisfied:[2]

- an application for a product ruling on an arrangement has been received;
- the Commissioner is satisfied that a private ruling cannot be made because it is not practicable to identify the taxpayers who may enter into the arrangement; and

1. See Sawyer, A. J., "A Proposed Binding Rulings Regime", 48 *Bulletin for International Fiscal Documentation* (October 1994), at 582. See also Sawyer, A. J., "Binding Rulings", 73 *Chartered Accountants' Journal of New Zealand* (November 1994), at 20.
2. See inserted clause 91T of the Bill.

- the characteristics of the taxpayers who may enter into the arrangement would not affect the content of the ruling.

It is clear that the Commissioner has discretion as to whether to issue a product ruling, depending largely upon whether it is practicable to ascertain the taxpayer's identity, and whether the identity of the taxpayer would materially influence the content of the ruling. An example where a product ruling may conceivably be appropriate is a futures market arrangement's tax situation or the tax treatment of an insurance/superannuation policy/scheme, where it is the product that is at issue, not the taxpayer's identity. However, if the taxpayer's position as a dealer or trader is important, then the application would probably fail to satisfy the third requirement.

In a similar fashion to private rulings, certain circumstances will prevent the Commissioner from making a product ruling, such as where the arrangement for which the ruling is sought is not seriously contemplated by the applicant.[3] With the nature of a product ruling being independent of the characteristics of the applicant, and with the feasibility of the arrangement frequently dependent upon its tax status, it may be extremely difficult to convince the Commissioner that the arrangement is seriously contemplated.

Furthermore, as with private rulings, the Commissioner has a general "discretion" to refuse to issue a ruling when the request for further information from the applicant does not yield sufficient information[4] or it is unreasonable to make a ruling in view of the resources available to the Commissioner.[5] The retention of these provisions for private rulings from the discussion document stage indicates that the Commissioner and the Government have a major role in determining whether a ruling will be provided to the applicant, irrespective of whether the application is complete as far as the applicant is concerned. Success of the regime will depend upon the cooperation of the Commissioner through his clear explanation as to why information is required and the Government in providing sufficient additional funds to the Inland Revenue Department's vote to ensure that the Rulings Unit can obtain sufficient resources. "Robbing Peter to pay Paul" will inevitably lead to the failure of the regime if the IRD must reallocate existing resources within an expanded Departmental public service environment.

In the course of applying for a product ruling, the applicant must (in addition to the requirements for a private ruling):[6]

"(c) Explain –

(i) Why it is not practical to seek a private ruling, and

(ii) Why the characteristics of the taxpayers who may enter into the arrangement are not relevant to the content of the ruling ..."

Placing the onus upon the taxpayer in this fashion may in fact reduce the number of applications for product rulings, and create an atmosphere of distrust when the Commissioner challenges the taxpayer's assertions and explanations for his application for a product ruling.

With both private and product rulings, provision has been made for consultation between the Commissioner and the applicant prior to the making of the ruling. This feature was absent from the original regime, and both the author and other tax professionals made extensive submissions on this issue. This is one instance of consultation that received favourable consideration from the drafters and Government officials. Recognition of the generic tax policy process ("GTPP"), recently adopted by the New Zealand Government, has consultation as a dominant feature.[7] The draft legislation for the binding rulings regime provides that the Commissioner must give the applicant a "reasonable opportunity to consult with the Commissioner about the content of the ruling",[8] although no guidance is given concerning what is "reasonable" and how the process of consultation will occur. Nevertheless, this is a minor issue and should be capable of resolution at an administrative level.

This approach has been applied to the new class of rulings, product rulings, although no provision for consultation has been included for public rulings. Consultation with tax advisers on public rulings could not only assist in their accuracy and applicability, but reduce the need for private and product rulings and therefore dispense with unnecessary costs for taxpayers and the Commissioner. Consultation would also endorse the intentions of the GTPP.

Both public and product rulings will be published in the *Gazette*, an official government publication and notification magazine. Consequently there will be issues of confidentiality surrounding product rulings, although they closely resemble public rulings in several respects. The creation of product rulings could be considered a compromise for the decision not to provide a facility for taxpayer contributions to the process of making public rulings.

B. Private rulings not to be published

In the original version of the regime, both public and private rulings were to be published. Public rulings will still be published in full by the IRD so that all interested taxpayers have access to them. The outlet for publication has now been determined as the *Gazette*. The discussion document appraised the arguments for and against the publication of private rulings. The result of the discussion was a proposal to publish all private rulings in "summary form", although this term was not clearly defined. A delay in publication would be permitted where the private ruling was commercially sensitive.

The delicate balancing of the pros and cons of publishing private rulings, particularly the interests of taxpayer privacy compared to the public good component of a private ruling eventually came to settle in favour of no publication of pri-

3. See inserted clause 91T(4)(b) of the Bill.
4. Inserted clauses 91I(4)(h) for private rulings and 91T(4)(f) for product rulings.
5. Inserted clauses 91I(4)(i) for private rulings and 91T(4)(g) for product rulings.
6. Inserted clause 91TD(1)(c).
7. See Organizational Review Committee, "Organizational Review of the Inland Revenue Department" (April 1994, Wellington NZ).
8. See inserted clauses 91P for private rulings and 91TG for product rulings.

vate rulings. Given the impending implementation date and the privacy considerations of publication, this change in direction is understandable, although it should not rule out the possibility of a change in thinking in the future, consequent upon research which may support and provide guidance on publication.

C. Continuing shortcomings of the regime

1. Materiality issues

The statements and references to penalties for providing false or misleading information have been removed from the draft legislation. Instead if the actual situation or arrangement does not "match" the arrangement or situation raised in the application for the ruling, then the resulting ruling does not bind the Commissioner and consequently it is of minimal use for the taxpayer applicant. References to situations where the Commissioner cannot refuse to provide a private ruling have not been retained, although essentially they represented a "political" statement rather than a substantial legislative contribution. Taxpayers can apply for a private ruling on any matter unless the Commissioner must invoke a limiting provision of the regime.

However, complete silence with respect to guidance as to what comprises a material difference or material omission/misrepresentation remains. The event of a material difference, omission or misrepresentation renders the application of the ruling ineffectual as against the Commissioner. With product and private rulings, payment by the applicant may result in a complete waste of time and resources if this materiality threshold is crossed.

2. Charging for rulings

Charging for private rulings, the most controversial or at least the more incompletely specified issue set out in the discussion document, has received minimal attention in the revised draft legislation. The only statement in the draft legislation concerning fees is contained in inserted clause 91W, where regulations enacted in the normal manner, may be made to *prescribe* or *provide for* the fixing of fees. Clause 91W states: "91W. Regulations – (1) The Governor-general may from time to time, by Order in Council, make regulations prescribing or providing for the fixing of fees payable in respect of applications for private rulings and product rulings.

(2) Any such regulations may –

(a) specify the person by whom any fees are payable;

(b) prescribe specific fees for specific work or services;

(c) prescribe a scale of fees or a rate based on the time involved in carrying out the work or services.

This fundamental component of the regime is not prescribed by the principal legislation other than through clause 91W. No accompanying proposed regulations have been included. However, in an accompanying commentary, the Government has made a brief statement on fees. There will be an initial non-refundable fee of $ 210 (GST inclusive), representing the time to review the application to see if it is valid. Thereafter, if the request for a ruling continues, there will be a fee of $ 105 (GST inclusive) per hour. The applicant may request an estimate of the cost of providing the ruling, but not a legally enforceable quote. In addition, if external advisers are utilized, the IRD may request full recovery of these fees from the applicant. If the applicant withdraws before completion of the ruling, he must pay the fees incurred to the time of notification of the withdrawal. Clearly, "full cost recovery" has been given a strained interpretation.

This situation can be compared to the Income Tax (Depreciation Determination) Regulations 1993, where Regulations 9-12 provide for and set fees, their payment and for waiver of fees. This raises an interesting conundrum: will this silence with respect to fees, in terms of an absence of draft regulations, mean retrospective application of fees[9] or will early application for private and product rulings be free!?

It would appear that charging for product and private rulings is "optional", since the making of regulations is optional. Obviously the charging process, which was discussed at length in an earlier article by the author,[10] will be applied in a manner similar to that proposed in the commentary. The issues involved are complex and cannot be adequately considered and discussed publicly prior to 1 April 1995 (the implementation date of the regime), indicating a serious flaw in the timing of introducing the binding rulings regime.

Product ruling fees may be lower than private ruling fees as a result of the former being published in the Gazette. Publication places a higher public good value on the product ruling and support from applicants for a higher general taxpayer funding contribution to subsidize the product ruling is anticipated.

The success of the regime is pivotal on the charging process yet all guidance on this aspect has been left out of the draft legislation (or regulations); only a commentary has been provided suggesting some details which may emerge in the form of regulations. The draft legislation also does not make any recognition of the "contractual" nature of payment for rulings and the ensuing obligations, yet another potentially serious omission. Details of the charging process and fees need to be clarified before 1 April 1995. Without detailed guidance and discussion on fees, then a delay to the implementation of the scheme is necessary to enable an initial fees structure to be proposed and discussed via the consultation process. Research on the charging process and costing mechanisms is also necessary; the current proposals do not represent full cost recovery in an accounting sense of the term.

3. Appeals against a refusal to issue a ruling

In the discussion document, a decision was made not to provide an appeal process against the Commissioner's discretion not to issue a ruling. This situation remains with the inclusion

9. The retrospective approach to implementing legislative changes is discussed later in this article.
10. *Supra* note 1, at 589.

of inserted clauses 91I(3) and 91T(3).[11] It is normally expected that where an administrative decision of this nature is permitted, a judicial review would be available. However, in conjunction with the policy to improve the dispute resolution process between the Commissioner and taxpayers, it is suggested that a process for appealing (or at least inquiring as to the reasons for the decision to decline the request for a private or product ruling) should be included in the draft legislation.

4. Repeals of and amendments to tax legislation

With inserted clause 91U of the Bill, a particularly disastrous series of events may be triggered. The effect of this clause is that if there is a repeal of the tax law for which a binding ruling has been issued, then the binding ruling ceases to apply from the effective date of that repeal. This situation is essentially not different to the existing rulings system in New Zealand. The problems arising from a lack of certainty and the associated costs of an ineffective "binding" ruling will arise; two of the problems associated with the current system and underlying the reason for change to a binding rulings environment. The environment proposed by clause 91U does not rest well with the purpose of the regime to provide certainty to taxpayers and assist them in meeting their obligations.

Consider the following scenario. The government determines that it wishes to "plug a loophole" in the tax law and to make the effective date of the change back to when the first instance of utilization of the loophole was observed (say two years previously). Working through the process outlined in the draft legislation, a binding ruling made with respect to the original legislation must be retrospectively altered back to the effective date of the repeal or substantial amendment if the application date of the repeal or amendment of the legislation is made retrospectively. Research which has been completed on the complexity and frequency of repeals of taxation law in New Zealand indicates that retrospective repeals are not uncommon and can take effect several months or even years prior to the date on which the legislation containing the repeal is passed by Parliament.[12] Furthermore, if the legislation is only partially altered, then the binding ruling ceases to apply to the extent of the repeal and from the effective date of the repeal. This situation may give rise to the need for another ruling to determine the extent to which prior ruling has been repealed!

To provide a remedy for these potentially unsatisfactory eventualities, if a taxation law change arises, any binding ruling issued under the previous legislation should remain in force until the ruling expires, or until the arrangement is completed. Partial repeals or complete repeals of binding rulings made in a retrospective manner should never occur (unless this provides a favourable result for the taxpayer), neither should retrospective changes to the legislation occur. Political concern over the undesirability of retrospective repeals and amendments to legislation has been largely more rhetoric than effective firm policy in New Zealand, especially in the taxation area.

5. A specified time period for providing a ruling.

In the discussion document, the Government stated it did not prefer a stipulated time period within which to provide a binding ruling. However, without an efficient turn-around period, the binding rulings facility will be ineffective for many taxpayers. One possible option is to set fees payable which reflect the time period required for providing a ruling – the shorter the time frame in which the ruling is required, the higher the (hourly) fee payable. A time period not only assists with certainty and efficiency, but provides a useful benchmark for measuring the performance of the Commissioner and the Rulings Unit personnel. Guidelines could be provided by way of regulation, at least, to ensure that the purpose of the binding rulings regime has a greater opportunity of fulfilment.

III. REVISIONS TO THE ENTERTAINMENT TAX REGIME

A. New focus on specific entertainment

New Zealand experienced a politically-motivated clampdown on business entertainment expenditure effective from 1 April 1993, when legislation was hastily implemented that rendered expenditure that would normally satisfy the business deduction expenditure tests,[13] 50 percent deductible for tax purposes. That is, there was notional assumption that 50 percent of expenditure that had a business entertainment component (subject to certain exemptions) was of a private nature. The previous approach to the tax treatment of business entertainment expenditure was all-encompassing, casting a wide net that snared an extensive variety of expenditure that was not intended to be subjected to the regime. Compliance costs were substantial, with anecdotal evidence suggesting that many businesses incurred costs over and above the tax value of the disallowed portion of the deduction, and that the increase in revenue for the Government was possibly less than the total compliance and administrative costs.[14]

The provisions on the Bill seek to redirect the focus towards limiting deductions on certain specified types of activity, that is excluding expenditure from the regime unless it comes with the scope of the four major areas of entertainment. Previously the regime was all-inclusive, capturing any expenditure that had an entertainment component unless specifically excluded by legislation.

The legislation has been condensed from six pages to one (plus a two page schedule of specified and excluded types of

11. For private rulings and product rulings, respectively.
12. Anderson, W., "Legislative Complexity: A Graphical Analysis of the New Zealand Revenue Acts", (unpublished research paper, University of Canterbury).
13. See Sec. 104 of the Income Tax Act 1976 (NZ).
14. Estimates of reduced expenditure claims by taxpayers were revised downwards from nearly $NZ 90 million for the 1994 financial year to a figure closer to $NZ 25 million.

entertainment.[15] The $NZ 25 daily exemption has been scrapped, along with the complicated definitions of "entertainment", "entertainment facility" and "recreation". The assumption held by Government that business entertainment generally involves a private benefit has not been challenged in the course of the review. While compliance costs for taxpayers should fall as a result of the changes, it has been argued that where accurate records have been maintained, full deduction for business entertainment expenditure in the "included categories" should be permitted, subject to challenge by the IRD.[16] All of the proposed changes are scheduled to take effect from 1 April 1995.

B. Categories of entertainment caught by the Entertainment Tax regime

The four broad areas or subject headings of 50 percent non-deductible business entertainment expenditure are: corporate boxes, holiday accommodation, pleasure craft, and food and beverages. The fourth category is treated only as a specific type of entertainment if there is entertainment within the first three categories present, or food and beverages are consumed off-premises and do not come within the exclusions, or food and beverages are consumed on business premises at a party, board-room, executive dining area or similar exclusive area.

Corporate boxes, marquees, tents and similar exclusive areas at sporting, cultural or other recreational events or activities remain subject to the regime; the areas principally cited as the reason for introducing the regime. Holiday accommodation is deemed to include houses, time-shares and similar leisure venues which are more than incidental to business activities or employment duties. Pleasure craft includes yachts, an abundant form of recreation and business New Zealand!

Most of the existing exemptions have been maintained where the expenditure would otherwise fall within the category of entertainment expenditure, such as:
- the taxpayers business is providing entertainment;
- the benefits are assessable income to the recipient (or subject to fringe benefit);
- the entertainment occurs outside of New Zealand;
- the entertainment is a public promotion;
- the entertainment involves the provision of samples;
- the entertainment is provided for charitable purposes;
- sponsorship is involved where the public generally benefit; or
- food and beverages are consumed on business trips or at certain conferences.

It is the food and beverages category of entertainment expenditure where a few inconsistencies remain, partially a result of direct copying of the original legislation. Opportunities for structuring the payment of meals between guests and employees will allow deductions for business meals to be maintained. In Australia, the approach is to deem certain types of entertainment expenditure to be subject to the Fringe Benefit Tax regime (the original proposal for entertainment expenditure in New Zealand, but rejected during submissions to the Select Committee); otherwise business expenditure remains fully deductible. Appendix 1 provides a comparison of entertainment expenditure under the current and proposed regimes, with the emphasis upon the food and drink area of business entertainment expenditure.

IV. CONCLUSIONS

A. Binding rulings regime

A number of the shortcomings from the proposed regime in the discussion document remain and several others have been created as a result of the Bill. These concerns are summarized below:

Shortcomings in the revised proposed binding rulings regime
(1) a failure to provide a succinct definition for each of the three types of binding rulings, namely public, private and product rulings;
(2) the absence of any specification of the situations that will give rise to unusual resource constraints and when there is insufficient information to permit the Commissioner to make a ruling;
(3) no clear statement of what is a "material difference" with respect to an application, the resulting ruling and disclosure of the actual transaction;
(4) no discussion on the specifics of how rulings will be costed and charged for;
(5) no clear statement whether the appeal against use of the discretion not to issue a private ruling is a judicial review, neither is there any discussion of the scope of this review;
(6) the potential for retrospective cessation of binding rulings consequent to retrospective repeals or amendments to the underlying tax law;
(7) the absence of guidance as to how a taxpayer may convince the Commissioner that a product ruling is necessary rather than a private ruling; and
(8) a failure to specify delivery times and to include this as a performance statistic for the Commissioner.

Possibly through the process of considering submissions on the Bill, several of these shortcomings may be addressed. It should be noted that points two, three, four and eight have remained from the discussion document stage and are unlikely to be addressed in any form before binding rulings are a reality for New Zealand taxpayers from 1 April 1995.

B. Entertainment tax regime

The long-awaited review of the entertainment tax regime, or more correctly, limitation on deduction of entertainment expenditure, provides some relief for taxpayers in terms of reducing compliance costs, but it retains the previously substantial degree of complexity with respect to food and bever-

15. See clause 46 of the Bill, and the new Schedule 6A.
16. See Sharma, B. and Knowles, G., "Gov't simplifies the lunch tax ... But the politics of envy remain", *The Independent* (December 1994), at 34.

ages. The private benefit assumption with business entertainment expenditure remains as a core component of the regime, to the disappointment of taxpayers and their advisers. Nevertheless, the amendments are an improvement and the opportunity for consultation through submissions to the Select Committee remains.

Appendix 1 (Source: TEO Newsletter No. 96 (19 December 1994)

THE ENTERTAINMENT TAX REGIME

"ETR" = Entertainment tax regime

Example	Existing Regime	Proposed Regime
The Standard Business Lunch The purchasing manager from New Zealand Export Co takes a major supplier to lunch. The lunch consists of a two course meal accompanied by mineral water.	Food and drink subject to the ETR.	Food and drink subject to the ETR.
The Standard Working Lunch A group of managers meet at 11.00 am to discuss strategy for the next year. The meeting takes 3 hours. A finger food lunch is provided.	Food and drink subject to the ETR.	Food and drink subject to the ETR.
Travelling A commercial representative incurs an average of $ 40 per day of expenditure on meals while travelling on business related matters.	$ 40 per day subject to the ETR with an exclusion for the first $ 25 per day	Excluded from the ETR.
Travelling With a Client The sales manager from New Zealand Export Co accompanies, and pays for, the import manager of Japan Inc to tour Export Co's South Island operations.	Food and drink subject to the ETR with an exclusion for the first $ 25 per person per day.	If they dine together the food and drink is subject to the ETR. If they dine separately the food and drink is excluded from the ETR.
The Standard Conference An employee organizes a conference in Rotorua (NZ) which consists of one and a half days of technical sessions and a compulsory recreational round of golf.	Food and drink is subject to the ETR, with a $ 25 per person exemption for an eligible conference and a further $ 25 per person per day spent travelling. The golf costs are subject to the ETR.	Food and drink is excluded from the ETR. The golf costs (excluding food and drink) are subject to FBT.
The Non-Standard Conference The employer organizes a "conference" at Rotorua (NZ) at which there is one administrative session of one hour and two days of recreational activities organized and paid for by the employer.	Food and drink, travel, accommodation and recreation is subject to the ETR.	Food and drink is subject to the ETR. Travel, accommodation and recreation is subject to FBT.
The Standard Christmas Party The staff Christmas party is held on the firm's premises. It consists of the provision of food and drink.	Food and drink, and incidental expenditure is subject to the ETR.	Food and drink, and incidental expenditure is subject to the ETR.

ISRAEL–UNITED STATES

TAX TREATY

Leon Harris

Kost Levary & Forer, Tel-Aviv.

In September 1994 the Israel–US tax treaty (hereinafter the "Treaty") was ratified. New withholding tax rates under the Treaty apply to amounts paid beginning 1 February 1995. For other purposes, the Treaty generally covers taxable years beginning 1 January 1995. The Treaty represents the culmination of efforts stretching as far back as 1947.

The Treaty complements the US–Israel Free Trade Agreement of 1985 which grants import tax concessions in each country for goods produced in the other country.

The Treaty is expected to improve the double tax relief previously available under the domestic tax laws of the United States and Israel. Following is a brief summary of the Treaty.

I. PERSONS COVERED

The Treaty will apply to US citizens and to US resident persons (corporations and individuals) for tax purposes in each country. A partnership, estate or trust will be resident in either country to the extent that income arising is taxable in that country as income of the entity concerned or of its partners or beneficiaries. A US "Green Card" holder who is not an Israeli resident (e.g. a former Israeli resident) is covered by the Treaty as a US resident if he/she has a substantial presence, permanent home or habitual abode in the United States.

A "limitation of benefits" clause denies Treaty benefits where third country residents effectively enjoy 50 percent or more of the ownership or gross income of an entity. This limitation does not apply to entities traded on a stock exchange in either country or on NASDAQ, nor to persons that conduct an active trade or business in the United States or Israel, if the income in question is derived from, or incidental to, the trade or business.

II. DUAL STATUS PERSONS

Where a person holds dual status, the Treaty provides the following "tiebreaker" rules for allocating residence to one country for tax purposes:

Situation under domestic legislation	Treaty rule
Individual resident in both countries	Residency would be allocated to one country based primarily on the person's centre of vital interests.
Israeli resident individual who holds a US "Green Card"	As above
US citizen who is an Israeli immigrant ("Oleh")	Resident in Israel
Corporation resident in both countries e.g. incorporated in the US but controlled and managed in Israel	Residency would be allocated to one country by mutual agreement between the US & Israeli tax authorities. Until then, treaty relief is restricted.

III. WHEN IS TAX IMPOSED

In general, a US resident or citizen will be taxable in Israel solely on income from Israeli sources, as defined in the Treaty. The converse case applies to Israeli residents that derive US-source income.

Tax payable in the source country under the Treaty may be credited against any tax arising on the same income in the taxpayer's country of residence, subject to various rules (see below).

The Treaty cannot be construed to restrict any exclusion, exemption, deduction, credit or other allowance in the two countries' domestic tax legislation, or in any other agreements between them.

Israeli taxes covered by the Treaty include income tax, company tax, capital gains tax, land appreciation tax and the wage and profit tax imposed on banks and insurance companies. The Treaty also covers US federal income taxes, but not state taxes or social security.

Standard Israeli and US tax rates may be summarized as follows:

	Israel (%)	US Federal (%)	US State (%)
Individuals	15–50	15–39.6	6–10 (Average)
Corporations – regular (1995)	37	15–35	6–10 (Average)
– approved enterprise	0–25	N/A	N/A
Standard withholding tax on passive dividend, interest and royalty income	25(*)	30(**)	N/A
Approved enterprise dividends	15	N/A	N/A

(*) Interest on certain non-business shekel bank deposits is exempt in Israel. Likewise, interest on non-residents' bank accounts is exempt in Israel for foreign residents who do not conduct a business or profession in Israel.

(**) In practice, portfolio interest and bank account exceptions makes virtually all interest exempt in the United States, except for bank loans, loans from related parties (10% related generally), and contingent interest debt.

IV. BUSINESS PROFITS

A corporation resident in one country should only be taxable on business profits in the other country to the extent that the profits are attributable to a "permanent establishment" ("PE") in the other country. A PE is essentially a fixed place of business ("branch") through which industrial or commercial activity is conducted. The Treaty definition of a PE excludes, among others:
- a building site, or construction or assembly project, or related supervision activity, lasting less than six months;
- the maintenance of substantial equipment or machinery for less than six months;
- the maintenance of a goods inventory for purposes of storage, display, delivery or processing by another person. This does not include a point of sale except for the sale of display goods at the end of a trade fair or convention;
- fixed place of business for purchasing goods, collecting information (e.g. a news bureau), advertising, supply of information or scientific research, or similar activity with a preparatory or auxiliary character;
- an independent agent.

In addition to the usual corporate taxes, the Treaty allows each country to impose a branch profits tax (in lieu of dividend withholding tax) of up to 12.5 percent and a branch interest tax of up to 5 percent. Until now the United States has imposed these taxes at a rate of 30 percent, while Israel merely imposes a 15 percent branch profits tax on "approved enterprise" branches.

V. WITHHOLDING TAX RATES – PASSIVE INCOME

The Treaty prescribes the following withholding tax rates for payments of passive income by residents of one country to residents of the other.

Payment	Circumstance	Rate
Dividend	Regular rate	25%
	From the profits of an approved enterprise in Israel	15%
	For corporate shareholders that held at least 10% of the voting stock of a payor company since the beginning of the previous taxable year (if any), unless the payor company has an approved enterprise in Israel or derives more than 25% of its gross income from passive interest or dividend income (with certain exceptions).	12.5%
	US Regulated Investment Company	25%
	US Real Estate Investment Trust	25–30%
	Israeli fiscally transparent entities (family company or capital intensive company or similar)	Regular rates on profits
Interest	Regular rate	17.5%
	To a bank, savings institutions or insurance company, or the like	10%
	Alternative election in the above cases	Regular rates on interest profit margin
	Interest on a governmental or government- guaranteed loan	Zero
Royalties (or performance related sale gains from relevant intangible assets)	Film and copyright royalties	10%
	Industrial royalties	15%

VI. CAPITAL GAINS

In principle the Treaty provides a resident of one country with an exemption from capital gains taxation in the other (source) country. However, capital gains relating to the following may be taxable in the other country:
- assets of a PE;
- real estate and certain real property corporations;
- performance-related gains from intangible assets capable of generating royalties, e.g. patents, know-how, copyrights. Tax on such gains in the other country will be restricted to the rates shown above, for royalties;
- individuals who visit the other country for more than 183 days in the taxable year;
- dispositions of stock in a corporation in the other country.

Nevertheless, a stock disposition may be exempt in the other country if the investor (corporate or individual) held less than 10 percent of the corporation's voting stock throughout the preceding 12 months. This provision should be beneficial to US investors in Israeli corporations, as it should override domestic Israeli capital taxation rules relating to stocks in Israeli companies.

Certain corporate reorganizations may proceed on a tax deferred basis in both countries where the transferor and the transferee companies are resident in the same country and one controls at least 80 percent of the voting rights and value of the other, directly or indirectly, or they are commonly controlled to the same extent by another company resident in the same country. This provision should augment restrictive Israeli tax reliefs (Income Tax Ordinance Sections 103-105) for reorganizations.

Notwithstanding the above, Israeli residents may enjoy exemption from most US-source capital gains under domestic US legislation, except for gains from US real property interests and the sale of permanent establishment assets.

VII. REAL ESTATE INCOME AND GAINS

The Treaty gives a first right of taxation to the country where the real estate is situated. Any tax in the other country may be offset by double tax relief (see below).

VIII. INDIVIDUALS

Self-employed individuals who are residents of one country will generally not be taxable in the other country on personal services income derived in the other country if they are present there less than 183 days in the taxable year. This is a significant concession not found in some other tax treaties.

Employees and officers of a corporation who are residents of one country will not be taxable on their remuneration for services performed in the other country if: they are present there less than 183 days in the taxable year; and they are employed by a home country resident or PE; and the remuneration is not borne by any PE of the employer in the other country; and the remuneration is taxed in the home country.

Social security payments and other public pensions will be exempt in both countries. Private pensions, alimony receipts and annuities will, in general, be taxable only in the recipient's country of residence. Child support receipts will be exempt in the recipient's country of residence.

The treaty contains additional provisions covering, among others, public entertainers, governmental personnel, teachers, students and trainees, and charitable contributions.

IX. FOREIGN TAX CREDIT

Double tax relief for items taxable under the Treaty takes the form of a foreign tax credit, subject to the provisions and limitations in the laws of each country. In addition, 10 percent-or-more corporate shareholders (by reference to voting stock) in one country who receive dividends from a payor corporation in the other country may credit the deemed paid (underlying) corporate tax of the payor corporation.

US citizens who are also Israeli residents will be taxable first as Israeli residents, then as US citizens on items of income that are exempt or taxed at reduced rates in the US when derived by Israeli residents. Taxes payable at one stage under this process are creditable at the following stages.

Unlike Israel's treaties with some other countries (e.g. the UK, France, Germany), the Treaty with the US does *not* contain a "tax sparing" clause. A tax sparing clause would have helped to preserve the benefit of Israel's investment incentive legislation (including "approved enterprise" incentive) by allowing a credit for full Israeli taxes rather than reduced Israeli taxes actually payable in applicable cases. According to a related Memorandum of Understanding, the Treaty will be amended should the United States alter its policy in this regard or include a tax sparing clause in a treaty with any other country.

X. RELATED PARTIES

The tax authorities are empowered to make adjustments as they see fit, if the terms of transactions between related parties appear to differ from those which would have applied between unrelated parties. Application may be made to the other tax authority for a corresponding adjustment. Failing this, mutual consultation procedures may be invoked.

XI. MUTUAL CONSULTATION

The tax authorities of the two countries are empowered to discuss transfer pricing and other double taxation issues and to issue joint advance pricing agreements.

XII. COMMENTS

Until now, US and Israeli residents resorted to unilateral double tax relief provisions with respect to their business and investments in the other respective country. The new Treaty will provide such persons greater certainty regarding the overall tax impact on their dealings. The Treaty will be particularly helpful in a number of instances.

First, US residents who sell Israeli securities will now enjoy exemption from Israeli capital gains tax in some cases. In other cases they are assured of a foreign tax credit. Previously, US residents often faced double taxation when selling Israeli securities due to incompatible gain sourcing rules in the two countries.

Second, Israeli residents who derive royalty income from the United States will now be assured of a credit in Israel for US withholding tax thereon. Previously, Israeli unilateral relief regulations were open to alternative interpretations as to the source country of such royalty income.

Third, the reduction in withholding taxes, especially on interest and royalties, will be welcome to recipients of such income.

A novel feature for lenders without a PE or fixed base in the other country is the ability to elect a withholding tax rate computed at regular tax rates on the interest profit margin. For example, an Israeli resident company that borrows funds at LIBOR and lends them onwards to a US resident borrower at LIBOR plus 1 percent may elect to pay US federal tax of 0.35 percent (= 1% profit x 35% US federal tax). Previously, Israel allowed such elections under its domestic law, but the US did not.

Fourth, individuals who are both Israeli residents and US citizens or green card holders are now assured of double tax relief according to special rules.

Fifth, international concerns may, under the Treaty, request bilateral "advance pricing agreements" from the US Internal Revenue Service and the Israeli tax authorities regarding transfer pricing policies on intragroup dealings between the two countries. In the long term, this could prove to be a useful facility in appropriate instances.

Readers are advised to refer to the Treaty and laws of each country and to obtain appropriate professional advice in specific proposed instances.

CUMULATIVE INDEX – 1995

I. ARTICLES

II. REPORTS AND DOCUMENTS

III. IFA NEWS

V. BIBLIOGRAPHY

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 48-52 of the January 1995 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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CANADA

1995 FEDERAL BUDGET: A NEW ROAD OF FUNDAMENTAL REFORM?

Ingrid Sapona

Ingrid Sapona is a barrister and solicitor in Toronto, Ontario, as well as a member of the New York bar.

I. INTRODUCTION

Canada's Finance Minister, the honourable Paul Martin, began his annual Budget Speech on 27 February 1995 (the "Budget") by telling the nation and the world's financial community that, "[T]here are times in the progress of a people when fundamental challenges must be faced, fundamental choices made – a new course charted. For Canada, this is one of those times."[1] Pledging to "set out on a new road of fundamental reform, of renewal – of hope restored," Martin's Budget featured expenditure reductions of C$ 25.3 billion over the next three fiscal years, as well as tax increases of C$ 2.6 billion and the elimination of tax preferences of C$ 1.1 billion.[2]

Despite setting short-term deficit reduction goals, the government did not set a timetable for total elimination of the country's staggering debt. Martin's Budget projects that Canada's 1995-1996 budget deficit will be C$ 32.7 billion, with the deficit dropping to C$ 24.3 billion for 1996-1997.[3] To the government's credit, however, the 1994-1995 budget deficit of C$ 35.3 billion is C$ 4.4 billion below the target set out in last year's budget.[4]

The 1995 Budget is the second handed down by the Liberal government and comes at a critical time. The country's credit rating is under review by one of the US's big bond rating agencies, the financial community is looking for a demonstration of the government's commitment to reducing the deficit, and there is considerable uncertainty over the future of Quebec, given its plans for a referendum later this year.

II. TAX MEASURES

Though the focus of the Budget was on spending cuts, (nearly C$ 7 of spending cuts for every C$ 1 of new tax revenues,[5]) there were some significant tax changes announced. According to Martin, the tax measures are "largely directed at removing preferences and increasing fairness and helping to meet deficit targets."[6]

A. Tax measures effecting individuals

Aware of "the heavy tax burden already borne by Canadians and the cost imposed on the economy as a whole,[7]" there were no changes to federal personal tax rates.[8]

Another "non-change" of significance to many Canadians is the government's decision to keep the C$ 500,000 lifetime capital gains exemption, which is available to individuals on capital gains derived from dispositions of shares of qualified small business corporations and qualified farm property. In last year's budget the government eliminated the C$ 100,000 cumulative lifetime capital gains exemption (which allowed individuals to shield up to C$ 100,000 of capital gains derived on the disposition of certain types of property) and promised to review the C$ 500,000 exemption. Consequently, much pre-budget speculation focused on whether the government might eliminate this provision, or scale it back in any of a variety of ways.[9]

In the area of tax-assisted retirement savings, the government reiterated its position that tax assistance to registered saving plans should be limited to two and one-half times the average wage. As a result, the government announced a number of changes, including reducing the dollar limit on deductible contributions to registered retirement savings plans ("RRSPs") and the contribution limit for money purchase

1. See *1995 Federal Budget Speech*, Department of Finance, Canada, at 4.
2. *Id.*
3. *Id.* at 5.
4. *Id.* at 2.
5. *Id.* at 4.
6. *Id.* at 15.
7. *Id.* at 15.
8. The basic federal tax rate is 17% on income up to C$ 29,590; 26% on income over C$ 29,590 up to C$ 59,180; and 29% on income over C$ 59,180. In addition there is a federal surtax. The surtax is 3% of federal tax determined after deducting applicable tax credits. On basic federal tax (after deducting applicable credits and before adding the 3% surtax) there is an additional surtax of 5% on basic federal tax in excess of C$ 12,500. And of course, in addition to the federal personal rates there are provincial personal taxes, which are generally calculated as a percentage of basic federal tax.
9. Among the options the government said it was considering with respect to the C$ 500,000 exemption was reducing the inclusion rate for capital gains on small business shares and farm property from 75% to 50% or providing an intergenerational roll-over for small business shares and farm property. See, e.g. the *Supplementary Information* released with the 1994 Federal Budget, Department of Finance, Canada, 22 February 1994.

registered pension plans ("RPPs");[10] a reduction in the RRSP overcontribution allowance from C$ 8,000 to C$ 2,000 starting January 1996;[11] and a phasing out of the ability to roll-over retirement allowances to RRSPs on termination of long-term employment.[12]

The government will be eliminating the deferral available to individuals on income from an unincorporated business that has a non-calendar fiscal year. Currently, individuals must report salaries, wages and most other income earned during the relevant calendar year in their income for that year, but income from an unincorporated business is included in the year in which the business' fiscal period ends. Effective for fiscal periods beginning after 1994, sole proprietors, professional corporations,[13] and partnerships where at least one partner is an individual or professional corporation, will be required to report income on a calendar year basis. This change will be phased in over ten years, so that taxpayers affected can bring in deferred amounts slowly over time. Furthermore, individuals that have business income will be given until 15 June of each year to complete and file their income tax returns, though any tax owing will continue to be due by 30 April annually.

The government announced significant changes applicable to family trusts, a popular income-splitting tool. Under the existing rules, property held in a family trust for the benefit of the beneficiaries is given special treatment. First, through use of a "preferred beneficiary election" the trust's income can be allocated to close family members, e.g. children, grandchildren, or a spouse of the settlor, and taxed at the beneficiary's rate, even if the income is not actually paid to the preferred beneficiary. (Taxable income of *inter vivos* trusts is taxed at the top personal rate; the taxable income of testamentary trusts is subject to the graduated rates applicable to individuals.) The preferred beneficiary election permits income splitting among large numbers of beneficiaries while allowing trust income to accumulate without the need to pay income to the beneficiaries and without regard to the amount the beneficiary will ultimately receive. To "level the playing field between property held in a trust and property held directly",[14] the preferred beneficiary election is being eliminated except in situations where the preferred beneficiaries are entitled to tax credits for mental or physical impairment. The change is to be applicable to taxation years of trusts commencing after 1995.

The second special treatment currently afforded to family trusts relates to the "exempt beneficiary election". Trusts other than family trusts are deemed to have disposed of trust assets every 21 years. This deemed disposition rule, which came into effect in 1972 to prevent trusts from being used to avoid the taxation of capital gains on death, was originally to apply to all trusts. However, in the early 1990s, as the first 21-year period after enactment of the rule approached (1993), the previous government enacted the exempt beneficiary election, which postpones the deemed disposition in the case of family trusts in certain situations. Under the exempt beneficiary election, the deemed disposition is delayed until the death of the last "exempt beneficiary", basically a family member no more than one generation removed from the trust settlor. The preferred beneficiary election is being eliminated effective 1 January 1999. Family trusts that have made an exempt beneficiary election at any time before 1 January 1999 will be subject to a deemed disposition of trust assets at fair market value on that date, unless all the trust property has been distributed to beneficiaries before that date. Capital gains on property distributed to an exempt beneficiary before 1999 will not be realized until the exempt beneficiary disposes of the property or when the exempt beneficiary (or the beneficiary's spouse) dies.

B. Tax measures affecting corporations

Unlike individuals, corporations were hit with tax rate increases. The Large Corporations Tax ("LCT"), which is essentially a capital tax, is increased from 0.2 percent to 0.225 percent. The LCT is levied on a corporation's taxable capital employed in Canada in excess of C$ 10 million. The increase is applicable for taxation years ending after 27 February 1995 (budget day) and is to be prorated for taxation years that began before that date.

The corporate surtax is increased from 3 percent to 4 percent, applicable for taxation years ending after 27 February 1995 and is to be prorated for taxation years that began before that date.

Banks and other large deposit-taking institutions are subject to a temporary capital tax increase. Effective from 28 February 1995 to 31 October 1996, banks and other large deposit taking institutions (other than life insurance companies) must pay a surcharge of 12 percent of the capital tax currently imposed upon them under Part VI of the Income Tax Act (Canada) (the "Act"). The surcharge is to be calculated before any credit for income taxes and as if there were a capital deduction of C$ 400 million. Furthermore, the surcharge cannot be offset by income tax payable under Part I of the Act. The temporary surcharge will be prorated for taxation years that straddle the effective dates.

10. The dollar limit on contributions to RRSPs for 1996 and 1997 will drop to C$ 13,500 (the 1995 limit is C$ 14,500), with the limit to increase to C$ 15,500 by 1999, at which time it will be indexed. The contribution limit for money purchase RPPs will be reduced to C$ 13,500 for 1996 (the 1995 limit is C$ 15,500) and will rise by C$ 1,000 until 1998, at which time it will be indexed.

11. The overcontribution allowance was designed to give taxpayers a margin of error for overcontributions that arose through inadvertence. Over the past few years, however, many taxpayers have intentionally overcontributed, thereby obtaining an unintended benefit.

12. Currently, when an individual who is terminated from employment receives a payment in respect of long service to that employer, the individual is permitted to roll-over, on a tax-free basis, up to C$ 2,000 for each year of service, plus up to C$ 1,500 for each year before 1989 that the person worked but earned no pension benefits. Such amounts rolled over were in addition to the regular RRSP contribution limits. Under the proposals, individuals will be permitted to transfer up to C$ 2,000 per year of service before 1996, plus C$ 1,500 for each year before 1989, but nothing in respect of years of service after 1996.

13. For purposes of this provision, any corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor will be considered a professional corporation.

14. See *Budget Plan*, Tabled in the House of Commons by the Minister of Finance, 27 February 1995, Department of Finance, Canada, at 169 [hereinafter "Budget Plan"].

In recognition of the fact that the spread between corporate and personal income tax rates has increased over the past few years and created an incentive for individuals to defer tax by accumulating investment income in a private corporation rather than earning the income directly, the Budget includes changes that are aimed at reducing the deferral advantage. Presently, individuals earning investment income through Canadian-controlled private corporations ("CCPCs")[15] can obtain a deferral because such income is taxed at about 45 percent when taxed at the corporate level, while such income is taxed at about 50 percent in the hands of an individual taxed at the top marginal rate.[16]

A $6^2/_3$ percent refundable tax on investment income (other than deductible dividends) of CCPCs will be levied. This additional refundable tax applies for taxation years that end after June 1995 and will be prorated for years that begin before July 1995. The additional tax will be credited to the CCPC's refundable dividend tax on hand ("RDTOH") account, which is an account used to compute the tax refund available to a CCPC when it pays its own dividends. A CCPC's RDTOH account is increased when the corporation pays Part IV tax (a tax on taxable dividends received by private corporations from corporations in which the recipient owns no more than 10 percent) and when it receives refundable taxes. Currently, a corporation receives a refund of C$ 1 for every C$ 4 of taxable dividend paid out of amounts in its RDTOH account. Under the proposed changes, refunds out of the RDTOH account will be made at a rate of C$ 1 for every C$3 of dividends paid after June 1995. In conjunction with these changes, the government is postponing the increase in refundable Part IV tax (announced in the last year's Budget) that was to take effect after 1994. Under the 1995 Budget proposals the increase in Part IV tax (from 25 to $33^1/_3$ percent) will apply only on dividends received after 30 June 1995.

In the area of tax incentives to promote research and development ("R&D") the government has made several modifications over the past three years, and the Budget features more changes, primarily (though not exclusively) relating to "contract R&D". Currently, taxpayers performing in-house R&D can claim deductions for qualifying current and capital expenses on scientific research and experimental development ("SR&ED"), and can earn investment tax credits ("ITCs") of 20 percent or 35 percent on these expenditures. On R&D that is contracted out, taxpayers can claim SR&ED deductions and earn ITCs on the R&D contract amount, to the extent that the R&D is performed in the taxation year.

Under the proposed changes, where a taxpayer ("the payor") contracts out its R&D to a non-arm's length third party ("the performer"), the amount paid to the performer will not be considered qualified investments for ITC purposes. Instead, the performer will be able to transfer its qualified expenditures incurred in the year to the payor up to a maximum of the contract amount. This change will apply to expenditures incurred by a payor in taxation years commencing after 1995.

The following example illustrates the effect of the change:[17] Sub Co. is a wholly-owned subsidiary of Parent Co. Parent Co. enters into a contract with Sub Co. whereby Sub Co. agrees to perform R&D for Parent Co. The only R&D performed by Sub Co. is that performed for Parent Co. The contract price is C$ 1,000, of which only C$ 750 constitutes qualifying expenditures. (The C$ 1000 contract price includes C$ 250 that is not eligible for tax incentives, e.g. a profit margin, certain overhead, etc.) Under the existing rules, Parent Co. would earn an ITC of C$ 200 (20 percent of C$ 1000). In addition, Parent Co. would have an SR&ED current deduction of C$ 1000. Parent Co.'s SR&ED expenditure pool would be reduced by the ITC in the year after the credit is used to reduce taxes otherwise payable or refunded. Under the proposed changes, Sub Co. could transfer to Parent Co. all or a part of the C$ 750 qualifying expenditures, and therefore Parent Co. could take a maximum ITC of C$ 150 (20 percent of C$ 750). Parent Co. would still be entitled to an SR&ED deduction of C$ 1000. Parent Co.'s and/or Sub Co.'s SR&ED expenditure pool would be reduced by the ITC in the year after the credit is used to reduce taxes otherwise payable or refunded.

The government will also expand the information reporting requirements with respect to contracted out R&D. Where contract expenditures for the year in respect of a particular performer exceed C$ 30,000, among the information the government will require is the name of the performer and an indication of the amount of the contract expenditures.

Addressing a general concern about non-arm's length transactions, the government proposes limiting the amount of ITCs an R&D performer ("the performer") can claim where the performer purchases goods or services for SR&ED from a non-arm's length party ("the vendor"). Applicable to expenditures incurred in taxation years commencing after 1995, in such a non-arm's length scenario the performer can only earn ITCs on an amount up to the vendor's cost of providing the goods or services.

In contrast to contract R&D is "third party" payments, which are situations where the payer does not control the R&D performer but merely obtains entitlement to exploit the results of the R&D. Currently, third party payments, unlike contract R&D, generally become eligible for the SR&ED tax incentives at the time the payment is made, rather than at the time the R&D is performed. The Budget proposes to treat third party payments made to corporations resident in Canada the same as contract R&D, i.e. third party payments made after 1995 will qualify for the SR&ED deduction and for ITC purposes only in the year in which the R&D is performed. Also, in an effort to better monitor the SR&ED incentives in the area of third party payments, effective for taxation years ending after 27 February 1995 tax-exempt corporations created for scientific research and experimental development will be required to file a form with their annual return reporting their SR&ED work and expenditures.

15. Canadian-controlled private corporations (CCPCs) are private corporations that cannot be controlled, directly or indirectly, by one or more non-residents, by one or more public corporations, or by any combination thereof.

16. The 45% and 50% rates are based on average combined federal/provincial rates.

17. The example is a slight variation of one set out in the *Budget Plan*, *supra* note 14, at 165.

The government will amend the Act so that SR&ED expenditures not paid for within 180 days of a taxpayer's year end will not be eligible for ITCs. Under the current system, ITCs can be earned in the year the work is performed even if payment has not been rendered. Under the proposed changes, all current expenditures incurred but not paid for within 180 days of year end will be deemed to have been incurred for ITC purposes in the year the amount is paid. This measure is effective immediately, but will not apply if payment is made within 90 days after the legislation implementing the proposal receives Royal Assent.

Concerned that the tax rules have not kept pace with the rapid changes in the area of information technology, and concerned that R&D tax breaks on information technology have increased significantly in recent years, the government will accelerate its review of the applicable rules. The review is to focus on the eligibility criteria for information technology R&D, i.e. the use of computer software and hardware to collect, process and disseminate information. During the review, all information technology R&D performed after 27 February 1995 by financial institutions, either directly or indirectly, will be excluded from the definition of SR&ED. For purposes of the restriction, "financial institutions" include banks, trust companies, credit unions, insurance corporations and registered securities dealers. The interim measure will be in effect pending completion of the review.

C. Excise taxes

The excise tax on leaded and unleaded gasoline and aviation gasoline was increased by 1.5 cents per litre, effective 28 February 1995. The increases bring the federal excise tax on leaded gasoline and leaded aviation gasoline to 11 cents per litre (from 9.5 cents) and on unleaded gasoline and unleaded aviation gasoline to 10 cents per litre (from 8.5 cents).

The air transportation tax is being increased. The maximum tax on domestic and transborder air travel and the tax on international travel purchased in Canada will be increased from C$ 50 to C$ 55. The tax on international air transportation purchased outside Canada and the maximum tax on transborder air travel subject to the US's 10 percent air transportation tax will be increased from C$ 25 to C$ 27.50. The new rates will apply to tickets purchased on or after 1 May 1995. (Where air transportation is purchased outside Canada and the tax is not prepaid, the new rates will apply to transportation that includes an international departure from Canada on or after 1 May 1995.)

D. Miscellaneous tax provisions

1. Ownership interests in foreign properties

The budget includes a proposal requiring Canadians (both individuals and corporations) that hold or acquire foreign investments to disclose additional information concerning their interest in such investments. The new reporting requirements, which are to be effective for taxation years beginning after 1995, are intended to ensure that Canadians pay an appropriate amount of Canadian tax on income accruing with respect to foreign holdings. The government plans to consult with interested parties concerning the new reporting requirements, but Martin specifically mentioned the following types of additional information will be sought:

- details of certain transfer to, or deposits with, foreign corporations, partnerships, trusts and estates;
- the name of, and equity percentage held in, each foreign affiliate[18] of Canadian-resident individuals;
- information concerning income earned by a controlled foreign affiliate,[19] including identification of the nature of the income that forms part of foreign accrual property income ("FAPI") included in the income of the taxpayer in the year, and disclosure of whether income that would otherwise have been FAPI was considered to be income from an active business; and
- an annual information return with respect to a non-resident trust in which money or property was transferred from a Canadian resident or in respect of which a Canadian resident is a beneficiary.

2. Interest on unpaid taxes

The rate of interest charged on late or deficient income taxes is to be increased. The rate of interest currently charged on overdue taxes and paid on refunds is set by the government on a quarterly basis and is calculated using a complex formula that is based on the average yield on three-month Treasury bills. Effective 1 July 1995 the rate will be increased by two percentage points. The new rate will apply to overdue income tax payments, insufficient income tax instalments, unpaid employee source deductions and other amounts withheld at source, unpaid Canada Pension Plan contributions, unpaid unemployment insurance premiums and unpaid penalties. The rate of interest paid on refunds, as well as the rate applied to determine certain employment and other benefits, will remain unchanged, however.

18. A foreign affiliate is a foreign corporation in which a Canadian resident owns directly or indirectly 10% or more of the shares of any class of the foreign corporation.
19. A controlled foreign affiliate is a foreign affiliate that is controlled directly or indirectly by (i) the Canadian resident taxpayer, (ii) the Canadian resident taxpayer and not more than four other persons resident in Canada, or (iii) by a related group of persons, of which the Canadian resident taxpayer is a member.

INTERNATIONAL

THE SHAPE OF FUTURE TAX ADMINISTRATION

Simon James and Ian G. Wallschutzky

Simon James is senior lecturer in Economics at the University of Exeter in the United Kingdom. His 13 books include *The Comprehensibility of Taxation* (1987) and *The Economics of Taxation* (4th ed. 1992, with C.W. Nobes).

Ian G. Wallschutzky is associate professor in taxation at the University of Newcastle, NSW. He has published widely in the field of taxation, specializing in tax compliance. He is the author of *Australian Income Tax Law* (2nd ed.) 1988 and co-author of *Australian Income Tax Questions and Answers 1994.*

Tax administration has usually developed when economic, social and political pressures have built up sufficient strength to overcome the considerable weight of administrative inertia. Historically, there are few examples of systems of tax administration being introduced following a careful and balanced consideration of the aims of the tax system, the environment in which the system must function and anticipated future changes in both these factors. As William E. Simon, a former Secretary to the US Treasury put it, a "nation should have a tax system which looks like someone designed it on purpose" (US Treasury, 1977).

The purpose of this article, therefore, is to review the requirements that society demands of its tax systems and the likely future tax environment. The article will also consider criteria against which the effectiveness of a tax system might be judged and different possible approaches to administration. Probably the best place to start is the environments in which future tax systems are expected to operate.

I. THE TAX ENVIRONMENT

In much of the literature on business management, the external environment is analysed under the headings of Economic, Technological, Social and Political. Such an approach can also usefully be applied to public sector activities in general and taxation in particular. Although the situation is, of course, different in different countries, some widespread trends can be discerned which might affect the relative merits of different methods of tax administration.

A. Economic environment

There are several important economic factors. One is the continued growth in individuals' income and wealth. As people prosper it is likely that their sources of income will increase in both number and complexity. Typical taxpayers are therefore likely to change from individuals or families with just one major source of income, to taxpayers who might have one or more sources of employment income and perhaps a range of business, professional, investment and pension income. Increasing prosperity has also meant that more taxpayers have been drawn into the tax net and existing taxpayers have reached higher rate tax brackets. This has made them more aware of the tax burden and given them a bigger financial incentive to spend time arranging their affairs to reduce their liability or to pay tax advisers to do so on their behalf.

A further aspect is that financial arrangements in general have also become more extensive and complex. A whole new generation of financial instruments have appeared and greater use has been made of some existing instruments. There are tax implications in the use of, for example, convertible notes, Eurobonds, interest rate swaps, options and zero-coupon bonds (see, for example, Shapiro, 1986). One important consideration is the timing aspect – whether income gained from certain financial instruments accrues over the term of the instruments or on their maturity. The same applies to the expenses involved. In both cases what best suits the taxpayer does not best suit the tax authority and this understandably leads to conflict.

All of these factors are further complicated by growth in internationalization. It is increasingly difficult for countries to operate tax systems without regard for the wider economic community. One major aspect is the increase in mobility of both labour and capital. More taxpayers are gaining employment or investment income, or both, in more than one country which means that the international aspects of tax administration are likely to become increasingly important. This is also true in respect of increasing world trade, the development of the global economy and the increasing sophistication of international money markets. These factors have led to many developments in areas such as double taxation agreements and taxation relating to transfer pricing and foreign currency translation. There is also the consideration about the way in which income accumulated in tax havens, and not remitted to the beneficial owner's country of residence, should be taxed.

Another aspect is increasingly rapid economic change such that in many countries individuals are experiencing more frequent changes in employment or location or both. The effects on the tax system can be considerable and the tendency is again towards greater complexity. One particular aspect is that economic change can involve redundancies. Those involved might use any compensation received to start their own business or move into casual employment.

B. Technological environment

There is no doubt that a major technological revolution is taking place. Information technology has made possible developments in tax administration that were undreamed of even only a decade ago. One of the most important of these is the replacement of paper tax returns with their electronic equivalents. The Internal Revenue Service (IRS) in the United States was one of the first in the field in the 1980s with their Electronic Filing System which could be used by professional tax preparers for taxpayers claiming refunds (Internal Revenue Service, 1988) and by 1991 over seven million income tax returns were being filed electronically (Internal Revenue Service, 1991). The Australian Tax Office implemented its Electronic Lodgement Service on a national basis in 1990. Just over half of Australian tax returns were submitted electronically by 1991/92 (Commissioner of Taxation, 1992, p.6) and by 1992/93 the figure was almost 60 percent. The Inland Revenue in the United Kingdom has been testing the electronic submission of Corporation Tax returns and this could be extended to individuals' returns from 1997 under the new self-assessment arrangements (Inland Revenue, 1994).

Electronic submission allows tax returns that have been prepared using an appropriate software package on computer to be sent to the revenue authorities and processed by them in that form. The initial benefits were seen as increased efficiency and accuracy in the assessment process. For instance, in the United States, the IRS found that the cost of processing an electronically filed return was only three cents – in comparison to the 72.5 cents it cost to process a paper return (CCH, 1988). It was also found that the error rate in the assessment of electronically filed returns was a mere 3 per cent, compared to a rate of 17-20 percent on paper returns. Other potential benefits have been described by James and Wallschutzky (1993).

Such computerization also has implications for the duties placed on revenue staff. Electronic submission reduces the mundane traditional paper handling procedures and allows staff to spend more time on other activities such as taxpayer support. This in turn has implications for types of revenue staff required, their training, career development and the duties they will be expected to undertake.

Computerization also has major implications for enforcement – which is becoming increasingly clear as the experience of computerization grows. It allows the tax authorities to undertake far more sophisticated analyses of information than was previously possible. It is true that information about large claims could always be tackled through tax audit action in the usual way. However, with the electronic submission of returns, it becomes economical to identify areas where large amounts of taxation are potentially being evaded over many small transactions.

One approach is to analyse the tax returns lodged by different tax agents. One of the benefits to revenue authorities of this approach is its potential to reach a much larger number of taxpayers, in other words it has a multiplier effect. The Australian system is referred to as KATE (Key Abnormal Tax Agent Evaluation). The KATE system allows the revenue service to identify tax agents with clients' returns that vary significantly from the average of those of other agents in the same region. In Australia the development of such a system arose from a concern about the substantial increase in claims for work-related expenses, together with some audit evidence that some taxpayers were claiming more than their entitlement. The KATE system is used to pick out those tax agents whose clients claim work expenses above the average. If there is no obvious explanation, such agents and clients may be subject to closer investigation.

Further investigations can be undertaken of employees' tax returns which are now categorized into quite specific occupation codes. Currently there are over 300 different categories but the number could easily be increased – which allow an even more sophisticated analysis of taxpayers' returns by occupation. One Australian tax agent who was recently asked about the high claims of his clients was able to defend the returns on the basis that they were mainly academics – who have considerable scope for claiming expenses under the Australian income tax. The tax agent's argument was accepted by the tax office but when the analysis by occupation becomes even more detailed, revenue officers will be able to compare this agent's claims for academic clients with the national average for academics' returns lodged by other agents.

A further possible development currently being examined by the Australian Tax Office is how far such computerized analyses can usefully be applied to the income and expenses of business taxpayers. Yet another enhancement to KATE would involve dividing a tax agent's client base into small, medium and large business segments and then applying ratio analysis by industry classification.

Computerization can also be used to enhance enforcement from a separate angle – information reporting. This is the requirement on employers, financial institutions and so on to report to the revenue authorities the amounts of income they have paid to individuals. With extensive computerization, this information from third parties can then be matched with the information on taxpayers' returns and discrepancies followed up. The use of these techniques is spreading. For example, in Australia a new Fast Income Matching Service (FASTIMS) was introduced in 1994 (CCH, 1994). The system matches details such as interest payments, with the information taxpayers have included on their returns. Where a discrepancy occurs a letter is automatically despatched to the taxpayer and an amended assessment issued after a prescribed period. Such a system increases taxpayer compliance both through direct detection and also because taxpayers become more aware of the risk of detection of under-reporting income (Long and Swingen, 1990).

C. Social environment

The social environment contains a number of relevant aspects. Demographic changes in many countries involve increases in the numbers of older people – the 'greying of the population' – and a relative decline in the proportion of younger ones. Some governments have therefore been making strenuous efforts to encourage individuals to make provision for their retirement and using tax incentives to do so. Nevertheless there is still likely to be a massive increase in the weight of taxation on the declining working population in order to sustain increasing numbers of dependent older people. It might also increase the numbers of older people who continue to participate in the labour market on a casual or informal basis, rather than in regular employment, and so add a further challenge to the tax system. A further demographic change in many countries has been a rapid growth in the number of single-parent families.

Taxpayers are also changing in many countries. They increasingly have higher levels of education and are perhaps more prepared to raise questions regarding their tax affairs. Many of them also have increased leisure time in which to pursue their affairs and this is particularly true of the increasing numbers of those retired from regular employment.

D. Political environment

In an increasingly complex and interdependent environment, there is the likelihood that political solutions will be increasingly used to solve actual or perceived problems. As tax systems have become more pervasive – involving larger and larger numbers of taxpayers and flows of revenue – taxation has become an increasingly tempting tool of government policy. The use of tax concessions in respect of certain forms of activity or groups within society is known as 'tax expenditure' (Surrey 1973). It is also tempting for sections of the community to seek financial advantage through tax concessions rather than direct subsidy since the former are relatively hidden and might be more palatable politically.

Tax expenditures have certain limitations, not least that they tend to be scrutinized less thoroughly on a continuing basis than are direct subsidies. Therefore they may continue in force even when the original case for them has diminished or even disappeared. They are worth differing amounts to different taxpayers – depending on their marginal rates of tax. For example, tax expenditures are worth nothing at all to those with income below the tax threshold. They may also encourage tax avoidance which could not have been the original intention of the concession. However, in this context, perhaps the most important point is that they add further complexity to existing tax systems.

A separate issue in the political context is the issue of equity. Taxes which are not considered to be equitable are difficult and expensive to administer. In some cases it becomes impossible to do so. A recent extreme example is the community charge or poll tax operated in the United Kingdom from 1989 to 1993. It is clear a major cause of the failure of the poll tax was its perceived inequity (Cullis et al., 1993 and King, 1993) which led to civil disobedience (Mair and Damania, 1992) and was undoubtedly an important contributory factor in the events leading to the resignation of Mrs Margaret Thatcher as Prime Minister (Gibson, 1990). As Smith (1991) concluded, "the episode is a salutary lesson in the importance of designing tax schemes that enjoy widespread acceptance".

II. APPROPRIATE SYSTEMS OF TAX ADMINISTRATION

This brief review of the taxation environment indicates clearly that the trends are towards greater complexity and greater change. To a significant degree, the technological changes involving information technology assist tax authorities in dealing with these factors. However, there is still the need to consider basic strategies. One such decision is whether it should be the tax authorities or the taxpayers who are primarily responsible for ascertaining taxpayers' taxable incomes and tax liabilities. In other words, who should be responsible for the assessment of taxation? The two broad options are self-assessment by taxpayers and official assessment by the revenue authorities. In fact the decision involves a range of possibilities rather than a simple choice between two extremes but the differences in approach are important. A second range of issues involves compliance. Again there is a range of possibilities but there are very different strategies and underlying philosophies ranging from a strongly punitive and confrontational style, to those emphasizing strong support and assistance in voluntary compliance. These issues will now be examined.

A. Self-assessment

The increasing change and complexity of the tax environment has made it more difficult for an official or automatic system of assessment, such as that traditionally operated in the UK, to operate effectively. Such a system relies very heavily on a sophisticated cumulative scheme for withholding tax from wages and salaries, together with extensive withholding on other forms of income (James and Nobes, 1992). This has the substantial benefit that most individual taxpayers are not required to submit a tax return each year. The withholding system is sufficiently comprehensive that the UK Inland Revenue can be reasonably certain that most individuals in receipt of taxable income have had the right amount of tax withheld at source and there is no need for any further action.

Although such a system has obvious attractions it has some important limitations. The system might have been appropriate when it was developed but it has become much less so as the tax environment becomes more variable and complex. Some of the drawbacks of the UK arrangements have been described in more detail by James and Wallschutzky (1994). A major problem is that as taxpayers' circumstances become more complicated it becomes increasingly expensive and difficult to maintain a system which collects the right amount of tax without asking most taxpayers to complete tax returns. Furthermore, to achieve such a result, there are substantial limitations on the flexibility of the tax system. For instance, to maintain accuracy with a comprehensive system of withholding at a reasonable cost, most taxpayers have to pay tax at the same rate. This might well conflict with the need to take account of issues of equity described above in the section on the political environment.

For reasons such as these, other countries have not been convinced that the official/automatic assessment strategy is the one to follow. For example, such an arrangement has been suggested for the United States (Murray, 1962) and the US Treasury (1984) has proposed the introduction of a tax system simple enough so that two-thirds of US taxpayers could change to 'return-free' filing. The IRS would have calculated tax liability based on information from third parties but this plan was not implemented (Slemrod, 1992). In Australia several commentators (for example, Burgess, 1991) have raised the possibility of reform designed to eliminate the requirement for a mass issue of tax returns but this also has not been implemented.

In some countries, such as the United States, self-assessment has evolved slowly. In other countries, such as Australia and the United Kingdom, a conscious decision has been taken to move towards self-assessment, largely because of deficiencies in the earlier methods of official assessment. In Japan, self-assessment was imposed by the American administration after the Second World War.

The basic feature of self-assessment is that it is the taxpayer rather than the revenue authorities who is primarily responsible for the assessment of tax liability. The taxpayer is therefore usually required to calculate gross income, allowable deductions and the difference between the two, which is taxable income. Under many systems of self-assessment the taxpayer also calculates the actual tax due.

The potential advantages of self-assessment are indicated by the analysis of the external tax environment. In a complex financial environment, the only person who is likely to have a full knowledge of a taxpayer's affairs is the taxpayer. It is much easier for an individual to take account of his or her personal circumstances than it is for some remote revenue agency. This is particularly true when taxpayers are experiencing increasing changes in their financial circumstances.

The main advantages of self-assessment have been described elsewhere, for example by Barr et al. (1977) and James (1994) and there is no need to repeat them in detail here. Apart from the potential flexibility of a self-assessment system – both in accommodating a wide range of possible taxpayer circumstances and tax structures – such a system has to be designed and operated so that the majority of taxpayers can understand it. Self-assessment might help to ensure that taxpayers are aware of the tax system and can take proper account of it in their economic behaviour. It might also mean that taxpayers are able to respond in an appropriate way to proposed tax reforms. For instance, if such a system had applied to local taxation in the United Kingdom, the poll tax fiasco described above would probably have been avoided. More generally, the tax awareness, arising from a self-assessment system, might constrain the propensity of government to complicate the system for reasons that might be trivial or temporary or both.

It might also provide a constraint on any upward pressures on public expenditure. In announcing the introduction of a major move towards self-assessment in the United Kingdom, the Chancellor of the Exchequer in his Budget Speech of 16 March 1993 stated that self-assessment would:

> also bring out more clearly the link between public expenditure and the burden this places on the individual taxpayer. A more transparent tax system can only lead to more informed choices and debate; and I believe that self-assessment...will contribute to that.

An important consideration is the administrative and compliance cost implications of a change to self-assessment. Administrative costs can be expected to fall below what they would otherwise have been and this might be a powerful political motivation for introducing self-assessment. As some tasks will be transferred to the private sector, compliance costs can be expected to rise, at least initially. This will also happen because there will be costs involved in taxpayers and their advisers learning how to follow new procedures. However, compliance costs might fall later as the private sector adapts to the new system. It might also be argued that the private sector has more powerful pecuniary incentives than the public sector has to minimize such costs. If the self-assessment scheme was actually operated so that it was easier for taxpayers to understand and deal with their affairs, this might provide a further reason why compliance costs might be contained.

In examining potential changes in compliance costs, one should remain aware of continuing changes in the tax environment. Whether or not self-assessment is introduced, compliance costs are likely to rise. In the United States, Blumenthal and Slemrod (1992) found that there had been an upward drift in the compliance costs associated with personal income taxation. This was possibly due to the increase in the proportion of taxpayers who have high compliance characteristics in terms of both high income and sources of income such as self-employment, capital gains, pensions and annuity income and rental income. The final aim might be not so much as to actually reduce compliance costs but how best to keep them within acceptable limits.

B. Tax compliance

To some extent compliance can be ensured by institutional arrangements. For example, if there is widespread withholding of tax at source and information reporting, compliance is likely to be higher than if these arrangements were not in place. For instance, Table 1 shows that in the United States, compliance has been estimated to have been highest for wages and salaries which are subject to withholding at source. Interest income experienced the next highest compliance rate – it was not subject to withholding but there was information reporting. The lowest level of compliance was for informal supplier income which was subject neither to withholding nor information reporting.

Table 1

Compliance rates for Different Classes of Income for the United States 1981 and 1987

	1981 %	1987 %
Wages and Salaries	94	97
Interest	86	90
Capital gains	58	85
Informal supplier income	20	11

Source: Tax Compliance Research Estimates 1973–81, Internal Revenue Service (Washington DC, US Government Publishing Service July 1983, Table iii. Income Tax Compliance Research Supporting Appendices to Publication 7285, Publication 1415 (Washington DC: US Government Publishing Service July, 1988), Table D 16.

Institutional arrangements such as withholding cannot feasibly be extended to all forms of income so the degree of tax compliance is crucial to the success of any tax system. The example of the UK poll tax might be considered an extreme one but it is by no means the only one. Indeed, the poll tax had been operated in Britain six centuries before. The Rising of 1381 originated from a hatred of the poll tax (Trevelyan, 1946). The Archbishop of Canterbury who, as Chancellor of the Realm, represented the government was beheaded by Wat Tyler's men on Tower Hill and the rebels even captured London itself. Other examples include the American revolution, following the Boston Tea Party (Labaree, 1964), and the revolt against property taxation which led to California's Proposition 13.

However, even taxes which are not totally rejected by the taxpaying population require the voluntary compliance of the great majority of taxpayers if they are to be effective and if the administrative and compliance costs are to be kept within acceptable limits.

The definition of compliance is usually cast in terms of the degree to which taxpayers comply with tax law. It has then been said that the degree of non-compliance can be measured in terms of the 'tax gap'. This represents the difference between actual revenue and that which would be received if there were 100 percent compliance.

Such a definition and measure are too simplistic for practical policy purposes since successful tax administration often requires taxpayers to cooperate willingly over and above the bare statutory minimum level. It also requires taxpayers to comply without the need for enquiries, reminders or the threat or application of legal or administrative sanctions. A more appropriate definition might therefore include the degree of compliance with tax law and administration without the need for enforcement activity.

The issue of timing is also important. A taxpayer might eventually pay his or her full liability but if it is paid late it cannot be considered to be compliance. In economic terms money in the future is worth less than the equivalent sum paid now. So although late payments will satisfy the 'tax gap' measure, they do not represent full compliance.

A related aspect concerns the traditional distinction between tax evasion and tax avoidance. The usual definition of tax evasion is that it is the illegal manipulation of an individual's affairs in order to reduce tax. Tax avoidance is the manipulation of one's affairs within the law to reduce tax liability. However, if taxpayers go to inordinate lengths to reduce their tax liability this could hardly be considered 'compliance' even if it were within the letter of the law. A better definition might therefore include compliance with the spirit as well as the letter of the law.

Non-compliance might therefore be defined simply as the failure of taxpayers to act in accordance with the statutory requirements or intentions of the tax law and administration without the application of enforcement activity.

The effects of non-compliance – legal or illegal – are significant. There are economic effects such that decisions are taken for tax purposes rather than on commercial or economic criteria. There is the time and expense involved in non-compliance. There may be other psychic costs, such as exile for tax purposes. There are also equity effects – that economic resources are transferred away from those who comply with the tax system and towards those who avoid or evade. This may be considered inequitable since the more income a person has the more incentive there is not to comply. If it is perceived that only individuals who are wealthy or dishonest or both can benefit, this might reduce 'tax morale' and the willingness of the rest of the taxpaying population to comply. This effect is reinforced because if the avoiders and evaders pay less, the rest have to pay more or face cuts in public expenditure.

It should be made clear that this is unlikely to be a zero-sum game. In other words the gains to the non-compliers as a result of such actions are likely to be less than the losses to the community as a whole. This is because such non-compliance distorts rational economic behaviour towards those activities which have significant scope for avoidance or evasion and away from those which do not. (For an economic analysis of taxation see, for example, James and Nobes, 1992). It is reasonable to conclude that non-compliance is likely to reduce both the efficiency and equity of an economic system.

The question, therefore, is how best to ensure compliance. It has been noted by Wallschutzky (1993) that most of the attention in this area has been devoted to why some taxpayers do not comply rather than why others do so. It might easily be argued that the emphasis should be the other way round. The norm is usually to comply rather than not to comply. For a tax system to be effective the majority of taxpayers must comply with it. It follows that there may be greater gains in assisting compliant taxpayers meet their fiscal obligations than in spending more resources in pursuing the minority of non-compliers. Many taxpayers might be willing to comply in full but are unable to do so because they are not aware of, or do not understand, their full obligations. Even if such taxpayers understood their obligations, they may not know how to meet them or may be unable to do so for other reasons. Additional expenditure devoted to assisting such taxpayers, for example by informing or educating them, might yield greater additional revenues than if it were spent on additional enforcement activities.

Clearly much depends on the motives of taxpayers. This is a complex area and different commentators have offered different analyses. The two main approaches mentioned above were a concentration on the probability of detection and penalties for non-compliance (the 'carrot and stick approach') or activities designed to promote voluntary compliance (the 'responsible citizen approach'). These will be dealt with in turn.

1. Carrot and stick approach

This approach is based on a narrow interpretation of economic rationality. By this way of thinking, totally amoral individuals maximize their utility by maximizing their income and wealth. They will evade tax if they consider that by doing so they can expect to increase their spending power. Non-compliance can therefore be explained by factors such as the level of tax rates, the probability of being caught evading, the penalties imposed and the degree of risk aversion. An early model on these lines was published by Allingham and Sandmo (1972) and many refinements have been made since.

Although this sort of approach has intuitive appeal, it does not seem to provide a complete explanation of either compliance or non-compliance. For instance, evidence from the United States suggests that reductions in the traditional enforcement efforts in terms of auditing do not necessarily result in lower levels of compliance. US *Tax Notes* (1988) reports that audit rates for individuals declined between the early 1960s to the late 1980s from around 6 percent to 1 percent. However, Long and Burnham (1990) found that during this period compliance levels in the US remained relatively stable. There are explanations that are consistent with the narrowly defined economic utility approach. One is that taxpayers had not realized that audit rates had declined. Another is that the remaining audits had become much more effective in detecting evasion. What is also possible is that taxpayers are not motivated only by some simple numerical calculation of the expected cash benefits of non-compliance in some sort of moral and social vacuum.

2. Responsible citizen approach

Other academic disciplines suggest that there are additional factors which might be important in motivating taxpayers in their compliance decisions. Sociology has offered a number of variables such as social support, social influence, attitudes and certain background characteristics such as age, gender, race and culture (see, for example, Meier and Johnson, 1977).

Psychology reinforces this approach and has even spawned its own branch of 'fiscal psychology' (Schmolders, 1959, Lewis 1982). Attitudes towards the state and the revenue authorities are important as are perceptions of equity. Individuals' roles in society and accepted norms of behaviour also have strong influences. The essential thrust of these approaches is that individuals are not simply independent, selfish, utility-maximizers (though this may be partly true). They also inter-react with other human beings according to differing attitudes, beliefs, norms and roles. The result is that tax compliance could be viewed, as Schmolders (1970, p.305) suggests, as a "behavioural problem" and that "the success of an income tax depends on cooperation".

There is empirical evidence to support the behavioural approach. For instance, Milliron and Toy (1988) analysed the views of 152 US certified public accountants from small accounting firms and gained results consistent with the fiscal psychology model. A similar conclusion was reached by Yankelovich, Skelly and White (1984). They analysed the data generated by 20 focus groups led by a moderator and a nationwide survey of 2,200 US taxpayers using in-home interviews. This investigation found considerable concern over issues of equity and fairness. There also seemed to be a perceived norm of cheating – a majority of the sample believed over a quarter of the population were evading taxes and nearly a quarter of the sample thought that more than half the population were evading.

If psychological and other factors are recognized as important a major drawback of the carrot and stick approach becomes apparent. While such an approach might be considered suitable for donkeys, human beings might not respond so positively and voluntary compliance might be reduced. For example, Strumpel (1969 and Schmolders, 1970) reported that the German system was very rigid in its assessment procedures which led to an efficient but expensive and confrontational system. The disadvantage was the generation of a high degree of alienation and taxpayer resistance.

It would seem that a successful compliance policy should take account of a much wider range of motivations than simple rewards and punishments. There are many examples of the implementation of such an approach. In Japan the purpose of tax administration in the self-assessment system is to ensure all taxpayers understand the importance of taxation and submit returns and pay their correct tax liabilities voluntarily. To achieve this, Japanese tax administration aims to establish a consistent and sound environment for compliance and sets out its policy under three main headings (National Tax Administration, 1992):

- establish an environment which encourages taxpayers to submit proper returns and pay taxes voluntarily. This includes communication with taxpayers through public relations, general guidance and consultations. In tax audits, one of the aims is also use the opportunity to improve taxpayers' understanding of the tax system and to facilitate voluntary compliance;
- to ensure correct assessments – with enforcement action as necessary;
- to develop self-disciplined and efficient offices with good human relations. This recognizes that to improve voluntary compliance on the part of taxpayers, the revenue authorities should act in a fair and impartial way and their work should be disciplined, cheerful and efficient. With the right attitudes, taxpayers find it easier to approach the tax authorities.

An even more complex approach is being developed by the Internal Revenue (1991b) with its mission-based strategy outlined in its document 'Compliance 2000'. The IRS recognizes the importance of voluntary compliance. The views of those with an interest in tax administration, both inside and outside the IRS were asked to respond to questions about the organizational goals of the IRS and compliance strategies to achieve those goals. The responses seemed to fall into 12 broad categories. A fairly full account of them is included here since it provides a reasonably comprehensive strategy towards promoting compliance:

1. Training
This should include customer service training and cross functional training for employees so they have an understanding system of the entire tax administration.

2. Public relations
There should be better publicity about how the tax system works, how taxpayers benefit by complying and how the IRS deal with abuses of the system.

3. Automation
This should be used in order to identify non-compliance.

4. Simplification and fairness
Simplicity is necessary because continuous changes and complexity in tax law have a negative effect on compliance. Also the law should be applied consistently.

5. Personnel issues
There is a need for a highly skilled and trained workforce which has multi-functional talents. There will be fewer low skilled employees.

6. Organizational structure
This should be arranged so that taxpayers' issues or problems can be resolved through a single point of contact. There is also a need for specialization so that expertise of particular industries may be developed to improve dealings with taxpayers and there should be better customer service.

7. There should be increased cooperation with state, local and foreign governments

8. Taxpayer service and education
There should be more assistance for small businesses to help them comply, more 'preventative' education for the public and increased awareness of tax responsibilities in schools.

9. Compliance efforts should be coordinated

10. Positive incentives to comply
There is a need to devise ways (not necessarily monetary) to recognize compliant behaviour and to reward those who submit tax returns and pay their tax on time.

11. A more organized approach to influence legislation
The revenue service should become a taxpayers' advocate in the legislature for simplification and fairness.

12. Inculcate in citizens a sense of responsibility toward taxes
There is a need for citizens to understand and accept their responsibilities of compliance. There is also a need to publicize the tax burden carried by compliers versus the burden that would be carried if everyone complied. Students should be educated early in their tax responsibilities.

All of this promotes a positive view to voluntary compliance. The IRS document goes on to state:

> These efforts should be viewed as 'doing the job right on the front end'. Correcting problems and unintentional non-compliant behaviour through enforcement sanctions should be viewed as 'rework'. Quality principles demonstrate that 'rework' is more costly than 'doing the job right on the front-end'...Increasing citizen participation and ownership of the tax system is an integral part of this direction. Such techniques as taxpayers accessing their own account data; identifying and removing organizational barriers to compliance; and positive incentives for compliance should be pursued. (Internal Revenue Service, 1991b, p.17).

What should be very clear by now is that such an approach cannot rely simply on rewards and punishments but on a wide range of factors.

3. Compliance and self-assessment

In a self-assessed system the primary responsibility for the assessment process lies with the taxpayer rather than the revenue authorities. No doubt heavy penalties will encourage taxpayers to discharge those responsibilities. However, it is clear that taxpayers are motivated in other ways and these should be taken into account in designing an effective and efficient compliance strategy.

Official and automatic forms of assessment ultimately depend on the willing compliance of taxpayers and self-assessment much more so. It would seem that if the responsibility of assessment is that of the taxpayer, then he or she should be assisted wherever possible in discharging that responsibility. This again indicates the importance of the voluntary compliance approach.

There is also a philosophical argument. Barr et al. (1977) referred to the implications for citizenship of the greater participation in tax administration required by self-assessment. However, there is a further dimension. The assessment and collection of taxation does not exist in some economic, social and political vacuum. Taxes are, or should be, raised for the benefit of the citizens. It is in their long-term interests that this process should work well and that they should participate in it. If this participation is only secured under the threat of severe penalties and enforcement action, it necessarily reduces the benefits of the whole exercise. Far better, in terms of active and willing citizenship, that taxpayers should be encouraged and assisted to comply voluntarily with the requirements of the tax system, than to be forced to do so under threat of punishment. If it is in the interests of society to behave collectively, then there must be scope for persuading individuals to do so voluntarily.

III. CONCLUSION

In analysing the likely future tax environment two major trends emerge – increasing complexity and increasing change. It is suggested that taxpayers rather than the revenue authorities are in the best position to assess taxpayers circumstances. It would therefore seem that some degree of self-assessment is necessary and it might be appropriate to operate a high degree of self-assessment.

In terms of compliance, it is likely that penalties for non-compliance will always have some role to play in tax administration. Nevertheless there would seem to be more potential in pursuing the fiscal psychology approach in which the issue is cast in terms of behaviour, and compliance is achieved through more positive taxpayer motivation. It is also concluded that it is in the nature of self-assessment that taxpayers be encouraged and supported in their assessment tasks rather than coerced by penalties. The shape of successful future tax administration is therefore likely to be based on the twin pillars of self-assessment and voluntary compliance.

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Conference diary

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

MAY 1995

Current problems regarding the application of tax treaties, Munich, 5 May 1995 (German):

Internationales Steuerseminar Zürich, z.Hd. Frau Salzberg, CH-8022 Zürich, Tel.: 41-1-219 2399, Fax: 41-1-219 3583.

Course on cross-border finance, Amsterdam, 8-9 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

V.A.T. sans frontières, Brusselles, 11 May 1995 (simultaneous translation into French and English):

Francis Lefebvre Formation Europe, Avenue E. Mounier 5, B-1200 Brusselles, Tel.: 32-2-775 2111, Fax: 32-2-770 4780.

The 8th East-West Tax Conference, Warsaw, 15-16 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Insurance for tax planning, London, 17 May 1995 (English):

IBC Financial Focus Ltd., Attn: Nicola Stephens or Katie Gwyn-Williams, DX 122100 Mortimer Street, London, Tel.: 44-171-637 4383, Fax: 44-171-323 4298.

New 1995 OECD Transfer Pricing Guidelines Compared with US § 482, Amsterdam, 18-19 May 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Methods for the Avoidance of Double Taxation, Vienna, 24 May 1995 (German):

Institut für Finanzrecht, Attn: Frau Gabriele Bergmann, Wirtschaftsuniversität Wien, Althanstrasse 39-45, A-1090 Wien.

JUNE 1995

Salary split, Brussels, 1 June 1995 (French):

Kluwer Formations, "Hof ter Linden", Hoge Weg 76, 2800 Mechelen-Battel, Tel.: 32-15-27 1210, Fax: 32-15-27 1476.

Course on international tax audit, Amsterdam, 1-2 June 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Corporate Finance Centres and Tax Havens, Geneva, 2-3 June 1995 (English):

Vicki Goffin or Kate Roberts, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

Meeting of the International Tax Planning Association, Amsterdam, 8-9 June 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-1732-762 910, Fax: 44-173-2 763 762.

Intercompany contracts: transfer pricing and US/EEC relations (legal and tax aspects), Brussels, 14 June 1995 (French and English, simultaneous):

F.P.V. EUROPE, rue de Luxembourg 45, B-1040 Brussels, Tel.: 32-2-502 2030, Fax: 32-2-502 3278.

Course on permanent establishments, Amsterdam, 15-16 June 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

AUGUST 1995

Course on the principles of international taxation, Amsterdam, 21 August through 2 September 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1995

Meeting of the International Tax Planning Association, Monte-Carlo, 19-20 October 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-1732 762910, Fax: 44-1732 763762.

AUSTRIA

Implementation of the Parent-Subsidiary Directive and New Anti-Abuse Provisions

Gerald Gahleitner LL M
Leitner and Leitner, Linz.

I. INTRODUCTION

Austria's membership in the European Union has required some adjustments to Austrian tax law. Implementation of the parent-subsidiary directive, in particular, has brought about changes which will affect Austrian holding companies and their tax planning strategies.

Prior to EU membership relief from double taxation on inbound dividends was granted under the international affiliation privilege.[1] This privilege was only partially effective, since tax withheld by a foreign subsidiary could not be offset as a credit against Austrian corporate tax payable. Although the burden of the withholding tax was lessened under double tax agreements (concluded between Austria and EU member states), implementation of the parent-subsidiary directive should provide a long awaited improvement in Austrian tax legislation for holding companies.

A new provision, Section 94a, has been included in the Austrian Income Tax Act (hereafter referred to as "EStG"). This provision lists the conditions required for the withholding tax exemption of dividends paid by an Austrian subsidiary. In order to achieve relief from corporate tax on inbound dividends in conformity with the directive, the international affiliation privilege has been revised.

Both the income tax and corporate tax provisions allow the Ministry of Finance to publish regulations detailing the circumstances under which the withholding tax exemption and international affiliation privilege exemption may be disallowed on grounds of abuse. These recently published regulations[2] set out sophisticated anti-abuse tests in accordance with the international trend of preventing the sheltering of income through the interposition of conduit companies and the disguised transfer of earnings to companies established in low tax jurisdictions.

This article provides an overview of the withholding tax exemption and the new international affiliation privilege. The Ministry of Finance regulations for the prevention of tax evasion and fraud are also outlined.

II. EXEMPTION FROM WITHHOLDING TAX

Withholding tax of 22 percent is generally due on dividend payments from an Austrian subsidiary to a foreign parent company.[3] This withholding tax is subject to the provisions of tax treaties which generally reduce the tax to 10 or 15 percent. The withholding tax rate is reduced to 5 percent for parent companies situated in one of the following countries: Germany, Netherlands, Switzerland, the United Kingdom and the United States.

As mentioned above, a new article has been implemented in the EStG to achieve the goal of the parent-subsidiary directive. In accordance with Article 2 of the parent-subsidiary directive this provision grants an exemption from withholding tax on dividends paid to EU corporations listed in Annex 2 of the EStG.

Continuous ownership of at least 25 percent equity in the subsidiary is required in order to qualify for the withholding tax exemption, and the participation by the parent company must be held for at least two years.[4]

A. Anti-abuse provisions[5]

The exemption will not apply if either:
- the parent company has not met the continuous ownership and holding period requirements set forth above; or
- application of the withholding tax exemption conflicts with Ministry of Finance regulations disallowing the exemption (for the prevention of tax evasion or abuse, or in the case of hidden profit distributions).

Article 1 of the parent-subsidiary directive allows the member state the general right to apply (existing or newly implemented) domestic or agreement-based provisions necessary to prevent tax evasion or abuse. Denial of the exemption in cases of hidden profit distributions may be in conflict with EU law due to the discriminatory nature of the clause which in effect treats Austrian parent companies more favourably than parent companies resident in another member state. Hidden profits distributed by an Austrian subsidiary to its Austrian parent, unlike profits distributed to a parent company

1. Sec. 10(2) Corporate Tax Act (hereafter referred to as "KStG").
2. *BGBL* 56/1995 and *BGBL* 57/1995.
3. Sec. 93(2) EStG.
4. Determination of the two year holding period does not appear to present a practical problem; however, attention will most likely be focused on Ministry of Finance Regulation 56/1995 which aims to prevent tax evasion or abuse of the withholding tax exemption.
5. Sec. 94a (2) EStG.

resident in another member state, do not trigger any withholding tax.[6]

If the tax exemption is denied, the Austrian company is liable for the withholding tax. The Austrian subsidiary and the parent company may then apply for reimbursement of the withholding tax.[7]

B. Regulation 56/1995

This Regulation is an attempt by the Ministry of Finance to ensure that Austrian-source dividends are not granted the tax exemption in cases where conduit companies are used primarily to take advantage of the parent-subsidiary directive. Regulation 56/1995 to Section 94a EStG defines the circumstances under which the taxpayer can be denied the withholding tax exemption. These are discussed below.

1. Circumstances suggest that tax evasion or abuse (under Section 22 BAO) are present, and the Austrian subsidiary is responsible for this abuse

Abuse under Section 22 BAO requires an unusual and inappropriate corporate structure, and one which makes sense only because of the tax savings achieved through the structure.[8] According to the rulings of the Austrian Tax Court, the tax authorities must prove the existence of the abusive activity as well as the intent to effect tax evasion or abuse.[9]

The Austrian subsidiary is not responsible for the abuse if the subsidiary possesses a declaration from the dividend recipient which states that:[10]
- the activities of the foreign parent are not of a nature similar to the mere administration of assets;
- the foreign parent has its own staff; and
- the foreign parent has an office at its disposal.

In addition to the above declaration by the foreign parent, there must be no evidence which casts doubt on the accuracy of the declaration.

2. A notorious hidden profit distribution

According to the Regulation, a hidden profit distribution is notorious if the Austrian subsidiary has actually recognized or should have recognized the hidden profit distribution with due observance of the Austrian Tax Court rulings and general practice of the tax authorities.[11]

3. The Austrian subsidiary cannot adequately prove the requirements for the withholding tax exemption are fulfilled

Proof that the requirements are fulfilled must be provided by submission of documents.[12] The taxpayer must prove that the recipient of the profit is a corporation resident in one of the EU member states. For this purpose the taxpayer must submit certification from the country where the parent company is resident.[13]

III. THE NEW INTERNATIONAL AFFILIATION PRIVILEGE

Austria had already implemented an international affiliation privilege prior to its membership in the EU which exempted inbound dividends at the level of the Austrian parent company. However, since this privilege was only applicable to foreign subsidiaries which were comparable to an Austrian corporation, the affiliation privilege had to be expanded to include distributed earnings from all EU companies (listed in the Annex to the parent-subsidiary directive).[14]

The activity clause of the affiliation privilege previously required that no more than 25 percent of the foreign subsidiary's business consist of investing in bond securities for its own account and of participations in other corporations in a business similar to that of the foreign subsidiary. This clause has been eliminated. The continuous duration of ownership of equity shares has been extended to a period of two years (previously the participation only had to exist continuously for at least 12 months).

The affiliation privilege can be denied if abuse is suspected according to Ministry of Finance regulations (in accordance with Section 10(3) KStG).

A. Grounds for suspected abuse

Section 10(3) KStG specifies three grounds for suspected abuse which also form the basis of the Ministry of Finance Regulations:
- the company's main source of income is passive income; and
- there is no comparable taxation with respect to the taxable base and the tax rate applied in the jurisdiction of the country of residence; and
- it is not proven that non-resident individuals directly or indirectly hold a majority interest in the Austrian parent company.

In such a case, the tax exemption granted under the international affiliation privilege will be replaced by an indirect foreign tax credit.

6. Regulation 56/199 5 of the Ministry of Finance attempts to reduce the impact of this provision by requiring the existence of a hidden profit distribution which is of notorious or obvious character as defined by Austrian Tax Court rulings (see text). This requirement shifts the burden of proof and tax risk to the taxpayer (subsidiary), although the EU parent may eventually be proven not to have been interposed abusively.
7. Application for reimbursement may be based on Sec. 240 BAO (Federal Tax Code). The statute of limitations is five years.
8. See *VwGH* 13 October 1993, 92/13/0054.
9. See *VwGH* 29 November 1988, 88/14/0184.
10. Sec. 2 of Regulation 56/1995.
11. Sec. 3 of Regulation 56/1995.
12. Sec. 4 of Regulation 56/1995.
13. Forms usually used for the certification of residence for application of tax treaties may be used. Certification documentation should not be more than a year old.
14. The qualifying EU companies are listed in Annex 2 of the EStG.

B. Regulation 57/1995

According to the Ministry of Finance Regulation 57/1995, double tax relief in the form of an exemption will be denied if:
- the three grounds mentioned in Section 10(3) KStG (see above) apply; or
- two of the grounds of Section 10(3) KStG are fully met and the third is closely met.

Even if the three grounds of suspected abuse are satisfied, the taxpayer may still qualify for the affiliation privilege if he can prove that the corporate structure of the enterprise is not regarded as abusive under Section 22 BAO.[15]

The Regulation defines the grounds mentioned in Section 10(3) KStG in more detail:

(1) When a company's main source of income is passive income[16]
The passive income of a company is regarded as its main source if staff and capital are mainly and repeatedly used to obtain interest income, income through the leasing of property or the sale of equity participations. The following are not considered a source of passive income and have no detrimental effect:
- the management of a banking business;
- commercial renting of property if the foreign subsidiary has its own staff and offices;
- the sale of equity participations to which the participation privilege could have been applied had they been sold by an Austrian company.

(2) Comparable taxation in the country of residence of the subsidiary[17]
In general, the following conditions must be met:
- the average tax burden of the foreign subsidiary is more than 15 percent;
- the average tax burden must be evaluated by applying the taxable base computed under Austrian tax law regulations;[18]

The fact that the average tax burden is less than 15 percent is not detrimental if this is due to the use of a special depreciation regime or to a reduction of the taxable base through the use of loss carry-forwards or carry-backs more favourable than what is available under Austrian law.

C. Definition of non-resident individuals[19]

A non-resident individual is defined by the Regulation as an individual with limited liability to tax in Austria;[20] or an individual having dual residency, whereby his personal and economic relations are closer to the foreign country than to Austria and a double taxation agreement exists with this foreign country.

IV. CONCLUSION

The principles of the parent-subsidiary directive with respect to relief from withholding tax on dividends paid by an Austrian subsidiary are generally fulfilled under Section 94a EStG. Disputes may arise with the tax authorities regarding the existence of a "notorious" hidden profit distribution. It is advisable to withhold tax if there is any doubt as to whether the requirements for the exemption are met, since the Austrian subsidiary is liable for the withholding tax. The foreign parent must prove its qualification for the exemption method when applying for reimbursement. Once it is established that the parent company is not being used as a mere conduit for a non-qualifying shareholder, the Austrian subsidiary is entitled to use the exemption method.

It is foreseeable that the Austrian tax authorities will strictly apply both the withholding tax exemption and the international affiliation privilege regulations. Well prepared documents will be crucial for the reorganization of corporate groups.

15. Regulation 57/1995 takes a different stance: if the grounds of Sec. 10(3) KStG (mainly passive income, no comparable taxation, majority holding by Austrian residents) are met, relief from double taxation may only be granted through an indirect tax credit, even if it is established that the Austrian holding company is not used abusively.
16. Sec. 2 of Regulation 57/1995.
17. Sec. 3 of Regulation 57/1995.
18. This evaluation must take into account the direct as well as the indirect taxes of the foreign country.
19. Sec. 4 of Regulation 57/1995.
20. This requires that the individual does not have a residence or a habitual abode (more than 183 days a year) in Austria.

MONGOLIA

TAXATION OF COMPANIES AND INDIVIDUALS

Peter Hann

Research Associate, IBFD.

I. GENERAL

The main tax legislation is found in the General Taxation Law; the Economic Entity and Organization Income Tax Law ("EEOITL"), the Personal Income Tax Law, the Sales Tax Law and the Foreign Investment Law.

The General Taxation Law states that the following are taxable:
- a citizen of Mongolia;
- a foreign resident and a foreign person without citizenship;
- foreign and domestic economic entities and organizations in the territory of Mongolia;
- a permanent establishment of a foreign economic entity with profits in Mongolia.

II. CORPORATE TAXATION

A. Overview

The EEOITL regulates the income tax on companies, cooperatives, foreign enterprises and joint ventures with foreign investment, situated in Mongolia. The tax also applies to a permanent establishment of a foreign entity which has income in Mongolia, and to commercial banks, credit agencies and insurance agencies.

The following are regarded as economic entities and organizations and are therefore subject to the EEOITL:
- companies, cooperatives, foreign enterprises and joint ventures with foreign investment, whatever the form of ownership, situated in the territory of Mongolia;
- a permanent establishment of a foreign economic entity obtaining revenue in Mongolia;
- a commercial bank, credit or insurance agency or other similar agency.

Foreign enterprises and joint ventures with foreign investment are subject to tax in Mongolia at the same rates as domestic entities. The permanent establishment of a foreign economic entity which is earning revenue in Mongolia is also subject to Mongolian tax.

A business entity with foreign investment is defined in the Foreign Investment Law as a business entity which is incorporated under the law of Mongolia and in which the contribution of a foreign investor is not less than 20 percent of the registered capital.

B. Residence

Under the EEOITL, companies, cooperatives, foreign enterprises and joint ventures with foreign ownership situated in the territory of Mongolia, whatever the form of ownership, are subject to taxation.

C. Taxable income

Most types of income are aggregated and charged at the appropriate rates under the EEOITL. The tax year is the calendar year.

The following types of taxable income are determined by the deduction of relevant expenses from the gross income:
- income from basic and auxiliary production, work and services;
- income from activities of a commercial bank or credit agency;
- income from insurance activities;
- income from stock exchange and brokerage activities;
- income from pawnshops;
- loan interest received;
- income from leasing property;
- income from intermediary activities.

In the case of barter trade, taxable income is defined by market value.

Income from production, work, services, insurance activities, brokerage activities, pawnshops and income from leasing property, intermediary activities and loan interest, and income of banks and credit agencies, is taxed at the following rates:

Taxable income (tgs.)	Rates
0 – 900,000	15%
900,001 – 2,100,000	135,000 tgs. plus 25% of income exceeding 900,000 tgs.
2,100,001 – 4,500,000	435,000 tgs. plus 35% of income exceeding 2,100,000 tgs.
4,500,000 and above	1,275,000 tgs. plus 45% of income exceeding 4,500,000 tgs.

The total amount of tax cannot exceed 40 percent of taxable income.

The following types of income are, however, charged at separate rates and are not aggregated with other income:
- tax on income from shares and income of a participant is 15 percent;
- where shares are sold through a stock exchange, the tax on the income from the disposal is 10 percent. Where the disposal is not through a stock exchange, the tax rate is 2 percent;
- income from video and audio tapes and their recording service, certain games, and lotteries is taxed at 60 percent;
- income from the sale of immovable property is charged according to the length of time for which the property was used by its owner, at the following rates:

Length of use	Rates
Up to 2 years	40%
2–5 years	30%
Over 5 years	20%

- tax on income from bank deposits is 10 percent.

D. Deductions

The following types of expense are allowed in the EEOITL as deductible in arriving at taxable income, where confirmed by documents:
- salaries and wages;
- material expenses, including raw materials, basic or auxiliary materials, semi-processed products, steam, water, energy, fuel, petroleum, spare parts, package and wrapping materials;
- social insurance premiums;
- payments to non-employees for work or services;
- payments for leases;
- loan interest paid;
- administrative expenses charged by the owner of property;
- transport facilities and vehicle tax;
- payment for use of natural resources;
- excise tax;
- depreciation.

The following expenses are not deductible:
- investment;
- repairs;
- insurance premiums (except premiums for the state insurance);
- normal losses of goods and materials;
- bad debts on loans;
- any kind of fine or payment for damage caused by the taxpayer to other persons.

E. Exempt income

Under the EEOITL, the following reliefs are available:

(1) Where a partnership or limited company with full private ownership invests for the purpose of production and creation of working places, income equal to the amount of the investment is exempt.

(2) The rate of tax on income of an entity or individual from the production of primary food raw materials (e.g. meat, milk, cereals, flour) is reduced by 50 percent.

(3) Where a taxpayer is engaged solely in the production of baby food, tax liabilities are reduced by 100 percent.

(4) Where an entity employs persons with certain disabilities, the taxable income of the entity is reduced by the ratio of disabled persons to the total workforce.

(5) Where an economic entity organized on the initiative of labour veterans and at least 70 percent of the workforce comprises females over the age of 55 or males over the age of 60, tax on the income of the entity is reduced by 50 percent.

(6) An economic entity which is producing goods which substitute for imported goods, and introducing new technology covered by the government's special programme for the equalization of the development of the territorial zones, is entitled to tax exemptions, the size of which is decided by the State Ih Hural on the proposal of the government.

The following incentives are granted by the Foreign Investment Law to a "business entity with foreign investment" (see above) from the date of commencing production:

(1) Entities involved with power and thermal plants and the related transmission network, highways, railways, air cargo, engineering constructions, and the basic telecommunications network, are given a ten year tax exemption, and 50 percent tax relief for the subsequent five-year period.

(2) Entities involved in mining and processing of mineral resources (except precious metals), oil and coal, metallurgy, chemical production, machinery and electronics receive a five year tax exemption and 50 percent tax relief in the subsequent five-year period.

(3) If a business entity with foreign investment, other than those referred to in (1) and (2), exports more than 50 percent of its production, it receives tax exemption for three years and 50 percent tax relief in the subsequent three year period.

(4) Where the income of a foreign investor is reinvested in the entity, tax relief is granted up to the amount of the reinvestment.

If the business activities of an entity with foreign investment cover more than one of the areas mentioned in (1) and (2) above, the tax preferences to be granted are determined with respect to the main area of such activity.

The preferences in (1) to (3) above may not be available to a business entity with foreign investment which was formed by the purchase of shares or securities of an existing business entity sold under the Privatization Law of Mongolia.

F. Relief from double taxation

Mongolia has signed tax treaties with China, Korea, Germany, Hungary and China. The treaties with Germany, Hungary and India have not yet entered into force.

The Foreign Investment Law states that where the international treaties to which Mongolia is a party provide otherwise than the Foreign Investment Law, the treaties shall prevail.

G. Dividends and distributions

Tax on income from shares is 15 percent. This tax is withheld at source by the paying entity.

H. Assessment and collection

An economic entity or organization should pay tax in advance, by the 25th of each month, and submit to the tax administration a quarterly return by the 20th of the month following the end of the quarter. The entity should submit a final annual return for the calendar year before 10 February in the following calendar year. An entity with annual income of less than 500,000 tgs. may pay tax quarterly rather than monthly.

I. Withholding tax

Economic entities should deduct taxes from payment of wages, author's awards and other income at the individual income tax rates at the time of payment.

Where an entity pays wages for work or services of individuals outside their main job, tax is to be withheld at the individual tax rate, however if the amount of wages is less than 8,000 tgs. the withholding rate is 3.5 percent.

Where the amount of withheld tax is calculated at less than 1,000 tgs., this is carried forward to be withheld from the payment for the following month.

Where a bank calculates interest on deposits of individuals, tax is withheld at 15 percent. Where an entity or organization pays dividends on shares or income of a participant, the withholding rate is 15 percent. Where shares are sold through a stock exchange, a 10 percent withholding rate applies.

An economic entity or organization which has withheld tax from payment of dividends, or from income to a participant, should submit an annual return of tax deducted on or before 10 April of the following year.

An employer withholding tax from wages, a bank withholding tax from interest or a stock exchange withholding tax on sale of shares should submit an annual return of tax deducted on or before 10 February of the following year.

J. Branches

Branches and other permanent establishments of non-residents are taxed at the normal corporate tax rates.

Under the Foreign Investment Law, foreign investment is allowed in any area of activity unless the activity is forbidden by domestic law. Foreign investment may be made in any part of the territory of Mongolia.

The following forms of foreign investment are permitted:
- establishment of a wholly foreign-owned business entity, local branch or subsidiary of a foreign enterprise;
- establishment of a business entity with the participation of a Mongolian investor;
- direct investment by acquisition of shares or other securities of an existing Mongolian business entity.

III. INDIVIDUAL TAXATION

A. Overview

Taxation of personal income is dealt with under the Personal Income Tax Law and the General Law of Taxation. Taxpayers include all citizens of Mongolia, foreign residents and foreigners without citizenship in Mongolia.

B. Residence

Under the Personal Income Tax Law, a person staying in Mongolia for 183 days or more is considered to be resident. Resident taxpayers are liable to tax on income from sources within and outside Mongolia. Non-residents are liable to tax on income whose source is within Mongolia.

C. Taxable income

The tax is imposed on the following categories of income:
- wages and salaries, which are defined as wages, salaries, bonuses, allowances and other income identical to them, earned in the main job under a labour contract with an entity, or earned outside the main job under contract with an entity or individual. Also included in the definition are pensions, additions to pension and allowances;
- income from self-employment or proprietorship, or from a business performed in addition to the main occupation. The taxable income from self-employment or from proprietorship is arrived at by deduction of expenses from income (see below), where these expenses are supported by documentation.

  Where the taxable income cannot be arrived at in this way, the tax authorities have the power to establish the taxable income taking into account market conditions and assessments made on similar businesses;
- capital gains, which are calculated by deduction of original purchase price or cost of construction from sale proceeds;
- income from dividends, share of a participator, interest or the leasing of property, is taxable without any deductions;
- literary and artistic royalties, etc.;
- other income.

D. Deductions

Expenses such as raw materials, purchase price of goods, energy, fuel, water, spare parts, packaging, lease payments, bank loan interest and social insurance premiums are allowable where supported by documentation. The proprietor of a business may deduct payments for business trip expenses, transport facilities and vehicles tax, excise tax, depreciation and payment for use of natural resources. Wages paid to family members are deductible in proportion to social insurance premiums paid.

Where goods are withdrawn from the business for own use, no deduction is allowable.

E. Exempt income

The following types of income are exempt from tax:
- salaries, wages, pensions, allowances and other income up to 96,000 tgs.;
- allowances for temporary inability to work, other than pregnancy and maternity allowances;
- allowances for child support;
- certain awards and pensions for war service;
- cost of protective clothing and uniforms supplied in connection with employment;
- grants from central and local government, foreign countries or the Red Cross in connection with accidents and emergency conditions.

F. Relief from tax

See above for double tax treaties entered into by Mongolia.

G. Assessment

Under the Personal Income Tax Law, a taxpayer who has income in Mongolia must register with the state tax administration, and obtain a registration number.

Tax is withheld from the salary of each individual working on a labour contract at the end of each month and paid over to the tax authorities on or before the tenth day of the following month.

Where an individual receives income from more than one organization, his income is assessed annually, and the annual return should be submitted on or before 10 April in the following calendar year.

For other types of income, the following payment dates apply:
- A self-employed person pays tax based on self-assessment at the appropriate rate each quarter. The tax must be remitted to the tax authorities on or before the 15th of the month following the end of the quarter. An annual return in respect of income of a self-employed individual or proprietor of a business, or of income from leased property, should be made on or before 10 February of the following year.
- An individual holding private livestock pays tax in two instalments (based on self-assessment), the first on or before 25 July and the second on or before 15 December. An agreement may be made with the tax administration to pay these taxes in advance.
- Tax on income from the sale of immovable property should be paid by an individual within ten days after the sale.
- Tax on income from the leasing of property should be paid by an individual on or before the first month of the next quarter.
- Tax on sale of shares, not through a stock exchange, should be paid within ten days of the sale.

H. Tax rates

The following rates of tax are imposed on wages and salaries; income from self-employment; income from proprietorship; income from secondary businesses; and all other income of individuals except where specified as exempt or subject to a special rate:

Taxable income (tgs)	Rates
0 – 96,000	Nil
96,001 – 192,000	2%
192,001 – 384,000	1,920 tgs. plus 5% of income exceeding 192,000 tgs.
384,001 – 768,000	11,520 tgs. plus 15% of income exceeding 384,000 tgs.
768,001 – 1,536,000	69,120 tgs. plus 27% of income exceeding 768,000 tgs.
1,536,001 – 3,072,000	276,480 tgs. plus 40% of income exceeding 1,536,000 tgs.
Over 3,072,000	890,880 tgs. plus 45% of income exceeding 3,072,000 tgs.

Under the Personal Income Tax Law, regulations are to be issued to determine income tax of a self-employed person where the income cannot be determined.

The government will set the tax rate for persons working abroad at the proposal of the government and who are paid by the state.

Remuneration for scientific, literary and art work, rights of patents and authors, invention, innovation and design, are taxed at either 3 or 5 percent.

Where shares are sold through a stock exchange, tax on the income is 10 percent, and where they are sold other than through a stock exchange the rate is 2 percent.

The tax rate on the disposal of immovable property depends on the length of time the property has been used by its owner as follows:

Length of time	Rate
Up to 2 years	40%
2–5 years	30%
Over 5 years	20%

The rate of tax on dividends, income of participants and interest on bank deposits is 15 percent.

IV. INDIRECT TAXES

A. Sales tax

Under the Sales Tax Law, effective from 1 January 1993, an individual, an economic entity or organization which is producing goods, furnishing work or services or importing goods into Mongolia is subject to sales tax.

An economic entity or organization must register with the tax administration as a taxpayer under the sales tax within 30 days of being notified by the administration.

All imported goods and sales of domestically produced goods or domestically provided services by a registered taxpayer are subject to sales tax.

The tax base of imported goods is the total of contract price, freight expenses and insurance premiums, converted into tugriks at the existing rate of exchange, plus customs duty and excise tax. The sales tax base of domestic goods and services is the price plus tariffs.

In the case of goods and services supplied to an associated enterprise at a non-commercial price, the sales tax base is determined on the basis of the price and tariffs of sales of the item between non-associated enterprises.

The rate of sales tax is 10 percent of the taxable base. A zero rate of tax applies to exports.

The point at which tax is charged is as follows:
- in the case of imported goods, the tax is imposed when the goods are brought into the territory of Mongolia;
- in the case of domestic goods, tax is imposed when the producer sells or leases the goods;
- in the case of provision of work or services, the charge to tax arises when an invoice is presented to the customer.

Taxpayers are obliged to add sales tax to the price of goods and services sold, and to pay sales tax for each month, calculated by subtracting sales tax paid on goods and services purchased from sales tax due on sales. Where sales tax paid on goods and services during the month is more than tax charged on sales in the same month, the difference is deductible from the liability for the next month.

An importer of goods should remit the sales tax at the same time as the customs duty.

An economic entity should pay the sales tax for a month on or before the fifth day of the following month.

B. Customs duties

All goods imported into Mongolia are subject to customs duties, with certain specified exceptions. Provision is made in the law for the government to set up customs special zones or bonded warehouses.

A "business entity with foreign investment", which is a business entity registered under Mongolian law in which foreign investors own at least 20 percent of the share capital, is exempt from customs duty on technological equipment and machinery forming part of its capital, from the date of approval by the Ministry.

For business entities with foreign investment except those in certain specified areas of activity, there is an exemption from customs duties for five years from the date of registration on raw materials, components and spare parts imported for production.

C. Exemptions from indirect tax

The following exemptions from customs duties and sales tax are available to business entities with foreign investment:
- technological equipment and machinery forming part of the registered capital of the business is not subject to customs duties and sales tax, from the date of approval by the Ministry and establishment of the business;
- for all business entities with foreign investment, except those in trading and catering, the raw materials, components, spare parts and materials brought in for carrying out production are not subject to customs duties for five years beginning from the date of registration of the entity with the General Department of State Taxation.

V. OTHER TAXES

Other taxes in Mongolia include the inheritance and gift taxes, the immovable property tax and the stamp tax. There are various fees such as the transport and vehicles tax, road fee and payments for use of land, water, timber and use of natural resources. There are also certain local charges such as payments for use of natural resources, quarries and springs.

MALAYSIA

A Review of Recent Tax Developments

Veerinderjeet Singh

Associate Professor, Faculty of Economics and Administration, University of Malaya

I. INTRODUCTION

Sustaining economic growth and controlling or reducing inflation has been a recurrent theme of the Budget strategy in recent years. The prudent measures taken in the past, while addressing immediate situations, were also clearly long-term as evidenced by the strong and sustained economic growth over the years.

For the seventh consecutive year, the Malaysian economy sustained growth rates above 8 percent. The growth rate of 8.5 percent for 1994 is expected to be maintained for 1995, given the expected recovery and growth in the economies of the industrialized countries, increase in world trade and the average growth of around 7 percent in the economies of Malaysia's important trading partners.[1]

This article examines the various measures introduced in the Budget and the Finance (No. 2) Bill 1994[2] with regard to direct and indirect taxation, as well as other recent developments in the Malaysian tax system.

II. 1995 BUDGET CHANGES

The 1995 Budget, presented by the Honourable Minister of Finance on 28 October 1994, focused on the following areas:
- sustaining strong growth;
- reducing inflation to as low as possible;
- developing skilled manpower; and
- building a progressive and balanced society.

Giving this Budget focus, the Finance Minister introduced several measures to reduce taxes, maintain fiscal prudence, combat inflation, develop human resources and upgrade research and development ("R&D").

A. Business taxation

1. Corporate tax rate

Currently, the income tax rate applicable to companies is 32 percent. As announced in the 1994 Budget, the rate of tax for companies has been reduced to 30 percent with effect from the year of assessment 1995.[3] This is in line with the stated policy of creating a more conductive investment climate, increasing competitiveness and reducing the cost of doing business.

Given Malaysia's imputation system and the various incentives and double deductions available, the Minister's statement that Malaysia's effective rate is more competitive compared with countries in the region has some merit. But given the trend of countries in the region to revise their tax rate downwards, Malaysia may yet need to reduce the rate further to remain competitive.[4]

It is anticipated that with the eventual shift towards indirect taxation, the corporate tax rate may be in the region of 25 to 28 percent which would be very competitive.

However, unlike the 1994 Budget, the Minister did not provide any hint in the 1995 Budget as to a possible reduction in tax rates for the following year of assessment.

2. 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 tax rate from the year of assessment 1995, the rate of tax deductible from dividends will be 30 percent. This will apply to dividends paid, credited or distributed from 1 January 1994.[5] As such, dividends paid in 1994 on which tax at 32 percent has been deducted will be recalculated as shown in Table 1.

1. Per capita income increased to RM 8,856 or US$ 3,406 in 1994, while the unemployment rate of 2.9% effectively means a state of full employment. Inflation was contained at 3.7% for the first nine months of 1994, and for the second successive year there is a balanced budget with a higher surplus of RM 637 million.
2. Recently enacted as the Finance Act 1995.
3. Amendment to para. 2 of Part I to Schedule 1 of the Income Tax Act, 1967 (the "Act").
4. The Table below compares Malaysia's corporate income tax rate with those in the other ASEAN countries.

Table Corporate Income Tax Rates of ASEAN Countries

Country	Rate (%)
Singapore	27
Brunei	30
Thailand	30
Malaysia	30
Indonesia (Maximum rate at 1/1/95)	30
Philippines	35

5. Via introduction of Sec. 108 (2D) and (4D) as well as Sec. 110 (1D).

Table 1: Re-computation of Dividend Under New Tax Rate

Shareholder's Position

	RM
Gross dividend	1,000
Less: Tax deducted at 32%	320
Net dividend received by shareholder	680
Re-grossing of net dividend: $\frac{100 \times 680}{70}$	971.42
Less: Tax deemed deducted at 30%	291.42
Net dividend received by shareholder	680.00

With the distribution of a gross dividend of RM 1,000, the Section 108(6) account will be as follows:

Section 108(6) Account

	Previous RM	Current RM
Balance of tax credit b/f (say)	10,000.00	10,000.00
Less: Tax deducted/deemed deductible from dividend	320.00	291.42
Balance of tax credit c/f	9,680.00	9,708.58

With the change, the tax deducted of RM 291.42 would be allowed as a set-off (under Section 110 of the Income Tax Act, 1967) against the tax chargeable on the shareholder.

3. Cooperative societies

The previous income tax rates for cooperative societies ranged from 2 to 34 percent. Further, a special deduction equal to 6 percent of members' funds (as defined in Schedule 6 of the Income Tax Act, 1967) was allowed against total income in arriving at the chargeable income of a cooperative society. With effect from the year of assessment 1995, the income tax rates range from 1 to 32 percent; and the special deduction has been increased to 8 percent of member's funds.[6]

The cooperative movement has been a vehicle used to mobilize the economic potential of the medium and low income group. As such, the changes will effectively further reduce the tax burden of the cooperatives.

4. Withholding taxes

With effect from 28 October 1994, the withholding tax rates have been reduced as follows:[7]

- Interest: 15 percent (previously 20 percent);
- Royalties: 10 percent (previously 15 percent);
- Special classes of income (including technical fees and use of moveable property): 10 percent (previously 15 percent).

The reduction in withholding tax on interest is expected to promote the inflow of foreign loans at a lower cost of borrowing to finance development projects, whereas the reduction in withholding tax rates on royalties and technical fees should encourage the transfer of technology and know-how to Malaysia.

Whilst the corporate tax rate has been reduced gradually over the years, the withholding tax rates had remained unchanged. The reduction in the withholding tax rates can be seen as an effort to make the whole tax rate structure more equitable.

With this reduction, the effectiveness of some of the double tax agreements would no longer be evident so far as tax rates on interest or royalties are concerned. For example, where a double tax agreement stipulates that the tax rate on royalties could not exceed 15 percent, the new proposed domestic tax rate of 10 percent would apply.

5. Scope of charge

Income of a resident person is charged to tax if it accrues in or is derived from Malaysia or received in Malaysia from outside Malaysia. The exceptions to this are income from approved overseas investments, overseas construction projects, export of services in the oil and gas industry and resident persons engaged in banking, insurance, shipping and air transport businesses (which are taxed on a world income basis).

With effect from the year of assessment 1995, resident companies would only be subject to tax on income derived from Malaysia (i.e. a territorial scope of charge).[8] However, resident companies carrying on the business of banking, insurance, shipping and air transport will continue to be taxed on their worldwide income. This represents a fundamental change in the scope of charge for resident companies. This change would be significant in Malaysia's push towards greater reverse investments as it is expected to encourage the remittance to Malaysia of foreign-source income so that such profit/income is reinvested in Malaysia.

However, it is not clear as to why the amendment was not extended to all resident persons. Further, there is no mechanism for such foreign income to be distributed by the resident company as tax- exempt dividends to its shareholders. As such foreign income would not have any imputation (Section 108) credits (as it is not taxable in Malaysia), its distribution (as dividends) would cause the company to utilize its existing credits or to be subject to tax (i.e. through a Section 108 charge) if there are no imputation credits available.

The change would be more complete and meaningful if provisions were incorporated to allow the foreign income to be paid out as dividends to shareholders without the need to comply with Section 108 franking requirements. On the other hand, it could be countered that the Government wishes to see such foreign income being reinvested instead of being distributed to shareholders.

6. Life insurance business

Under previous legislation, the adjusted business income of a person carrying on life insurance or *takaful* (i.e. insurance under Islamic principles) business was arrived at by taking the aggregate of the gross income from investments made out of its life funds and the gross proceeds (whether or not of an

6. Amendments to Part IV of Schedule 1 and Sec. 65A (b).
7. Amendments to paras. 1 and 2 of Part II and Part V to Schedule 1.
8. Via introduction of Sec. 3C.

income nature) receivable in respect of the realization of investments and deducting therefrom the following:

- the cost of acquiring or realizing the investments;
- a proportion of management expenses calculated based on a prescribed formula; and
- 2 percent of the balance of revenue account as at the last day of the basis period for that year of assessment (restricted to the amount of commissions paid).

To promote the life insurance and takaful industry and to encourage savings through insurance and takaful, a new approach to the taxation of the aforesaid business has been adopted with effect from year of assessment 1995. The income of the life fund and that of the shareholders' fund would be treated as separate sources of income and the chargeable income of the life fund would be taxed at the concessionary rate of 8 percent. The rate of tax on the chargeable income of the shareholders' fund will remain at the normal corporate rate (i.e. 30 percent).[9]

The adjusted income of the life fund of an insurer would be arrived at by taking the aggregate of investment income and gains or losses on realization of investments made out of the insurer's life funds.

Similarly, the adjusted income of the shareholders' fund (which shall be deemed to be its statutory income) shall be ascertained by taking the aggregate of the income from investments made out of shareholders' funds, gains and losses on realization of those investments plus an amount equal to a certain percentage of the actuarial surplus from the life fund as is apportioned to the shareholders' fund. It is understood that the percentage of the actuarial surplus will be an amount equal to 20 percent of that surplus. The actuarial surplus as aforesaid will be subject to any adjustment as the Director General of Inland Revenue may think fit to make in accordance with the provisions of the Income Tax Act.

It is pertinent to note that under the amendments, no deduction of expenses will be allowed in arriving at the adjusted income and statutory income of the life fund and shareholders' fund, respectively.

With regard to the unabsorbed capital allowances and losses of the life insurance business brought forward from the year of assessment 1994, such unabsorbed capital allowances and losses are only available for deduction against the adjusted income and statutory income of the life fund of the insurer, respectively for the year of assessment 1995 and subsequent years of assessment. Capital allowances for the current year may be deducted from the adjusted income of the life fund. However, the balance of such allowances shall not be available as a deduction against the adjusted income of the shareholders' funds but may be carried forward for offset against the adjusted income of the life fund in subsequent years of assessment.

For the purposes of determining the amount available for franking of dividends under Section 108 of the Income Tax Act, the income tax of 8 percent paid on the life fund of the insurer would not be taken into account. Section 108 thus would not apply in respect of income distributed from the life fund.

A comparison of the changes to the tax treatment of life insurance business is shown below:

	Previous <---Legislation---> Life and Shareholders' Funds	Current <---Legislation---> Life Fund	Shareholders' Fund
Investment income	X	X	X
Proceeds on realization of investments	X	X	X
Actuarial surplus	–	–	X
Less: Cost of acquiring or realizing the investments	(X)	(X)	(X)
Proportion of management expenses	(X)	–	–
2% of revenue account	(X)	–	–
Adjusted business income	X	X	X
Less: Capital allowances	(X)	(X)	–
Unabsorbed capital allowances b/f	(X)	(X)	–
Statutory business income	X	X	X
Less: Unabsorbed loss of life business b/f	(X)	(X)	–
Chargeable income	X	X	X
Income tax rate	32%	8%	30%

It is felt that, despite the concessionary tax rate of 8 percent on chargeable income from the life fund, the non-deductibility of expenses may place a heavy tax burden on life insurance companies. As such, the benefit of the reduced rate may not be sufficiently significant to be transferred to policy holders by way of reduced premiums or increased bonuses. If indeed the effect of the change is as stated above, it would be interesting to see what happens in the next Budget, i.e. would there be some changes to neutralize the effect as had happened a few years ago when commissions paid were not allowed as deductions and subsequently a new deductible item was granted (i.e. 2 percent of the revenue account balance) which restored the "status quo" as far as life insurance companies were concerned.

7. General insurance business[10]

With effect from year of assessment 1995, recoveries under reinsurance contracts made in connection with a general insurance business are taxable on an accruals basis rather than a cash basis.

Previously, only admitted claims were allowed as a deduction in arriving at the adjusted income of the general insurance business. With effect from year of assessment 1995, claims incurred but not reported, as confirmed by Bank Negara Malaysia, would be fully deductible as an expense in arriving at the adjusted income of the general insurance business.

9. Via amendments to Sec. 60, introduction of Sec. 60AB, amendment to Sec. 108(11) and introduction of Part VIII to Schedule 1.
10. Amendments to Sec. 60(5) and (6).

8. Promotional gifts

With effect from year of assessment 1995, expenses incurred on promotional gifts (which are not products of the business) given within Malaysia would qualify for deduction provided such gifts consist of articles which incorporate a conspicuous advertisement or logo of the business.[11]

This change to allow a deduction for promotional items bearing the company's logo, emblem, insignia or brand name is indeed welcome. This has come after various representations by the business community over the past three years. It had been contended that the making of promotional gifts is part of a company's advertising or marketing strategy. As such, the view taken by the tax authorities that such expenditure was entertainment in nature was incomprehensible to many and appears to show a lack of appreciation of business practices. Unfortunately, the amendment does not have retroactive effect.

9. Double deductions

(a) *Insurance premiums for exports*

As a step to encourage exports on the basis of cost, insurance and freight which will result in a reduction in the outflow of freight charges and insurance premiums and contribute to reducing the deficit in the services account of the balance of payments, insurance premiums paid in respect of cargo exported would be allowed a double deduction provided the risks are insured with a locally incorporated insurance company.[12] This change is to take effect from the year of assessment 1995.

This will streamline the tax treatment with that for premiums paid to local insurance companies for the insurance of cargo imported which is also allowed a double deduction.

(b) *Payments to R&D companies*[13]

With effect from year of assessment 1994, the double deduction incentive will be extended to include payments for the use of the services of an research and development company or a contract R&D company.[14] However, this incentive is not available for payments made by a related company[15] of an R&D company which has been granted Investment Tax Allowance under the Promotion of Investments Act, 1986 and whose period of relief of ten years has not expired.[16]

10. Industrial building allowance

With effect from year of assessment 1995, buildings used for the purposes of industrial, technical or vocational training approved by the Minister of Finance; or research undertaken by an R&D company or a contract R&D company will be classified as industrial buildings qualifying for industrial building allowance.[17] This is in line with the Government's efforts in accelerating private sector involvement in industrial, technical or vocational training programmes and R&D activities.

11. Approved donations

(a) *Low cost housing fund*

In the 1994 Budget, it was stated that donations to the Government Low Cost Housing Fund (managed by Bank Negara Malaysia) made during the period 1 November 1993 to 31 January 1994 qualify for double deduction. The qualifying period was extended to 30 June 1994 so as to enable those who made donations up to that date to enjoy the double deduction[18].

(b) *Technical or vocational training*

Contributions in cash to a technical or vocational training institute established and maintained by a statutory body approved by the Director General of Inland Revenue would be eligible, with effect from year of assessment 1995, for a deduction as approved donations in arriving at total income[19].

(c) *Gift of used machinery or equipment*

With effect from year of assessment 1995, the disposal value of qualifying plant and machinery (which had been used by the donor for the purposes of a business) would be deemed to be zero if such an asset was donated to

- a technical or vocational training institute established and maintained by the Government or a statutory body;
- a technical or vocational training institute approved by the Minister of Finance; and
- an approved research institute as defined in Section 34B of the Income Tax Act.[20]

Thus, the disposal value would be treated as zero instead of the market value of the asset at the date of the gift. As such, the residual expenditure of the asset would be allowed as a balancing allowance to the donor.

B. Personal taxation

1. Income tax rates

(a) *Non-residents and other bodies*

In line with reduction in the corporate tax rate, the rate of income tax imposed on non-resident individuals, trust bodies, executors of estates of deceased persons who died domiciled outside Malaysia and receivers has been reduced from 32 to 30 percent with effect from year of assessment 1995.[21]

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11. Amendment to Sec. 39(1)(l).
12. This change will be introduced by way of a gazette order.
13. An R&D company means a company which provides R&D services in Malaysia to its related company or to any other company.
14. A contract R&D company is defined as a company which provides R&D services in Malaysia only to a company other than its related company.
15. Related company means a holding company; a subsidiary; or a subsidiary of the holding company of the R&D company or contract R&D company.
16. Amendment to Sec. 34B.
17. Amendment to para. 37B of Schedule 3.
18. Amendment to Sec. 44(6).
19. Amendment to Sec. 44(7).
20. Amendment to para. 62 of Schedule 3.
21. Amendment to para. 2 of Part I to Schedule 1.

(b) *Resident individuals*

As expected, the income tax rates for resident individuals have been lowered by 2 to 3 percent for all chargeable income bands. With effect from year of assessment 1995, the rates range from zero to 32 percent. Further, the maximum rate of 32 percent only applies to chargeable income above RM 150,000 and the first RM 2,500 of chargeable income will no longer be taxed.[22] The reduction in tax rates will benefit all taxpayers from the lower income groups to the high income taxpayers.

With the abolition of the minimum 2 percent rate, the lower income group whose chargeable income is not more than RM 2,500 is now relieved from paying income tax. Coupled with the increase in tax rebates, it is estimated that 380,000 taxpayers will no longer have to pay income tax. This represents 30 percent of the total number of taxpayers. The abolition of income tax on the first RM 2,500 of chargeable income effectively means a personal relief of RM 2,500 to resident individuals.

It is, however, unfortunate that the top rate for individuals has not been reduced to be on par with the corporate tax rate of 30 percent. High income individuals may find it worthwhile, depending on circumstances, to incorporate their businesses to take advantage of the 2 percent differential between the top personal marginal rate of 32 percent and the corporate rate of 30 percent.

It is felt that this revision of tax rates should be an ongoing process. With the expansion of the consumption tax base and the impending introduction of the Sales and Service Tax, a further reduction in income tax rates would be needed to provide a psychological edge in allaying fears of the impact of a broad-based consumption tax.

2. Reliefs and rebates

(a) *Personal relief*[23]

With effect from year of assessment 1995, the following reliefs (in addition to the standard personal and wife reliefs) have been introduced:
- RM 5,000 for a disabled individual;[24] and
- RM 2,500 for a disabled wife who has no income or who elects for a combined assessment with the husband.

Further, a tax relief of up to RM 2,000 will be given for fees expended by a resident individual on further education in acquiring technical, vocational or industrial skills in any institution in Malaysia recognized by the Government. This is intended to encourage individuals to upgrade their skills. However, it appears that this relief is not intended for individuals undergoing professional training or taking up management courses.

(b) *Child relief*

Previously, a resident individual could claim child relief of RM 800 per child up to a maximum of five children. With effect from year of assessment 1995, child relief is to be given without limiting it to five children.[25]

(c) *Rebate*

In line with the Government's aim to reduce the tax burden of the lower income groups, the tax rebate of RM 90 for a resident individual and RM 50 for the wife has been increased to RM 110 and RM 60 for the individual and the wife respectively.[26] The condition that chargeable income of the individual must not exceed RM 10,000 still applies. This change is effective from year of assessment 1995.

3. Contribution to libraries[27]

With effect from year of assessment 1995, a deduction is allowed against aggregate income for cash donations of up to RM 20,000 made by an individual to public libraries, libraries of schools and institutions of higher education. This deduction is not available if the individual is entitled to a claim for such a donation against his business income under the existing legislation. This change aims to extend a deduction for donations made to libraries by individuals with non-business sources. It is aimed at fostering the development of well-equipped libraries and a knowledgeable and well-read society.

Individuals will also be allowed a deduction for cash donations made to approved technical or vocational training institutes (see above).

4. Tax exemption on annuities

With effect from year of assessment 1995, sums received by way of annuities granted under annuity contracts issued by Malaysian life insurance and takaful companies will be exempted from tax in the hands of the annuitant.[28] The tax exempt status will make annuities a more attractive investment.

C. Investment incentives

1. Technical and vocational training

(a) *Investment tax allowance*[29]

To encourage the private sector to participate in the provision of technical and vocational training, Investment Tax Allowance will be extended to companies intending to establish technical or vocational training institutes, and to existing companies providing technical or vocational training that upgrade their training equipment or expand their training capacities.

The allowance is at a rate of 100 percent for qualifying capital expenditure incurred within a period of ten years from the

22. Amendment to para. 1 of Part I to Schedule 1.
23. Amendments to Secs. 46 and 47.
24. A "disabled person" means any individual certified in writing by the Department of Social Welfare to be a disabled person.
25. Amendments to Sec. 48.
26. Amendment to Sec. 6A(2).
27. Introduction of Sec. 44(8).
28. Via introduction of para. 36 to Schedule 6.
29. Via introduction of Secs. 26G, 27G and 29H to the Promotion of Investments Act, 1986 which came into force on 28 October 1994.

date of approval. Capital expenditure in this respect means capital expenditure incurred on a building or on any plant and machinery used in Malaysia in connection with and for the purposes of an activity relating to training.

It is to be noted that capital expenditure qualifying for the allowance does not include capital expenditure incurred on buildings used as living accommodation or on plant and machinery provided for the use of a director or a member of the management, administrative or clerical staff.

Although the Investment Tax Allowance is given at a rate of 100 percent of capital expenditure, exemption is restricted to 70 percent of statutory income. The amount of statutory income exempt from tax will be credited to a tax exempt account which can be used to declare exempt dividends. Any unutilized allowance is carried forward for set off against statutory income for the subsequent year of assessment.

2. Other incentives

A number of other incentives took effect from year of assessment 1995. These are:
- exemption to technical or vocational training institutes from import duty, sales tax and excise duty on machinery/equipment, materials and samples used for purposes of training;
- industrial building allowance for buildings used for training by companies providing technical or vocational training (see Business Taxation above);
- deduction for cash donations to a technical or vocational training institute established and maintained by a statutory body (see Business Taxation above);
- treating the disposal value of used machinery or equipment donated to a technical or vocational training institute as zero (see Business Taxation above).

These incentives together with the investment tax allowance and the existing double deduction incentive for training are intended to provide the impetus to generate skilled manpower to meet the nation's growing labour requirements.

3. Operational headquarters ("OHQ")

With effect from year of assessment 1995, the following changes have been introduced:
(1) to allow locally-owned companies to set up OHQs in Malaysia;[30]
(2) to extend the OHQ incentive to all economic sectors, including agriculture, construction and mining;
(3) to re-classify qualifying services into five specific categories:
   - management and administrative services
   - treasury and fund management services
   - other financial services
   - R&D
   - training and personnel management;
(4) to allow OHQs to borrow freely in foreign currency (without the need to seek approval of Bank Negara Malaysia) from any commercial or merchant banks in Malaysia including the offshore banks in Labuan and any party outside Malaysia to fund their treasury and fund management operations for their related companies outside Malaysia. However, OHQs are not allowed to lend or raise funds in any currency in Malaysia on behalf of related companies outside Malaysia;
(5) where the OHQs are established by financial institutions, they are prohibited from providing treasury and fund management services to their related companies in Malaysia unless the related companies are institutions licensed under the Banking and Financial Institutions Act 1989;
(6) to allow OHQs to borrow freely in Ringgit up to RM 10 million for any purpose in Malaysia;
(7) to allow OHQs to freely invest in foreign securities and lend to related companies outside Malaysia, provided that the domestic borrowing in Ringgit is within the RM 10 million limit and the remittances are made in foreign currency equivalent;
(8) to allow OHQs to open foreign currency accounts with licensed financial institutions in Malaysia including offshore banks in Labuan, subject to certain conditions imposed by the Controller of Foreign Exchange (i.e. Bank Negara Malaysia).

The widening of the scope of services, relaxation of borrowing requirements by OHQs and the ability of locally-owned companies to now apply for OHQ status is expected to make Malaysia an attractive base for OHQs in the Asia-Pacific, even rivalling Singapore.

With the abolition of income tax on overseas income remitted into Malaysia, OHQ status is made even more attractive as dividends received from related companies outside Malaysia will be free from Malaysian tax even after the tax relief period of ten years which is currently available to OHQs on such income.

However, Malaysian resident OHQ companies will not be able to pay tax exempt dividends to shareholders as there are no provisions to credit overseas dividend income received in Malaysia to a tax exempt account. Thus, such companies will have to account for Malaysian income tax on dividends paid to their shareholders on distribution of overseas income.

D. Petroleum income tax

1. Approved donations

With effect from the year of assessment 1994, cash donations made during the period from 1 November 1993 to 30 June 1994 to the Government Low Cost Housing Fund managed by Bank Negara Malaysia will be allowed a further deduction of one half of the donation in arriving at the chargeable income of the donor.[31]

In the 1994 Budget, a double deduction was allowed for such donations under the Income Tax Act, 1967. Petroleum companies making such donations did not enjoy an increased deduction. As such, this amendment rectifies the oversight in

30. Via amendment to Sec. 60E of the Act.
31. Amendment to Sec. 22(1) of the Petroleum (Income Tax) Act 1967.

not amending the Petroleum Income Tax Act. However, petroleum companies are only eligible for a deduction of 11/2 times the donation. This is due to the fact that the petroleum income tax rate is higher than the tax rate for other companies.

2. Contributions to approved schemes

With effect from year of assessment 1994, the maximum deduction allowed to the employer for its share of contributions to approved schemes has been increased to 16 percent.[32] This is in line with a similar increase to the Income Tax Act, 1967 introduced in the 1994 Budget. Once again, this amendment is to rectify an oversight.

E. Indirect taxation

1. Stamp duty

(a) *Loan agreements for education*

Generally, loan agreements for education were subject to *ad valorem* stamp duties of RM 2.50 for every RM 500 or part thereof. However, where loans for education are provided by the Federal Government, State Government or statutory bodies, then the agreements entered between the students and the aforementioned authorities were subject to stamp duties up to a maximum of RM 6 only and the excess amount of duty was remitted. With effect from 28 October 1994, all loan agreements for education are subject to stamp duty of up to a maximum of RM 6.

This change seeks to rectify the present inequality in the stamp duty treatment between study loans provided by the private sector and those provided by the Federal Government, State Government and statutory bodies. Now, all such loan agreements for education are subject to a maximum stamp duty of RM 6.

(b) *Transfer of an undivided interest in property*

An instrument of conveyance either on sale or by way of gift or settlement which operates to vest or transfer an undivided interest in real property and where the transaction concerned forms part of a larger transaction and the aggregate consideration or market value of the separate parts or parcels being conveyed exceeds RM 100,000, then the *ad valorem* stamp duty upon the instrument and upon every other instrument was calculated on that excess at the rate of 2 percent of the consideration or the market value of each part or parcel whichever is higher.

With effect from 1 January 1995, such instrument(s) will attract *ad valorem* duty calculated on the aggregate of the consideration or market values of the separate parts or parcels being conveyed, whichever is higher, at the rates specified under item 32(a) of the First Schedule to the Stamp Act, 1949.[33]

2. Import duty structure on passenger vehicles

With effect from 28 October 1994:

(i) only three rates of duties (from 140 to 200 percent of value) will be imposed on imported petrol driven and used diesel passenger vehicles based on engine capacities;
(ii) a single flat import duty rate of 120 percent will be imposed on new diesel passenger vehicles.

This change will rationalize and simplify the present import duty structure to enable the importer to readily ascertain the rate of duty payable.

3. Reduction of import duty and sales tax on heavy construction equipment

Import duties and sales tax on machinery such as crane trucks, bulldozers, graders, scrapers, road rollers and pile drivers used in the construction sector have been abolished with effect from 28 October 1994. The abolition of the duties would assist in the implementation of development projects which require substantial use of heavy machinery and equipment.

4. Excise duty on goods, vehicles and locally manufactured goods

With effect from 28 October 1994, excise duty on goods, vehicles and other locally manufactured goods such as beverages, petroleum oils and products, rubber tyres and tubes and primary cells and batteries have been abolished. The abolition of excise duty on goods vehicles will help in the reduction of transport costs which will assist in the strategy to combat inflation.

The move to abolish excise duty on locally manufactured goods is to increase the competitiveness of these goods against imported goods whose duties have either been reduced or abolished.

5. Import duty on raw materials and components

Previously, many types of raw materials and components which are used for the manufacture of goods had an import duty of 2 percent or 3 percent. With effect from 28 October 1994, the import duty on a whole range of items was abolished. Previously, companies manufacturing goods for the export market were exempted from the payment of such duties whereas those who were manufacturing goods for the domestic market were required to pay the duty. The abolition of the duty on these raw materials and components will help to increase the productivity and competitiveness of the manufacturers for the domestic market.

32. Amendment to para. 16(3)(a) of the Petroleum (Income Tax) Act, 1967.
33. The rates are as follows:
- 1% on the first RM 100,000;
- 2% on any amount in excess of RM 100,000 but not exceeding RM 500,000;
- 3% on any amount in excess of RM 500,000 but not exceeding RM 2 million;
- 4% on any amount in excess of RM 2 million.

Amendment to Sec. 20B of the Stamp Act, 1949.

6. Sales tax on machine parts

As a continuation of the rationalization measures initiated in 1993, sales tax on various machine components parts was abolished from 28 October 1994.

7. Import duties

With effect from 28 October 1994, import duty on a whole range of goods has been either reduced or abolished. These goods include food items, petroleum products, textiles, electrical machinery and equipment, household appliances and pianos. All in, around 2,600 items were affected by the various changes in duties. The reduction or abolition of duties are designed to assist in the effort to control inflation and promote competition with the view to overcome market imperfections and stabilize prices.

8. Sales and service tax ("SST")

The much talked-about SST did not materialize. For once, over the past three years, the service tax base was not widened. No indication as to the timeframe of the introduction of SST was given. However, silence does not mean that it would not be introduced. It is understood that work is being carried on with the SST and discussions with industry groups and consumer associations will continue in order to ensure the smooth implementation of SST. So, SST will be back in the limelight at the appropriate time when it is more palatable.

F. Other changes

1. Foreign exchange control regulations

In line with greater world trade demands and to cater for increased foreign exchange transactions, the exchange control regulations have been liberalized as follows:

- exporters will be allowed to retain a portion of their export proceeds in foreign currency provided these proceeds are deposited in foreign currency accounts with authorized banks in Malaysia. This will enable exporters to minimize their foreign exchange conversion costs;
- to facilitate payments, residents employed overseas and students pursuing studies abroad will be allowed to open and maintain foreign currency accounts with Malaysian as well as foreign banks;
- the threshold on foreign currency loans requiring approval has been raised from RM 1 million to RM 5 million equivalent in aggregate;
- guarantees and foreign exchange lines of Non-Resident Controlled Companies ("NRCCs") are to be excluded from the definition of 'credit facilities', i.e. excluded from the computation of the borrowing limits that do not require approval which currently is RM 10 million. This will enable NRCCs to increase the amount of domestic borrowings without having to seek approval;
- the domestic debt to eligible capital funds ratio of NRCCs has been increased from 2:1 to 3:1, i.e. NRCCs will be allowed to borrow up to three times their eligible capital funds;
- ringgit loans to non-resident individuals have been increased to RM 200,000. They can also obtain housing loans of any amount from banking institutions.

2. Power to make rules

The Minister of Finance is authorized under the Income Tax Act to make rules, e.g. for the deduction of tax at source from employment income. With effect from year of assessment 1995, the Minister has been empowered to make rules for the imposition of penalties for failure to comply with rules prescribed by the Minister. However, the penalty is restricted to a fine ranging from a minimum of RM 200 to a maximum of RM 2,000 or to imprisonment for a term not exceeding six months or to both.[34]

3. Withdrawals from the employees provident fund ("EPF")

A contributor to the EPF can withdraw the balance to his credit partially (i.e. on attaining the age of 50 years or for the purchase of a house) or wholly (i.e. on attaining the age of 55 years, on leaving Malaysia permanently, on death or on being physically or mentally incapacitated and therefore unable to engage in any other employment).

With effect from 1 November 1994, a contributor can:

- opt to either withdraw the savings in one lump sum or through monthly instalments on attaining the age of 55 years;
- withdraw 10 percent of the savings for medical expenses;
- withdraw 30 percent of the savings for the purchase of a house.

These changes provide greater flexibility for withdrawal of savings and have been well-received by contributors.

III. PROMOTION OF INVESTMENTS (AMENDMENT) (NO. 2) ACT 1994

This legislation was gazetted on 8 September 1994 and incorporated proposals announced in the 1994 Budget. The various changes introduced are summarized below.

A. Promoted areas

A new Section 4C is introduced which permits the Minister of Finance to determine such areas as he may deem fit to be promoted areas. Companies operating in such promoted areas would be eligible for pioneer status which allows 85 percent of the statutory income to be exempt from tax for five years. Alternatively, such companies may also qualify for investment tax allowance ("ITA") at a rate of 80 percent of qualifying capital expenditure incurred within five years. Such ITA will be utilized to abate up to 85 percent of the statutory income.

34. Amendment to Sec. 154(1) of the Act.

This incentive is for companies located in the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak. The 'Eastern Corridor' covers Kelantan, Terengganu, Pahang excluding the districts of Lipis, Raub, Jerantut and Cameron Highlands (except for those approved industrial estates located in these districts) and the district of Mersing in Johor.

B. Infrastructure allowance

A company which is resident in Malaysia and has incurred capital expenditure on infrastructure[35] in respect of a business or businesses in operation in a promoted area will be eligible for an infrastructure allowance of 100 percent of the capital expenditure incurred within five years from 29 October 1993. Such an allowance is deductible against 85 percent of the statutory income. Any unutilized allowance can be carried forward to subsequent years.

Capital expenditure incurred on infrastructure by a pioneer company for its pioneer business during its tax relief period would be deemed to have been incurred on the day following the end of the tax relief period.

C. Research and development

A contract R&D company participating in an activity relating to R&D is eligible to apply for pioneer status which means total exemption from tax of the statutory income for five years. Any unabsorbed loss at the end of the pioneer period can be carried forward. Alternatively, a contract R&D company is eligible for an ITA of 100 percent of the capital expenditure incurred within ten years from the date of approval. However, the amount of the ITA deductible is restricted to 70 percent of the statutory income.

A contract R&D company refers to a company which undertakes R&D activities in Malaysia for a company other than its related company (i.e. the holding company, a subsidiary company or a subsidiary of the holding company).

An R&D company (which provides R&D services in Malaysia to its related company or to any other company) is only eligible for an ITA of 100 percent of the capital expenditure incurred within ten years from the date of approval. The amount of the ITA deductible is restricted to 70 percent of the statutory income.

A company undertaking in-house R&D (for its own business) is only eligible for an ITA of 50 percent of the capital expenditure incurred within ten years from the date of approval. The amount of the ITA deductible is restricted to 70 percent of the statutory income.

D. High technology companies

A company participating in a promoted activity or producing a promoted product in areas of new and emerging technologies is eligible to apply for pioneer status which exempts 100 percent of the statutory income from tax for a period of five years. Any unabsorbed loss at the end of the pioneer period cannot be deducted against the post pioneer income unlike a contract R&D company.

Alternatively, such a company is eligible for an ITA of 60 percent of the capital expenditure incurred within five years from the date of approval. There is no restriction as to the amount of ITA deductible against statutory income.

E. Plant and machinery used in connection with scheduled wastes

Plant and machinery used directly/indirectly for the purposes of storage, treatment or disposal of scheduled wastes as defined in The Environmental Quality (Scheduled Wastes) Regulation 1989 incurred by a pioneer company for the purposes of its pioneer business during tax relief period will be deemed incurred on the day following the end of the tax relief period. Thus, capital allowances will be given in the post-pioneer period. This is an exception to the current rule requiring capital allowances to be claimed during the tax relief period on other plant and machinery. This amendment took effect from the year of assessment 1991.

IV. CORPORATIZATION OF THE INLAND REVENUE DEPARTMENT ("IRD")

The Inland Revenue Board of Malaysia Bill 1994 was recently passed by Parliament. The Bill proposed the establishment and incorporation of the Inland Revenue Board of Malaysia. The Board will enjoy some degree of autonomy especially in terms of financial and personnel matters. It is envisaged that the corporatization of the IRD through the establishment of the Inland Revenue Board will enable it to operate more efficiently and effectively. For taxpayers and tax agents, it is hoped that there will be a better work culture, greater efficiency and better services.

V. SCHEDULAR TAX DEDUCTION SYSTEM

It was announced in the 1994 Budget that the system of tax deduction for employees based on schedules as in Sabah and Sarawak called the Schedular Tax Deduction System (STD) would be extended to Peninsular Malaysia with effect from 1 January 1995.

The STD system is a scheme of tax deduction which ensures an efficient manner of collecting tax from employees through deductions by employers. Presently, salaried taxpayers are required to pay their income tax under an instalment payment scheme issued by the IRD. Under the STD system, employers are required to deduct from the salaries of their employees

35. Infrastructure is defined to mean any construction, reconstruction, extension or improvement of any permanent structure including a bridge, jetty, port or road in respect of a business or businesses in operation in a promoted area but excludes capital expenditure which qualifies for capital allowances or other incentives.

a certain sum according to the STD tables which were recently gazetted. The STD system therefore also reduces the voluminous administrative paperwork that the IRD would otherwise need to handle.

The STD system applies to all employment income taxable under Section 13 of the Income Tax Act 1967 (the Act). It therefore includes any wages, salary, overtime, commission, tips, allowances, bonus, gratuity, directors' fees, benefits-in-kind, etc. The STD system is also applicable to expatriates if they qualify as 'resident' under Section 7 of the Act. The amount of tax deduction applicable for an employee depends on the employee's monthly income less deduction for contribution to the EPF, marital status and number of children.

The pay-as-you-earn ("PAYE") system presently adopted in Sabah and Sarawak requires tax to be collected in the same year the salary is earned. The STD system, on the other hand and as far as existing employees are concerned, requires the payment of tax only after income has been earned. However, for "new employees" who started work on or after 1 January 1995, their employers are required to deduct the amount of tax applicable upon paying the net salaries. "New employees" is defined as those employees who have not worked elsewhere before 1 January 1995. This means that persons who started work on or after 1 January 1995 are effectively on the PAYE system.

In cases where, as at 31 December 1994, taxpayers have not settled their tax liabilities for year of assessment 1994 in full under the instalment scheme issued in 1994, the IRD will continue to issue directives to their employers to deduct the outstanding tax liabilities by monthly instalments in 1995. Therefore, during the transitionary year 1995, it is possible that salaries of employees would be deducted twice, i.e. to settle the outstanding tax liability for the year of assessment 1994 and the tax liability for the year of assessment 1995.

In view of the personal details required to identify the amount of tax deduction applicable to an employee, employers are advised to maintain proper and up-to-date records for all their employees.

Employers are also reminded that the tax deduction according to the STD table must be strictly complied with and no changes whether to increase or reduce the tax deduction may be made to the deductions without the approval of the IRD. In this regard, since most taxpayers' incomes are assessable to income tax in the following year while the tax deduction to be applied under the STD system is based on the employee's present salary, it is very likely that most taxpayers will have an overpayment in their tax position. The IRD has clarified that should this occur, taxpayers may request for refunds to be made to them. It is understood that these refund cheques should be ready within one month in most cases. On the other hand, where the tax deducted from salaries is insufficient to settle the taxpayer's income tax payable stated in the Notice of Assessment, the difference must be paid within 30 days from the date of the Notice of Assessment.

Under the Income Tax (Deduction from Remuneration) Rules 1994, an employer is required to make the relevant deductions for each employee in accordance with the table, complete the Statement of Tax Deductions by an Employer (Form CP 39) and remit the aggregate amount of tax deductions to the IRD on or before the 10th day of the subsequent month together with the duly completed Form CP 39. The employer also has to give to each employee a statement in respect of the total deductions made during the relevant year. Employers who fail to remit their employee's taxes without any reasonable excuse would be liable to a fine not exceeding RM 1,000 or imprisonment of six months or both.

VI. APPEAL STRUCTURE

In 1994, the appeal structure was amended with the establishment of a Court of Appeal. Thus, appeals from the High Court would be heard by the Court of Appeal and an appeal against the decision of the Court of Appeal would be heard by the Federal Court (formerly, the Supreme Court) depending on the circumstances of the case.

VII. DOUBLE TAX AGREEMENTS

As at the end of 1994, Malaysia had concluded 40 double tax agreements (inclusive of the limited treaty with the United States). During 1994, three new agreements were signed with the Republic of Albania, Sudan and Zimbabwe.

VIII. CONCLUSION

Overall, the 1995 Budget can be described as bold and imaginative which provides benefits for almost everyone especially since the general elections are expected to be held soon. It is clear that the Government is anxious to make the Malaysian tax regime competitive and attractive. However, the expected loss of RM 2 billion through reduction in tax rates is a huge amount and it is unclear as to how this will be compensated for especially since no new taxes were introduced. To rely totally on increased collection of taxes through increased economic activity does not sound too prudent.

Notwithstanding the generous mood of the Government, in the final analysis, the projected growth rate is achievable with careful monitoring of the situation.

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CENTRAL AMERICA

Taxation of Investment Income

Miguel Massone

Miguel Massone obtained his law degree at the Universidad de Valparaiso, Chile in 1991, and was admitted to the bar in the same year. He is a former IBFD non-resident research associate for Latin America, and currently is an affiliate to Estudio Tributario Massone in Chile. Mr Massone also lectures in tax law at the Universidad Adolfo Ibanez and Universidad del Mar, Vina del Mar, Chile.

I. INTRODUCTION

This article discusses the taxation of dividends, interest and royalties paid by legal entities to resident and non-resident taxpayers in the Central American countries, namely Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama.

A brief synopsis of the income tax systems and rules on the territorial scope of the six countries is followed by a comparative analysis of the tax treatment of dividends, interest and royalties. The concluding section looks at international double taxation of investment income.

II. GENERAL ASPECTS

In all of the countries the income tax system includes a general income tax which is levied on both legal entities and individuals. Income of corporations[1] is taxed at corporate level. The corporate income tax is levied at a flat rate, except in Honduras and Panama where it is levied at progressive rates. Dividends and profit distributions are taxed again at the participator's level, except in Guatemala and Nicaragua where they are taxed, in principle, only when paid to non-residents.

III. TERRITORIAL SCOPE

The territorial scope of income tax is almost uniform in the Central American region. Central American nations rely on the territoriality principle of income taxation,[2] with the sole exception of Honduras which applies the worldwide principle.

As a result of the adoption of the territoriality principle, the concept of domestic-source income is decisive in most Central American countries; only income derived from local sources is taxable within their respective tax jurisdictions. In contrast, the distinction between residents and non-residents is, as a rule, of less importance than in most other Latin American countries, since income is only subject to tax when derived from domestic sources. Nevertheless, the distinction may be relevant for withholding taxes on payments to non-residents.

A. Costa Rica

Income from Costa Rican sources is defined as income arising from services rendered, goods situated or capital used in the Costa Rican territory.[3]

B. El Salvador

Any income arising from property located or registered in El Salvador or activities performed in El Salvador is deemed to be Salvadorean-source income, even if it is received or paid outside that country.

C. Guatemala

Guatemalan-source income is defined as any income arising from capital, goods, services or rights used in Guatemala, or originating from activities performed in Guatemala, regardless of the nationality, domicile or residence of the person involved and the place where the contracts are concluded.

D. Honduras

The income tax law defines resident legal entities as entities which have their central administration or management in Honduras.

For income tax purposes, resident individuals are individuals who currently reside in Honduras and are not temporarily staying in Honduras, or travellers. Any individual present in

1. In general, the terms corporations and companies include SAs (joint stock companies), SRLs (limited liability companies), general partnerships, limited partnerships and partnerships limited by shares.
2. In the case of Costa Rica, dividends paid by a resident company are subject to tax even if paid out of foreign-source income.
3. Costa Rican-source income includes: income from capital, goods or rights used in Costa Rica; interest and commission fees on loans used in Costa Rica; payments for the use of patents, formulae, trade marks, privileges, franchises and other rights; income from the supply of news from abroad; income from the production, distribution, brokerage and any other form of negotiation of cinematographic films, films for television, videotapes, radio, phonograph records and other means of projection, transmission or broadcasting of images or sounds.

Honduras for more than three months in a tax year is deemed to be a Honduran resident. An individual is not treated as staying temporarily merely because he intends to move abroad at an unspecified date. On the other hand, a foreigner whose stay in Honduras is limited by the Immigration Law is not treated as a resident, provided there are no other circumstances revealing his intention to stay in Honduras for a period longer than that originally requested.

Since the law does not discuss the concept of non-resident, a legal entity or individual is deemed to be non-resident if he does not fall within the rules for residents.

E. Nicaragua

Nicaraguan legislation has no general provisions on the concept of Nicaraguan-source income; however, it provides some instances in which income arising from certain sources is deemed to be Nicaraguan-source income. Generally speaking, income from Nicaraguan-situs property or from services rendered or transactions conducted or producing effects in the country is deemed to be Nicaraguan-source income.

F. Panama

Income arising from property used or located in Panama or derived from any activity carried out in Panama is deemed to be Panamanian-source income.[4] This definition is, however, restricted because of Panama's role as an international financial centre.[5]

IV. TAXATION OF INVESTMENT INCOME

A. Dividends

Dividend and other profit distributions to residents are subject to a final withholding tax in Costa Rica (when distributed to "personal companies"[6] or individuals), Honduras and Panama, are included in the taxpayer's taxable income in El Salvador, and are not subject to tax in Costa Rica (when distributed to "stock companies"[7]), Guatemala and Nicaragua. Stock dividends distributed to residents are not taxed in Central American countries, except in El Salvador where they are treated as ordinary dividends.

Foreign-source dividends received by resident taxpayers are only taxable in Honduras. The remaining countries do not tax foreign-source dividends because they adopt the territoriality principle of income taxation.

Dividend and other profit distributions to non-residents are subject to a final withholding tax in all six countries. Salvadorean withholding tax, however, is neutralized by the underlying (corporate) tax credit. Stock dividends distributed to non-residents are not taxed, except in El Salvador where they are treated as ordinary dividends, and therefore are subject to the (neutralized) withholding tax referred to above.

Central American countries do not have any comprehensive tax treaties in effect – the only treaty is the Costa Rica–Germany treaty signed in 1993, but not yet effective. As a result, the taxation of outbound dividends is not subject to any tax rate limitation imposed by virtue of treaty law.

1. Costa Rica

Dividends paid to resident "stock companies" are exempt from tax at the corporate level. Dividends paid to resident "personal companies" or individual taxpayers are subject to a final withholding tax of 15 percent. This tax is applied at a reduced rate of 5 percent for dividends distributed by joint stock companies whose shares are registered on an officially recognized stock exchange, provided the acquisition and subsequent sale of the shares are effected through a stock exchange. Stock dividends paid to resident taxpayers are exempt from tax if the dividends are related to registered shares issued by the paying company.

As Costa Rica applies the territoriality principle of income taxation, foreign-source dividends received by resident taxpayers are not subject to income tax in that country. This rule is applicable to dividends paid by a foreign subsidiary to its Costa Rican parent.

Dividends paid to non-residents, whether legal entities or individuals, are subject to a final withholding tax of 15 percent. This tax is applied at a reduced rate of 5 percent for dividends distributed by joint stock companies whose shares are registered on an officially recognized stock exchange, provided the acquisition and subsequent sale of the shares are effected through a stock exchange. Stock dividends paid to non-resident taxpayers are exempt from tax if the dividends are related to registered shares issued by the paying company.

4. Under Panamanian legislation, the following items, *inter alia*, are specifically included in Panamanian-source income: income derived from property, capital, securities and rights located, invested or used in Panama, such as interest from loans, money deposits or securities; dividends; royalties; and income from the licensing of trade marks and patents.

5. The following, *inter alia*, are not considered to be Panamanian-source income:
- dividends paid out of income not produced in Panama;
- interest, commissions and similar items derived from loans, deposits and other financial transactions carried out with borrowers domiciled outside Panama, even if the principal and interest is paid from Panama, but provided the money is used outside Panama;
- income from transactions which are concluded or produce effects outside Panama from an office located in Panama; and
- income from the transfer of shares in companies organized under Panamanian law which carry out their activities exclusively abroad.

Accordingly, income derived by an enterprise organized under Panamanian law which has an office in Panama, employees in Panama and a licence to conduct business in Panama is not considered to be Panamanian-source income where the transactions which give rise to the income take effect or are performed outside Panama. No tax liability arises even though payment for merchandise is made from Panama or received in Panama, provided the merchandise does not enter Panama.

6. For income tax purposes, Costa Rican law defines "personal companies" as those including limited partnerships, general partnerships, companies of professionals and, in general, all companies whose capital is not represented by shares and which are not listed as "stock companies".

7. For income tax purposes, Costa Rican law defines corporations to include "stock companies", partnerships limited by shares and limited liability companies.

2. El Salvador

Dividends paid to resident legal entities are included in the gross income of the recipient entity and are subject to the corporate income tax at a flat rate of 25 percent.[8] The recipient entity may credit the underlying (corporate) tax paid by the distributing company against its liability to corporate income tax. Dividends paid to resident individuals are included in the individual's total income and are subject to individual income tax at progressive rates ranging from 10 to 30 percent. The individual shareholder may credit the underlying (corporate) tax against his liability to individual income tax.

Under the source principle, foreign-source dividends received by resident taxpayers are not subject to income taxation in El Salvador. This rule is applicable to dividends paid by a foreign subsidiary to its Salvadorean parent.

Dividends paid to non-residents, whether legal entities or individuals, are subject to income tax at a rate of 25 percent. However, the underlying (corporate) tax is creditable against the 25 percent tax, thus neutralizing the tax.

3. Guatemala

Dividend and other profit distributions to resident taxpayers, whether legal entities or individuals, are exempt from income tax if the distributing entity has paid corporate income tax on its profits.

Dividends received from non-resident corporations are not subject to income tax in Guatemala.

Dividend and other profit distributions to non-residents are subject to a final withholding tax of 12.5 percent.[9]

4. Honduras

Dividend and other profit distributions paid to resident legal entities or individuals are subject to a final withholding tax of 10 percent. When a dividend has been so taxed, any subsequent redistribution to residents made by the recipient company is tax- free. As the capitalization of reserve funds is exempt from income tax, stock dividends paid to residents are tax-free.

Foreign-source dividends received by resident taxpayers, whether legal entities or individuals, are subject to tax at the rate of 10 percent.[10] This rule is applicable to dividends paid by a foreign subsidiary to its Honduran parent.

Outbound dividends are subject to a final withholding tax of 15 percent. If the dividend is paid out of dividends already subject to the final withholding tax of 10 percent, only the difference necessary to reach 15 percent is due. As the capitalization of reserve funds is exempt from income tax, stock dividends paid to non-residents are tax-free.

5. Nicaragua

Dividend and other profit distributions effected by companies subject to income tax to resident taxpayers, whether legal entities or individuals, are exempt from income taxation.

Foreign-source dividends received by resident legal entities or individuals are not subject to income taxation in Nicaragua because of the territoriality principle. This rule is applicable to dividends paid by a foreign subsidiary to its Nicaraguan parent.

Dividend and other profit distributions paid to non-resident beneficiaries are subject to a final withholding tax of 5 percent.

6. Panama

Dividends and other profit distributions paid to resident legal entities or individuals are subject to a final withholding tax of 10 percent; this rate is increased to 20 percent for dividends paid on bearer shares. However, a Panamanian holding company which has, as its only income, received dividends from other companies, whether Panamanian or foreign, is exempt from taxation on such dividends. When a dividend has been subject to the withholding tax or specifically exempted therefrom, any subsequent redistribution made by the recipient company is tax-free. Stock dividends paid to resident taxpayers are non-taxable.

Under the source principle, foreign-source dividends are not subject to tax in Panama. This rule is applicable to dividends paid by a foreign subsidiary to its Panamanian parent.

Outgoing dividends are subject to a final withholding tax of 10 percent; this rate is increased to 20 percent for dividends paid on bearer shares. Stock dividends paid to non-resident taxpayers are non-taxable.

B. Interest

In all six countries interest payments to residents are generally included in the recipient's taxable income. Nevertheless, Costa Rica, Guatemala, Honduras and Panama apply a final withholding tax on certain items of interest. There are also several instances where interest may be exempt.

All countries levy a final withholding tax on payments to non-residents. A particular feature of the Nicaraguan tax system is that withholding tax is not levied on the gross interest but on a notional amount. Further, there are cases where such payments may be exempt.

As indicated above, none of the six countries have any comprehensive tax treaties in effect. Consequently, the taxation of outgoing interest is not subject to any tax rate limitation imposed by treaty provisions.

1. Costa Rica

Interest paid to residents, whether legal entities or individuals, is generally taxed as ordinary income. This means that, as

8. Applicable on that part of income exceeding 75,000 colones (75,000 colones is near US$ 8,000).

9. A stamp tax of 3% is also levied on documents supporting the payment of dividends.

10. In calculating the tax, foreign tax may be deducted from the taxable amount.

a rule, in the case of legal entities, interest is included in taxable income and is subject to income tax at a flat rate of 30 percent, and in the case of individuals, interest is included in taxable income and is subject to progressive rates ranging from 10 to 25 percent. However, interest is subject to final withholding tax at a rate of 8 percent when paid on (i) securities registered on a stock exchange or issued by registered financial entities, the Government or agencies thereof, banks or cooperative societies; and (ii) bills of exchange and bank acceptances. In addition, a final withholding tax of 15 percent is applicable in respect of interest paid and discounts granted to resident taxpayers on securities other than those referred to above. Moreover, there are some instances where interest is exempt.

Interest paid to non-residents is subject to a final withholding tax of 15 percent on the gross amount. The interest paid to non-residents is exempt, *inter alia*, when it is paid to foreign banks and financial institutions recognized by the Central Bank of Costa Rica, and when paid to foreign suppliers for the importation of merchandise.

2. El Salvador

Interest paid to resident legal entities is taxed as ordinary income. Hence, interest paid to these entities is included in business profits and is subject to corporate income tax at a flat rate of 25 percent. Interest paid to resident individuals is included in the individual's total income and is subject to individual income tax at progressive rates ranging from 10 to 30 percent. Interest paid to individuals on bank deposits is exempt from tax.

Interest paid to non-resident individuals or legal entities is subject to a final withholding tax of 25 percent. However, interest on credit granted by qualified non-resident financial institutions is exempt from tax.

3. Guatemala

Interest paid to resident taxpayers, whether legal entities or individuals, is generally taxed as ordinary income. In the case of legal entities, interest is included in the entity's taxable base and is subject to corporate income tax at a flat rate of 30 percent. In the case of individuals, interest is included in the individual's taxable income and is subject to individual income tax at progressive rates ranging from 15 to 30 percent. Nevertheless, interest paid by resident legal entities or entrepreneurial individuals to resident taxpayers not subject to the control of the Superintendency of Banks is subject to final withholding tax at a rate of 10 percent.

Interest paid to non-residents is, in principle, subject to a final withholding tax of 20 percent on the gross amount. There are, however, some instances in which interest paid to non-residents is exempt, e.g. interest paid on foreign loans granted by financial institutions if the foreign currency is sold to a local bank, or interest paid on foreign loans to the State, municipalities and agencies thereof.

4. Honduras

Interest paid to resident taxpayers, whether legal entities or individuals, is taxed as ordinary income. Therefore in the case of legal entities, interest is included in the taxable base and is subject to income tax at progressive rates ranging from 15 to 35 percent, plus a surcharge of 10 or 15 percent (resulting in a maximum combined tax burden of 40.25 percent), and in the case of individuals, interest is included in their taxable income and is subject to progressive rates ranging from 12 to 40 percent, plus a surcharge of 10 or 15 percent (resulting in a maximum combined tax burden of 46 percent). However, interest paid on securities relating to the non-banking private sector which are sold on a stock exchange, as well as interest on saving accounts with certain institutions, is subject to a final withholding tax of 10 percent.

Interest paid to non-residents is generally subject to a final withholding tax of 5 percent. Nevertheless, interest paid on securities relating to the non-banking private sector which are sold on a stock exchange, as well as interest on saving accounts with certain institutions, is subject to a final withholding tax of 10 percent.

5. Nicaragua

Interest paid to resident taxpayers is taxed as ordinary income. Interest payments to resident legal entities are included in the recipient's taxable base and are subject to tax at a flat rate of 30 percent. Interest payments to resident individuals are included in their taxable income and are subject to tax at progressive rates ranging from 7 to 30 percent. There are, however, some items of interest which are exempt, including interest on negotiable mortgage bonds and government securities.

Interest payments to non-residents are subject to a final withholding tax at the same rates indicated above for resident legal entities and individuals, as the case may be. The net taxable interest on loan or credit facilities granted by non-residents is determined by allowing a notional deduction for expenses. Accordingly, the amount of taxable interest is: 75 percent if the beneficiary is an entity other than a financial institution; 10 percent if the beneficiary is a financial institution domiciled outside Nicaragua; and 75 percent if the beneficiary is an individual. Thus, the maximum effective withholding tax on outgoing interest is equal to 22.5 percent. There are also cases where interest payments to non-residents are exempt from taxation.

6. Panama

Interest paid to residents is included in taxable income and is subject to tax at progressive rates ranging from 30 to 34 percent in the case of legal entities, and from 130 balboas[11] to 33 percent[12] in the case of individuals. However, interest paid on bonds and securities registered with the National Commis-

11. The balboa is at parity with the US dollar; Panama uses the US dollar as its currency.
12. Note, however, that a flat rate of 30% applies on taxable income in excess of 200,000 balboas (i.e. the upper tax bracket). For example, the tax due on a taxable income of 300,000 balboas (at 30%) is 90,000 balboas.

sion of Securities is subject to a final withholding tax of 5 percent. Some examples where interest is exempt from tax include interest on government securities and interest on loans granted to the Government or agencies thereof.

Interest paid to non-residents is most commonly subject to a final withholding tax of 6 percent. Nevertheless, interest paid on bonds and securities registered with the National Commission of Securities is subject to a final withholding tax of 5 percent. In addition, interest is exempt under certain circumstances.

C. Royalties

In the six countries royalty payments to resident taxpayers are included in the recipient's taxable base and are taxed as ordinary income at the rates applicable to legal entities and individuals, as the case may be.

In turn, royalty payments to non-residents are subject to a final withholding tax in all countries, except in Panama where in principle the withholding tax is not final. Each country uses an identical tax rate for taxing each kind of royalties, except Honduras which uses two rates. In Nicaragua and Panama the final withholding tax on payments to non-residents is not levied on the gross amount of royalties but on a notional amount.

1. Costa Rica

Royalties received by resident legal entities are subject to corporate income tax as ordinary income at a flat rate of 30 percent. Royalties received by individuals are also taxed as ordinary income and are subject to individual income tax at progressive rates ranging from 10 to 25 percent. Royalties paid to non-residents are subject to a final withholding tax of 25 percent on the gross amount.

2. El Salvador

Royalties received by resident taxpayers are taxed as ordinary income at a flat rate of 25 percent in the case of legal entities, and at progressive rates ranging from 10 to 30 percent in the case of individuals. Royalties paid to non-resident taxpayers are subject to a final withholding tax of 25 percent on the gross amount.

3. Guatemala

Royalties received by resident legal entities are treated as business income and are subject to corporate income tax at a flat rate of 30 percent. Royalties received by resident individuals are included in the recipient's taxable income and are subject to individual income tax at progressive rates ranging from 15 to 30 percent.

As of 1 January 1995, non-resident entities and individuals are subject to a 30 percent final withholding tax on Guatemalan-source income on patent, trade mark, know-how and copyright (other than films/tapes) royalties and similar payments (formerly 25 percent). Notional Guatemalan-source income on film/tape royalties (60 percent of gross payments) remains subject to withholding tax of 25 percent (thus the effective rate is 15 percent).

4. Honduras

Royalties received by resident legal entities or individuals are included in their taxable income and are subject to tax at progressive rates ranging from 15 to 35 percent plus a surcharge of 10 or 15 percent in the case of legal entities, and at progressive rates ranging from 12 to 40 percent plus the surcharge of 10 or 15 percent in the case of individuals.

Royalties paid to non-resident taxpayers are subject to a final withholding tax at a rate of 25 percent in general, and 10 percent in respect of cinema and television royalties; in both cases the tax rate is applied on the gross amount.

5. Nicaragua

Royalties received by residents are included in the taxpayer's taxable base and are subject to tax at a flat rate of 30 percent in the case of legal entities, and at progressive rates ranging from 7 to 30 percent in the case of individuals.

Royalties paid to non-residents are subject to a final withholding tax at the same rates indicated above for resident legal entities and individuals, as the case may be. The net taxable royalty of non-resident royalty holders is determined by allowing a 5 percent notional deduction for expenses. Accordingly, only 95 percent of the gross royalty is taxable. Thus, the maximum effective withholding tax on outgoing royalties is equal to 28.5 percent.[13]

6. Panama

Royalties received by residents are included in taxable income and are subject to tax at progressive rates ranging from 30 to 34 percent in the case of legal entities, and at progressive rates ranging from 130 balboas to 33 percent in the case of individuals.

Royalties paid to non-resident taxpayers are subject to withholding tax at the same rates indicated above for resident legal entities and individuals, as the case may be. The withholding tax is calculated by allowing a 50 percent notional deduction for expenses. Accordingly, 50 percent of the gross amount of royalties is taxable, resulting in a maximum effective rate of 17 percent in the case of legal entities and 15 percent in the case of individuals. These taxpayers must file a return at the end of the tax year. If no return is filed, then the withholding tax becomes final. Royalties paid by enterprises operating in the Free Zone of Colon to non-residents are not subject to tax.[14]

13. That is, 95% of the gross amount of royalties is taxed at the 30% (flat) rate for legal entities or 30% upper (progressive) rate for individuals.

14. In this case, the paying company may not deduct the exempted payment.

V. AVOIDANCE OF INTERNATIONAL DOUBLE TAXATION

As mentioned, Central American countries – with the sole exception of Honduras – do not apply the worldwide principle of income taxation, so that only income obtained from local sources is taxable within their tax jurisdiction; income derived from foreign sources is not subject to income taxation in those countries, thus preventing double taxation of foreign-source investment income.

Honduras, the only country in this survey which applies the worldwide principle, has no general provisions for the avoidance of double taxation.[15]

Regarding outbound income, it is worth to emphasize that Central American countries have been extremely inactive in concluding double tax treaties; Costa Rica is the only country which has concluded such a treaty, and it is not yet effective. As a result, outbound investment income may be taxed in the state of residence of the recipient, and the (Central American) source country has the right to apply an (unlimited) withholding tax on the same income. Notwithstanding this, Central American countries have been moderate in taxing outgoing investment income.

15. However, in calculating the tax on foreign-source dividends some relief may be obtained by deducting the foreign tax from the taxable amount.

SOUTH AFRICA

1995 BUDGET

Marius van Blerck

Group Tax Consultant, Anglo-American Corporation; Chairman of the Scientific Committee of the South African branch of IFA; and founding editor of the *South African Tax Review*.

I. INTRODUCTION

The following is a summary of salient points of the 1995 Budget tabled by the Minister of Finance, Mr Chris Liebenberg, in Parliament on 15 March 1995.

A. Companies

1. Tax rates

The basic rate remains unchanged at 35 percent and STC rate is unchanged at 25 percent, giving a combined rate on distributed earnings of 48 percent. This last rate is calculated as 35 percent plus 25 percent of the remaining 65 percent.

The temporary transition levy has not been renewed.

2. Transkei, Bophuthatswana and Ciskei

The tax liability of any company in respect of taxable income derived from a source within these former "homeland" areas during any year of assessment ending between 1 April 1995 and 31 March 1996 will be the average of the company's liability for tax as determined under the law of the relevant former area and the national law.

3. Write-off periods: ships and aircraft

The cost of acquisition of ships and aircraft will be allowed to be written off under section 12C of the Income Tax Act at the straight-line rate of 20 percent per annum for all ships and aircraft acquired on or after 1 April 1995, commencing in the tax year in which the ship or aircraft is brought into use. Where the ship or aircraft is acquired under an agreement formally and finally concluded by every party thereto before 1 April 1995, the existing more favourable tax depreciation rules will continue to apply.

4. Interest on debt arrangements

It is proposed that all interest payable in respect of financial instruments issued or entered into after 15 March 1995, be deductible on a day to day basis (using the internal rate of return method). As far as the accrual of any interest to a taxpayer is concerned, all interest payable in respect of instruments issued or entered into after that date shall be taxable on a day to day basis if the term of the instrument exceeds one year and is issued at a discount or bears deferred interest.

5. Small enterprises

It is proposed in principle that small business enterprises be permitted to choose taxation on a cash-flow basis.

6. Withholding tax on dividends abolished

Non-resident shareholders' tax is currently levied at a rate of 15 percent on dividends to non-residents. This tax is to be abolished. Abolition takes effect on *final* dividends declared on or after 1 October 1995, and on *interim* dividends, the payment of which has been approved in terms of the company's appropriate authorization procedures on or after this date.

B. Individuals

1. Tax rates

A single scale of rates for all individuals has now been introduced, reaching a maximum marginal rate of 45 percent at a taxable income of R 80,000. Previously the maximum rate was 43 percent and there were separate tax tables for married women. The primary rebate has been increased to R 2,625 (previously R 2,225) is granted to all individuals, with an additional rebate of R 2,500) for individuals aged 65 years and older. The child rebate of R 100 per child has fallen away.

2. Artificial persons other than companies

A special scale of rates reaching a maximum marginal rate of 45 percent at a taxable income of R 80,000 has been introduced for this category of taxpayers. No rebates are allowed.

3. Transition levy

A transition levy at the rate of 1.67 percent of taxable income exceeding R 50,000 will apply to taxpayers other than companies, as provided in the previous budget. This will fall away at the end of the 1995/96 tax year. Separately announced is that the collection period of this levy from salary and wage earners and pensioners will be March to May 1995.

4. Transkei, Bophuthatswana and Ciskei

The above rates and rebates will apply to all persons other than companies deriving taxable income within these former "homeland" areas, with effect from 1 March 1995.

5. Company car fringe benefits

The taxable benefit of the private use of a second or subsequent vehicle granted by an employer to an employee or his family, where the vehicle is not used primarily for business purposes, will with effect from 1 May 1995 be determined at 2 percent per month of the value of the vehicle. The rate was previously 1.2 percent.

6. Taxation of lump sum benefits

Two proposals are made regarding the determination of the rate of tax at which lump sum benefits from pension and other retirement funds (amongst others) are taxed:

- in calculating the ordinary taxable income (i.e. excluding special income and lump sums) which determines the effective rate of tax to be applied to the lump sum, the deduction allowable in respect of retirement annuity fund contributions will be limited to the deduction which would have been allowable had the amounts included in the ordinary taxable income calculation been the taxpayer's only income for the year; and
- amounts qualifying for the rating concession will be taxed at the higher of the rating amounts (i.e. the average tax rates) calculated for the current year and the preceding year.

These proposals will apply to lump sum payments derived in consequence of the termination of service on or after 1 September 1994 or, where the lump sum so derived otherwise than on termination of service, to lump sums which accrue on or after that date.

7. Interest derived by non-residents

Interest derived on or after 1 April 1995 by an individual not ordinarily resident in the Republic will be exempt from tax only if, in addition to being not ordinarily resident in the Republic, the individual was also physically absent from the Republic for at least 183 days during the tax year.

II. OTHER CHANGES

A. Provisional tax payments

The effective date for the making of the third provisional tax payment is extended by one month to 30 September for all taxpayers (i.e. individuals and companies) who use a 28 February year-end.

B. Tax avoidance

The Minister expressed disappointment that tax avoidance schemes were still prevalent. He noted that funding mechanisms had come to the fore which are structured in such a way that they resulted in substantially reduced and even negative borrowing costs through excessive deductions or the conversion of what is in essence capital, into deductible expenditure. The schemes involved among others fixed property acquisitions, convertible debenture issues, intellectual property and leasebacks.

He was of the view that such schemes could be challenged in terms of the anti-avoidance provisions of the Income Tax Act, but that they were deliberately engineered in such a complex manner that detection is very difficult.

Accordingly, the Minister instructed the Commissioner for Inland Revenue to make resources available to detect and challenge these schemes and to apply all the sanctions in the law against the taxpayers involved and, where possible, their advisers. The Katz Commission was also asked to investigate the possibility of introducing further anti-avoidance provisions and to make this a priority of the Commission.

C. Tax amnesty

A general tax amnesty is to be granted to persons who were not registered as taxpayers on 27 April 1994 or whose whereabouts were unknown on that date. Such persons will, on application within an amnesty period of three months, generally be absolved from liability for taxes relating to periods prior to 1 March 1994. The exact terms and conditions will be embodied in a General Tax Amnesty Bill to be tabled later.

D. Fuel levy

The fuel levy on both petrol and diesel will be increased with 1 cent per litre with effect from 5 April 1995 and with a further 1 cent per litre on 3 May 1995.

E. Surcharge on imports

The remaining import surcharges on "luxury" and "white" goods will be abolished as from 1 October 1995. Following this, the entire range of import surcharges introduced in 1989 will have been abolished.

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UNITED STATES

PROPOSED US REGULATIONS ON CONDUIT FINANCING

Thomas P. North

Thomas P. North is an American lawyer and Senior US Tax Manager with KPMG Meijburg & Co. in Amsterdam. He obtained a B.A. degree from Loras College in 1976 and his J.D. from the University of Iowa College of Law in 1979. Among other affiliations, Mr North has been admitted to practise before the US Supreme Court and the US Tax Court. From 1979-1990, Mr North practised US and international law in Germany, where he was also a faculty member of the Johannes Gutenberg Universität Mainz and a lecturer at the post-graduate programme of the Verwaltungshochschule in Speyer. Mr North has lectured frequently on the new US–Netherlands Tax Treaty and has authored and co-authored several articles on the subject. He joined KPMG Meijburg in 1990, where he specializes in US and international tax law.

I. INTRODUCTION

In response to a growing Congressional concern over the avoidance of US withholding taxes through the use of intermediate entities ("conduits"), Section 13238 of the Omnibus Reconciliation Act of 1993 (OBRA) created new IRC Section 7701(l). That section directs the Internal Revenue Service to:

> ...Prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among 2 or more of such parties where the [IRS] determines that such recharacterization is appropriate to prevent avoidance of any [US] tax...

Pursuant to this authority given the IRS to issue "legislative" regulations, the IRS published proposed regulations (popularly known as "conduit regulations") on 12 October 1994.[1] The proposed regulations were the subject of a public hearing on 16 December 1994 and are to be effective for *payments* made 30 days after the regulations are issued in final form. The regulations have been given high priority by the IRS, which has indicated that final regulations may be issued by mid-1995.[2]

Although a senior IRS official has indicated that the conduit regulations "are not intended to break a lot of new ground", and were intended to express what common law could have achieved in this area,[3] a close study of the proposed regulations reveals that they indeed go beyond existing case law and IRS pronouncements and give IRS officials unprecedented authority to recharacterize transactions so as to prevent the avoidance of US withholding taxes.

This article will first review the case law and IRS rulings and memoranda which have heretofore been used as authority to recharacterize multiple party financing transactions. The article will then analyse the proposed regulations and the impact such regulations, when final, may have on taxpayers and withholding agents.

II. PRIOR CASE LAW AND RULINGS

A. *Aiken Industries*

The most significant and often-cited judicial precedent for recharacterizing a financing transaction so as to deny the application of treaty benefits to an intermediate entity is *Aiken Industries, Inc. v. Com'r.*[4] At issue in that case was whether interest payments made by Aiken Industries, a US company, to a sister company incorporated in Honduras was entitled to the exemption from US withholding tax provided for in Article IX of the US–Honduras Treaty for interest "received by" a Honduran corporation. Monies had originally been loaned to Aiken by its parent, a Bahamas corporation. Subsequently, the Bahamas corporation assigned the notes to its Honduran subsidiary in exchange for notes having substantially similar terms.

The Tax Court held that the Honduran intermediate company did not "receive" interest payments from Aiken as intended by that term in Article IX of the Treaty since the Honduran corporation made substantially similar interest payments to its Bahamas parent and therefore did not have "dominion and control" of the interest paid to it. The court's holding was based primarily on the basis that the phrase "received by" was not otherwise defined in the Treaty and therefore the United States, whose taxes were concerned, was entitled to define such phrase under its domestic law.[5] The court also indicated that Aiken failed to show any valid economic or business purpose for the use of the Honduran entity in this transaction, other than the avoidance of US tax. Presumably, had a valid business purpose been established, the Tax Court would have held differently.

1. 59 FR 52110.
2. Remarks of Robert Culbertson, IRS Associate Chief Counsel (Int'l), 6 March 1995. Cited at *BNA Daily Tax Rep't*, 1995 DTR 43.
3. Remarks of Robert Culbertson, IRS Associate Chief Counsel (Int'l), 20 October 1994. Cited at *BNA Daily Tax Rep't*, 1994 DTR 202.
4. 56 TC 925 (1971).
5. The treaty contained an article substantially equivalent to OECD Model Treaty Art. 3(2).

The *Aiken* case can therefore be cited as authority for the following. First, the United States may, consistent with the standard treaty articles to this effect, assign a meaning to terms not otherwise defined in a tax treaty. Second, terms normally found in withholding articles such as "received by", "paid to" or "beneficial owner of", generally were intended to convey the notion that the recipient must have "dominion and control" of the monies it receives. Third, although *dicta*, demonstration of a valid business or economic purpose, other than US tax avoidance, may be a defence to a "conduit" or "treaty shopping" challenge.

B. Revenue Rulings 84-152 and 84-153

Revenue Rulings 84-152[6] and 84-153,[7] issued on the same date, both considered the use of a Netherlands Antilles intermediate company in financing transactions involving US borrowers.

Article VIII of the US–Netherlands Antilles Treaty exempted interest paid by a US borrower and "derived by" a person resident in the Antilles from US withholding tax. Revenue Ruling 84-152 involved a Swiss parent which loaned funds to its wholly-owned Antilles subsidiary which, in turn, loaned such funds to a US sister corporation at a rate of interest 1 percent higher than charged by its Swiss parent. Citing *Aiken*, the IRS held that the interest paid by the US borrower was not "derived by" the Antilles intermediate lender since the Antilles intermediate did not have "dominion and control" of the interest payments. In addition, the IRS held that there was not a *sufficient* (emphasis added) economic or business purpose (other than US tax avoidance) for use of the Antilles intermediate company in the financing transaction. In suggesting that *any* valid business or economic purpose (other than US tax avoidance) would not be sufficient to justify the use of an intermediate, the holding and rationale of *Aiken* was therefore carried one small step further by the IRS.

Revenue Ruling 84-153 involved a Netherlands Antilles subsidiary of a US corporation. The US corporation caused the Antilles subsidiary to issue bonds to unrelated lenders in the Eurobond market. The Antilles corporation then loaned the proceeds of such bonds to its US parent at a rate of interest 1 percent higher than charged by the bond holders. Again, the IRS held that the income paid by the US corporation was not "derived by" the Antilles company and that there was no sufficient business reason (other than US tax avoidance) for use of the intermediate entity.[8]

C. Revenue Ruling 87-89

Rev. Ruling 87-89[9] considered three separate transactions involving loans made by unrelated persons (BK) to US borrowers (DS and DP). In situations 1 and 2, the parent (FP) of a US subsidiary (DS) deposited funds in foreign bank (BK). In turn, BK loaned to DS funds equal to approximately 80 percent of the deposits made by FP at a rate of interest which was 1 percent higher than paid to FP on its deposits. The rate of interest charged by BK to DS was lower than it would normally charge in similar lending transactions. Other than the deposit, FP did not provide collateral or guarantees to BK for its loans to DS. Situation 2 was nearly identical, except for the fact that BK was not a bank. Situation 3 involved similar facts, except that the US borrower was the parent of the foreign depositor to BK.

In situations 1 and 2, the IRS, citing *Gregory v. Helvering*[10] held that substance rather than the form of the transactions is controlling and that the arrangements should be considered a direct loan between the foreign depositor (FP) and the intermediate company (BK). Crucial to the ruling was the fact that BK would not have made the loans on the same terms had it not been for the deposit made by FP.

In situation 3, the IRS also held the substance of the transaction should control and that, in effect, a direct loan was made from the foreign subsidiary (FS) to its US parent (DP). The result of the recharacterization was that the FS, a controlled foreign corporation, was considered to increase its earnings in US property under IRC Section 956.

With respect to all three situations, the IRS stated that the principles of the rulings could not be used by taxpayers to compel the IRS to disregard the form of transactions.[11]

D. Technical Advice Memorandum 9133004

The IRS expanded its attack on conduit financing arrangements in TAM 9133004.[12] The Memorandum concerned a Netherlands[13] finance and holding company established by its Canadian parent. The Canadian parent contributed capital to the Netherlands subsidiary in return for non-interest-bearing convertible demand debentures. The Netherlands company loaned (the same day) equivalent funds to its US subsidiary at market rates. In addition to its function in lending funds to its US subsidiary, the Netherlands company engaged in other financing transactions, effectively serving as a treasury centre. Funds for the treasury function were raised from a variety of sources. In the year in question, the Netherlands company paid dividends to its Canadian parent which were substantially equivalent (less a minor "spread") to the interest it received from the US subsidiary. Despite the lack of earlier precedent (judicial or otherwise), and apparently influenced by the similarity of cash flows, the IRS held that the interest payments were not "paid to" the Netherlands company as required by the interest article of the US–Netherlands Treaty, since the Netherlands company did not have "dominion and control" over the payments. The IRS was not persuaded by

6. 84-2 C.B. 381.
7. 84-2 C.B. 383.
8. Subsequent to the issuance of Rev. Rul. 84-152 and 84-153, the IRS stated in Rev. Rul. 85-163, 84-2 CB 383, that the principles of the two earlier rulings would not be applied to payments made with respect to instruments issued, or subject to a binding written contract, before 15 October 1984.
9. 1987-2 C.B. 195.
10. 293 U.S. 465 (1935).
11. Citing *Com'r v. Nat'l Alfalfa Dehydrating & Milling Co*, 417 U.S. 134 (1974).
12. TAM 9133004 (3 May 1991).
13. Although the countries of residence of the foreign entities concerned were not identified in the Memorandum, the facts clearly suggest their residences.

the fact that the Netherlands company had a largely independent board of directors and was under no legal obligation to pay dividends. The IRS also held that the taxpayer had failed to demonstrate a sufficient business or economic purpose (other than US tax avoidance) for use of the Netherlands intermediate entity.

E. Revenue Ruling 80-362

With respect to royalty conduits, the IRS has applied a somewhat different approach than the "dominion and control" rationale applied in debt financing arrangements. In Rev. Rul. 80-362,[14] a Netherlands corporation licensed the US rights to intangible property and sub-licensed such rights to an unrelated US corporation. The IRS held that the royalty payments made by the US licensee to the Netherlands sub-licensor were exempt from US withholding tax under Article IX of the (1948) US–Netherlands Treaty. However, the IRS further stated that the payments made by the Netherlands company to its licensor constituted US source income under the sourcing rules of IRC Section 861 since such payments were for use of intangible property in the United States. Consequently, the IRS held that the Netherlands intermediate was required to withhold US tax on royalty payments made by it to the third country licensor.

F. Treaty responses

In addition to the case law, IRS rulings and memoranda which specifically address conduit arrangements, the United States has sought to negotiate bilateral income tax treaties which contain effective provisions for preventing the inappropriate use of intermediate entities to obtain treaty benefits. Most notably, modern US tax treaties contain "limitation on benefits" provisions which restrict the benefits of tax treaties to persons which meet one of several enumerated tests.[15] Such tests generally require a minimum level of local ownership or business activity in the country in which residence is claimed for treaty purposes. The tests also generally require that the person claiming treaty benefits meet certain "base reduction" criteria designed to ensure that a treaty resident entity is not being used as a conduit for persons located in less favourable jurisdictions.[16] While limitation on benefits provisions greatly restrict the use of intermediate entities in favourable jurisdictions to avoid US tax, the United States apparently does not believe such safeguards, by themselves, are adequate.

As a further backstop against the improper use of intermediate entities, the recent tax treaties entered into by the United States contain in the withholding articles the requirement that the treaty resident claiming reduced withholding rates also be the "beneficial owner" of the income item in question. This language replaces the less concise and restrictive terms such as "paid to" or "derived by" which were used in some older treaties. The proposed regulations on conduit financing can be viewed primarily as defining for US tax treaty purposes the phrase "beneficial owner" and similar restrictive withholding article terms.

Finally, some recent US tax treaties contain a royalty provision which allows the United States to apply the general principles of Rev. Rul. 80-362. For example, Article 13(5) of the US–Netherlands Treaty allows the United States to enforce a "second level" withholding tax on royalties paid by a Netherlands person, if that Netherlands person has received a royalty for use of an intangible in the US, and subsequently pays a royalty to a third country resident for use of that same property in the United States.

III. THE PROPOSED REGULATIONS

A. Effective date

The regulations are proposed to be effective for *payments* made 30 days after final regulations are published in the Federal Register.[17] Therefore, the regulations do not make any provision for "grandfathering" payments made under instruments which were entered into (or subject to binding contracts to be entered into) prior to their effective date. The failure to grandfather existing instruments may cause taxpayers who have arrangements which were "legitimate" under existing law to restructure such arrangements if they do not meet the requirements of the new regulations. This may result not only in substantial restructuring and refinancing costs, but also may penalize US borrowers if the instrument in question contains either a tax indemnification provision or a penalty provision for early termination.

B. General rules for recharacterization

The proposed regulations authorize the IRS to recharacterize a transaction only if it is a "financing arrangement".[18] A "financing arrangement" is generally defined as an arrangement consisting of two or more "financing transactions".[19] If a financing arrangement exists, the further analysis depends on whether the "intermediate entity" (generally an entity interposed between the "financing entity" and the "financed entity") is related either to the "financing entity" (generally the ultimate lender, licensor or lessor) or the "financed entity" (generally the ultimate borrower, licensee or lessee). If the intermediate is related to the financing and financed entity, the financing arrangement will be subject to recharacterization if the IRS establishes that:

– the participation of the intermediate entity reduces the US withholding tax which would be applicable absent the use of the intermediate; *and*

14. 80-2 C.B. 208.
15. The most notable recent example is Art. 26 of the US–Netherlands Treaty.
16. For example, base reduction requirements apply to the ownership and publicly-traded tests of Art. 26 of the US–Netherlands Treaty, but not to the "substantial trade or business test" or the "headquarters company test".
17. Prop. Reg. § 1.881-3(g).
18. Prop. Reg. § 1.881-3(a).
19. Prop. Reg. § 1.881-3(a)(2)(i).

- the use of the intermediate entity is pursuant to a tax avoidance plan, *one* (emphasis added) of the principle purposes of which is the avoidance of US withholding tax. Several enumerated factors are considered in determining if a "tax avoidance plan" exists.[20]

If the financing arrangement does not involve a related intermediate entity, the IRS must, in addition to the two factors listed above, also show that the intermediate would not have entered into the arrangement on substantially the same terms *but for* the participation of the financing entity.[21]

C. Step 1 – Is there a "financing arrangement"?

A "financing arrangement" exists if there are two or more "financing transactions pursuant to which one person (the "financing entity") advances money or other property to another person (the "intermediate entity") and such intermediate entity advances money or other property to a third person (the "financed entity").[22] If there is more than one intermediate entity, there must be a chain of transactions linking each intermediate.

A "financing transaction" includes:
- any advance of money or other property in exchange for debt;
- under limited circumstances, any exchange of money or other property in exchange for stock (described more fully below under "equity transactions");
- any lease or licence;
- any advance of money or other property pursuant to which the transferee is obligated to repay or return a substantial portion of the money or other property advanced; and
- any transaction in which a person becomes a party to an existing financing transaction.[23]

Based on these standards, a "financing transaction" can therefore include not only common debt financing (loans), but also the leasing or licensing of tangible and intangible property. The inclusion of leasing and licensing transactions within the scope of the proposed regulations may be an overliberal interpretation of the Congressional mandate to develop regulations with respect to "multiple party financing transactions". Neither the legislative history of Section 7701(l) nor the authorities cited in the legislative history specifically refer to leasing or licensing activities. It has therefore been suggested that under the *ejusdem generis* principle of statutory construction the conduit regulations should be limited to transactions which are similar to those cited in the legislative history.[24]

1. Equity transactions

The Preamble to the proposed regulations states:

> An advance of money or other property in exchange for stock will be considered a financing transaction only if the issuer or holder of the stock has rights, or there are arrangements in place, that are intended to ensure that payments on the instrument will be made as contemplated. Therefore, an exchange for common stock or ordinary perpetual preferred stock will not be considered.[25]

The definition of a "financing transaction" in the proposed regulations similarly includes exchanges of money or other property in exchange for stock only if:
- as of the issue date, the holder has the right (or it is more likely than not that he will receive the right) to cause the issuer to redeem the stock; or
- the holder has the right, or it is more likely than not that he will receive the right (other than that derived from merely owning a controlled interest) to cause the issuer to make any payment, to cause the issuer to be liquidated, to enforce payment through a legal proceeding, or to elect the majority of the issuer's board of directors.[26]

This suggests perhaps that a valid "equity block" can be constructed to avoid characterization of an arrangement as a "financing arrangement" as defined by the proposed regulations. For example, it appears that, based on the above standards, the factual circumstances presented in TAM 9133004 would not be considered a "financing arrangement", and hence would not be subject to IRS recharacterization.

Despite the apparent effectiveness of an equity block to prevent IRS recharacterization under the proposed regulations, taxpayers wishing to use an equity block to thwart an IRS attack should proceed with caution. First, the IRS has given itself flexibility in determining when equity investments carry sufficient debt characteristics to be treated as debt for purposes of defining a "financing transaction". Second, the legislation mandating the issuance of conduit regulations specifically authorizes the IRS to address financing arrangements involving equity investments. Although the IRS has thus far chosen not to take full advantage of such authority, the Preamble to the regulations indicates that the IRS and Treasury will monitor developments with respect to equity investments and extend the regulations to cover stock, if necessary.[27]

Third, Example 4[28] of the proposed regulations sets forth one circumstance in which an equity block can be set aside. In the Example, FP lends $ 10 million to FS in exchange for a ten year note bearing 8 percent interest. FS contributes $ 10 million to FS2, a wholly-owned subsidiary of FS, in exchange for common stock. FS2 then lends $ 10 million to DS in exchange for a ten year note bearing 10 percent interest. Throughout the period the FP-FS note is outstanding, FS "causes" FS2 to make dividend payments to FS in order for it to meet its obligations to FP under the FS-FP note.

The IRS concludes in this Example that the equity block can be ignored since, under the authority of Prop. Reg. Section 1.881-3(a)(4)(ii), FS and FS2 may be treated as a single inter-

20. Prop. Reg. § 1.881-(4)(i).
21. *Id.*
22. Prop. Reg. § 1.881-3(a)(i)
23. Prop. Reg. § 1.881-(3)(a)(ii)
24. Letter of Richard M. Hammer and Robert T. Scott, US Council for International Business, to Leslie Samuels, Assistant Treasury Secretary (Tax Policy) and IRS Commissioner Margaret Milner Richardson. Cited in 1994 DTR 81, Bureau of National Affairs, 29 April 1994.
25. See Preamble 59 Fed. Reg., at 5114.
26. Prop. Reg. § 1.881-3(a)(2)(ii).
27. See Preamble 59 Fed. Reg., at 52114.
28. Prop. Reg. § 1.881-3(f), Example 4.

mediate entity. As such, the transactions constitute a "financing arrangement" since two financing transactions are now linked (the loans from FP to FS and from FS2 to DS). A similar conclusion cannot be reached with respect to the facts of TAM 9133004, however, since that case involved only one intermediate entity and one financing transaction.

As a final caution to those wishing to use equity blocks, the proposed regulations do not expressly state that earlier judicial precedent such as *Aiken* or earlier IRS rulings or memoranda (such as TAM 9133004) will no longer be applied after publication of final regulations. Nevertheless, in view of the legislative nature of the regulations and the detailed and sometimes novel rules they contain, earlier precedents should be superseded by the final conduit regulations.

D. Step 2 – Is US tax reduced?

Once it has been determined that a "financing transaction" exists, the IRS must determine that US tax is reduced by the use of the intermediate entity.[29] This might be referred to as the "no harm, no foul" rule. The application of this rule should be relatively straightforward. The analysis requires that the US tax applicable to payments made by the US person to the intermediate entity be compared with the US tax applicable to similar payments if they had been made directly to the financing entity (ignoring all intermediate entities). Only if the US tax would be higher on payments made directly to the financing entity will the proposed regulations allow recharacterization. If there is no reduction in US tax by the use of an intermediate, the analysis can stop at this point.

E. Step 3 – Does the arrangement involve a related intermediate?

The next steps (application of factors and presumptions in determining the existence of a "tax avoidance plan") distinguish between arrangements involving intermediates which are related or unrelated to the financed entity and financing entity. Therefore, a determination must first be made as to whether the arrangements involve related entities.

Under the proposed Regulations, "related" means related within the meaning of IRC Sections 267(b) or 707(b)(1), or controlled within the meaning of Section 482. The constructive ownership rules of Sections 318 and 267(b) will also be used to determine if parties are related.[30]

F. Step 4 – Is there a "tax avoidance plan"?

With respect to both related and unrelated entity arrangements, in order to recharacterize a transaction the IRS must determine that the participation of the intermediate entity in the financing arrangement is pursuant to a plan one of the principal purposes of which is the avoidance of US tax ("tax avoidance plan").[31] This determination is made "based upon all of the facts and circumstances"; however, the proposed regulations list four factors the IRS will consider.[32] The proposed regulations do not assign relative importance to any of the factors. The determination of the existence of a tax avoidance plan is therefore quite subjective and subject to the broad discretion of the IRS.

1. Factors

The first factor[33] considers whether the participation of the intermediate entity significantly reduces the amount of US withholding tax which would otherwise be imposed if the payments had been made directly to the financing entity. The regulations do not define "significantly". Naturally, the greater the reduction in withholding tax, the more likely a "tax avoidance plan" will be found to exist. The regulations provide, however, that the mere reduction in US withholding tax will not, by itself, result in the determination that a tax avoidance plan exists.

The second factor[34] considers whether the intermediate entity would have been able to make the advance of money or other property to the financed entity without the advance of money or other property to it by the financing entity. With respect to lending transactions, the test is presumably whether the intermediate would have had a sufficient amount of its own funds to make the loan. It is not clear whether an intermediate entity's ability to borrow funds will be taken into account. As applied to a licensing and sub-licensing or leasing and subleasing arrangement, it would appear that the intermediate would never be able to make the sub-licence or lease in the absence of the licence or lease from the financing entity. This is due to the fact that licences and leases rarely involve "fungible" property. With respect to licences and leases, it would be more appropriate to ask whether the intermediate entity would be able to meet its obligations under the lease or licence from the financing entity without the benefit of income derived from the lease or licence to the financed entity.

The third factor[35] considers the length of time that separates the advances of money or other property by the "financing entity" to the "intermediate entity" and by the intermediate entity to the "financed entity". This factor seems to incorporate to some extent the "dominion and control" tests applied in earlier rulings (see above). In Example 9 of the regulations, a 12 month delay by the intermediate in on-payment to the financing entity was considered evidence of a "tax avoidance plan". This factor is also relevant to the determination of whether the intermediate would have been able to make a loan without the participation of the financing entity, since a close connection in time between payments received and made by the intermediate would tend to indicate that it is dependent on payments from the financed entity to meet its obligations to the financing entity. Note that although the similarity in cash flows is relevant, the Preamble to the Reg-

29. Prop. Reg. § 1.881-3(a)(4)(i).
30. Prop. Reg. § 1.881-3(a)(2)(v).
31. Prop. Reg. § 1.881-3(a)(4)(i).
32. Prop. Reg. § 1.881-3(c).
33. Prop. Reg. § 1.881-3(c)(2)(i).
34. Prop. Reg. § 1.881-3(c)(2)(ii).
35. Prop. Reg. § 1.881-3(c)(2)(iii).

ulations indicates that a strict cash flow test was rejected by IRS in developing the proposed regulations.

The fourth factor[36] is applicable only if the intermediate entity is related to the financed entity. This factor provides an "indication" that there is no tax avoidance plan if the two entities enter into a financing transaction to finance a trade or business actively engaged in by the financed entity that forms a part of, or is complimentary to, a substantial trade or business carried on by the intermediate entity (other than the business of making or managing investments, except pursuant to a banking, insurance, finance or similar trade or business the income from which is earned predominantly with transactions with unrelated persons).

This factor closely resembles the "substantial trade or business test" of Article 26(2) of the US–Netherlands Treaty. Under this factor, the extent to which the intermediate may be making payments to the financing entity is not expressly relevant. If the required substantial trade or business is found to exist, it raises only an "indication" that there is no tax avoidance plan. Note that such an "indication" is somewhat weaker than the "presumption" afforded intermediates which are unrelated to both the financing and financed entities as discussed below.

A significant defect of the proposed Regulations is that this factor does not provide, as do similar treaty limitation on benefits tests, for attribution of a substantial trade or business from one related entity to another. For example, a single-purpose Netherlands intermediate finance or royalty company which is related to the US financed entity may not be considered to engage in a "substantial trade or business" under this factor of the proposed regulations, even though a substantial trade or business may be conducted by its parent or sister company also located in the Netherlands. The final regulations should remedy this defect by providing for attribution rules similar to those found in limitation on benefits provisions of tax treaties.[37]

Similarly, unlike the limitation on benefits provision of Article 26(2) of the US–Netherlands Treaty, the proposed regulations do not provide a "safe harbour" rule with respect to the "substantiality" requirement. One would assume that, in practice, similar rules would apply under the proposed regulations; however, the final regulations should provide assurances that this will indeed be the case. If the analogous rules of Article 26(2) of the US–Netherlands Treaty were applied under this factor, the extent of the intermediate entity's assets, gross income and payroll expenses would be compared with the corresponding items of the financed entity to determine if the business of the intermediate entity is "substantial".

Finally, this factor may only be used if the intermediate entity is related to the financed entity. As discussed below, a *presumption* of no tax avoidance plan may be raised if the intermediate is engaged in a substantial trade or business and is unrelated to both the financed entity and the financing entity.[38] However, the proposed regulations give no favourable consideration to an intermediate entity which conducts a substantial trade or business and which is related only to the financing entity. There appears to be no legitimate policy reason for this omission.

2. Presumption of non-tax avoidance plan – "significant financing activities"

With respect to transactions involving an intermediate entity which is related to either or both the financing entity and the financed entity, a presumption that there is no tax avoidance is created if the intermediate entity performs "significant financing activities" with respect to the financing transactions which form a part of the financing arrangement to which it is a party.[39] The presumption may be rebutted by the IRS if, after consideration of other relevant factors, it is determined that a "tax avoidance plan exists".[40]

In order for the presumption to arise, the "significant financing activities" (as defined below) must be made in respect of the financing transaction in question[41]. In other words, the fact that the intermediate performs "significant financing activities" *in general* will not suffice if they are not performed with respect to the transaction with the US financed entity.

"Significant financing activities" include two broad categories of activities. The first[42] applies only to rents and royalties and provides that an intermediate entity will be considered to perform "significant financing activities" if the rents or royalties are derived in the active conduct of a trade or business within the meaning of Reg. § 1.954-2T(c) or (d).

The rules under Reg. § 1.954-2T are applicable to determine if royalties derived by a controlled foreign corporation (CFC) constitute "Subpart F income". In applying this definition of significant financing activities, the intermediate is to be substituted for the term "controlled foreign corporation". In general, the rules provide that, with respect to royalties, an active trade or business will exist if the royalties are derived by the CFC ("intermediate") from licensing (i) property the licensor has developed or created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the business of marketing and servicing the licensed property and which is substantial in relation to the royalties derived from the licensing of such property; or (ii) property which is licensed as the result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties derived from licensing of such property.

In general, "adding substantial value" means that the licensor (intermediate) must incur "active licensing expenses" which

36. Prop. Reg. § 1.881-3(c)(2)(iv).
37. See Art. 26(2)(f), US–Netherlands Treaty.
38. Prop. Reg. § 1.881-3(c)(4).
39. Prop. Reg. § 1.881-3(c)(3).
40. *Id.*
41. *Id.*
42. Prop. Reg. § 1.881-3(c)(3)(ii)(A).

are equal to or greater than 25 percent of the "adjusted licensing profit". "Active licensing expenses" include those expenses which are properly allocable to the royalty income. Such expenses would not include royalty fees or amortization or depreciation. "Adjusted licensing profit" would mean the gross licensing income less royalties paid or incurred with respect to such gross royalty income and the amount of amortization or depreciation which would have been allowed with respect to such royalty income had the licensor (intermediate) been a domestic US taxpayer.

Note that under the formula for "adjusted licensing profit", ironically the lower the "spread" earned by the intermediate, the lower the "adjusted licensing profit", and hence the better the chances the "active licensing expenses" will exceed 25 percent of such adjusted licensing profit. This formula is appropriate in the case of a CFC, but it does not appear to always make sense in the context of the conduit regulations.

It is also apparent that in many cases the fourth "factor" described above ("substantial trade or business") will overlap with the "presumption" for significant financing activities. For example, an intermediate entity which is related to the financing entity can benefit from the application of the "significant financing presumption" but may not benefit from the less potent "substantial business factor".

Further, the "substantial trade or business test" of Reg. § 1.954-2T is not consistent with the similar tests of Articles 13(5) and 26(2) of the US–Netherlands Treaty. For example, the "substantiality" requirement of the Treaty article compares the assets, gross income and payroll expenses of the Netherlands company with the corresponding items of the US "income producing activity (financed entity). The proposed regulations compare only the "active licensing expenses" with the "adjusted licensing profit". Although the Preamble to the proposed regulations states that the rules are intended to be "consistent with" or to "supplement" the limitation on benefits articles of existing treaties[43], this particular provision would appear to be a treaty override of Articles 13(5) and 26(2) of the US–Netherlands Treaty if it were to be applied to the detriment of Dutch royalty companies.

The second type of "significant financing activity" will, in practice, be of primary relevance to so-called "treasury centres". In order to constitute this type of activity, several requirements must be satisfied. First, the intermediate must employ officers and employees who participate actively and materially in arranging the intermediate's participation in the financing transaction. This requirement is not met if such officers and employees are assisted to a material extent by officers and employees of related persons in arranging the financing transaction (not including the approval of any guarantee).[44] In this respect, the regulations do not make an exception for participation by employees of related persons organized in the same country as the intermediate. Such an exception would be appropriate.

Second, the officers and employees of the intermediate entity must exercise, manage and carry out the strategic business decision-making process and the day-to-day operations of a "substantial trade or business". Alternatively, the day-to-day operations can consist of the supervision, administration and financing of a substantial group of related persons.[45] With respect to the "substantial trade or business", the test appears to be similar to the "substantial trade or business test" of limitation on benefits articles. However, such limitation on benefits articles normally exclude activities which consist of making or managing investments, unless carried on by a bank or similar entity. The alternative provision with respect to the supervision of a substantial group of related persons resembles the "headquarters company test" of Article 26(5) of the US–Netherlands Treaty.

Finally, this type of "significant financing activity" requires that officers and employees of the intermediate actively manage, on an ongoing basis, material business risks, including currency risks, of the intermediate's financial and capital requirements.[46]

The proposed Regulations provide three examples of the application of the "significant financing activity presumption" (Examples 12, 13 and 14). In Example 12,[47] the intermediate employs 100 persons to manage its treasury activities which includes coordinating the financing of group companies, disbursing payments to unrelated persons on behalf of group members, and maintaining a centralized cash management accounting system. The Example demonstrates the activities of a very large treasury centre; however, based on the text of the rule rather than the Example, it should be sufficient that the intermediate employ merely that number of persons necessary to carry out the management of its financing activities.

In Example 13,[48] the same intermediate also provides long-term financing to a US company for the purpose of acquiring another US company. The intermediate borrows funds from a syndicate of banks and "eliminates" the currency exposure by entering into a long-term currency swap. The Example provides that the intermediate has not performed "significant financing activities" with respect to this transaction since it has eliminated all material business risks. The rationale of this rule is puzzling. While the text of the regulations requires that the intermediate "actively manage, on an ongoing basis, material business risks", it does not indicate the method in which such risks should be managed. The business decision as how best to manage such risks would be better left to the intermediate than the IRS. Further, the Example seems to suggest (though not explicitly stated), that the intermediate should also *bear* such business risks. The text of the regulations requires only that the risks be managed by the intermediate, not that such risks be borne by the intermediate.

3. Unrelated intermediate presumption – substantial trade or business

The regulations contain a special presumption for intermediate entities which are not related to the financing entity or

43. See Preamble 59 Fed. Reg., at 52113.
44. Prop. Reg. § 1.881-3(c)(3)(ii)(B).
45. Prop. Reg. § 1.881-3(c)(3)(ii)(B)(2).
46. Prop. Reg. § 1.881-3(c)(ii)(B)(2)(ii).
47. Prop. Reg. § 1.881-(3)(f), Example 12.
48. Prop. Reg. § 1.881-3(f), Example 13.

financed entity.[49] The presumption that no tax avoidance plan exists arises if the intermediate entity is engaged in a "substantial trade or business" (other than the making and managing of investments, unless the intermediate is a bank, insurance company, finance company or similar entity the income of which is earned predominately from unrelated persons). Again, the term "substantial trade or business" is not defined. If, however, one applies the principles of the "substantial trade or business test" of Article 26(2) of the US–Netherlands Treaty, the intermediate entity's business would always be considered "substantial" in respect of income received from an unrelated person. The regulations provide an example of the operation of this provision.[50] In the Example, FP is actively engaged in a substantial trade or business (manufacturing) and obtains a $ 100 million loan from BK, an unrelated bank. One year later, FP (the intermediate entity) makes a $ 10 million loan to DS, an unrelated US company. The Example does not specify the purpose of this loan. The Example provides that the arrangement is entitled to the presumption that FP's participation is not pursuant to a "tax avoidance plan".

G. Step 5 – Unrelated entity "but for" test

If the intermediate entity is unrelated to both the financing entity and the financed entity, the IRS must establish that the intermediate entity would not have participated in the arrangement on substantially the same terms but for the fact that the financing entity engaged in the transaction with the intermediate.[51] The determination is made "based on all facts and circumstances". This fact must be established even if it is determined that the participation of the intermediate was pursuant to a "tax avoidance plan" as described in Step 4.

This "but for" test for unrelated persons appears to be directed primarily at financing transactions involving guarantees, deposits and similar arrangements provided by related persons to unrelated lenders on behalf of the financed entity.

1. Presumption for guarantees

The Preamble to the regulations states that a mere guarantee of a debt does not constitute a financing transaction.[52] However, in the event that the guarantee is also accompanied by a deposit or collateral provided by a related party, a "financing transaction" will take place and the conduit rules will have application.

The "but for" condition is presumed met (and therefore the transaction can be recast) if the related person has provided both a deposit and a guarantee or "comfort letter" to the lender.[53] In this respect, the definition of a "guarantee" is the same as set forth in the earnings stripping provision of IRC Section 163(j)(6)(D)(iii).[54] With respect to guarantees coupled with deposits made to third party banks who lend to the financing entity, the third party bank will not be liable for withholding tax unless it (or one of its agents) had knowledge of the pre-existing financing plan[55].

IV. DISCRETION OF THE IRS

The proposed regulations give the IRS unprecedented discretion in determining whether an arrangement can be recharacterized. First, the IRS has the discretion to determine which transactions comprise the financing arrangement and which persons are parties to the arrangement. Second, the factors to be considered in determining the existence of a "tax avoidance plan" are very subjective in nature. Even if a presumption, which is normally a powerful evidentiary rule in US jurisprudence, arises that a tax avoidance plan does not exist, the presumption can be rebutted in the discretion of the IRS. Finally, in a rather unusual provision, the IRS has purported to establish a standard of review for judicial authorities in reviewing IRS determinations. The standard provides that IRS determinations will be subject to an "abuse of discretion" standard.[56]

The unusually broad discretionary power given to the IRS will, in practice, significantly reduce the beneficial value of the presumptions that certain arrangements do not constitute "tax avoidance plans". In addition, the discretion given to the IRS, combined with the subjective nature of most of the relevant factors, will result in considerable uncertainty as to whether an arrangement can be recharacterized. In the absence of a greater certainty, the Regulations are likely to have a "chilling effect" on taxpayers who will be reluctant to enter into "legitimate" financing arrangements if there is even a remote chance that the IRS can exercise its discretion to deny treaty benefits.

V. INTERACTION WITH TAX TREATIES

The proposed Regulations provide that a financing arrangement can be recharacterized by the IRS even if the intermediate is a resident of a country with which the United States has an income tax treaty.[57] The Preamble to the proposed Regulations explains that the "Regulations are intended to provide anti-abuse rules that supplement, but do not conflict with, the limitation on benefits articles of US income tax treaties."[58] The Preamble further provides that "[It] has been recognized that contracting states may supplement these rules by transactionally-based domestic anti-abuse rules, including rules under which a particular transaction may be recast, in accordance with the substance of a transaction."

The United States applies the general rules that provisions of a treaty and the Internal Revenue Code have equal status and, as such, the provision enacted later in time shall have prece-

49. Prop. Reg. § 1.881-3(c)(4).
50. Prop. Reg. § 1.881-3(f), Example 15.
51. Prop. Reg. § 1.881-3(a)(4)(i)(c)(2).
52. See Preamble 59 Fed. Reg., at 52113.
53. Prop. Reg. § 1.881-3(b).
54. Prop. Reg. § 1.881-3(a)(2)(iv).
55. Prop. Reg. § 1.1441-7(d).
56. See Preamble 59 Fed. Reg., at 52111.
57. Prop. Reg. § 1.881-3(d)(3).
58. *Id.*

dence.[59] Nevertheless, courts are reluctant to apply US domestic law to override a tax treaty unless the implementing legislation contains an express statement to this effect. The legislative history to Section 7701(10) does not contain any express statement that the Regulations to be issued by the IRS are intended to override tax treaties. The fact that the actual rules will result from IRS Regulations rather than specific statutory provisions makes it even more questionable that the Regulations can effectively override treaties.

Nevertheless, most of the provisions of the proposed Regulations can be implemented without raising serious treaty override issues. This is primarily due to the authority of the United States under tax treaty provisions similar to the OECD Model Treaty Article 3(2) to provide meaning to undefined or ambiguous treaty terms such as "beneficial owner".

One example of a possible treaty override would be the application of the proposed Regulations with respect to royalty payments. As discussed above, for example, Article 13(5) of the US–Netherlands Treaty provides specific rules with respect to intermediate royalty companies. These treaty rules are not consistent with the corresponding provisions of the proposed Regulations.

VI. EFFECT OF RECHARACTERIZATION

In the event that a transaction is recharacterized by IRS, the intermediate entity (or entities) will generally be ignored and the relevant payment will be considered made from the financed entity directly to the financing entity. Therefore, the US may impose the withholding tax based on the withholding rate which would be applicable between the United States and the ultimate financing entity.

In some situations, the payment made to the intermediate entity by the financed entity and the payment made by the intermediate entity to the financing entity may not completely "match". For example, the intermediate entity may have funded part of the loan lent to the US financed entity through its own equity. In such instances, that portion of the payment which will be recharacterized by IRS will be limited to the ratio of the average principal amount of the transaction between the intermediary and the financing entity to the average principal amount of the transaction between the financed entity and the intermediary.[60]

VII. PROBLEMS FOR WITHHOLDING AGENTS

The Regulations may prevent severe problems for US withholding agents. A US withholding agent is required to withhold tax "if it knows or has reason to know that the financing arrangement is subject to recharacterization..."[61] This standard appears to suggest that the withholding agent, to be liable, must simply know or have reason to know that there is a "financing arrangement". Second, the standard appears to suggest that it is sufficient to know or have reason to know that it is *possible* under the regulations for the transaction to be recharacterized. Given the subjective nature of the regulations, this puts a severe burden on the withholding agent. If the above standard is met, the withholding agent must disregard the intermediary and withhold tax accordingly.

VIII. REPORTING REQUIREMENTS

If a US financed entity is required to report transactions with related parties under IRC Section 6038(A) and knows, or has reason to know, that conditions exist which may result in recharacterization under the proposed regulations, then such financing transactions must be described in the IRC 6038 report.[62] In addition, records relating to such transactions must be maintained. Thus, in addition to the possible liability for withholding tax, the financed entity may be liable to penalties under IRC Section 6038A for failing to report such transactions.

IX. CONCLUSION

The proposed Regulations, when published in final form, will in some senses further restrict the ability of taxpayers to use intermediate entities in "financing transactions". The proposed rules, while generally consistent with current case law and IRS pronouncements, are significant primarily because of the explicit discretion given to the IRS to recast financing transactions involving intermediate entities. The authority given to the IRS signals an increased seriousness-of-purpose which will undoubtedly result in more vigorous IRS enforcement activity. Combined with existing limitation on benefits articles of tax treaties, the Regulations will provide the IRS with a potent weapon in attacking perceived treaty shopping abuses.

In order to determine if an intermediate entity will qualify for tax treaty benefits, taxpayers will not only have to contend with increasingly complex "bright line" rules of limitation on benefits articles of US tax treaties, but will now also need to contend with the complicated conduit financing Regulations. The proposed Regulations in their present form unfortunately raise more questions than they answer.

59. IRC Sec. 7852(d); *Cook v. U.S.*, 288 U.S. 102 (1933).
60. Prop. Reg. § 1.881-3(d).
61. Prop. Reg. § 1.1441-7(d).
62. Prop. Reg. § 1.881-4.

AUSTRALIA

TAXATION OF SUPERANNUATION

Ann O'Connell

BA (Hons), LL B (Hons), LL M (Melb). Senior Lecturer, Law School, University of Melbourne. Visiting Research Fellow, Taxation Law and Policy Research Institute, Deakin University.

Superannuation is a major component of the Australian Government's retirement incomes policy. The Government uses both the social security system (by providing for a means tested non-contributory pension) and the tax system (by providing tax concessions to privately funded superannuation saving and, more recently by imposing a compulsory charge on employers) to provide income security to the aged. Retirement incomes are therefore provided through the social security system or from private superannuation savings or some combination of these arrangements.

The government has increasingly sought to encourage reliance on privately funded superannuation, primarily because of the great and expanding cost of providing an aged pension to retirees. At present, Australia provides a means tested,[1] flat rate pension to men aged 65 years or more and women aged 60 years or more. Unlike the case in many other countries, the aged pension is paid from recurrent government expenditure and not by specific payroll taxes collected from either employers or employees or both.[2] In May 1993 there were 1.5 million aged pensioners representing approximately 13 percent of the total population and approximately 75% of persons at retirement age. Outlays totalled $ 9.9 billion.[3]

Changing demographic factors have raised concerns, both of a budgetary nature and the more general question of whether the existing pension structure can provide a satisfactory standard of living. These factors include the ageing of Australia's population, (the Department of Social Security submission to the Senate Select Committee on Superannuation suggested that the number of persons aged 65 years and over will increase from 11 percent to approximately 17 percent of the total projected population in 20 years time)[4] and changing "dependency ratios", that is, the ratio of labour force participants to aged persons.[5] A further factor is that a far higher proportion of young people participate in higher education than previously. This lower workforce participation by the 15-24 age group both increases government expenditures and lowers government revenue.[6] The significant trend to earlier retirement and changing community attitudes about what level of retirement income is satisfactory has also played a part. Whereas the objective of government in relation to the age pension has been to ensure a minimum level of income, currently 25 percent of average weekly earnings, superannuation tends to target post retirement earnings to some percentage of pre-retirement earnings.

Initially the government sought to encourage superannuation by means of tax incentives. Despite the generosity of these incentives, it has generally been felt that the voluntary approach has failed to ensure an adequate spread, level or rate of growth of superannuation.[7] A further concern expressed about the use of the tax system to encourage saving for retirement has been its inequitable nature, that is, it provides the greatest assistance to those on higher incomes who are perhaps better able and more likely to make their own arrangements for retirement and it provides inadequate security for those who are less well off, for example, because they are on lower incomes or are not in employment.[8] Another unintended and ironic consequence of the government's tax incentive package which permits superannuation benefits to be taken as a lump sum and also rules which permit benefits to be accessed prior to retirement, is that it puts additional pressure on the social security system.[9]

In 1991, the Government announced that it intended to legislate for compulsory superannuation coverage. One of the stated objectives of this initiative was to facilitate "an efficient method of encouraging employers to comply with their obligations under various awards[10] to provide superannuation to employees".[11] It was also stated that the levy would ensure a major extension of superannuation coverage to employees not covered by award superannuation,[12] and provide a mechanism for increasing depth of coverage from 3 to

1. For a discussion of how the means test operates, see A. McClelland and R. Krever, "Social Security, Taxation Law, and Redistribution: Directions for Reform", 30 *Osgoode Hall Law Journal* (1992), at 48.
2. Senate Select Committee on Superannuation "Super System Survey – A Background Paper on Retirement Income Arrangements in Twenty-One Countries" (December 1991).
3. McClelland and Krever, *supra* note 1, at 49.
4. Senate Select Committee on Superannuation, First Report "Safeguarding Super: The Regulation of Superannuation", at 7.
5. *Id.* at 7-8.
6. "Security in Retirement", Statement by Treasurer, 30 June 1992, at 15.
7. *Id.* at 15.
8. McClelland and Krever *supra* note 1.
9. Senate Select Committee on Superannuation, First Report, at 9.
10. Award superannuation had been implemented progressively since the 1986 and 1987 National Wage Case decisions. One of the problems with award-enforced superannuation was said to be non-compliance by employers – see submission by Department of Industrial Relations to the Senate Select Committee on Superannuation, Sub No 81. Additional evidence of 1 May 1992, at 2-3.
11. Superannuation Guarantee Levy Paper (December 1991).
12. Superannuation coverage increased significantly as a result of award-based superannuation but a survey in 1991 by the ABS indicated that only 80% of full-time employees and 42.3% of part-time employees were covered by superannuation: ABS Employment Benefits Australia (July 1991).

9 percent of employee earnings over a period of nine years.[13] The Superannuation Guarantee (Administration) Act 1992 provides for a minimum level of superannuation set initially at 3 percent for small businesses with payrolls of less than $ 1 million and 5 percent for larger businesses.[14] Those employers not providing the minimum level of coverage will be liable for a penalty to cover the superannuation guarantee shortfall.[15]

Despite the moves to compulsion in the form of the superannuation guarantee charge, the Government has continued its policy of encouraging superannuation by means of tax incentives.

I. TAX TREATMENT OF SUPERANNUATION

Changes to the tax system in and since 1987 have ensured that contributions to superannuation funds attract significant tax advantages. Changes made to expand the tax base (by introducing capital gains tax and fringe benefits tax) mean that contributions to superannuation funds by an employer remain one of the few tax effective ways of receiving income. By comparison with other investments a number of features of the tax system need to be borne in mind in determining whether the investment is tax effective. First, the Income Tax Assessment Act 1936 (Cth) ("ITAA") provides concessional treatment for capital gains. In some cases this means total exemption from taxation, for example, for gains realized on the disposal of the family home and all assets acquired prior to 20 September 1985. If an asset is held for more than twelve months any gain is discounted for inflation. Secondly, qualifying investors in company shares receive a major tax advantage via the imputation credit system of company tax introduced in 1987. This system gives a credit to resident shareholders for the tax paid by the company when a dividend is paid to them. Thirdly, the tax system permits a taxpayer to offset expenses incurred on investments, including interest expenses, against other taxable income, including wages and other personal exertion income. This has encouraged investment in a variety of tax shelters, that is investments which, at least for a period, generate allowable deductions in excess of the assessable income it produces.[16] The most attractive features of the tax system, however, for persons seeking a low risk investment, are the superannuation and roll-over fund tax concessions. The use of the tax system to encourage private saving for retirement dates from the first ITAA in 1915, but the form of concession granted has changed over time. Broadly speaking, there are three types of concessions dealing with:

- contributions to superannuation funds;
- taxation of fund earnings; and
- taxation of superannuation benefits.

A. Employer contributions

The ITAA has always provided that contributions to a superannuation fund by an employer on behalf of an employee or the dependants of an employee are deductible. Furthermore, contributions by an employer are generally not subject to fringe benefits tax. Sections 82AAA–82AAR allow a deduction to employers for contributions made to superannuation funds for the benefit of their employees or the dependants of their employees.[17] Limits are imposed on the amount of deductible contributions an employer can claim on behalf of an employee.[18] It has also been noted that since the introduction of the Superannuation Guarantee Charge legislation, contributions by employers on behalf of all employees, as defined, are now compulsory.[19]

B. Employee contributions

Although the legislation previously allowed employees and self employed persons a deduction for contributions made to superannuation funds, the position since 1992 has been that where an employer provides superannuation support, contributions by employees are not usually deductible.[20] However, persons who are self-employed, substantially self-employed (that is, their income as an employee is less than 10 percent of their assessable income for the year) or who receive no employer superannuation support[21] may be eligible for a deduction.[22]

The 1992 amendments also enacted a new rebate provision[23] which is available to taxpayers who make personal contributions to a complying superannuation fund to obtain superannuation benefits for themselves or their dependants, whether or not they are entitled to any superannuation support. The rebate ceases when the taxpayer's income reaches $ 31,000.

13. It is proposed to increase the contribution level to 12% by 2001. However, the Government has stated that it does not intend to replace the age pension with privately funded superannuation; see Security in Retirement, *supra* note 6, at 2.
14. Sec. 20 *Superannuation Guarantee (Administration) Act* 1992. These figures apply for the year ended 30 June 1994. The section also sets out how the rates will change over time.
15. The *Superannuation Guarantee Charge Act* 1992.
16. Some tax shelters rely upon special incentive deductions provided by the Act, for example, those dealing with primary production or Australian films. R. Woellner, T. Vella and L. Burns, "Australian Taxation Law", CCH, 5th ed., at 1333. Other investments, such as investments in rental-producing real estate simply rely on the general deduction provision in section 51(1). For a discussion of "negative gearing", see G. Lehmann and C. Coleman, *Taxation Law in Australia* (Butterworths, 3rd ed., 1994), at 951.
17. The contributions are deductible whether made to a complying or non-complying superannuation fund, (as to what constitutes a complying fund, see Part 4.4.2), but fringe benefits tax will be payable on contributions to a non-complying fund: Sec. 136, *Fringe Benefits Tax Assessment Act* 1986.
18. From 1 July 1994, those limits are $ 9,000 for employees aged under 35 years, $ 25,000 if aged 35-49 and $ 62,000 if over 50 (indexed annually): Sec. 82AAC(2), ITAA.
19. The Charge, which came into operation on 1 July 1992 operates by imposing a tax on employers who fail to provide a specified minimum level of superannuation support for each employee.
20. Employees may, however, qualify for a limited rebate.
21. The introduction of the Superannuation Guarantee Charge means this is extremely unlikely.
22. Secs. 82AAS and 82AAT, ITAA. There are limits on the amount which can be claimed as a deduction, see Sec. 82AAT.
23. Sec. 159SZ, ITAA.

II. FUND EARNINGS

The 1915 legislation provided an exemption for investment income derived by superannuation funds. Calls had been made for some time to introduce taxation of superannuation fund income to establish capital market neutrality.[24] Two other advantages were also identified: the first was the revenue gain of bringing forward the time at which tax would be imposed from the time when benefits were received to the time when the income was earned. The other advantage was that a tax on superannuation funds would alleviate the problems associated with dividend streaming.[25] In May 1988, the Treasurer announced a 15 percent tax on superannuation fund earnings and on contributions where a deduction had been claimed by the contributor. However, the rationale appeared to be the need to fund the loss to revenue caused by reducing the company tax rate from 49 percent to 39 percent rather than any motive concerning capital market neutrality.

From 1 July 1988 the income of funds is taxed in accordance with the provisions of Part IX of the ITAA, comprising Sections 267–315F. Tax is imposed at two points: when a deductible contribution is made to a fund by or on behalf of a member,[26] and when a fund receives investment and other income.[27] The trustee of a complying[28] fund is liable to pay tax, generally at a rate of 15 percent on the funds taxable income.[29] Taxable income is calculated according to the ordinary rules subject to some adjustments.[30] If applicable, the taxable income of a complying fund is divided into a "standard component" and a "special component". The standard component is the amount remaining after deducting from taxable income the special component (if any).[31] The special component is the amount of any "special income" less any deductions related to that income.[32] "Special income" is defined to mean, broadly, private income dividends, unless the Commissioner is of the view that the income ought not be treated as special income, and "excessive" income (other than dividends) derived from non-arm's length transactions.[33] The special component is always taxed at the maximum marginal rate. The standard component is taxed at 15 percent.[34]

III. SUPERANNUATION BENEFITS

A particularly important component of the government's policy of encouraging private provision for retirement is the concessional treatment to benefits received from superannuation funds. Three factors need to be considered in relation to the tax treatment of benefits. First, it should be noted that historically tax arrangements have favoured lump sum retirement benefits. As a result, lump sum payments have become entrenched even though they are recognized as being the least efficient means of providing for retirement. Secondly, the tax rates applicable to payments received on retirement or termination ("eligible termination payments") have become increasingly complex. Thirdly, in an effort to avoid abuse of the tax concessions, the government has imposed ceilings on the amount of tax advantaged benefits which can be received.

A. Favourable tax treatment of lump sums

Prior to 1983, only 5 percent of any lump sum received when a taxpayer retired or left a job was included in assessable income.[35] The 5 percent rule applied to any lump sum, including superannuation benefits, which included employer contributions and fund earnings which were themselves untaxed. One effect of the 5 percent rule was to encourage taxpayers to take their retirement savings as a lump sum. In 1983, the Government announced its intention to tax lump sum retirement payments (still at less than marginal rates) but indicated that the new rates would not apply to benefits accrued prior to July 1983. The reforms eventually introduced were not as drastic as had been mooted. The desire to tax lump sum payments at a higher rate than previously was said to be inconsistent with the government's aim of encouraging taxpayers to make provision for their retirement (the top marginal tax rate at the time was 60 percent) and proved to be politically unacceptable. The resulting legislation introduced a more complicated regime for taxing benefits depending on age of the recipient[36] and whether any part of the payment represented a return of "undeducted contributions".[37] A further concession was that the new regime only applied to the post 1 July 1983 component of any lump sum benefit and the calculation of this component depended on apportionment based on length of service rather than benefits accrued to that date. In addition the former 5 percent rule still applied for certain payments such as payments made on early retirement or under a redundancy scheme. This legislation also permitted taxpayers to "roll-over" a lump sum received into a new superannuation fund (and thereby defer paying tax) and to facilitate this, introduced a new class of retirement savings vehicle – the approved deposit fund. These funds could act as

24. See, for example, the Campbell Committee Report 1981.
25. McClelland and Krever, *supra* note 1, at 62.
26. Sec. 274(1), ITAA. This includes contributions under Sec. 65 of the *Superannuation Guarantee (Administration) Act* 1992.
27. Some income may be excluded from assessability because, for example, it accrued prior to 1 July 1988. Modified rules apply to capital gains: see Secs. 302–315 ITAA.
28. A complying fund is defined as a fund which has received a notice under Sec. 45 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act): Sec. 267 ITAA. A complying fund under the SIS Act is a regulated fund which has complied with the Act and Regulations. All other funds are non-complying funds and are subject to tax at the rate of 47%.
29. Sec. 278(1) ITAA.
30. See Woellner, Vella and Burns, *supra* note 16, at 1148.
31. Sec. 285 ITAA.
32. Sec. 284 ITAA.
33. Sec. 273 ITAA.
34. Sec. 278(1) ITAA.
35. Sec. 26(d) ITAA.
36. The government introduced a 30 percent maximum rate applicable to lump sums received by taxpayers under 55 and a dual-rate maximum tax applicable to taxpayers 55 or older. That is, a rate of 15% would apply to the first \$ 50,000 of any lump sum benefit, and a rate of 30% would apply to benefits in excess of \$ 50,000. The position prior to 1 July 1994 was that under Secs. 27B and 27C the lump sum payment was included in assessable income and potentially subject to tax at marginal rates but the rebate under Secs. 159S–159SH reduced this. The payment was effectively taxed at 30% on the excess over \$ 60,000, subject to indexation, for the untaxed component and 20% for the taxed component if the taxpayer recipient was under 55 years. The rates were 15% and 30% if the taxpayer was over 55. For the present position, see Part 3(b).
37. "Undeducted contributions" are those contributions to a superannuation fund which have not had the benefit of deductibility Sec. 27A.

a holding vehicle for lump sum benefits awaiting reinvestment in another superannuation fund or prior to conversion to an annuity.[38]

The position since 1994 is that, in relation to approved early retirement scheme payments and bona fide redundancy payments,[39] there is a limit on the amount the taxpayer can receive and still retain the tax concession. For the year 1994-95 the amount is $ 4,000 plus $ 2,000 for each year of full service with the employer who makes the payment.[40] These amounts are indexed annually. The position in relation to invalidity payments[41] paid after 1 July 1994 is that they will be totally exempt from tax.[42]

B. Tax treatment of payments made on retirement

One means of encouraging the process of setting aside current income to provide for retirement is to provide concessional tax treatment to payments made upon retirement. The concessional tax treatment takes the form of lower rates of tax on such payments, including payments from superannuation funds, compared with the rates of tax applying to other investment returns, especially when the payments are preserved until retirement age. There is also, increasingly, favourable treatment where the payments take the form of a pension or annuity, compared with a lump sum.

The provisions dealing with the assessability of all payments made on retirement or termination, called eligible termination payments ("ETPs"), are in Sections 27A-27J. Section 27H deals with annuities. Section 27A defines an ETP to include "payments, voluntary or otherwise, made as a result of termination (including retirement, death[43] or invalidity) of any employment of the taxpayer", as well as "payments made in a lump sum form from a superannuation fund". An ETP may, therefore, include, but is not limited to superannuation payments. In relation to the tax treatment of ETPs, different rules apply to different components depending, in part, on the period of service pre- and post-30 June 1983 and the age of the recipient.

A lump sum ETP is divided by Section 27AA into one or more of the following components:

- pre-1 July 1983;
- post-30 June 1983;
- post-June 1994 invalidity;
- concessional;
- excessive component;
- non-qualifying component (of an immediate annuity ETP); or
- undeducted contributions.

1. Pre-1 July 1983 component

If any part of a lump sum payment from a superannuation fund relates to a period of service (or membership)[44] prior to this date, an apportionment must be made based on the number of days in the period of service or membership which occurred prior to 1 July 1983. This component is taxed at the rates which applied prior to that time, namely, 5 percent of the sum will be included in the taxpayer's assessable income and taxed at marginal rates.[45]

2. Post-30 June 1983 component

This is the residue of the ETP when all the other components have been calculated and deducted from the payment received by the taxpayer. Section 27AB divides the post-June 1983 component into taxed and untaxed elements. Since 1 July 1988 the rates of tax which apply to the post-June 1983 component of an ETP vary according to whether the payment is taxed or untaxed. The reduction in the rates in relation to the taxed element is to compensate recipients of ETPs for the tax which is now levied on fund income.[46] In keeping with government policy of encouraging taxpayers to provide for their own retirement, the maximum rate of tax on the taxed and untaxed elements of a post-June 1983 component reduces when the taxpayer reaches age 55. The mechanism to achieve this is that the whole component is included in the taxpayer's assessable income and taxed at marginal rates,[47] but is subject to a rebate under Sections 159S-159SG which limit the tax rate applicable.[48]

3. Post-June 1994 invalidity component

This is that part of an ETP, if any, which consists of an invalidity payment made on or after 1 July 1994 and is totally exempt from tax.[49]

38. Sec. 27D ITAA.
39. An approved early retirement scheme must be approved in advance by the Commissioner. To be approved it must satisfy certain requirements, such as that it must apply to employees as a class rather than as individuals, and it must arise out of a proposal by the employer to reorganize or rationalize the employer's operations, see Ruling TR 94/12. A bona fide redundancy payment refers to a payment made to an employee by reason of his or her dismissal arising out of a bona fide redundancy. Although the words "dismissal" and "redundancy" are not defined, they are generally taken to mean an involuntary termination, but Ruling TR 94/12 indicates an employer can take expressions of interest from employees as to who would like to accept a redundancy package.
40. Sec. 27E ITAA.
41. An invalidity payment is a payment made on termination of employment because of the employee's disability which two legally qualified medical practitioners have certified is likely to result in the employee being unable ever to be employed in a capacity for which reasonably qualified because of education, training and experience.
42. Sec. 27G ITAA.
43. From 1 July 1994, Sec. 27AAA deals specifically with death benefit ETPs. If the benefits are within reasonable benefit limit, payments to dependants will still be exempt from tax, but payments to non-dependants will be taxed as ordinary ETPs.
44. "Eligible service period" is defined in Sec. 27AA(1), ITAA and is dependent on whether the fund is employer related (the period is the period of employment) or a private superannuation fund (the period is the period of membership of the fund).
45. Sec. 27C ITAA.
46. See Part 2.
47. Sec. 27B ITAA.
48. If at the time of receipt, the taxpayer is aged 55 years or older, the rate of tax on the first $ 79,586 (for 1994-95, but subject to indexation) of the untaxed element is limited to 15% plus the Medicare levy. If less than 55 years, the rate is 30% plus the Medicare levy. In relation to the untaxed element, a taxpayer aged 55 years or older pays no tax on the first $ 79,586 and 15% on the balance and if aged under 55, 20% on the entire amount.
49. Sec. 27CB ITAA.

4. The concessional component

This is defined as so much of an ETP as consists of or is attributable to a bona fide redundancy payment, an approved early retirement scheme payment or an invalidity payment.[50] From 1 July 1994 the concessional component has been redefined. These payments must be paid before 1 July 1994 to retain their concessional status under Section 27C. However, the concessional status will be retained for payments which have been rolled over before that date even though payment is made from the roll-over fund after that date. If the concessional treatment applies, the taxpayer pays tax on 5 percent of the amount. The new form of concessional treatment which applies to these payments has already been considered.

5. The excessive component

This applies from 1 July 1990 where the amount of the eligible termination payment exceeds the maximum threshold specified in the reasonable benefit limit legislation.[51] From 1 July 1994 the definition is altered to be the amount the Commissioner has determined under Section 140R as exceeding the reasonable benefit limit. This component is included in the taxpayer's assessable income and taxed at the taxpayer's marginal rate. No rebate is available.

6. The non-qualifying component

This applies only to an immediate annuity eligible termination payment and means the income component as distinct from the purchase price component.[52] This amount is included in assessable income under Section 27B(2) and taxed at marginal rates.

7. Undeducted contributions

This is defined as that part of the ETP consisting of contributions made by a taxpayer or another person after 30 June 1983 to a superannuation fund where no deduction has been allowed for those contributions.[53] Because these contributions have been made out of after-tax income they are not subject to any further tax liability.

The taxation of non-government pensions and annuities is dealt with in Section 27H. The section applies to annuities payable from superannuation funds or purchased from life offices or other organizations. Annuities which commenced after 1 July 1983, less a deductible amount based on the undeducted purchase price, are assessable at the taxpayer's marginal rate subject to a possible rebate. The rebate is available in relation to certain superannuation pensions and rollover annuities (that is, annuities purchased with the roll-over of an ETP) paid to taxpayers aged over 55 or on death or disability.[54]

C. Reasonable benefit limits

Prior to the establishment of the Insurance and Superannuation Commission (the ISC) in 1987, the income tax legislation afforded the Commissioner of Taxation considerable discretion in determining who qualified for tax concessions. One important function of the Commissioner's rules was to place a cap on access to tax concessions by imposing "benefit limits" on funds eligible for concessions. The limits referred to the maximum lump sum that could accrue to a beneficiary in a tax-exempt superannuation fund. Analogous limits were established for pension benefits and combination lump sum and pension benefits.[55] The Tax Office originally adopted a progressive scale. The scale defined maximum lump sum benefits as multiples of final average salary, starting with seven times final average salary for salaries of $ 27,000 or less with a progressively smaller multiple applied to each additional step of salary. In 1985 the Commissioner replaced the tapering limit scale with a flat rate seven times final annual salary formula. Where the benefit was in the form of a pension the maximum amount was three quarters of a taxpayer's final annual salary. When the ISC was established it took over responsibility for the administration of reasonable benefit limits. The Economic Statement of 25 May 1988 introduced a large number of changes to this area. The limits introduced by the 1988 reforms were again based on a multiple of final salary (averaged over the last three years of employment) but the multiples declined on a progressive basis with salary. Benefits subject to the rules did not include non-deductible employee contributions that attracted no tax concessions in any event. Enforcement of reasonable benefit limits was achieved by taxing excess benefits as ordinary income at the recipient's marginal tax rate and by denying tax preferred status to funds that permitted excess contributions.

In 1990 the ISC announced further changes. The Commission rather than the funds took over administrative responsibility and the only sanction against excessive payments was that such amounts were taxed as ordinary income. The limits were based on a tapered scale of reasonable benefit multiples and the calculation related to a taxpayer's highest average salary over the three year period prior to retirement.

From 1 July 1994 the system of reasonable benefit limits has been transferred from the ISC back to the Commissioner of Taxation. The amount of the reasonable benefit limit has been changed from a multiple of the taxpayer's highest average salary to a fixed amount. For the 1994-95 income year the lump sum reasonable limit is $ 400,000, indexed annually.[56] This amount is discounted by 2.5 percent for each year a taxpayer is under 55 when the lump sum is received. The pension reasonable benefit limit for the same period is $ 800,000. This amount is indexed.[57] There is no discount if the pension is received before a taxpayer is 55.

Despite the reforms introduced since 1983, a number of important concerns have remained over the special tax rules for superannuation.[58] One concern expressed has been that

50. See Sec 27C ITAA.
51. See Part 3(c).
52. See Sec. 27A(1) ITAA.
53. Sec. 27A(1) ITAA.
54. Secs. 159SJ–159SU ITAA.
55. McClelland and Krever, *supra* note 1, at 59.
56. Sec. 159SG ITAA.
57. Sec. 159SG ITAA.
58. See McClelland and Krever, *supra* note 1.

the tax system provides encouragement to those highly paid taxpayers who need it least while providing no assistance to those who fall below the tax threshold. This has been described as the "upside-down" effect of existing tax concessions. Another, related concern has been that the tax concessions are poorly targeted. That is, the government not only gives more assistance to higher income earners but also does nothing to discourage exploitation by those who need no encouragement to save for their retirement. Another aspect of poor targeting concerns the lack of discrimination between funds which are genuinely furthering the goal of providing adequate retirement income and those that are not. A further concern has been that despite the 1983 amendments, there were still significant lump sum payments that retained at least partial exclusion. Although the amendments in 1994 reduce the concession available, lump sums are still treated favourably. As previously mentioned, this has encouraged taxpayers to take benefits in a lump sum, and, because of the income test associated with receipt of a pension, to encourage immediate consumption.[59]

59. Described by McClelland and Krever, *supra* note 1, at 47, as "triple-dipping".

Conference diary

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

JUNE 1995

Intercompany contracts: transfer pricing and US/EEC relations (legal and tax aspects), Brussels, 14 June 1995 (French and English, simultaneous):

F.P.V. EUROPE, rue de Luxembourg 45, B-1040 Brussels, Tel.: 32-2-502 2030, Fax: 32-2-502 3278.

Course on permanent establishments, Amsterdam, 15-16 June 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

AUGUST 1995

Course on the principles of international taxation, Amsterdam, 21 August through 2 September 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1995

Meeting of the International Tax Planning Association, Monte-Carlo, 19-20 October 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-1732 762910, Fax: 44-1732 763762.

SINGAPORE

1995 BUDGET: GOOD BUDGET BUT NO TAX REDUCTIONS FOR COMPANIES AND INDIVIDUALS

Lee Fook Hong MBA, Ph.D, FCIS, FAIA, ACIArb

The Minister for Finance, Dr Richard Hu delivered the 1995 Budget Speech in the Singapore Parliament on 1 March 1995. The Speech comprises three parts:

Part I: Review of the Economy
Part II: The FY 1995 Budget
Part III: Revenue and Tax Changes

In Part I of his Speech, the Minister reported that the Singapore economy grew by 10.1 percent in 1994 and that growth was broad-based and all major sectors did well. Inflation remained low, at 3.6 per cent and the introduction of the 3 percent Goods and Services Tax had a smaller than expected impact on inflation due to keen competition in the retail sector.

On the economic outlook for 1995, the Minister said the external environment remained favourable though some caution was called for. World capital markets had recently been volatile due to concern over US rates, the devaluation of the Mexican peso and the Kobe earthquake. After two years of strong growth, increased cost pressures would have some negative impact on the growth prospects in 1995, and the Ministry of Trade and Industry had accordingly revised its forecast for 1995 slightly downwards from 8-9 percent to 7.5-8.5 percent.

On longer term issues, the Minister outlined how Singapore could lay the foundations for sustained growth into the next century. In the next stage of economic development, Singapore will face different challenges and new issues, namely, the entry into the world trading and production system of large economies like China, India, Indonesia and rapidly growing countries like Malaysia, Thailand and Vietnam which would alter the economic structure.

The Minister said that the trends he had outlined had implications for how to manage the economy to ensure many years of economic prosperity and social stability. Three key areas would require attention:

- preparing Singaporeans for challenges to global economy;
- giving maximum incentive for wealth creation; and
- building a more cohesive society.

The Government would refine and adjust the economy to maintain Singapore's competitiveness. One major aspect would be the fiscal policy.

In Part II of his Speech, the Minister emphasized that the budgetary policy was to keep total expenditure within operating revenues. Budgetary surpluses generating in the past had enabled the Government to start programmes like Edusave, Medifund and CPF-SOTUS. The Government would continue to use budget surpluses to enhance the assets of Singaporeans through the CPF share ownership top-up scheme or SOTUS. He also announced that a Pension Fund would be set up to recognize the Government's pension liabilities and to make provision for it as part of prudent financial management. Such Fund would be established on 1 April 1995.

In Part III of his Speech, the Minister announced the proposed tax changes for companies and individuals.[1] This article highlights a number of such changes.

On Goods and Services Tax (GST), the Minister reiterated that the Government was committed to make GST revenue negative in the short run and revenue neutral in the long run. On corporate tax, the medium term goal is to bring the rate down to 25 percent. He felt that there would be no need to lower the tax rate again this year as the rate had already been reduced with effect from year of assessment 1994.

On personal income tax, the Minister said as there was substantial tax reduction in the year of assessment 1994 to accompany the introduction of GST, there was also no need to make significant changes to the personal income tax structure.

I. TAX CHANGES FOR COMPANIES

A. 5 percent on incremental profits from high value-added financial activities

To further boost fund management, risk management and capital market activities in Singapore, a concessionary tax rate of 5 percent will be granted on the incremental profits of such activities. The increase in taxable income over the preceding qualifying year from the following activities will be taxed at a concessionary rate of 5 percent:

- the managing of funds of at least S$ 5 billion from foreign investors by Asian Currency Units and Approved Fund Managers;
  - the underwriting, managing or placing of foreign securities by Asian Currency Units and Approved Securities Companies, if the taxable income from such activities exceeds S$ 10 million;
- the trading of foreign securities by Asian Currency Units and Approved Securities Companies, provided the tax-

1. Unless otherwise stated, all tax changes are effective as from the 1995 year of assessment.

able income from such activities exceeds S$ 10 million; and
- the trading of new futures and options contracts on SIMEX by its members for a period of up to five years from the commencement of trading of the new contract on SIMEX. Only the top 20 most active firms will qualify for the 5 percent tax.

The scheme will be effective for five years in the first instance and may be reviewed thereafter.

B. Taxation of unit trusts

To foster the development of the domestic unit trust industry, a new tax incentive will be granted for a unit trust. Under the new scheme, all income except Singapore dividends received will no longer be taxed at the level of the unit trust. For distributions made out of income that is not taxed at the trust level, the tax treatment will be as follows:
- all distributions to non-resident unit holders will be tax exempt;
- distributions paid out of gains from disposal of securities to residents other than individuals and partnerships will be taxed. In the case of individuals or partnerships, only 10 percent will be subject to tax. The remaining 90 percent will be tax exempt;
- distributions of other income such as interest and foreign dividends to resident unit holders will be taxed.

For distributions which are taxable, tax will be withheld by the unit trust at the prevailing corporate tax rate at the time of distribution. As with Singapore dividends, unit holders will be able to claim a credit for the tax withheld at the trust level.

C. Tax deduction for general provisions made by banks

General provisions made by banks and merchant banks have been allowed as tax deductible with effect from year of assessment 1992. Since then, banks and merchant banks have recorded strong profit growth. To encourage banks to set aside a greater proportion of their profits as general provisions, the maximum annual limit on the amount of general provisions eligible for tax deduction will be increased. Currently the general provision allowable is the lower of 25 percent of qualifying profit or $^1/_4$ percent of qualifying assets. With effect from year of assessment 1996, the $^1/_4$ percent will be increased to $^1/_2$ percent of qualifying assets. The total amount of general provisions eligible for tax deduction will continue to be limited to 2 percent of qualifying assets.

D. Removing the present constraints for onward payment of tax-exempt dividends out of foreign income

Currently, a Singapore company does not have to pay any Singapore tax on foreign income received if tax exemption has been granted or the foreign tax credit is equal to or exceeds the Singapore tax payable. Such income is also allowed to be distributed as tax exempt dividends to enable foreign income to flow through to shareholders without double taxation.

The flow through of tax exempt dividends is limited to two levels of shareholding and subject to a 50 percent shareholding requirement. The current two-tier restrictions can result in the foreign income being subject to double taxation when it is finally distributed to the ultimate shareholders.

To remove the limitation, the follow-through of tax exempt dividends will be extended beyond the two levels of shareholders where the 50 percent shareholding requirement is satisfied. Holding companies at every tier of a group corporate structure will be allowed to onward pay exempt dividends received where the dividends originate from foreign income received in Singapore.

The requirement of a 50 percent shareholding in the dividend-paying company for onward payment of exempt dividends will be waived on a case-by-case basis.

These changes, applicable to dividends received on or after 1 March 1995, will benefit large corporate groups forming consortiums to venture abroad.

E. Waiver of the 25 percent shareholding requirement for unilateral tax credit to be given on the underlying tax of foreign dividends

A Singapore company does not have to pay any Singapore tax on dividends derived from investments in countries where the tax rates are comparable to or higher than Singapore, if it holds at least 25 percent of the share capital of the dividend paying company. The tax credit for foreign dividends received by such company includes the underlying tax, i.e. foreign tax on the profits out of which the dividends are paid.

For most investors, the 25 percent shareholding requirement to qualify for credit of the underlying tax poses no problem. However, there are cases where for valid reasons, the 25 percent shareholding cannot be achieved. The 25 percent shareholding requirement will be waived on a case-by case basis. This will apply to dividends received on or after 1 March 1995.

F. Double tax deduction for approved expenses incurred in the promotion of master franchising and master licensing[2]

To further encourage companies to invest and expand into the region, the double tax deduction scheme for promotion of

2. "Master Franchising" means an agreement whereby a party (master franchisee) acquires the right to operate a franchise in a number of territories (within his country or in other countries) over an agreed period of time from the franchisor (owner of the business system). The master franchisee may open his own outlets, sub-franchise, or do both.

"Master Licensing" means an agreement whereby a party (master licensee) acquires the rights from the owner of intellectual property (licensor) to use or sub-license the property in a number of territories (within his country or in other countries) over a period of time.

Singapore services overseas will be extended to include the promotion of master franchises and master licences overseas. Approved expenses incurred by companies to promote master franchising and master licensing overseas will be granted double tax deduction. The extension will take effect from 1 April 1995 and will be administered by the Trade Development Board.

G. Approved aircraft leasing incentive

Since year of assessment 1991, aircraft leasing companies operating from Singapore have been enjoying a 10 percent concessionary rate of tax on income derived from offshore aircraft leasing. Additional incentives to complement this concessionary tax treatment will be introduced. Interest payments on foreign loans taken during the incentive period to finance the operating leases will be exempt from tax. Approved companies will also be allowed the flexibility to depreciate their aircraft bought during the incentive period over 20 years instead of the normal five years. The additional incentive may be granted for five years in the first instance, and may be extended thereafter. It will take effect from year of assessment 1996.

II. TAX CHANGES FOR INDIVIDUALS

A. Income tax rebate

There will be no change in personal income tax rates but an across-the-board one-off rebate of 10 percent on individual income tax will be granted for year of assessment 1995.

B. Rebates on HDB service and conservancy and rental charges

When GST-related personal income tax changes took effect from year of assessment 1994, 71 percent of individuals no longer pay income tax. The Government will continue to pay, on behalf of citizen householders staying in rented and owner-occupied HDB flats, certain service and conservancy charges to offset the impact of GST.

C. CPF top-up scheme

The Government will pay a sum of S$ 200 into the ordinary CPF account of every Singapore citizen aged 21 and above. The payment will be made on 1 October 1995.

D. Tax deduction for CPF contributions by self-employed

Self-employed persons who contribute to the CPF are allowed to deduct their contributions, inclusive of compulsory Medisave contributions, from their assessable income. At present the limit for such deductions is 18.5 percent, subject to a maximum of S$ 13,320.

On 1 July 1994, the employer's CPF contribution rate was increased to 20 percent. Following the increase, the limit for the tax deduction will be raised to 20 percent of the assessable income from self-employment, subject to a maximum of S$ 14,400.

III. OTHER TAX CHANGES

A. Reduction in property tax

To further enhance the competitiveness of doing business in Singapore, the property tax rate will be reduced by 2 percent, from 15 to 13 percent. The reduction will take effect from 1 July 1995. The 4 percent concessionary tax rate for owner-occupied residential properties will remain unchanged.

B. Withdrawal of property tax exemption for land under development

Since 1987, land under development has been exempted from property tax for a period of up to five years. In view of the current strength of the economy in general, and the property market in particular, this tax exemption will be withdrawn with immediate effect.

C. Contract note stamp duty on trading of stocks in Singapore

To enhance competitiveness and to continue to attract international investors to trade in Singapore and regional stocks on the Exchange, the Stock Exchange of Singapore (SES) has recently reduced its minimum stockbroking commission rate from 0.5 percent to 0.3 percent for transactions of Singapore stocks exceeding S$ 1.5 million.

In support of the SES's efforts to keep stock transactions costs in Singapore competitive, the contract note stamp duty on stock transactions will be reduced from 0.1 to 0.05 percent of the contract value. This change will take immediate effect.

D. Waiver of stamp duty on loan agreements for SES listed stocks

To support the development and encourage the growth of stock options trading, loan agreements for lending and borrowing of Singapore stocks, for ASCs, ACUs and residents outside Singapore will be exempt from stamp duty with immediate effect.

E. Water Conservation Tax

To restrain the growth in water consumption, the Water Conservation Tax on domestic customers who consume more than 20 cubic metres of water per month will be increased from 10 to 15 percent. The tax for non-domestic and shipping customers will also be increased from 15 to 20 percent. This tax change will take effect from 1 April 1995.

F. Duties on cigarettes and tobacco

Currently imported cigarettes are subject to both import and excise duties, while locally manufactured cigarettes are subject to an excise duty on the leaf tobacco and an excise duty on the finished product. To equalize the tax treatment between locally manufactured and imported cigarettes, import duty on cigarettes will be eliminated and excise duty on cigarettes raised to S$ 115 per kg with immediate effect. In addition, local cigarette manufacturers will be exempted from excise duty on tobacco leaves used in the production of local cigarettes.

IV. CONCLUSION

In concluding, the Minister said Singapore was facing a period of historic transformation of Asian economies. As the region is taking off and excellent opportunities abound, he urged Singapore to seize the moment or risk being left behind. He was confident that with guts, gumption and enterprise, Singapore will stay ahead and prosper.

Post-budget reaction and debates in the Parliament indicate that the responses to the Budget are generally favourable but with some disappointment. Whilst it is heartening to welcome additional and extended tax incentives to encourage more entrepreneurs to venture abroad and attract more foreign investments to Singapore, it is disappointing that there is no reduction in tax rates for individuals and companies.

Many questioned the Minister about the need for maintaining large budget surpluses part of which could be distributed in the form of more or new rebates to benefit the people now rather than the future. There is a big fuss over the budget surpluses and in reply the Minister said that Singapore's cash reserves might be large, it had precious little else by way of nature resources. He added that all Singapore has is cash reserves and nothing else. It has no natural resources like other countries. That is why Singapore needs cash reserves more than anybody else. Although the Budget has been approved, Budget Surplus still remains a hot topic within and outside the Parliament.

HUNGARY

TAXATION OF CORPORATIONS AND INDIVIDUALS[1]

I. INTRODUCTION

Companies listed in the company law (Law on Economic Associations) and other entities carrying on profit-making activities are liable to corporate income tax. Resident entities are liable to tax on their worldwide income. Non-residents are taxed on their Hungarian-source income, including income derived through a permanent establishment ("PE") in Hungary. Companies are also liable to VAT, consumption tax, tax on transfer of property and to local taxes.

In Hungary individuals are subject to individual income tax, to local taxes, to inheritance and gift tax and in certain cases to VAT and to the tax on transfer of property. In addition, they may pay contributions to employees' pension plans and they have to pay pension premiums and contribute to the Solidarity Fund – other social security contributions are paid only by the employer.

II. CORPORATION TAX

A. Type of tax system

The Hungarian corporate income tax is a classical corporate income tax system, but modified by the participation exemption. Corporate-source income, including profit distributions, is fully taxed at the corporate level at a split-rate corporate tax. For corporate shareholders, distributions received are deductible from the taxable base. For tax purposes distributions of profit include dividends, interest on interest-bearing shares or any other kind of distribution of (after-tax) profits derived from a participation in a corporate entity.

With effect from 1 January 1995 the corporate income tax is levied at two stages: a basic corporate income tax of 18 percent (previously 36 percent), and a supplementary tax of 23 percent. Dividend relief for individual shareholders was also introduced on the same date. Distributed profits are taxed in the hands of the individual shareholder, but dividend income at the individual shareholder's level is partially relieved from income tax. A minor amount of tax credit is given for the tax liability on the first 100,000 forints of dividend income, but not more than 10,000 forints of tax. The remaining part of dividends received is taxed at a lower flat rate.

B. Taxable persons

Taxpayers carrying on economic activities with the aim or with the result of receiving income or wealth are liable to corporate income tax.

Various types of entities and persons are listed as taxpayers in the Act on Taxation of Corporations ("Act"). These include:

(a) State-owned companies, groups of State-owned companies (called trusts) and cooperatives;
(b) entities listed in the company law (economic associations), including partnerships, limited liability companies and joint-stock companies;
(c) individual entrepreneurs provided they have elected to become subject to this tax;
(d) lawyers' offices, associations of individuals having legal personality;
(e) housing societies, public associations, church and voluntary mutual insurance schemes if they derive income from entrepreneurial activities or deduct expenses;
(f) associations for the benefit of the public;
(g) legal entities, entities without legal personality or other associations with headquarters abroad if they carry on a business activity through a PE in Hungary (foreign entrepreneurs);
(h) foreign entrepreneurs if they derive Hungarian-source income from a resident person as consideration for business activities, but this income is not attributable to their PE; and
(i) legal entities, entities without legal personality or other associations with headquarters abroad receiving income from resident persons as consideration for business activities carried out in Hungary (foreign organizations).

Joint ventures with foreign participation (up to 100 percent) may take any of the corporate forms listed in (b). Although partnerships have no legal personality, they are treated as taxable entities, i.e. their profits are subject to tax at the partnership level. Any profit distributions from partnerships are taxed in the hands of individual partners; corporate partners distributions are exempt.

Social and religious organizations, housing societies and foundations may be exempt from basic corporate tax if their income from listed business activities does not exceed 10 percent of the total income and is not more than 10,000,000 forints.

Income derived by associations for the public interest from activities for the public interest (as listed in the law) is exempt, subject to some restrictions.

Voluntary mutual insurance funds may be exempt from basic corporate tax if their income from additional business activities does not exceed 20 percent of the total income.

1. Adapted from *Supplementary Service to European Taxation*, (Amsterdam, IBFD) Chapter Hungary.

1. Residence

Taxpayers for corporate income tax purposes are treated as residents if they are created under Hungarian law and if their registered seat is located in Hungary. Non-residents are divided into two categories depending on whether or not they carry on a business activity through a PE.

C. Taxable base

The computation of taxable profits of resident taxpayers is based on their accounting system and on the principles provided for in the Law on Accountancy. For companies keeping double-entry books, the starting point is the balance sheet profit. Companies keeping single-entry books must calculate their taxable profit on a cash basis. In order to arrive at the taxable profit, the accounting profit in both cases is reduced or increased by items listed in the tax law. Some of the most important deductions are:

- losses carried over;
- amounts used from non-tax provisions to cover expected losses if they are shown as miscellaneous revenue on the balance sheet (except for banks and insurance companies);
- allowable transfers to provisions for doubtful debts;
- the amount of depreciation up to the amounts allowed in the appendices of the Act;
- dividends received and entered on the profit and loss statement as revenue;
- decreases in the value of assets, if allowed under the Law on Accountancy;
- tax refunds not previously deducted;
- the total amount of donations made to public foundations serving cultural, educational, social, health care, religious, environmental protection, youth and sport purposes and the amount of donations and contributions made to other public interest foundations listed in the law up to 20 percent of the company's taxable base for the basic corporate tax of 18 percent;
- allowances for the employment of previously unemployed persons; and
- the amount of cancelled debt of the debtor during the bank consolidation procedure.

There are several items included in the taxable base in addition to the balance sheet result, including:

- the amount of non-tax provisions made to cover expected losses if they are shown as miscellaneous expenditures on the balance sheet;
- the amount of depreciation exceeding the amount allowed under the Act, if deducted as a cost according to the Law on Accountancy;
- expenditures for assets not used in connection with profit-making activities;
- the book value of assets transferred for no consideration unless the law prescribes such a transaction (e.g. for the return of confiscated property);
- the difference between the nominal value and the sales price of bonds transferred for no consideration or transferred for less than their nominal value to the employees, if the nominal value was deducted by the employer;
- amounts paid for leasing (excluding VAT but including fees for related services) in excess of a monthly 3 percent (1.1 percent in the case of immovable property) of the proportional part of the acquisition cost of the assets related to the taxable year;[2]
- the part of entertainment expenses exceeding 0.5 percent of turnover;
- the amount of rental fees if the rental period is less than a year or the contract contains a purchase option, and rental fees paid for the rent of shares/quotas in limited liability companies and securities if the rent is for less than one year;
- increase in the value of assets resulting from revaluation of assets during a transformation (merger, split, etc.) of a company;
- the proportional part of interest on loans granted by entities (except for financial institutions) holding more than 25 percent of the registered capital of the taxpayer if the amount of the loan exceeds more than four times its own equity; and
- the amount transferred to an employees' shareholding programme, up to 20 percent of the taxable base.

With effect from 1 January 1995 the minimum tax is abolished. Under the minimum tax provision, if the computed taxable base was less than 2 percent of turnover, the corporate tax was levied on this deemed taxable base.

1. Depreciation

Generally, the straight-line method is applied. Since, for accounting purposes, other depreciation methods are allowed as well, the accounting profit must be amended by the difference between the amount of depreciation for accounting and for tax purposes.

Capital assets may be depreciated for tax purposes only by using the straight-line method and at the depreciation rates determined in the schedules to the Act. However, certain assets in the 33 percent depreciation rate group (computer technology, machines used in environmental protection and medical equipment) and assets valued at less than 100,000 forints may be depreciated by using other depreciation methods allowed by the Law on Accounting, according the taxpayer's choice. Machinery and equipment purchased after 1 January 1992 may be depreciated at a rate of 14.5 percent and motor vehicles at a rate of 20 percent. Based on the taxpayer's choice, depreciation expenses may be accounted for investments in progress kept in the register at the end of the tax year, whereby the basis for depreciation using the given rates is at least 50 percent of the value of the investment.

Buildings may be depreciated at a rate of 2 percent. Fixed assets used in mining have special rules of depreciation. The depreciation of leased assets (by the owner) may not exceed 30 percent of the book value of the asset (10 percent in the

2. In the case of cross-border leasing, an additional amount of 20% of the leasing fee accounted for as expense in the tax year.

case of buildings) unless explicitly mentioned otherwise in the Act.

Acquisition cost of assets not exceeding 20,000 forints may be written off in one instalment at the taxpayer's choice. Assets with an acquisition cost not exceeding 50,000 forints may be written off in two equal instalments.

The purchase or production cost of intangibles (e.g. patents, inventions, copyrights, know-how) must be apportioned to the years during which the assets are expected to be used. The estimated useful life of rights representing money (e.g. leaseholds, easements or concessions) is deemed to be six years. In the case of goodwill, a period of five years is applied as useful life. However, goodwill may be written off in a period longer than five years (maximum 15 years) but it must be justified in a supplement to the balance sheet.

2. Valuation of stock

Purchased stock in trade (inventory) is valued at its purchase price or, if it is fungible items of stock, at the weighted average purchase price. Self-manufactured stock in trade is valued on the basis of production costs (as determined under the law on accountancy) or at the calculated or standard direct prime costs. Direct prime costs include costs directly incurred in or closely attributed to the manufacturing process and costs which can be attributed to the product with the help of appropriate parameters or indices.

3. Reserves and provisions

(a) Doubtful debt reserve

Provisions may be set up for doubtful debts, although limits are set on the amount which may be deducted from the taxable base.

(b) Non-tax reserves

There is no obligation to establish reserves under Hungarian tax laws but after taxation a taxpayer is free to use his profits to form reserve capital. This reserve may be used to supplement after-tax profits (e.g. for distribution).

D. Capital gains

Profits from the sale of assets are treated as business income. In the case of assets sold for no consideration the book value of this asset is treated as business income. In the case of shares and other securities sold for no consideration or below their nominal value, the nominal value is treated as income for tax purposes. The depreciated value of the assets sold may be entered as expenditure.

E. Tax incentives

1. Investment allowances

Incentives for the employment of previously unemployed persons are granted to the taxpayers in order to stimulate the labour market.[3]

2. Investment credits

Taxpayers may reduce the amount of tax they are required to pay by utilizing incentive allowances, which are deducted from the amount of tax due (i.e. as credits). Tax credits cannot be transferred to another year. In connection with the introduction of a two-stage corporate tax, the substantial reduction in the basic corporate tax rate and the abolition of certain tax incentives, the tax credits for companies already entitled to such incentives may be used only to offset the basic corporate tax. Certain limits have been introduced as well. The limitations do not affect reliefs granted to offshore companies.

(a) Incentives for preferential loans

A tax allowance is granted proportional to capitalized interest and interest deducted as expense in respect of some preferential loans (e.g. loans used for financing investments expanding export capacity, loans for investments). From 1995 the tax allowances vary between 19 and 30 percent of the capitalized interest or from 6 to 12 percent of the interest accounted as expense. In the case of the general tax allowance introduced from 1 January 1994, which is granted to companies using loans to finance investments, the credit has been reduced to 19 percent (from 38 percent) of capitalized interest and 12 percent (from 25 percent) of the deducted interest expenses.

(b) Incentives for joint ventures

Foreign investors may continue to benefit from the special tax incentives granted to them during the previous years provided they have acquired the right to them and they meet the conditions outlined below. Existing tax reliefs may be used with restrictions laid down in the law.

A joint venture with foreign participation may receive a tax allowance, subject to the following conditions:

- more than 50 percent of the joint venture's annual sales proceeds are derived from manufactured products;
- the share capital exceeds 50 million forints; and
- the foreign participation is at least 30 percent.

In these circumstances the tax due will be reduced by 60 percent in the first five years of activity and by 40 percent in the following five years. In the case of "particularly important activities", the rates are increased to 100 and 60 percent, respectively.[4]

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3. Companies may deduct the total amount of the social security contribution paid in the last 12 months from their taxable base provided the new employee was registered as unemployed for at least six months previously and no one having the same type of job was dismissed in the period beginning six months before the employment of the unemployed person.

4. However, companies seeking these benefits must meet the three conditions by 31 December 1993. A transitional provision is granted only for joint ventures intending to perform "particularly important activities". According to this criterion "starting the investment" in the form of acquiring/importing the equipment/machines necessary to carry on the particularly important activity or starting the construction work by 31 December 1993 is sufficient to qualify for the tax holiday. The benefits will be applied *pro rata temporis*. The 100% tax exemptions previously granted for qualifying joint ventures carrying on "particularly important activities" may be applied up to the amount of the basic tax payable.

Joint ventures with foreign participation are also entitled to the same allowances which apply to enterprises without foreign participation. Entities will no longer be entitled to begin to benefit from this incentive after 31 December 1993.

(c) Other

As of 1 January 1994, two new types of large-scale investment incentive became effective, namely the reinvestment incentive and the large-scale investment incentive. The Government is entitled to grant these special tax benefits on a case-by-case basis to those companies (domestic or with foreign participation) which are of a substantial size, provided these companies meet the specific conditions outlined below. With effect from 1 January 1995, the incentives for large-scale investment and reinvestment of dividends have been repealed. However, companies which were granted these special incentives continue to benefit, but with restrictions.

(1) Reinvestment incentives
The taxpayer is entitled to a tax credit corresponding to the tax paid on the reinvested dividends if the share capital of the company is at least 100 million forints; or at least 25 million forints of the distributed dividend is reinvested, provided the whole amount or a part of it is used for increasing the share capital and the share capital so increased is not reduced (or the company is not split, demerged, etc.) in five years following the reinvestment.

(2) Large-scale investment incentives
The Government may also grant tax incentives to companies with a share capital of at least 500 million forints if the company makes an investment of at least 200 million forints provided that, as a result of the investment, at least half of the company's turnover is derived from the production or sale of environmentally friendly products produced with modern technology; and the investment increases export revenues or creates new jobs.

The tax incentives may be granted for a maximum period of ten years and may not exceed 100 percent of the tax liability in the first five years and 60 percent in the second five years. The actual period and rate is established by the Government on a case-by-case basis.

(3) Investment incentives for companies operating in regions with high unemployment
A new investment incentive has been introduced as of 1 January 1995 for companies having their registered seat in regions with unemployment rates of at least 15 percent established in July of the year preceding the tax year. Companies making investment in machines and equipment and putting them into operation are entitled to a tax credit of 6 percent of the invested value of machinery from the basic tax.

(d) Incentive for offshore companies

A tax credit of 85 percent of the tax due, including the basic and the supplementary tax, is granted to offshore companies. This means that the effective tax rate of companies qualifying for the offshore company incentive is reduced to 5.4 percent.

A joint stock company or limited liability company with 100 percent foreign ownership is treated as an offshore company for income tax purposes if it meets the following conditions:
- it has a permit granting semi-offshore status for the company (as required by the foreign investment law);
- it is engaged in trading activities or provides services (excluding financial services) solely to third countries;
- all of its lawyers and the majority of its personnel, managers, and the members of the supervisory board are Hungarian;
- the obligatory audit is made by a licensed auditor or an auditing firm resident in Hungary;
- its bank account is kept in Hungary;
- the owners (including indirect owners) of the company are all foreign persons; and
- neither the company nor its owners have interests in other Hungarian entities or maintain permanent representation in Hungary.

3. Restrictions regarding the application of tax credits

Most of the tax incentives (including the incentives for joint ventures, the reinvestment incentives and the large-scale investment incentives) were repealed from 1 January 1995. Qualifying joint ventures which were entitled to these incentives under previous terms continue to benefit from them. However, tax credits can be only set off against the basic tax, except for incentives for offshore companies. The present application of the tax credit system is as follows:

(a) A special tax credit up to 100 percent of the basic tax liability is available for:

- companies with foreign participation engaged in "particularly important activities" and which obtained the 100 percent tax allowance until 31 December 1993 and which are entitled to the 100 percent allowance in the tax year in consideration; and
- companies making large-scale investments which are entitled to a 100 percent corporate income tax holiday in the tax year in consideration based on a government licence issued before 1 January 1995.

(b) The aggregate maximum amount of tax credit may not exceed 70 percent of the basic tax for:

- taxpayers who are entitled to tax incentives for preferential credits;
- companies with foreign participation which make the reinvestment of dividends from the retained earnings accumulated before 1994 and, therefore, are entitled to a tax credit corresponding to the tax paid on the reinvested dividends;
- companies with foreign participation which by 31 December 1993 acquired the right for the 60 percent tax credit as being engaged either in manufacturing or in 'particularly important activities' and which are entitled to this 60 percent incentive in the tax year in consideration; and

- companies which are entitled to the 60 percent incentive in the tax year in consideration based on government licence issued before 1 January 1995.

In addition, in the case of companies entitled to the 60 percent tax incentive, the tax credit may not exceed 20 percent of the basic tax.

All tax incentives which were available before 1 January 1995 and which were lower than 60 percent have been repealed.

F. Losses

Losses may be carried forward for five years. The costs of establishing a business and the losses from the first two years may be carried forward for an indefinite period. In the agricultural sector, losses may also be carried back for two years. Legal successors may not carry forward the losses of their predecessor.

G. Rate

From 1 January 1995 the corporate income tax is levied in two stages: the basic corporate income tax is imposed on taxable profits at the rate of 18 percent, and a supplementary tax at the rate of 23 percent is levied in the event of distribution of profits. The supplementary tax is payable on payments made out of retained earnings, such as dividend distributions, redemption payments for shares and the provision of cash without consideration.

Distribution can be made without triggering supplementary tax liability for the following purposes:
- to increase registered capital, provided no decrease takes place in registered capital for three years;[5]
- to distribute profits to individual shareholders who use the distribution to repay loans received to acquire an enterprise in the framework of the privatization process;
- to grant housing subsidies up to a limited amount according to the provisions of the personal income tax law;
- to redistribute dividends received and distributing dividends from retained earnings before 1995; and
- to transfer funds from retained earnings as contribution to foundations or to an employees' shareholding programme.

The distributable profits for supplementary tax purposes include the tax itself and the amount actually distributed.[6]

H. Assessment and collection of tax

Taxpayers are obliged to file a tax return and to determine their tax liability (self-assessment). Foreign entrepreneurs must make quarterly advance payments based on the previous year's profits. Resident companies must make advance payments of tax twice a month.

I. Groups of companies

1. Group treatment

Currently, under Hungarian law there is no group taxation. However, according to the Law on Accountancy, as applicable from 1994, a company which has a majority holding in another company must prepare a consolidated balance sheet. A majority holding is understood to mean that the company has a decisive influence over another company or that its share in another company exceeds 50 percent of the share capital of the company.

2. Intercompany dividends

Income of a corporate entity, i.e. an economic association, from which distributions are made is taxed at the 18 and 23 percent corporate income tax rates. Distributions received by a corporate entity in respect of a share participation in another such entity are deductible from the taxable base, and in the case of redistribution they are not subject to supplementary tax.

3. Transfer pricing

If a higher or lower value is used in contracts (including contracts for advisory activity, technical assistance and loans) between related parties than would have been used in the case of unrelated parties, the tax authorities have the right to substitute a fair market value (as determined by their authorized experts) in assessing the taxable base. A related party is defined as:
- a person who participates directly or indirectly in the management or in the control of the other taxpayer or holds more than 25 percent of voting power in making decisions concerning the other taxpayer; or
- persons who participate directly or indirectly in the management or in the control or they together hold more than 25 percent of voting power in decisions concerning at least one of the parties.

If these related parties have a contractual relationship, transfer pricing provisions apply.

4. Thin capitalization

A thin capitalization provision was introduced in Hungary as of 1 January 1993. According to this provision, the proportional amount of interest on loans granted by entities owning more than 25 percent of the share capital of the taxpayer is not deductible for tax purposes if the amount of the loan is more than four times its own equity. The thin capitalization provision does not apply to financial institutions.

5. In the case of a decrease in registered capital within three years, the supplementary tax is clawed back.

6. The following example will illustrate the calculation of tax liability: assume that the pre-tax profits (the taxable base) are 100. The basic tax at 18% is 18. Supposing the company is going to distribute the total amount of after-tax profits, the supplementary tax is (82 x 23)/123 = 15.33 units. Thus, the total tax burden on retained profits is 18 percent while on distributed profits it is 33.33% (18 + 15.33).

J. Double taxation relief

Foreign income (other than dividends) received by a resident company is included in its taxable base. In the absence of a treaty, unilateral relief is provided by way of a credit for income taxes paid abroad. The proportion of the credit to the entire tax liability may not be greater than the proportion of the foreign income to the total taxable base.

III. OTHER INCOME TAXES

A. Tax on "State dividends"

The tax on "State dividends" was repealed as of 15 May 1994.

B. Tourist fund contribution

As of 1 January 1994, a tax is levied on certain tourism related activities. The tax is levied at a rate of 2 percent of the gross turnover derived from hotel accommodation and car rentals, and of the taxed turnover from casinos, 1 percent of the profit margin of travel and exchange agencies and 1 percent of the gross turnover from other tourism related activities and 1 percent of the gross turnover of restaurants.

C. Local income taxes

Municipal authorities may levy local business tax on business activities of companies carried on in their jurisdiction. The taxable base is the net value of goods sold and services rendered (excluding VAT) less consumption tax paid. The tax may not exceed 0.8 percent of the taxable base.

IV. NET WORTH TAX

There is no tax on net worth but there is a local tax on dwelling houses and land. The law regulates only the maximum tax rates. The municipality has the option to levy the taxes and to establish the rates.

V. PAYROLL TAXES

There are no general payroll taxes in Hungary since the tax on wage increases was abolished with effect from 1 January 1993. However, the following special contributions are based on payroll.

A. Contribution to the professional training fund

Taxpayers for corporate income tax purposes are liable to this contribution. The tax is levied at a rate of 1.5 percent of the total payroll.

B. Contribution to the rehabilitation fund

If the number of handicapped persons a company employs is less than 5 percent of the total number of employees, it must pay an annual contribution of 5,000 forints for each person below the required 5 percent.

VI. SOCIAL SECURITY CONTRIBUTIONS

Basically all employees doing any kind of work are covered by the social insurance scheme. Social insurance premiums are paid by the employer at a rate of 44 percent of wages. This premium covers all types of health insurance, medical care, child allowances and financial aid for schools and social institutions.

The taxable base for the social insurance premiums is the gross payroll, including in addition:
- fringe benefits in cash or in kind, except for the first 1,600 forints of the monthly value of meals provided at the work place or the first 1,200 forints of the monthly value of meal vouchers;
- redundancy payments exceeding the amount fixed by the Labour Code; and
- bonuses and insurances paid for the benefit of the employee and domestic holiday allowances, if the total amount of these benefits exceeds 30 percent of the minimum wage.

Employers must also pay premiums for unemployment insurance to the Solidarity Fund at a rate of 4.2 percent of the gross payroll of all employees.

In the case of joint ventures, the obligation to pay contributions for social insurance in respect of foreign employees is restricted to those employees who wish to benefit from the services rendered by the social security system.

VII. WITHHOLDING TAXES

A. Dividends

No withholding taxes are imposed on dividends. According to a commentary to the legislation submitted to the parliament, the supplementary tax set at 23 percent is likely to be characterized as a tax on dividends, and therefore in the case of a foreign corporate investor, tax treaties may reduce the applicable rate to 5-15 percent. However, the classification of the supplementary tax as a dividend tax is still open and there is no provision in the law which reflects this commentary.

B. Interest

Interest in the case of resident companies is normally treated as business income and taxed accordingly. In the case of foreign companies, there is a withholding tax on interest if it is received from a resident entity. The effective tax rate is 18 percent, unless a lower treaty rate is applicable. No withholding tax is imposed on interest paid abroad by the Hungarian State, the Hungarian National Bank and Hungarian resident financial institutions. However, if the interest is paid by resident banks on bonds and the bank performs brokerage services on behalf of the issuer, withholding tax is applicable.

C. Royalties

Royalties in the case of resident companies are normally treated as business income and taxed accordingly. In the case of foreign entities, there is a withholding on royalties if received from a resident company. The tax rate is 18 percent, unless a lower treaty rate is applicable.

VIII. NON-RESIDENT CORPORATIONS

Non-resident persons are subject to corporation tax if they carry on activities through a PE or receive Hungarian-source income. Non-resident taxpayers are legal entities, entities without legal personality, associations of individuals and other organizations having a statutory seat abroad. The Act defines the term "source of income" as:

- in the case of business income the place of a PE, and the place where the company carrying on the activity is registered (if the activity is not carried on through a PE);
- in the case of income from immovable property or from natural resources, the place where the property or the natural resource is situated;
- in the case of consultancy services provided by non-residents, the place where the user of the service is resident;
- in the case of interest income, the place where the loan is used;
- in the case of royalties, the place where the payer is resident;
- in the case of the sale of participation in economic associations, the place where the association is registered;
- in the case of sportsmen and entertainers, the place where the performance is held;
- in the case of consulting services provided by non-residents, the place where the purchaser of the service is resident; and
- in the case of bonds, the legal seat of the issuer.

A PE is defined as a fixed business premise through which the entrepreneurial activity of the company is wholly or partly carried out. Construction sites constitute a PE after three months. A representative of a non-resident person is considered to be a PE of the non-resident if the representative may conclude contracts on behalf of the non-resident and regularly exercises this right or makes regular deliveries from stocks of goods and products on behalf of the non-resident person.

Foreign entrepreneurs carrying on business activities through a PE are taxed on their profits derived through the PE after the deduction of expenses. Income attributable to the PE is defined as any income in cash, notes of credit or in money's worth received in relation to the activity of the PE. Expenses related to the taxable income are those which are directly related to the income plus a proportional amount of head office expenses. The amount of the taxable base cannot be less than 10 percent of the gross returns; otherwise the latter is regarded as the taxable base and the PE is taxed on this deemed profit level.

Non-resident persons who carry on business activities through a PE are subject to corporate tax according to other rules than those applicable to resident entities. The taxable profits of a PE are subject to the basic corporate tax of 18 percent. In addition, such profits are subject to the supplementary tax of 23 percent, but only on 65 percent of the tax base for the basic corporate income tax, regardless of whether the amount was actually transferred to the foreign company. Thus, the effective tax rate is 32.95 percent (18+14.95).

Foreign organizations which have no PE in Hungary but which have received income which is treated as Hungarian-source income from business activities from a Hungarian person as well as from non-resident persons having a PE in Hungary, but deriving income which is not attributable to the PE, must pay only the basic corporate tax at a rate of 18 percent on the gross Hungarian-source income.

IX. VALUE ADDED TAX

A. Taxable persons

VAT applies to all natural persons, legal entities (including PEs of foreign enterprises), associations of individuals and partnerships which supply goods or services on a regular basis for profit.

B. Taxable base

The supply of goods and services in Hungary by the taxpayer as well as the importation and exportation of services and products is subject to tax. The taxable base is the value of goods and services supplied excluding the tax itself. In the case of imports, the taxable base is the customs value plus customs duties and fees and the consumption tax. In computing the final tax liability, the tax paid on purchases of goods and services may be deducted so that, in effect, only the value added is taxed.

Three kinds of exemptions are available under the VAT law: exempt entities, exempt transactions and zero-rated transactions. Small businesses may opt to be exempt under the law. Exempt services include financial services, health services and education. No credit for purchased goods or services is allowed if the transaction concerned is exempt. Zero-rated transactions include exports and (up to 31 December 1994) medicines. A credit for input VAT may be claimed for such transactions.

C. Rates

The general tax rate is 25 percent. The low rate of 12 percent and the zero rate are applied to enumerated transactions.

X. INDIVIDUAL INCOME TAX

A. Taxable persons

Resident individuals as well as non-residents are liable to tax. Resident individuals are taxed on their worldwide income. However, special rules are applied to foreign nationals staying in Hungary only for the purposes of employment. Non-residents are taxed on their Hungarian-source income.

Individuals having their dwelling or habitual abode in Hungary are treated as residents. Individuals are considered to have a habitual abode in Hungary if they stay more than 183 days in a calendar year in the country. If a dwelling is available for the taxpayer in more than one state, he is treated as a resident where a permanent home is available to him. If this latter can be found in more than one state, the centre of vital interests will determine the place of residence. The centre of vital interests is in the state to which the individual is linked most closely through his family and economic connections. If the residence cannot be determined on the basis of the above conditions, then citizenship will be the determining factor.

B. Taxable base

1. Taxable income

Income is defined as all receipts obtained in any manner by an individual. The Hungarian individual income tax law defines various categories of income which determine the available allowances and deductions. For most of the categories of income described below, taxable income is the remainder of the receipts after the deduction of specified expenses. In some cases taxable income is a percentage of the gross income as prescribed by the law. In other cases it is the gross income received, i.e. no deductions are available for expenses. Tax is computed on the aggregate amount of taxable income, except income taxed separately at flat rates. Basically, the deductions previously available from the aggregate taxable base have been replaced with a tax credit system from 1 January 1995.

(a) Sources of income

(1) Income from dependent services
Income from dependent services in Hungary is generally taxable. Income from dependent services includes income from employment, remuneration of members of parliament and income derived from economic associations with respect to membership. The salary paid in cash or in kind is treated as income. With effect from 1 January 1994, daily allowances paid in foreign currency for official trips abroad are also treated as income, but as a general rule only 70 percent of such income is taxable. Reimbursement of expenses received in connection with dependent services is not considered as part of income. The part of income which is used to pay unemployment contributions to the Solidarity Fund and membership fees to trade unions and labour organizations is excluded from taxable income.

Cash benefits received by employees are aggregated and taxed together with other types of aggregated income according to the general progressive rates. Benefits provided in kind are subject to tax at a flat rate of 44 percent paid by the payer of the benefit.

Expatriates may benefit from a special expatriate relief (see below).

(2) Income from independent services
Any income other than that listed in (1) and (5) derived from any activity is treated as income from independent services. Income from independent services includes, *inter alia*, income from individual entrepreneurial activity.

As a general rule, the taxpayer (with the exception of those keeping double-entry books) may choose to keep records of the expenses incurred and deduct them from the receipts up to the amount of the receipts. Alternatively, the taxpayer may opt for 90 percent of the gross receipts to be considered as taxable income.

Taxable income derived from independent services is computed as the difference between gross income and deductible expenses. Income from independent services includes any money or money's worth, benefits in kind, the market value of self-supply and interest and capital gains received with respect to the activity. Expenses are deductible only if they are directly related to the profit-making activity and incurred in the tax year exclusively in order to obtain the income or continue the activity. Income and expenses are entered into the books on a cash basis, with the exception of capital expenses which are to be depreciated according to the rules applicable to legal entities, with certain deviations laid down in the law.

Individuals receiving income from any, other than employment income, and individuals who keep single-entry books may keep itemized records for expenses and deduct them from the income, or opt for a lump-sum deduction of expenses of 10 percent of the gross income (see below for losses).

With effect from 1 January 1995, optional lump-sum taxation has been introduced for small-scale entrepreneurs who are subject to personal income tax (and whose turnover in the previous year did not exceed 3 million forints or 15 million forints for retail traders). The deemed taxable income is determined as 20 percent of turnover (13 percent or 7 percent for retail trade) and is taxed at flat rates of 25 to 35 percent. This deemed income is not aggregated with other income of an individual. Tax credits do not apply to income so taxed.

(3) Income from the alienation of property
This category includes gains from the alienation of immovable and movable property, and rights representing money if the gains are not effectively connected with a business (if so connected, the gains will fall in category (2)).

(4) Income from saving deposits and securities
The category of income from saving deposits and securities includes income from saving deposits, bonds, shares, busi-

ness shares in economic associations and other income. Income derived in respect of a contribution to the capital of a partnership falls also under this category. Items of income in this category are taxable on their gross amount. These items are not aggregated but are taxed separately.

(5) Payments under 3,000 forints
If a sum paid under a single contract does not exceed 3,000 forints, the whole of this sum is taxable but it will be taxed separately at a flat rate of 40 percent. The taxpayer may opt for aggregation.

(6) Other income
Income not included in any of the above categories, e.g. fringe benefits, unemployment payments, state pensions and damages paid as compensation for a loss of income or sums received under insurance to replace lost income, and contributions made by the employer on behalf of an employee to the employer's voluntary insurance funds is treated as "other income". The gross amount of other income is taxable (if not otherwise exempt).

(b) Exempt income

The following are the most significant types of exempt income:
- income exempt on the basis of international agreements and reciprocity;
- certain pensions;
- social welfare allowances;
- educational, health and social welfare benefits in kind;
- child maintenance allowances and child care allocations;
- scholarships for fulltime students, foreign scholarships of students and researchers studying or working abroad;
- 50 percent of gains derived from the sale of immovable property;
- certain capital gains;
- insurance payments if they are not a replacement of income;
- withdrawals of money invested in a business venture;
- tax refunds;
- interest on accounts in convertible (hard) currency and on giro accounts;
- state pensions (but see below for exemption with progression);
- non-refundable municipal housing subsidies and non-refundable employer's housing subsidies amounting to 30 percent of the acquisition price of a dwelling, subject to a maximum of 500,000 forints once in a five-year period.

2. Fringe benefits

The individual income tax law makes a distinction between cash benefits and benefits in kind. Benefits paid in cash are treated as "other income", aggregated with other types of income to be taxed at the progressive rates. Benefits in kind are considered "other income" as well, but are taxed separately at a flat rate of 44 percent on the value of the benefit; this tax is payable by the employer.

The scope and tax treatment of fringe benefits has been changed with effect from 1 January 1994. Fringe benefits are defined as that part of the value of products or services provided by an employer not reimbursed by the employee.

As a general rule, fringe benefits are taxable. The tax is levied on the market value of the benefit. The employer or other payer providing the benefit in kind must pay the personal income tax at the highest tax rate (currently 44 percent). The tax so paid is deductible in calculating the payer's corporate income tax base. The employee then receives a "net of tax" benefit.

Some important fringe benefits are exempt:
- meals provided in kind up to 1,600 forints, or meal vouchers up to 1,200 forints per month;
- compensation for uniforms, working clothes and protective wear as defined in the law;
- nursery school facilities in an employer-operated day-care centre.

Certain transactions are treated as fringe benefits and taxed accordingly. For example, assets leased by the employer from third parties and given to the employee to use, with a later purchase option, are treated as fringe benefits and the difference between the net book value of the asset and the price at which the asset is sold to the employee is taxable. The value of goods and services received in close connection with the performance of work (such as business entertainment, small gifts), is not considered to be a taxable fringe benefit.

Where the employer provides the employees with an interest-free or low-interest loan, the difference between the deemed fair market rate of 20 percent and the actual interest rate is taxed as a fringe benefit.

As a general rule, from 1 January 1995, income from deemed private use of company cars is treated as a taxable fringe benefit. The tax on the deemed benefit is determined on the basis of the actual purchase price and the useful life of the car according to a schedular table.[7]

The granting of share quotas, property bonds or shares or any other securities without consideration to an individual who is a member of a cooperative, and any property bonds and employee shares at their nominal value minus any payment made by the employee, does not constitute taxable income. However, any gains from their subsequent disposal become taxable capital gains.

3. Directors' remuneration

There are no specific provisions concerning directors' remuneration. It is taxed in the normal manner under the category income from dependent services (for employee shares see above).

7. The tax varies between a monthly amount of 3,000 forints and nil, respectively, for a car which has an acquisition value of up to 1 million forints and is one to eight years old. The highest amounts are 26,000 forints per month for a car with a purchase price of more than 16 million forints in the first year and 20,000 forints per month if it is more than eight years old. The tax is usually paid by the employer.

4. Pension income

As a general rule, pensions received from the State, from the Hungarian Art Foundation and pension funds of churches in Hungary or pensions from abroad are exempt from tax. No tax is payable on pensions, old age and disability allowances and old age annuities of members of cooperatives. If the taxpayer has other sources of taxable income as well, the pension income remains exempt but for the purpose of calculating tax on the person's other income, the exempt amount is taken into consideration (exemption with progression).

Under new legislation, effective from 1 January 1995, amounts derived by employees from pension plans are treated as tax-exempt income, but contributions to such plans made by employers are considered to be taxable income for the employee. Under the new tax credit provisions, 50 percent of the premiums paid by the employee himself, or employer on behalf of the employee, may be deducted from his tax due. The general 50 percent tax deduction limit does not affect these contributions.

C. Capital gains

In principle, all gains derived from the disposal of property, whether movable or immovable, or intellectual property rights, are treated as income. However, gains from the disposal of immovable property acquired more than ten years before 1 January 1992 are tax exempt. Gains from the disposal of immovable property (regardless of when it was acquired) are also exempt if the income is used for the acquisition of a new home. The portion of gains not exceeding 100,000 forints derived from the non-commercial sale of movable property, with the exception of securities, is tax exempt.

Taxable income is generally assessed as the difference between the market value and the acquisition cost and the expenses incurred in connection with the acquisition or improvement of the property. However, in respect of gains from immovable property, only 50 percent of the income calculated in this way will be treated as taxable.

D. Allowances, deductions and credits

1. Deductions

The deductions previously available from the aggregate taxable base have been replaced by a tax credit system with effect from 1 January 1995. At the same time, however, a new deduction was introduced for individual entrepreneurs in order to promote the employment of trainees, disabled or previously unemployed persons. The entrepreneur may deduct a monthly amount of 1,500 forints for the employment of each trainee and each qualifying handicapped person and additionally 500 forints per month for the employment of previously unemployed persons, provided certain conditions are met.

2. Credits

With effect from 1 January 1995, allowances and investment incentives previously granted by way of deductions from the taxable base have been transformed into tax credits, i.e. the amounts can be credited against the tax computed on the taxable income. The tax credits include the following

(a) Personal credits

- 7,200 forints for individuals whose total annual income, including pensions and dividend income, does not exceed 500,000 forints;
- 25 percent of income derived from intellectual property and independent activities which are protected by copyright (subject to a maximum 50,000 forints);
- 30 percent of donations to qualifying charities;
- 20 percent of local taxes paid.

(b) Credits for investment

- 30 percent of the excess investment in securities (investment bonds, publicly-traded shares) as compared with the previous year's investment portfolio. This investment tax credit is a temporary credit available for as long as such excess investment is held in the capital account. It is deferred until there is a disposal of the investment. It is applicable to investments made after 1 January 1995 provided the acquisition of securities was made through a broker and a capital account regarding the investment is kept by a brokerage institution;
- the amount of the tax which was withheld on dividend distributions, income derived from securities and other similar items taxed at a flat rate of 10 percent. The credit is subject to a maximum of 10,000 forints.

(c) Credits for insurance

- 25 percent of social security contributions paid to the State Pension Fund and the Health Care Fund;
- 50 and 25 percent, respectively, of contributions paid by either the individual or the employer to their voluntary insurance funds for pension and health care insurance. The credits together may not exceed a maximum of 100,000 forints;
- 20 percent of premiums for a private life insurance or pension plan paid either by individual taxpayers or their employers on behalf of employees (the credit may not exceed a maximum of 50,000 forints).

(d) Credits for housing

- 20 percent of saving deposits made for the purpose of buying or constructing a dwelling (the credit may not exceed a maximum of 12,000 forints);
- 20 percent of the mortgage payments, both interest and principal, on housing loans made by banks for the purpose of building or purchasing newly built dwellings or enlarging existing homes (the credit may not exceed a maximum of 35,000 forints).

The total amount of tax credits may not exceed the annual tax liability calculated on the aggregate income. With respect to the tax credits for contributions to charities, local taxes, life insurance and investment, the aggregate tax deduction may not exceed 50 percent of the tax liability computed on the aggregate taxable income and the dividend income.

E. Losses

An individual entrepreneur may deduct the production and administrative costs connected with his entrepreneurial activity in a given calendar year up to the gross receipts from that activity for that year. Any expenses over this amount may be carried forward to the next five years. Start-up losses (losses of the first two years) may be carried forward for an indefinite period.

F. Tax rates

1. Progressive tax rates on the aggregated taxable base

Tax rates range from zero percent to 149,500 plus 44 percent depending on the amount of income.

A zero percent rate is established on interest income, including income from saving deposits (including foreign currency deposits) and securities, gains from the public or stock exchange sale of securities representing debt-claims and gains from investments registered on the capital account of an individual. Interest income derived by an individual on a loan granted to an economic association is taxed at zero percent, provided the actual interest rate does not exceed the prime rate of the National Bank and 10 percent of the company's registered capital, with a maximum of 200,000 forints. Otherwise this interest income is considered to be "other income" and taxed at progressive rates.

A final tax of 10 percent is levied on income (e.g. dividends) other than the type described above (which is treated as interest) derived from securities, income from the alienation of securities acquired for no consideration (e.g. employee shares) and on income from the withdrawal of investments in a business venture. The 10 percent tax withheld (which is subject to a limit of 10,000 forints on the first 100,000 forints of dividends) may be deducted from the final tax due or refunded, and will be calculated separately on the dividend income.

A final tax of 20 percent is withheld at source on taxable income from land rents. A final tax of 40 percent is withheld at source on taxable income from small sums and winnings from gambling.

G. Assessment

Taxable persons are generally obliged to file a return on their income derived during the calendar year. Certain individuals are not required to file tax returns, including those who declare to their employer that they derive income either only from a single employment or that they derive employment income from a similar employer and/or derive income from independent services, whereby the taxable income is determined using the option of a lump-sum deduction of expenses of 10 percent of turnover (which means that only 90 percent of the income is treated as taxable). Individuals making use of investment tax credits must file tax returns every year.

In general, advance payments of income tax must be made. No advance payment is required in respect of exempt income, income from small-scale agricultural activities and income derived from the alienation of property and in other miscellaneous cases. Employers and business enterprises are required to withhold tax at source from salary and other payments to individuals. A new rule was enacted with effect from 1 January 1994 which introduced a 30 percent advance payment to be withheld at source on payments made in foreign currency.

H. Double taxation relief

If a treaty between Hungary and another state is in force, the provisions of that treaty override the provisions of domestic law. In the absence of a treaty, a foreign tax credit is granted. For that purpose, the total foreign-source income has to be added to the taxpayer's taxable base, but foreign taxes paid on foreign-source income may be deducted from the tax due.

To obtain the tax credit the income must fall under an income category to be aggregated. Thus, for example, dividends, income from securities and interest do not give the right to a tax credit for the tax paid abroad.

If a tax treaty allows the taxation of foreign-source income, Hungary generally uses the exemption with progression method.

XI. WAGES TAX

There is no separate wages tax.

XII. OTHER TAXES ON INCOME

Hungary levies no other taxes on income.

XIII. WEALTH TAXES

Hungary does not levy a national wealth tax.

XIV. SOCIAL SECURITY CONTRIBUTIONS

Compulsory social security contributions are paid by employees at a rate of 10 percent of the annual gross salary up to 915,000 forints. The rate is composed of a 6 percent contribution to the State Pension Fund and a 4 percent contribution to the Health Care Fund. Employees must also contribute to the Solidarity Fund (unemployment fund) at a rate of 1.5 percent of their monthly salary, without a ceiling amount. The above-mentioned contributions are tax deductible.

Contributions may be made by individuals to Employee Retirement Funds. The law on such funds came into force in 1994 and the creation of private retirement funds is not possible.

XV. INHERITANCE AND GIFT TAX

The acquisition of property through inheritance, whether under a will, as a compulsory share of a deceased's estate for dependents, or on intestacy, is subject to inheritance tax. The donation of movable or immovable property or any right representing money is subject to gift tax if there is a written gift contract or the value of the gift exceeds 150,000 forints. Inheritance and gift tax are payable by the person receiving the inheritance or gift.

Fees incurred to acquire an inheritance or gift are deductible from the value of the gift or inherited property. There are also certain exemptions and allowances from the inheritance and gift tax. The rate of tax in both cases depends, on the one hand, on the relationship between the deceased/donor and the beneficiary/donee and, on the other hand, on the type of property acquired through inheritance or donation.

XVI. EXPATRIATES

According to the new law, only 70 percent of the remuneration is treated as taxable income if it is derived by an employee who has no permanent domicile in Hungary (the stay in Hungary is solely for purposes of work) but who is employed by:

- an economic association with foreign participation;
- a legal entity having its headquarters abroad and carrying on a business activity in Hungary;
- an unincorporated foreign individual firm or partnership; or
- an association owned solely by foreigners.

The monetary value of the benefit derived from the right to use a dwelling, or allotment given to cover rents, falls within the category of remuneration taxed as described above. In cases so defined in a contract of employment, the costs of business trips abroad or of other business-related obligation are not to be regarded as taxable remuneration. All other kinds of fringe benefits and allowances are treated as normal income and taxed according to the general rules.

Insurance premiums paid by the employer on behalf of the employee, and severance payments in connection with the termination of employment, are regarded as income taxable as above. The taxable income must be aggregated with income from other sources.

In the case of foreign employees of joint ventures, the obligation to pay contributions for social insurance is restricted to those who wish to benefit from the services rendered by the social security system.

XVII. NON-RESIDENTS

The term "resident" is defined in the law, as described above. Otherwise individuals are treated as non-residents and taxed on their Hungarian-source income only, according to the same rules as residents.

Income having its source in Hungary, including the customs-free zones, is domestic income. Income in the following categories is considered, in particular, to be domestic income:

- income from employment with an employer who is resident in Hungary;
- income from any activity carried on in Hungary;
- income from sales of assets situated in Hungary.

Income from a foreign source includes, in particular, activities performed outside Hungary under a contract with a non-resident employer and income from assets abroad.

Note, that the withholding tax rates are also applicable to non-resident individuals.

XVIII. VALUE ADDED TAX

See above VAT for corporations.

INTERNATIONAL

SHOULD THE EXEMPTION METHOD HAVE PRIORITY OVER THE CREDIT METHOD IN INTERNATIONAL TAX LAW?

Report on the 12th Munich Symposium on International Taxation[1]

Frank Stockmann

Mr Stockmann is a Scientific Assistant at the University of Munich, Research Centre for Foreign and International Financial and Tax Law. He is also working with Professor Klaus Vogel on the new edition of his commentary "On Double Taxation Conventions". The author expresses his appreciation to Mr Bruce Elvin for his valuable assistance in the translation of this report.

I. INTRODUCTION

The prevention of double taxation is essential to facilitate the rapidly increasing cross-border activities of both businesses and individuals. In the absence of a single, unifying international tax principle, the tax claims of two or more states may often lead to double taxation, or sometimes double "non-taxation". Where overlapping claims to taxation arise, the exemption method (as found in Article 23A of the OECD Model Treaty which in effect is an application of the source principle) seeks to ensure the prevention of double taxation by having the resident state of the recipient not tax the source state income. Under this arrangement, the resident state naturally suffers tax losses since it agrees not to apply the principle of worldwide taxation to the particular income.

To discuss the economic and legal consequences of the exemption method, the University of Munich organized a conference on 24 March 1995 addressing the topic, "Exemption in International Taxation – legal and political issues". Speakers were Professor Klaus Vogel (University of Munich), Professor Franz Wassermeyer (Judge at the Federal Tax Court ("BFH")), Dr Albrecht Schäfer, LL M (General Legal Council, Siemens), Dr Helmut Krabbe (Federal Ministry of Finance ("BMF")) and Mr Hansgeorg Hauser (member of the Fiscal Committee of the German Parliament). The discussion following the lectures was led by Professor Moris Lehner (Free University of Berlin).

II. FUNDAMENTALS OF THE TAX SYSTEM

A. Essence and effect of tax exemption

1. General remarks

The opening address, given by Professor Vogel, began with a discussion of the general operation of exemptions in the international context. The exemption method (which is the traditional method used in continental Europe as compared to the credit method employed by the United Kingdom and the United States)[2] results in capital import neutrality by admitting only source state taxes, while the credit method raises the tax level to the higher tax rate of the two states involved (capital export neutrality). Consequently, when the source state has a lower level of tax, the tax benefits will be consumed by the residence state. This often impedes investment in low-tax countries, which was the reason for introducing the matching credit or tax sparing credit. In addition to bilateral exemption, some countries (e.g. Switzerland and the Netherlands) even grant unilateral exemptions for specific income. The broadest form of exemption occurs where tax is only imposed on income from national sources, as is the case, *inter alia*, in Bolivia, Hong Kong, Kenya and Uruguay.

2. Effects of the negative proviso safeguarding progression[3]

Professor Vogel raised the unforeseen issue of the taxable effects of the "negative proviso safeguarding progression" in Germany. According to German jurisprudence, exemption means that tax-free foreign income will not be included in the calculation of taxable income. Therefore in principle foreign losses cannot be set off against domestic positive income;[4] in fact, this accords with the OECD Commentary (see paragraph 44 to Article 23) which states that it is up to the contracting states to decide whether or not losses may be deducted. However, both foreign positive and negative income have an impact on the tax rate.[5] Surprisingly, this issue has never

1. The text of the lectures and the discussion will be published in *Munich Series on International Taxation*, ed. Prof. Klaus Vogel. (Munich: Beck Verlag).
2. The OECD Model Treaty allows each state to choose between the two principles; see Art. 23 para. 28 of the OECD Commentary.
3. The "negative proviso safeguarding progression" means that the calculation of the tax rate includes in total income any foreign losses in connection with exempt classes of income, and consequently, such inclusion reduces the rate of tax.
4. Notwithstanding Secs. 2a Abs. 3 and 4 EStG (German Income Tax Act) for commercial income from foreign permanent establishments.
5. See Sec. 32b Abs. 1 Nr. 2 Abs. 2 Nr. 2 EStG, which also applies to negative foreign income under current case law (insofar as Secs. 2a Abs. 1 and 2 EStG do not apply; see Federal Fiscal Court ("BFH") decisions of 17 October 1990, Germany–France tax treaty (Federal Tax Gazette, BstBl. II, 1991, at 136); 12 December 1990, Germany–US treaty, Art. XV (rulings of the BFH not officially published, BFH/NV 1991, at 820; 12 December 1990, Germany–US treaty, Art. IX (BFH/NV 1992, at 104); 26 March 1991, Germany–Switzerland treaty (BStBl. II, 1991, at 704); 13 May 1993, Germany–Australia treaty (BFH/NV 1994, at 100).

been examined in detail. Professor Vogel demonstrated that it may lead to taxation of the constitutionally guaranteed tax-free subsistence minimum, and in some cases to taxation at a marginal tax rate of up to almost 500 percent.

Mr Hauser, the member of Parliament, argued that the German Federal Constitutional Court (BVG) failed to consider the treatment of losses in its "subsistence minimum decision",[6] and therefore Professor Vogel's analysis was based on an inaccurate constitutional premise. Other participants remarked that the unexpected result ("German international subsistence minimum", as Professor Lehner called it) may be influenced by using different foreign and domestic computations of taxable income or by abolishing the "negative proviso safeguarding progression". None of these arguments was fully accepted by the conference delegates. Instead, it was agreed that domestic income must be computed according to domestic tax rules, and as the Supreme Court held in the above-mentioned decision, the real remaining income must be the decisive criterion, and that abolition of the negative savings clause would aggravate the tax effects. As a possible solution Professor Vogel suggested considering the Dutch, and more recently Swiss models,[7] which allow for the complete offset of foreign losses and which prevent double exemption of losses solely by the use of domestic rules. A similar proposal had been submitted by the German Government in 1969 but was rejected by the Bundesrat.[8] Therefore the recent statutory prohibition of clearing international losses was called a "legal overkill" by Professor Vogel.

B. Deduction of business expenses in intercorporate shareholdings

1. Impact of tax treaty interpretation on computing taxable income

Professor Wassermeyer spoke on international intercompany dividend exemptions. He felt the issue of the deductibility of coherent business expenses must be answered according to the provisions of the relevant tax treaty. Although treaties do not contain rules on the computation of taxable profits, treaty provisions certainly imply that domestic tax computation methods should be applied. For example, the term *Einkünfte* in a German treaty should be regarded as net income in contrast to the term *Einnahmen* which is gross income.[9] Professor Vogel expressed some doubt that this distinction in German domestic law may be taken into account because the term in the treaty partner's language may not contain the same distinction. Taxable income is computed according to the domestic regulations of the resident state which solely has the right to determine the deductible business expenses incurred with respect to dividends.

2. Prohibition of deduction of expenses under domestic law

Section 3c EStG, which denies the deduction of expenses directly related to tax-free income, is currently a subject of controversy in Germany. As Professor Wassermeyer reported, the BFH must decide in an appeal whether refinancing costs and commitment commissions are deductible, an issue which has not been discussed intensively in the past. In a reaction to the BFH's tendency to allow the deduction, the tax authorities of Baden-Württemberg, for reasons not readily apparent to the conference delegates, issued a decree which directly conflicts with the BFH's position.[10] According to many of the speakers, this narrower view would lead to a tax planning strategy whereby the foreign shareholding would be financed by the company's own capital, which would thus be unavailable for necessary domestic investment, or to an increasing number of foreign subsidiaries which would mainly be used for holding equity interests. In light of the basic aim of reinvesting foreign profits in domestic companies, this decree is certainly a mistake.

3. Are tax-free negative intercompany dividends possible?

Professor Wassermeyer discussed whether it is possible to incur a loss from a tax-free intercorporate participation. The BMF, in contrast to the tax authorities of Baden-Württemberg, would answer this question in the negative. According to the BMF, tax exemptions cannot be prejudiced with respect to tax credits in domestic law (i.e. due to the maximum amount of crediting).[11] Professor Wassermeyer and the state treasury rejected this argument by asserting that the domestic tax reduction with respect to the tax exemption is more favourable in loss cases; in fact, the offset of positive against negative income is possible in such situations. In addition, the fact that there are two possible levels of exemption, i.e. the basic, international tax exemption level and the respective treatment under the domestic law of the residence state, must be taken into account. If the domestic state does not intend to incur losses out of tax-free intercorporate participations, it is up to the state to deny this possibility by new legislative provisions which should also clarify the deductibility of refinancing costs, commitment commissions, etc. However, this negative tax-free income is also liable to the negative proviso safeguarding progression lowering the tax rate as well as other foreign losses.

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6. German Federal Constitutional Court, decision of 25 September 1992, in Rulings of the Federal Constitutional Court ("BVerfGE") 87, at 153.
7. Under current Dutch tax law, the complete offset of foreign exempted and non-exempted losses is allowed, but they must be set off against foreign positive income within the following eight years; see Resolution on avoidance of double expenses of 21 December 1989 and Sec. 3(4) of the Explanatory Memorandum. For a recently issued bill that would provide an indefinite carryover of losses, see *Tax Notes International* (1994), at 1541.

Under Swiss Federal Law on the Federal Direct Tax of 14 December 1990 which came into force on 1 January 1995, the Swiss tax duty is not extended to business operations, permanent establishments or real property situated abroad. Therefore under negative proviso safeguarding progression, tax is exempted in Switzerland. If a Swiss enterprise has offset losses abroad from a permanent establishment against domestic profits, but records profits from this permanent establishment within the next seven years, these losses will only be retroactively taken into account in Switzerland in determining the tax rate. See Art. 6(1) and (3); 7(1); 52(1) and (3); 53(1) Federal Law on the Federal Direct Tax.
8. See Official Document of the German Parliament of 26 February 1969, No. V/3890.
9. This distinction in German domestic law might roughly be translated as "income" (*Einkünfte*) and "receipts" (*Einnahmen*).
10. Decree of the Baden-Württemberg Ministry of Finance of 24 February 1995, published in *IWB* part 3 group 2, Deutschland, at 287.
11. See Sec. 26 KStG (German Corporate Tax Act).

III. INDUSTRY VERSUS THE TAX AUTHORITIES PERSPECTIVE

A. Tax exemption as a necessity for international competitiveness

Dr Schäfer discussed the further distribution of tax-exempt foreign dividends to the domestic subordinated parent company and the restructuring of foreign participations under new Section 8b KStG.[12]

1. Effects on tax-exempt foreign distributions

As expected, Dr Schäfer firmly emphasized the economic interests of domestic-based international companies. From their perspective, new Section 8b KStG, which introduces the tax exemption method to assist domestic companies on further distributions to a parent company (unilateral national holding privilege), is a first step in the right direction to make Germany an attractive country for investment. In the past, the tax exemption of dividend distributions was only guaranteed if the relevant income was accumulated. If the foreign tax-free profits were distributed, a compensatory corporation tax was imposed. This finally led to the imposition of both the foreign withholding tax and domestic income or corporation tax, and consequently (compared to domestic distributions), to lower profits because of the failure to credit the foreign corporation (withholding) tax.

A compensatory imposition of corporation tax is no longer necessary and the tax exemption is preserved. In fact, the private investor suffers the disadvantage. Dr Schäfer rightly criticized the fact that the exemption is only favourable for companies, not for individuals, and because the compensatory imposition has been withdrawn, the net return on investment is decreasing because of the lack of a domestic tax credit for foreign corporation tax. This leads to a classification of "good" and "bad" dividends, depending on whether they were earned in foreign countries or in Germany, and whether the recipient is a foreign or domestic individual or company.[13]

Some participants argued that to satisfy the shareholders with the previous gross dividend, distributing companies are forced to use a larger sum of net earnings which decreases the remaining capital. In contrast, attempting to increase the dividend will have an impact on share value as has already occurred in several companies. Considering the high level of foreign engagement of German enterprises, these consequences are risky for international competitiveness. Therefore, some participants supported an "international individuals' dividend exemption" as a counterpart to the company exemption. This, of course, caused some hesitation by other speakers as well as the delegates. However, it was agreed, with the support of Mr Hauser, that crediting foreign corporation taxes would be both a favourable and possible solution, as the Italy–France and Italy–UK tax treaties demonstrate.

2. Restructuring of foreign participations

Subsequently, Dr Schäfer reported on the long demanded, but only recently issued regulation on cross-border holdings. Section 8b Abs2 KStG allows tax-exempt assignments of foreign essential participations because capital gains based on a lasting accumulation of profits cannot be treated less favourably than regular distributions. However, selling a company controlled through subsidiaries for relocation of a holding company back to Germany is not exempt, which would help German enterprises strengthen their competitiveness. The federal tax authorities have already agreed that this issue needs to be addressed.

B. Tax exemption and abuse of right

1. Basic situation

The abuse of tax laws is generally discussed with respect to treaty abuse in the source state, i.e. treaty shopping. Dr Krabbe pointed out that abuse may also take place in the residence state, such as when residents unlawfully receive tax exemptions. Taxpayers often establish entities in other states (which in principle is not objectionable) solely for the purpose of enjoying the benefit of particular treaty rules which otherwise would not be applicable to them (e.g. using a base company). This tax planning strategy is limited by domestic regulations; for instance, in the German Fiscal Code ("AO"), the German External Tax Law ("AStG") and by the rules which deem the place of management to be situated in Germany.[14] As a result, income is attributed to the domestic partner despite the existence of a company located abroad.

2. Tax treaty tax exemption and unilateral abuse regulations

The controversy flares in cases where income is exempt in the residence state under a treaty, but is also regarded as "abusive income" and therefore attributed to the domestic recipient by his tax authorities. With respect to dual resident companies (place of management in the residence state, seat of company in the other state), the OECD Commentary favours the state of the place of effective management (Article 4 (3)); in other cases the basic domestic (abuse) rules are not affected by tax treaty provisions (OECD Commentary, Article 1(23)).

Accordingly, Section 10 paragraph 5 AStG gives the treaty exemption priority if the distribution of dividends in an international intercorporate shareholding would also be tax exempt, which means that the accumulated foreign profit will not be attributed to the domestic partner. This, of course, is only a voluntary measure from the legislative perspective, not a treaty requirement; such position therefore conflicts with other opinions (i.e. Professor Vogel's). In respect of the government's viewpoint subsequent restriction is therefore possible, as is the case with "interim income with a capital investment character".[15] Under Article 10(5) of the OECD

12. Sec. 8b KStG came into force on 1 January 1994; see Federal Law Gazette Part I, 1993, at 1569, 2310.
13. In fact, in reaction to this situation the Siemens company prefers joint ventures with partnerships rather than with corporations.
14. See Secs. 10; 42 AO and Secs. 7 ff. AStG.
15. Sec. 10 para. 6 AStG.

Model Treaty, which only rejects the taxation of the accumulated profits at the company level not at the partner level, Dr Krabbe denied that a treaty override existed. He argued, in contrast, that Section 20 paragraphs 2 and 3 AStG, which provide that the credit method rather than the exemption method is applicable to interim income with a capital investment character of a foreign permanent establishment, is considered a clear treaty override.

3. Treaty abuse regulations in treaties

In addition to the unilateral measures, many treaties already include their own anti-abuse provisions (e.g. paragraph 1(d) of the 1989 Germany–US treaty). Other treaties exclusively deny application of the treaty benefits: for example, US Regulated Investment Companies (Article 23(2)(a) Germany–US treaty); Luxembourg holding companies (Final Protocol to Article 1(1) Germany–Luxembourg treaty); or the tax exemption may depend on "active occupations" or "productive activities" as in Article 24(1)(1b) Germany–Switzerland treaty or in Article 24(1)(c) Germany–Kuwait treaty.

A further example is the switch-over clause, used, for example, in the Germany–US treaty[16] and in the Germany–Norway treaty.[17] This allows the crediting rather than exempting of foreign taxes to prevent double exemption or treaty abuse. One delegate suggested including a definition of a general "tax treaty abuse clause" in treaties, although this idea was rejected by Dr Krabbe who argued that every contracting state likes to see its own definition in a treaty, and therefore, due to negotiating difficulties, the treaty application would be unclear. Professor Vogel suggested using open clauses in particular cases, a practice already provided for in the OECD Model.

IV. PERSPECTIVE OF THE GERMAN PARLIAMENT'S FISCAL COMMITTEE

A. Confirmation of tax exemption as the regular method

Mr Hauser gave an overview of the discussion in the Fiscal Committee concerning German international tax policy. He indicated that the Committee considers both the exemption and the credit method as appropriate instruments to prevent double taxation, but ultimately, the disadvantages of the credit method – i.e. increasing the tax rates to the higher level, loss of tax allowances in the source state and inability to control the tax payments – are outweighed by the exemption method. Considering the excess amounts of creditable foreign tax, real double taxation exists (since a carry-back or carry-forward of foreign taxes exceeding the maximum deduction for credit is not provided for). Overall, this situation has led industry representatives to feel that the credit method is of a "hegemonic nature". Application should be restricted to counter treaty abuse; otherwise, enterprises would be forced to keep foreign profits in the source state to avoid the high level of German taxation.

The exemption method, on the other hand, guarantees foreign tax allowances, and is in fact easier for the tax authorities to administer, although tax treaty abuse remains a possibility. According to Mr Hauser, this could be prevented by unilateral switch-over clauses in cases where the treaty partner exempts or reduces taxes on specific income in its domestic law after the treaty has been signed. However, to strengthen the export-oriented German industry, and to ensure German domestic employment, the exemption method plays a key role in the Finance Committee's national and international tax policy, so the Committee intends to use the exemption method as the regular principle in treaty cases.

B. Does Germany need a tax treaty law?

A lively discussion ensued as Mr Hauser proposed a general German domestic legislative regulation to apply to all German treaties. The overwhelming majority of the conference delegates rejected such a law on the grounds that it would probably result in a full treaty override and international condemnation. In addition, the scope of treaty negotiations would be restricted because of the issues already regulated under domestic law, and worse, treaty partners would try to compensate for the treaty disadvantages by an extensive interpretation in their domestic application which might lead to even more complicated situations than are the current norm. Finally, the consequences of similar laws inspired by the German example in other countries are unknown. Considering these arguments, Mr Hauser agreed that a treaty law would most likely not be passed by the Fiscal Committee in the near future.

C. Is there a need for a multilateral Model Treaty?

Most of the conference delegates answered this question in the negative, but it was left open by Mr Hauser. Dr Krabbe reported on the negative experience he had attempting to set up a multilateral "inheritance and gift convention" within six EU Member States, a law in which there was no interest. A representative of German industry indicated that, due to conflicting domestic interests, there probably will be an agreement only at the lowest possible level, and therefore particular cases will not be adequately taken into account. Professor Vogel recalled the European Commission's proposal to enact a "European Double Taxation Convention" in 1968 which was withdrawn due to a lack of consensus. He concluded that a multilateral Model Treaty could only be realized between similar legal systems, as is the case with the Scandinavian countries. Professor Wassermeyer, however, argued that a multilateral Model Treaty based on the OECD Model may be expected eventually.[18] In spite of the criticism, Mr Hauser was convinced of the advantages of possible harmonization and simplification of international taxation, but he agreed that a serious discussion would have to take place in the Fiscal Committee.

16. See para. 21 of the Protocol.
17. See para. 10 of the Protocol.
18. This development is indicated in the "Schumacker" case, recently decided by the ECJ, which seems to establish a most-favoured nation clause which, for its part, leads to a multilateral double tax treaty. See decision of 14 February 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*.

SPAIN

Controlled Foreign Corporation Legislation

Pedro Amat and Pablo Monasterio

Pedro Amat has a law degree from the University of Barcelona and **Pablo Monasterio** has a law degree from the University of Deusto (Bilbao). Both are trainees at the IBFD.

I. INTRODUCTION

Tax havens and low tax countries have been employed by individuals and companies resident in Spain to keep income out of the domestic jurisdiction. In order to prevent such practices and following the lead of other countries that have enacted CFC regimes,[1] Spain introduced controlled foreign corporation ("CFC") legislation in 1994.[2] The legislation is designed to control the diversion of income from Spain to CFCs established in low tax countries. The law provides for alternative approach,[3] and focuses on the country in which a CFC is established and the type of income it derives. Therefore, if a CFC earns or receives certain types of passive income, such income will be attributed to the Spanish shareholders.

II. DEFINITION OF A CFC

A. Introduction

CFC legislation applies to non-resident entities that are controlled by companies[4] or individuals resident in Spain and that are subject to a lower level of taxation in the country in which they are resident. If the entity is considered resident in Spain, the CFC rules do not apply, and it will be taxed on its worldwide income.[5]

B. Control

1. Basic test of control

The concept of control is one of the basic issues in the definition of a CFC. Although the proposed rules under the original Bill required a substantial participation in the CFC of 25 percent or more, the final rules omitted that requirement and imposed a greater participation to trigger CFC status.

A foreign corporation is considered to be controlled by resident entities if 50 percent or more of its capital, equity, voting rights or results is owned by Spanish resident entities, either directly or through related individuals or associated enterprises, at the end of the tax year. A CFC will be controlled by resident individuals, if at the end of the tax year, they own directly or together with associated enterprises, 50 percent or more of the capital, equity, voting rights or results of the foreign corporation.

Unlike the legislation in other countries (Germany, United Kingdom, Japan) which requires that all participating rights owned by residents be taken into account in determining whether a foreign corporation is a CFC, Spain requires concentrated ownership. In Spain, the 50 percent ownership must be concentrated in a single Spanish taxpayer (individual or company), regardless of whether the ownership is direct or through related parties.

In order to prevent abuse of the minimum ownership requirement by fragmenting ownership, the law sets forth indirect and constructive ownership rules.

1. The following countries have enacted CFC legislation: United States (1962), Germany (1972), Canada (1972), Japan (1978), France (1980), United Kingdom (1984), New Zealand (1988), Sweden (1990), Australia (1990), Norway (1992) and Portugal (1995).
For a comparison of various CFC regimes, see B. Arnold, *The taxation of Controlled Foreign Corporations: An international comparison* (Toronto: Canadian Tax Foundation, 1986).
2. Law 42/1994 of 30 December 1994 on Tax, Administrative and Social measures.
3. The alternative test is also followed by France, Germany, Japan and the United Kingdom. The United States and Canada, however, use a transactional test, which identifies a CFC by looking at the type of income earned or received by the CFC. This approach does not take into account the country where the CFC is established. Neither the United States nor Canada provide a definition of tax haven.
4. Law 42/1994 refers to resident legal entities that are subject to the Corporate Tax Law. Resident corporate taxpayers include all types of commercial companies, including the corporation (SA), the limited liability company (SRL) and all types of incorporated partnership, unless subject to fiscal transparency. For purposes of simplicity, the term "corporation" will be used throughout the article.
5. Under Spanish corporate tax law, a company is deemed resident in Spain if it is incorporated under Spanish Law, if its head office is located in Spanish territory or if its effective place of administration and management is in Spain.

2. Indirect control

The ownership standard of the Spanish resident shareholders of a CFC is satisfied by direct or indirect control. Indirect control can be carried out through related individuals or associated enterprises. According to Article 16(5) of the Corporate Tax Law, companies are associated when:[6]

- one company has a 25 percent participation in the capital of the other company;
- one company has decision-making authority over the other company;[7]
- each company owns directly or indirectly at least 25 percent of the stock of a third company;
- companies form a group of companies pursuant to commercial law.[8]

For example, if Spanish company A owns 25 percent of foreign corporations B and C, which in turn each own 25 percent of foreign corporation D, D is a CFC, because company A indirectly owns 50 percent of D. However, if a Spanish company holds an interest in a CFC through a chain of corporations (resident or non-resident), its participation is determined by multiplying its interest in each company in the chain.

As mentioned above, the ownership standard of Spanish resident companies can also be satisfied through related individuals. Article 16(4) of the Corporate Tax Law includes shareholders or directors of a Spanish resident company or shareholders or directors of another company that belongs to the same group of companies, as well as their ancestors, descendants or spouses.

3. Constructive ownership rules

Constructive ownership rules operate by attributing to a resident individual ownership in a foreign corporation held by related persons in determining whether a Spanish resident individual has fulfilled the 50 percent participation in a foreign corporation requirement. The law provides that capital, equity, voting rights or results owned by an individual's Spanish resident children, grandchildren, parents, grandparents and siblings will be considered to be owned by the Spanish resident individual.

C. Low tax country

The anti-avoidance measures apply only to non-resident entities controlled by Spanish residents which are subject to a lower level of taxation in the country of residence. A foreign company is considered subject to a lower level of taxation if the tax paid in its country of residence on the attributable income (see below) is less than 75 percent of the corresponding Spanish corporate tax that would be payable if the foreign company were resident in Spain.[9]

Although Royal Decree 1080/1991 of 5 July 1991 lists territories and countries that are considered to be tax havens with respect to tax and exchange control laws (i.e. "grey list"), that list is not taken into account for CFC purposes.[10] The grey list is only used to establish a presumption which can be rebutted by the taxpayer.

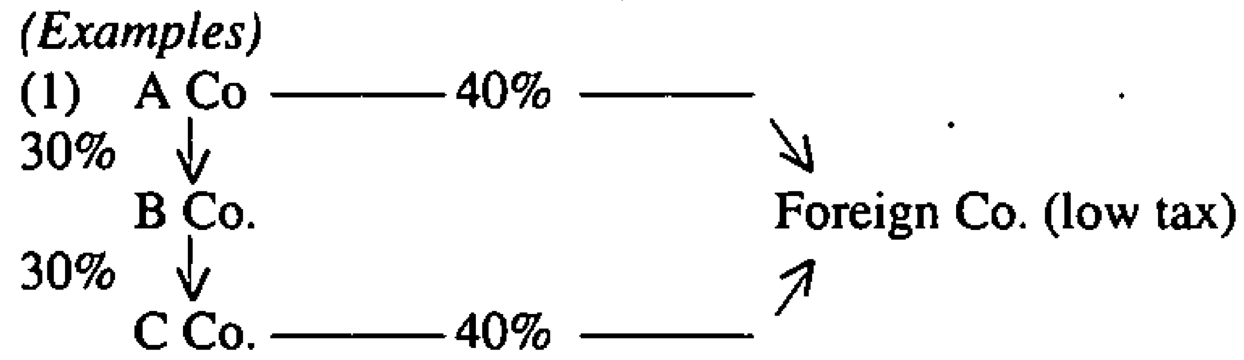
When an entity is resident in a tax haven it will be presumed that the tax paid abroad is less than 75 percent of the Spanish corporate tax and that all the income obtained by the non-resident entity is passive income. Furthermore, it will also be presumed that the annual minimum income derived by the non-resident entity is equal to 15 percent of the acquisition price of the holding.

III. DOMESTIC TAXPAYERS SUBJECT TO TAX

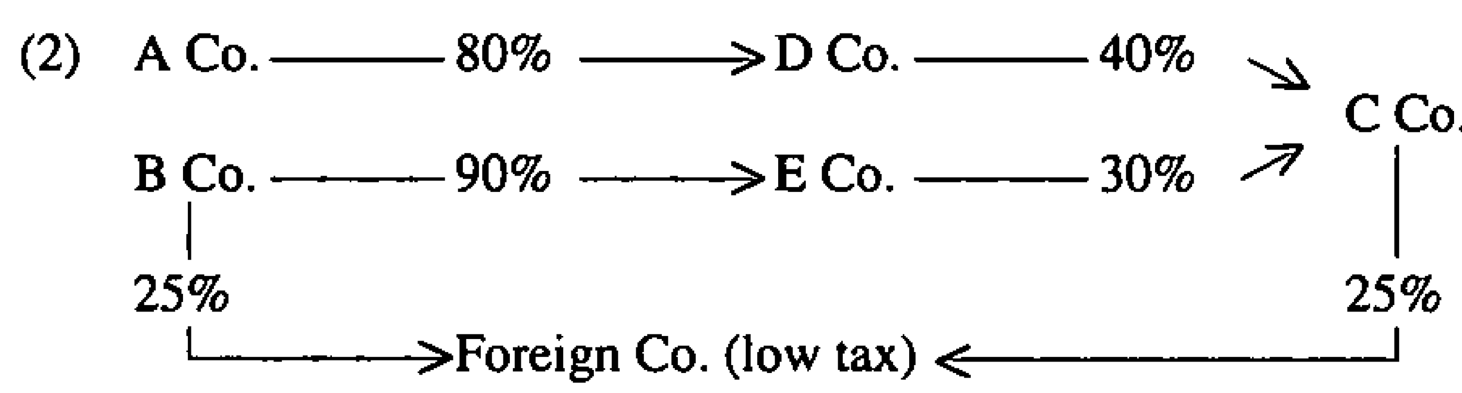
The anti-avoidance legislation applies both to resident individuals and corporations, insofar as they use CFCs established in low tax countries to avoid domestic tax.

Most of the countries having a CFC regime impose a minimum ownership requirement, meaning that shareholders with

6. *Indirect Control through associated enterprises. (Examples)*



A Co. and B Co. are associated enterprises.
B Co. and C Co. are associated enterprises.
A Co. and C Co. are not associated (30% of 30% = only 9%), unless A Co. has the decision making power over C Co.
Therefore if A Co. owns 40% of F Co., and C Co. owns 40% of the F Co., that foreign corporation does not qualify as a CFC



All of these companies are associated. Therefore if B Co owns 25% of F Co. and C Co. also owns 25% of F Co., that foreign corporation qualifies as CFC.

7. The requisite decision-making power exists when:
- a company has the right to elect, appoint or replace the majority of the members of the board of directors of the other company;
- a company has the majority of voting rights of the other company, or the power to elect the majority of the members of the board of directors of the other company through an agreement with other shareholders;
- there is a coincidence of directors between both companies.

8. According to Art. 42 of the Commercial Code, as amended by Law 19/89 of 25 of July 1989, a group of companies is deemed to exist when:
- a company holding a participation in another company owns the majority of the voting rights of that other company; or
- it has the right to appoint or dismiss the majority of the members of the board of directors of the other company; or
- it has appointed exclusively (with its votes) the majority of the board of directors of the other company.

9. The current rate of corporate income tax in Spain is 35%; therefore the CFC's attributable income must be subject to an effective rate of less than 26.25%.

10. The following countries or territories are considered tax havens under the Royal Decree:

Europe: Andorra, Cyprus, Gibraltar, Isle of Man, Channel Islands, Liechtenstein, Luxembourg (only for companies subject to special holding company status under the Law of 31 July 1929), Malta, Monaco and San Marino.

Africa and Middle East: Bahrain, Jordan, Lebanon, Liberia, Mauritius, Oman, the Seychelles, and the United Arab Emirates.

Asia and the Pacific: Brunei, the Cook Islands, Fiji, Hong Kong, Macau, the Mariana Islands, Nauru, Singapore, Solomon Islands and Vanuatu.

less than the minimum ownership are not subject to domestic tax until they receive the distributed dividends.

In Spain, however, minimum ownership and control requirement are the same. Any Spanish resident who owns directly or indirectly 50 percent or more of the capital, equity, voting rights or results of the foreign corporation is taxable on that corporation's undistributed income. The attributable income to be included in the taxable base of the resident shareholder is determined in accordance with his percentage interest in the results, or the capital, equity or voting rights.

IV. COMPUTATION OF THE INCOME OF A CFC

A. Attributable income

The CFC legislation provides that only passive income, capital gains from that income and certain base company services of a CFC are attributed to its domestic shareholders. Resident shareholders must include in their taxable base the following income obtained by the CFC:

(1) income derived from immovable property and rights thereon which are not used in business activities (unless the property has been transferred to a non-resident entity that belongs to the same group of companies);

(2) income arising from a participation in a company's capital and loan capital.[11] However, the following types of income are not considered passive income and need not be included in the taxable base:
- income from financial assets held to meet legal obligations arising from business activities;
- income from financial assets that involve debt claims arising from contracts entered into in the course of business activities;
- income from financial assets held in the course of intermediary activities in official securities markets;
- income from financial assets held by credit and insurance entities in the course of their business activities.

(3) income from credit, financial and insurance activities and the rendering of services (excluding export-related activities) carried out directly or indirectly with Spanish resident individuals or entities, where the amount payable for such services is considered a deductible expense for tax purposes. An exemption applies where more than 50 percent of the income derives from transactions with non-associated companies or individuals, i.e. the income will not be included in the taxable base.

(4) capital gains derived from transfer of property and rights referred to in (1) and (2).

B. Method of calculating income

Where the income is attributed to a Spanish entity under the CFC regime, it will be computed according to Spanish corporate tax rules, and the income of the CFC will be converted into pesetas at the applicable exchange rate at the end of the CFC's year.

The income will be attributed in the tax year the non-resident entity concluded its financial year (which may not exceed 12 months) except where the taxpayer chooses to attribute the income to the tax year in which the annual accounts are approved.

Capital gains derived from the transfer of shares of the CFC are computed taking into account the difference between the sale price and the combined value of acquisition and ownership. This combined value is the purchase price plus the portion of the company's undistributed profits imputed to the shareholders.

Service expenses related to transactions carried out directly or indirectly with individuals or entities resident in tax havens, or paid through individuals or entities resident therein, may not generally be deducted for corporate income tax purposes, unless the taxpayer proves that such expenses were incurred in connection with a real transaction. Finally, transactions carried out with residents of tax havens will be valued at arm's length prices for calculation of the taxable base of the corporate and individual income tax.

C. Exempt income

Although the Law does not expressly mention an exemption for active business income, such an exemption is inherent in the Spanish approach, insofar as only passive income is attributed. However, a specific exemption applies to income mentioned in paragraphs 1, 2 and 4 above which is derived by a CFC which holds directly or indirectly a participation of more than 5 percent in another entity: if the CFC actively manages the holding and at least 85 percent of the entity's income derives from active business activities the income is considered active business income and therefore not attributable.

In addition, the CFC legislation provides for a de minimis exemption, according to which passive income will not be attributed to the Spanish participators of the CFC where the aggregate income is less than 15 percent of the corporation's taxable income or less than 4 percent of its turnover.

D. Tax relief provisions

Where CFC income is attributed to its Spanish resident shareholders, the income may be subject to both Spanish and foreign taxation. Therefore, relief provisions are necessary to prevent double taxation. The Spanish legislation provides that if the income of a CFC is subject to foreign tax, Spain will grant a credit against the domestic tax for the foreign taxes paid by the corporation on such income. The corporate taxpayer will be entitled to the following tax credits:
- corporation income tax or similar taxes paid by the CFC on the income attributed to the Spanish entity. Taxes

11. Income from loan capital is deemed to arise from credit or financial activities where the lender and borrower are related to companies mentioned in Art. 42 of the Commercial Code (group of companies) and at least 85% of the profits of the borrower are derived from business activities.

effectively paid by the non-resident entity and its participated entities (however, there must be a holding of at least 25 percent during the period of distribution and the preceding tax year) will be credited. Therefore, if the CFC does business through a subsidiary in a third country and pays tax in respect of such income, the foreign taxes will be creditable against Spanish corporation tax;
- foreign withholding tax paid on dividend distributions (either under domestic law of the foreign country or under a tax treaty).[12]

Where the Spanish entity indirectly holds a participation in the CFC through other non-resident entities, the corporate tax paid by those entities on the attributed income may be credited against domestic tax. These credits also apply to taxes paid in respect of fiscal years other than the year of attribution, although taxes paid in countries qualified as tax havens will never give rise to a credit. The sum of the tax credits cannot exceed the Spanish tax due on the attributed income.

Relief is also granted when the CFC subsequently pays dividends out of previously taxed profits. In Spain, dividends derived from income already attributed to the resident entity and dividends on account are not included in the taxable base of the resident entity or individual.

V. ADMINISTRATIVE REQUIREMENTS

Because the revenue authorities must have adequate information to properly implement the CFC legislation, the law provides that taxpayers subject to CFC rules must report the following information regarding the foreign corporation to the tax authorities:

- the name of the company and location;
- the list of directors;
- balance sheet and profit and loss account;
- the attributed income;
- statement of the taxes paid related to the attributed income.

VI. TAX TREATIES AND CFC LEGISLATION

The existence of CFC legislation affects treaty practice when the foreign company is resident in a treaty country, and the compatibility of such legislation with tax treaties remains a thorny issue.

It has been argued that CFC legislation is contrary to tax treaties based on the OECD model, unless a specific saving clause acknowledges the counteracting measures.[13] This argument is mainly based on Article 7 of the OECD Model Treaty which prohibits the taxation of the profits of a non-resident enterprise. For that reason, some countries have excluded application of CFC rules when a tax treaty is involved. Sweden only applies CFC legislation to non-treaty countries, and Norway uses different rules depending on whether a CFC is resident in a treaty or non-treaty country. The Spanish regime expressly provides that tax treaties take precedence over CFC legislation. This approach conforms to Article 96 of the Spanish Constitution where international treaties prevail over domestic legislation.

12. This tax credit is also available to Spanish resident individuals.
13. See D. Sandler, "Pushing the boundaries", *The Interaction Between Tax Treaties and CFC Legislation* (London: Institute of Taxation, 1994).

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 48-52 of the January 1995 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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The first four articles were presented as papers at the annual meeting of the US branch of IFA, held in Washington, D.C. on 2-3 March 1995.

UNITED STATES

INTERNATIONAL TAX DEVELOPMENTS

James P. Fuller

James P. Fuller, a partner in the law firm Fenwick & West in Palo Alto, California, is a frequent speaker at tax programmes and the author of numerous articles, including a monthly column in *Tax Notes International*. He is a departmental editor of the *Journal of Taxation*, serves on numerous advisory boards (World Trade Institute, Practising Law Institute, etc.) and teaches an international tax course at Stanford Law School. He is chairman or a former chairman of the ABA Section of Taxation subcommittees on Foreign Tax Credits, Foreign Currency and Section 482.

Contents

I. SECTION 482

A. The Final Section 482 Regulations

1. General

The IRS issued final Section 482 regulations which offer substantially more flexibility than did the 1993 temporary regulations. Some of the rules in the temporary regulations that were the subject of taxpayer concerns and comments remain in the final regulations. The final regulations nonetheless constitute a substantial improvement over the temporary regulations, especially insofar as routine intercompany transactions are concerned.

"Inexact" comparables potentially may be used under all methods in the final regulations, certain limitations on the use of profit split methods were removed, and the comparable profits method ("CPM") is relegated to the status of "a method" instead of having special status as more significant method. The final regulations increase the emphasis on comparability and the importance of the best method rule. A taxpayer also may reflect prices to report an arm's length result on its original tax return which are different from the prices set forth in the taxpayer's books and records. The taxpayer, however, need not make a compensating adjustment to adjust for that difference.

2. Treas. Reg. § 1.482-1: General Rules

(a) Best method rule

The best method rule in the final regulations provides that an arm's length result must be determined under the method that, given the facts and circumstances, provides the most *reliable* measure of an arm's length result. The temporary regulations referred to the "most accurate measure" of an arm's length result. In deciding which of two or more methods provides the most reliable measure of an arm's length result, the regulation provides that there are two primary factors: comparability and the quality of the data and assumptions used in the analysis.

(b) Comparability

The rules on comparability are similar to the temporary regulations' rules on comparability. These rules provide that in determining the degree of comparability between a controlled and uncontrolled transaction, the functions, contractual terms, risks, economic conditions, and property or services in the two transactions must be compared. The uncontrolled transaction need not be identical to the controlled transaction but must be sufficiently similar to the controlled transaction so that the uncontrolled transaction provides a reliable measure of an arm's length result.

(c) Risk

The discussion of risk, particularly as it relates to identifying the party that bears risk, as noted above, is different from the temporary regulations. In general, the determination of which party bears a risk is made in accordance with the provisions of the parties' contractual arrangements. Thus, to the extent that taxpayers allocate risk by contract and their conduct is consistent with their contract, the allocation of risk will be respected unless the contract is executed after the impact of the risk is known or knowable. In cases where the allocation of risk is not clear from the party's contractual arrangements, several factors may be particularly relevant to determine which party bore the risk. In evaluating the economic substance of the transaction, the IRS will consider whether the parties' conduct is consistent over time with the purported allocation of risk, whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur, and the extent to which each taxpayer exercises operational control over the business activities that influence the amount of income or loss realized.

(d) Market share strategy

There also must be a reasonable likelihood that the strategy will succeed. The strategy must be pursued only for a reasonable period of time given the industry in question. The strategy and related matters also must be documented before the strategy is implemented. Significantly, a market share strategy will be taken into account only if it can be shown that an uncontrolled taxpayer engaged in a comparable strategy under comparable circumstances for a comparable period of time. The critical component of this requirement is that there be evidence that uncontrolled taxpayers engaged in similar behaviour under comparable circumstances.

(e) Arm's length range

The arm's length range is established in one of two ways, depending upon the extent to which material differences between the uncontrolled comparables and the controlled transaction can be identified, and the reliability of adjustments made to the account for such differences:

- the arm's length range will consist of the results of all uncontrolled comparables when certain requirements are met: each identified material difference has a definite and reasonably ascertainable effect on price or prices; appropriate adjustments for such differences are made; and the data is sufficiently complete such that it is likely that there are no unidentified material differences;
- if the standards above are not met, then the reliability of the analysis must be enhanced, if possible, by applying valid statistical techniques to the uncontrolled comparables that are of similar comparability and reliability. This may require limits on the range such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range, but a different statistical method may be applied if it provides a more reliable measure.

(f) Foreign legal restrictions

The proposed rules dealing with foreign legal restrictions were adopted. These rules provide that a foreign legal restriction will be taken into account to the extent that such a restriction affects the results of transactions at arm's length. If there is no evidence that the restriction affected uncontrolled taxpayers, the restriction will be disregarded in determining an arm's length result. A foreign legal restriction is defined as a restriction that is publicly promulgated and generally applicable to all similarly situated persons (both controlled and uncontrolled). It must not be imposed as part of a commercial transaction between the taxpayer and a foreign government. The taxpayer also must have exhausted all remedies afforded under foreign law or practice for obtaining a waiver of the restrictions (other than remedies that would have a negligible prospect of success if pursued). The restriction also must expressly prevent the payment or receipt, in any form, of part or all of the arm's length amount within the meaning of Section 482, and it must not have been circumvented by the controlled taxpayers.

(g) Effective date

The new regulations generally are effective for taxable years beginning 90 days after publication of the final regulations in the Federal Register. Taxpayers, however, may elect to apply these regulations retroactively for any open taxable year (in which case they must also be applied to all subsequent years). The "commensurate with income" provision added to Section 482 by the 1986 Tax Act must be applied to all years to which the 1986 Tax Act applies. The "commensurate with income" language must be applied, prior to the effective date of the final regulations, using any reasonable method not inconsistent with the statue. The IRS considers a method that applies these regulations or their general principles to be a reasonable method.

3. Treas. Reg. § 1.482-3: Tangibles

Treas. Reg. § 1.482-3 provides rules for transfers of tangible property. Six methods are provided: CUP, the resale price method, the cost plus method, CPM, profit split and unspecified methods.

(a) Unspecified methods

Guidance is provided in the final regulations with respect to considerations that should be taken into account in applying an unspecified method. Such a method should reflect the principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to the transaction. An example of the application of these rules is provided in which a *bona fide offer* is used to establish an arm's length price. This is helpful: a bona fide offer served as important evidence in the *Ciba Geigy* case. Unspecified methods are not, however, limited to an examination of potential methods that did not occur. They should, in general, be based on actual transactions and other indicia derived from actual or potential market transactions.

(b) Coordination of tangibles and intangibles rules

The section of the regulations dealing with the coordination of the tangible property and intangible property rules provides that in most cases the transfer of tangible property with a so-called "embedded intangible" will not be considered a transfer of the intangible if the purchaser does not acquire the right to exploit the intangible other than in connection with the resale of the tangible property. Where a purchaser of a tangible product acquires the right to commercially exploit an embedded intangible, it may be necessary to apply the tangible property rules to determine the arm's length consideration for the tangible property transferred and the intangible property rules to determine the arm's length consideration for the embedded intangible.

4. Treas. Reg. § 1.482-4: Intangibles

Treas. Reg. § 1.482-4 provides rules with respect to the transfer of intangible property. Four methods are provided: CUT, CPM, profit split and unspecified methods.

(a) Form of the consideration

The regulations provide that when a controlled taxpayer pays nominal or no consideration for the right to exploit an intangible, and the transferor retains a substantial interest in the intangible, the arm's length consideration will be in the form of a royalty, unless a different form is more appropriate.

(b) Periodic adjustments

If an intangible is transferred for a period in excess of one year the consideration charged is generally subject to an annual adjustment to ensure that it is commensurate with the income attributable to the intangible. The temporary regulations contained two exceptions to this rule. The final regulations retain these exceptions with slight modifications to the 80-120 percent permissible bands of projected profits and add three additional exceptions.

(c) Ownership rules

The temporary regulations' "developer" rules are modified. They are now "ownership rules". The temporary regulations provided that, for purposes of Section 482, intangible property generally will be treated as owned by the controlled taxpayer that bore the greatest share of the costs of development. The preamble states that this rule was criticized by many commentators, principally because it disregarded legal ownership.

(d) Lump sum payments

The final regulations address lump sum payments. This issue was reserved in the temporary regulations. The regulations provide that lump sum payments are potentially subject to periodic adjustments to the same extent as licence agreements providing for periodic royalty payments. For purposes of determining if the lump sum payment satisfies the arm's length standard and if periodic adjustments may be made, the lump sum must be treated as an advance payment of a stream of royalties over the life of the agreement. This "equivalent royalty amount" requires a present value calculation based on the lump sum, an appropriate discount rate, and projected sales over the relevant period.

5. Treas. Reg. § 1.482-5: Comparable profits method

The final regulations provide that CPM is subject to the same considerations as any other method. The language providing that CPM "ordinarily will provide an accurate measure of an arm's length result" was deleted. The final regulations also contain a much more extensive discussion of comparability considerations under CPM than did the temporary regulations. While it may be permissible to apply CPM where there is (or may be) a material difference and where it is not possible to make a reliable adjustment for such difference, application of CPM in such a case is permissible only if the other methods are less reliable than CPM under the facts and circumstances.

Given adequate data, methods that determine an arm's length price (CUP) or gross margin (such as resale) generally achieve a higher degree of comparability than CPM. Because the degree of comparability, including the extent and reliability of adjustments, determines the relative reliability of the result under the best method rule, the results of these methods will be selected unless the data necessary to apply them is relatively incomplete or unreliable. In this regard, CPM generally will be considered a method of last resort.

The final regulation describes two types of profit level indicators: rate of return on capital employed and financial ratios.

The discussion of comparability is substantially more comprehensive than that contained in the temporary regulations. A number of comparability factors must be taken into account under CPM. Comparability under CPM is particularly dependent upon resources employed and risks assumed. Since resources and risks are directly related to functions, functional comparability, while somewhat less important than under the resale price or cost plus methods, also is an important consideration under CPM. Product similarity is not as important a consideration under CPM as it is under the cost plus or resale price methods.

6. Treas. Reg. § 1.482-6: Profit split method

The discussion of comparability factors under the comparable profit split method is more comprehensive than under the proposed regulations. This method is particularly dependent on the considerations described in the rules relating to CPM because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. These rules state that the greater the degree of comparability between the tested party and the uncontrolled party, the more reliable will be the results derived from the application of this method. Comparability is particularly dependent on resources employed and risks assumed. Comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

The residual profit split method in the final regulations is similar to the residual profit split method set forth in the proposed regulations. It involves a two-step process. First, using other methods such as CPM, market returns for routine functions are estimated and allocated to the parties that perform them. The remaining, residual amount then is allocated between the parties on the assumption that this residual amount is attributable to intangible property contributed to the activity by the controlled taxpayers. Based on this assumption, the residual income is divided based on an estimate of the relative value of the parties' contributions of such property. Since the fair market value of the intangible property usually is not readily ascertainable, the regulation permits the use of other measures of the relative values of intangible property, including capitalized intangible development expenses.

The regulations contain an extensive discussion of comparability and reliability considerations under this method. Since the second step ordinarily will not be based on a market benchmark, the reliability of this method will tend to be reduced for purposes of the best method rule as the amount of the residual profit allocated pursuant to the second step increases.

7. Cost sharing

The cost sharing rules were not finalized with these regulations. The temporary regulations, which incorporate the text of the 1968 regulations, continue to apply. The preamble states, however, that final regulations based on the 1992 proposed regulations are anticipated in the near future.

8. Treas. Reg. § 1.482-8: Important examples

Treas. Reg. § 1.482-8 provides a number of important examples illustrating the application of the best method rule under specific fact patterns.

B. Modification in transfer pricing penalty regulations

The IRS modified the temporary and proposed regulations under Section 6662(e) on 1 July 1994 to conform the temporary transfer pricing penalty regulations with the final Section 482 regulations. The regulations were amended to conform with the revised best method and arm's length range rules. New profit split information is required, and statements may have to be filed with the taxpayer's return.

Following the revisions, the specified method requirement to avoid the penalty is met if the taxpayer selects and applies a specified method in a reasonable manner. The taxpayer's selection and application of a specified method is reasonable only if, given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most *reliable* measure of an arm's length result under the principles of the best method rule. A taxpayer can reasonably conclude that a specified method provided the most reliable measure of an arm's length result *only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods* in a manner consistent with the principles of the best method rule. However, it is not necessary for a taxpayer to conclude that the selected specified method provides a more reliable measure of an arm's length result than any unspecified method.

Factors relevant to this determination are those previously set forth in the temporary regulation, with one addition. If the taxpayer determines an arm's length result by using more than one uncontrolled comparable, a new factor states that a consideration is whether the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived from the uncontrolled comparables. Such a result generally would not likely be closest to an arm's length result.

The required documentation is now divided into three categories, principal documents, background documents and *tax return documentation.*

The principal document rules now include the following statement: "For example, if a *profit split method* is applied, the documentation must include a schedule providing the total income, costs and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity." It also states: "For example, if a *profit split method* is applied, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits would be split."

In the case of the *tax return documentation*, if a *profit split method* is used, the taxpayer must attach a statement to a timely filed US return (with extensions) disclosing the kind of profit split method employed, the combined operating profit from the relevant business activity, and the split of that profit among the controlled participants in that activity. This statement must be entitled "Disclosure of Profit Split Methodology Required by Section 1.6662-6T".

In the case of *lump sum payments* for an intangible, the tax return documentation rules require that a statement be attached to a timely filed US income tax return (with extensions) for each taxable year throughout the useful life of the intangible. The statement must disclose the calculation of the arm's length consideration for the transfer and must be entitled "Disclosure of Lump Sum Payment Required by § 1.6662-6T".

If the taxpayer uses an *unspecified method*, the tax return documentation rules require that the taxpayer attach a statement to a timely filed US tax return (with extensions) disclosing the use of such method for the taxable year in which the method is applied. The statement must be entitled "Disclosure of Use of Unspecified Method Required by Section 1.6662-6T".

The regulations, as modified, are stated to apply to taxable years beginning after 31 December 1993. The final Section 482 regulations, however, apply to taxable years beginning 90 days after those regulations are published in the Federal Register. Presumably, the modified Section 6662(e) regulations should have the same effective date as the final Section 482 regulations.

C. IRS penalty committee

The IRS has established a Penalty Screening Committee that must approve an international examiner's recommendation to impose a penalty under Section 6662(e) before the penalty can be applied.[1] The IRS established the committee to address the concerns voiced by taxpayers that examiners might apply the penalties inconsistently or unfairly, stated

1. BNADTR 8 June 1994.

Joy DeGrosky, IRS National Administrator of the International Field Assistance Specialization Program (IFASP). She stated that an international examiner cannot close a case if it includes a Section 6662(e) penalty without approval of the committee. The committee consists of DeGrosky, four IFASP specialists and attorneys from the IRS Office of Associate Chief Counsel (International).

D. IRS Section 482 audit manual

Revised IRS audit guidelines for transfer pricing examinations were issued by the IRS on 14 June 1994. Much of the new material deals with the 1993 temporary regulations, and the manual undoubtedly will need to be further revised to be consistent with the recently finalized Section 482 regulations.

The new guidelines, which are contained in Chapter 500 "Audit Techniques – International Enforcement Program", contain a substantial discussion on obtaining documents. They discuss summonses, the transfer pricing penalty rules, Section 6038A, obtaining information from the US customs service, etc.

The guidelines state that the examiner should exercise care and good judgment when recommending Section 482 adjustments. A referral for economic assistance is mandatory if the issue has a potential deficiency of over $ 500,000 or will have significant precedential value. It states that the examiner needs to consider a number of items including worldwide profit splits. Volume price discount information also should be sought.

The functional analysis discussion is similar to the functional analysis discussion set forth in the IRS manual before this recent revision, although the analysis of risk is now set forth in a separate section. The functional analysis list now includes the following questions: What was done? What economically significant functions were involved in doing it? Who performed each function? How was the function accomplished? Are there any valuable intangibles used in performing the given function? Why were the transactions structured the way they were? Where and when did the transactions occur and which entities were involved?

Examiners are encouraged to conduct on-site visitations. Exhibit 500-5 contains a lengthy discussion of why an on-site visitation is appropriate, who should go and what to do in advance of and during the visit. Exhibit 500-6 contains a checklist of general audit procedures and techniques, including how to gain an understanding of the taxpayer's operations.

E. OECD discussion draft

The OECD published Part II of its draft report entitled, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration." The report is very important. Part II of the draft report discusses special considerations related to intangible property, intra-group services, cost contribution arrangements, penalties and documentation. It also addresses mutual agreement procedures and tax treaties, simultaneous examinations, safe harbours and advance pricing arrangements. I will summarize below some of the provisions in the draft report.

Chapter IV discusses intangible property. The report states that particular attention is appropriately given to intangible property transactions because the transactions are often difficult to evaluate for tax purposes. It also discusses specific difficulties that arise when the enterprises conducting marketing activities are not the legal owners of the marketing intangibles such as trade marks and trade names. Marketing intangibles include trade marks and trade names that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols or pictures that have an important promotional value for the product concerned. The differences between production and marketing intangibles are discussed in the report.

Arm's length pricing for intangible property must take into account the perspective of both the transferor of the property and the transferee. In some cases, the value of intangible property will be embedded in the transfer price of goods or services that incorporate or make use of the intangible property. The transfer of goods or services with an embedded intangible should not be considered a transfer of the intangible itself if the associated purchaser does not acquire any rights to exploit the intangible other than rights relating to the resale of the goods under normal commercial practices.

In applying the arm's length principle to controlled transactions involving intangible property, some special factors affecting comparability between the controlled and uncontrolled transactions should be considered. These factors include the expected profits from the intangible property; any limitations on the geographic area in which rights may be exercised; the exclusive or non-exclusive character of the rights transferred; the capital investment, start-up expenses and development work required in the market; the possibility of sublicensing; the licensee's distribution network; and whether the licensee has the right to participate in further developments of the property by the licensor.

In cases involving highly valuable intangible property, it may be difficult to find transactions between independent enterprises that are sufficiently close in their transactional features to the controlled transaction to achieve adequate comparability for the transaction-based methods. In such a case, it may be useful, as a last resort, to take into account evidence provided by profit methods. However, it may not be necessary to value the intangible property or find comparables for it where it is possible to determine under a transaction-based method the appropriate return to the licensee for the functions it is performing. This approach could be combined with a residual profit split method.

In discussing periodic adjustments, the report states that no such adjustment should be made if comparable independent enterprises would have agreed to comparable fixed amount or fixed rate arrangements with respect to the sale or licence of intangible property presenting a comparable level of uncertainty in valuation. A future adjustment would be appropriate only if the tax administration has no other recourse to determine an appropriate transfer price. Where intangible property has been transferred at a fixed sales price or a fixed royalty rate, tax administrators should make every effort to establish an arm's length amount that requires no future adjustments, using all information that is available. Thus, future adjustments should be limited to those exceptional cases in which associated enterprises have sold or licensed intangible property under fixed terms for multiple years where comparable independent enterprises would have insisted on bonus payments, a price adjustment clause, or would have been able to achieve a renegotiation of the contract.[2]

In considering marketing activities undertaken by enterprises not owning trade marks or trade names, the report states that in arm's length dealings, the ability of a party that is not the legal owner of a marketing intangible to obtain future benefits of promotional activities that increase the value of that intangible will depend on the substance of the economic rights of that party. For example, a distributor would have the ability to obtain the future benefits from investments in developing the value of a trade mark to the extent that it had a long-term contract of sole distribution rights for the trademarked product, although in some cases the nature of the risk may require a higher margin.

Chapter V discusses special consideration for intra-group services. Intra-group arrangements for rendering services are sometimes linked to arrangements for transferring goods or intangible property (or the licensing thereof). In some cases, such as with know-how contracts containing a service element, it may be very difficult to determine where the exact border lies between the transfer or licensing of property and the transfer of services. Ancillary services are frequently associated with the transfer of technology. It may therefore be necessary to consider the principles for the aggregation and segregation of transactions where a mixed transfer of services and property is involved.

There are two issues in the analysis of transfer pricing for intra-group services. One is whether intra-group services have in fact been provided. The other is what the intra-group charge for such services should be for tax purposes in accordance with the arm's length principle.

Determining whether intra-group services have been rendered depends on whether a comparable independent enterprise would have concluded that the activity would provide economic or commercial value to enhance its commercial position. This can be determined by considering whether the independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself.[3]

Some intra-group services are performed by one member of a multinational group to meet an identified need of one or more specific members of the group. In such a case, it is relatively straightforward to determine whether a service has been provided.

The report states that more difficult cases are presented where an associated enterprise undertakes activities that relate to more than one member of the group or to the group as a whole. Activities undertaken solely because of the parent's ownership interest in one or more other group members, i.e. in its capacity as a shareholder, would not justify a charge to the recipient companies. It may be referred to as a "shareholder activity," distinguishable from the broader term "stewardship activity." Stewardship activities cover a range of activities by a shareholder that may include the provision of services to other group members, for example, services that would be provided by a coordinating centre. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice, or in some case assistance in day-to-day management or internal audit as far as required for coordination purposes.

Activities that relate to the group as a whole are those centralized in the parent company or a group service centre and made available to the group. The activities that are centralized depend on the kind of business and on the organizational structure of the group, but in general they may include administrative services, such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal advice, factoring, computer services, etc. Expenses covering activities such as these ordinarily will be considered intragroup services because they are the type of activities that independent enterprises would have been willing to pay for or to perform for themselves.

Once it is determined that an intra-group service has been rendered, it is necessary to determine whether the amount of the charge, if any, is in accordance with the arm's length principle. In some cases, multinational groups may find that they have few alternatives but to use cost allocation and apportionment methods which often necessitate some degree of estimation and approximation. These methods of calculating charges would generally not be acceptable where specific services that form a main business activity of the enterprise are provided not only to associated enterprises but also to third parties. While every attempt should be made to charge fairly for the service provided, any charging has to be supported by an identifiable and reasonably foreseeable benefit. The allocation might be based on turnover, or staff employed, or some other basis.

In determining the arm's length price in relation to intragroup services, the matter should be considered both from the perspective of the service provider and also from the perspective of the recipient of the service. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances, as well as the costs to the service provider.

2. Contrast this with the recently adopted US Sec. 482 regulation's provisions on periodic adjustments.

3. Contrast this with the US Sec. 482 regulations, as discussed in LTR 8806002, where the 1979 and 1984 OECD reports were described as merely advisory in nature. See also, Fuller, "Section 482: Revisited Again," 45 *Tax Law Review* (1990) at 421.

Often, the application of these guidelines will lead to use of the CUP or cost plus method for pricing intra-group services. A CUP method is likely to be used where there is a high degree of comparability between the intra-group service being provided and a comparable service that is provided between independent enterprises in the recipient's market, or between the associated enterprise providing the service and an independent enterprise. The cost plus method might be used in the absence of CUP where information on the "plus" margin of comparable independent enterprises is available. Profit methods would not often be needed to establish the transfer price of intra-group services that do not belong to the core business of the associated enterprise performing the services.

The issue may arise whether it is necessary that the charge include an element of profit for the service provider. For example, it may be the case that the value of intra-group services to the recipient is not greater than the costs incurred by the service provider. This could occur where, for example, the service is not an ordinary or recurrent activity of the service provider but is offered incidentally as a convenience to the multinational group. A multinational group may provide the service intra-group rather than using a third party, so long as the costs incurred do not exceed what the third party would charge in comparable circumstances. To require a profit element in such a case could cause an associated enterprise to pay more for service than, for example, what the arm's length price would be under the CUP method.

Chapter VI discusses cost contribution arrangements. An arm's length allocation of cost is one that is reasonably expected to produce contributions appropriate for the economic enhancement (i.e. benefits) expected to be received and the burdens (e.g. risks) assumed by the participants as a result of the joint activity. There is no formula that could be universally applied as the circumstances may vary considerably. There is not always a reasonable connection between sales and benefits. Other possibilities include using capital invested, number of employees, production capacity, gross profits, value added or staff time spent as the basis of allocation. Whether any particular allocation method is appropriate depends on the nature of the activity and the relationship between the allocation factors and the benefit or expected benefit to the participants.

For the arrangement to be commercially realistic, the joint activities carried out have to be closely related to the needs and interests of each participant, so that each one could benefit from the activity from the point of view of its own operations.

Chapter VII deals with administrative approaches to avoiding and resolving transfer pricing disputes. In discussing penalties, the report states that because cross border transfer pricing issues implicate the tax base of two jurisdictions, an overly harsh penalty system in one jurisdiction may give taxpayers an incentive to overstate taxable income in that jurisdiction.[4] If this were to happen, the penalty system would have failed its primary objective to promote compliance and instead would lead to non-compliance of a different sort – non-compliance with the arm's length principle and underreporting in the other jurisdiction. The better approach is to consider the fairness of the penalty system by considering whether the penalties are proportionate to the offence.

When a "no fault" penalty is applicable, the balance can be somewhat more difficult to obtain, since the condition for imposing the penalty is low, i.e. the mere existence of an understatement of a certain amount. Given the inexactness and subjectivity of transfer pricing determinations, the imposition of a sizable penalty for accidental understatement may seem unduly harsh, unless there are means to moderate the penalty.

The report states that at least one country (i.e. the United States) has a procedure that may avoid the need for primary adjustments by allowing the taxpayer to report a transfer price for tax purposes that is an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment, sometimes known as a "compensating adjustment", would be made before the tax return is filed. However, the report notes that compensating adjustments are not recognized by most OECD member countries, on the grounds that the tax return should reflect the actual transactions. If compensating adjustments are permitted in the country of one associated enterprise but not permitted in the country of the other associated enterprise, double taxation may result.

In discussing treaties' mutual agreement procedures, the report states that while the taxpayer has the right to initiate the procedure, the taxpayer has no specific right to participate in the process. In practice, the report states that tax administrations of many OECD member countries routinely give taxpayers the opportunity to submit information, keep them informed of the progress of the discussions, and often ask them during the course of the discussions whether they can accept the settlements contemplated by the competent authorities. These practices, already standard procedure in most countries, should be adopted as widely as possible.

As a result of the increased use of simultaneous tax examinations among member countries, the report recommends the drafting of an "OECD Model Agreement for the Undertaking for Simultaneous Examinations" for those countries that are able and wish to engage in this type of cooperation.

In a discussion of safe harbours, the report states that while safe harbours could accomplish a number of objectives relating to the compliance and administration of transfer pricing provisions, they raise fundamental problems. These are discussed at some length.

At present, only a few OECD member countries have experience with APAs. Those countries which do have some experience seem to be satisfied so far, so that it can be expected that under appropriate circumstances the experience with APAs will continue to expand. The report concludes that it is too early to make a final recommendation whether the expansion of APA programmes should be encouraged. The report states that it seems likely that in certain circumstances they

4. This discussion appears directed at the US 40% transfer pricing penalty.

will aid in resolving transfer pricing disputes. The report states that wherever possible, the APA should be concluded on a bilateral or multilateral basis. Greater uniformity in APA practices could be beneficial to both tax administrations and taxpayers.

Advance pricing agreements involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedures of the relevant treaty, even though such agreements are not expressly mentioned there. Some countries lack the basis under domestic law to enter into APAs. However, when a tax convention contains a clause regarding mutual agreement procedures, the competent authorities generally should be allowed to conclude an APA.

Chapter VIII deals with documentation. A taxpayer ordinarily should give consideration as to whether its transfer pricing is appropriate for tax purposes before the pricing is established. For example, it would be reasonable for a taxpayer to have made a determination regarding whether comparable data from uncontrolled transactions is available. The taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. It would be expected that the application of these principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle, including the information on which the transfer pricing is based. However, there should be no contemporaneous obligation at the time the pricing is determined or the tax return is filed to produce these types of documents or prepare them for review by a tax administration.

Tax administrations should limit the amount of information that is requested at the stage of filing the tax return (contrast the US contemporaneous documentation requirements). At that time, no particular transaction has been identified for transfer pricing review. It would be quite burdensome if detailed documentation were required at this stage in all cross border transactions between associated enterprises, and to all enterprises engaging in such transactions. Therefore, it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer pricing determinations. The result could be to impede international trade and foreign investment. Any documentation requirement at the tax return filing stage should be limited to requiring the taxpayer to provide information sufficient to allow the tax administration to determine approximately which enterprises need further examination.

F. Section 482 control

W.L. Gore & Associates Inc. v. Commissioner[5] involves Gore, a US company, which owns a 30 percent interest in a Japanese company, Junkosha. Gore and Junkosha each own 50 percent of a Japanese company, Japan Gore-Tex Inc. ("JGT"). JGT licensed certain technology from Gore on a royalty-free basis. The agreement also provided that Gore and JGT would share any newly developed technology of the type covered by the licence agreement. The IRS made a Section 482 royalty allocation.

Gore filed a motion for summary judgment contending that Gore did not control JGT within the meaning of Section 482. The IRS successfully opposed Gore's motion, arguing that a trial would reveal additional facts that would support three bases for the IRS' determination that Gore controlled JGT, specifically: (1) Gore's ownership of half of JGT's stock and its ownership of 30 percent of Junkosha, (2) Gore's managerial control of the use of the technology in Japan by JGT through a web of interlocking arrangements between Gore, Junkosha and JGT and (3) the arbitrary shifting of income from Gore to JGT, resulting from the royalty-free transfer of the technology.

The court stated that the question of control, which was the focus of Gore's motion, involves a factually intensive inquiry. The "common objective" control in *B. Forman Co. v. Commissioner*[6] could be an issue on trial. Gore's 30 percent ownership of Junkosha could be relevant. The IRS's statement with respect to Gore's managerial control over JGT, augmented by specific factual allegations to support such an assertion, could show control. The court also stated it had difficulty understanding how the condition of arbitrary shifting of income can be satisfied short of evidence as to the details of the royalty-free arrangements, including a comparison of the nature and value of the exchanges of technology which were expected to take place among Gore, JGT and Junkosha.

The court stated that the facts that JGT does not have a presence in the United States and that Gore is asserting an absence of control over JGT have given rise to problems with respect to the ability of the IRS to obtain critical information through the discovery process. The court also stated that discovery has not been completed and that this is a factor which can be taken into account, especially when the non-moving party does not have the burden of proof and is the one seeking discovery.

Interestingly, the court closed its opinion with a comment about the "already voluminous record". The court stated the parties can be expected to exhibit "an overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement". The court stated that, given the vagaries of the trial and of its outcome which are reflected by the court's analysis in this opinion, "it would seem to the court that a determined effort to settle this case would be the better part of valor".

I would think the presence or absence of control is a black and white issue: it either exists or it does not exist. Presumably, the Judge was referring to the vagaries of a trial on the

5. T.C. Memo 1995-96.
6. 54 T.C. 912 (1970), *rev'd*, 453 F.2d 1144 (2d. Cir. 1972).

amounts involved if control sufficient for the application of Section 482 is present.

G. *Altama Delta Corp.*: Sections 936 and 482

Altama Delta Corp. v. Commissioner[7] involved a closely-held corporation ("ADC") which has a wholly-owned subsidiary Alta Delta Puerto Rico Corp. ("ADPR").

ADC manufactured military boots and sold them to the US Defense Department. ADPR manufactured the upper part of the boot in Puerto Rico and shipped the parts to ADC. ADC used the upper parts to complete the finished boot product in Georgia. Leather was shipped to ADC in Georgia where it was measured for quantity. The leather was then shipped to Puerto Rico, where ADPR's personnel inspected it, marked it for imperfections, cut it with moulds, and stamped the pieces with the contract and lot numbers. The pieces where then stitched and reinspected. The upper parts were finally packed and shipped back to ADC in Georgia, for the lasting and vulcanization processes and finishing. In 1985, there was a substantial change in the specifications from those of the old boot. An unrelated company, Ro-Search, designed, converted or manufactured all of the moulds for the new boot and charged the US company a technical assistance/mould leasing fee.

The IRS determined that ADPR had not filed a cost sharing method election with its federal income tax return (the years 1985, 1986 and 1987 were in issue). The IRS then made a Section 482 adjustment, allocating 86 percent of ADPR's profits to ADC. This produced a 92 percent-8 percent profit split, with ADPR having the 8 percent. The IRS concluded that a mark-up should be applied only to manufacturing costs, which did not include material costs.

First, the court concluded, based on the evidence, that ADPR's tax return has been timely filed with the IRS. The IRS had lost or destroyed the envelope in which the return was mailed. Since the return was timely filed, the court held that ADPR had properly made a cost sharing election under Section 936(h).

The taxpayer had not made cost sharing payments, however, contending that it did not have any product area research. The IRS contended that the royalties paid to Ro-Search for the use of the moulds constituted product area research within the meaning of the Section 936(h) rules. The court concluded the taxpayer had the right to use, through its licensing agreement with Ro-Search, an intangible, as defined under Section 936(h). Ro-Search had designed the moulds, which the taxpayer's affiliated group had the right to use.

The court also held that the taxpayer's failure to make a timely cost sharing payment for product area research did not revoke its cost sharing election because the failure was not due in whole or in part to fraud or wilful neglect. The taxpayer had consulted its accounting firm and reasonably relied on the accounting firm's advice that such payments were not required.

The amount of cost sharing payment will be based upon the court's determination of the appropriate transfer price of the upper parts. Under Treas. Reg. § 1.936-6(a)(2) Q&A-2, the sales price of the component for this purpose is determined based on CUP, a price determined under the appropriate Section 482 method, or the use of a production cost ratio.

That price needed to be determined. The taxpayer contended that the IRS's determinations in its notice of deficiency and as argued at trial were arbitrary and unreasonable since the IRS's adjustment allocated to ADPR only 8 percent of the joint profit. The taxpayer also contended that the burden of proof should shift to the IRS because the IRS's determinations in the notice of deficiency were based on a contract manufacturing theory, a theory that the IRS later abandoned. The IRS stated that it did not employ a contract manufacturing theory in the notice of deficiency. While the court held the burden of proof would not shift, it also held that the IRS's determination was arbitrary and unreasonable.

The taxpayer's expert witness, Larry Dildine, testified that the appropriate method for analyzing the related party transactions was the cost plus method. He performed a functional analysis, identified comparables in the military footwear industry, checked the reasonableness of his results with the published mark-ups of other possessions corporations and compared ADPR's transactions with ADC's transactions under what he referred to as "the profit split method".

Thomas Horst, the IRS's expert witness, testified that computations which he made supported the IRS determination. His computations used operating margins instead of gross mark-ups to apply to ADPR's costs to determine the appropriate transfer price. He also based his computations on the assumption that the cutting and stitching operations performed by ADPR were operations that could have been performed by any footwear manufacturer. Thus, he did not limit his comparables to the military footwear industry.

The court agreed with the taxpayer that the IRS expert did not apply the cost-plus method described in the regulations. The court rejected as unreasonable the IRS method for determining the appropriate transfer prices. The IRS expert's comparison of ADPR to manufacturers outside the combat boot industry, the court stated, was without merit. The court felt that it should look to the combat boot industry and not the footwear industry as a whole to find close comparables for ADPR.

The court stated that the taxpayer's expert's comparables were not strictly comparable to ADPR since they incurred expenses that ADPR did not incur. They also performed all of the manufacturing operations necessary to make a combat boot, while ADPR manufactured only the leather upper portion of the boot. However, the court felt that use of those comparable's gross profit margins was reasonable for comparison purposes.

The court made its "best estimate" of the appropriate transfer price on the basis of all of the facts available. While ADPR

7. 104 T.C. No. 22 (1995).

did incur risks with respect to its production of the leather upper parts, ADC virtually guaranteed the purchase of ADPR's product. ADPR, however, was responsible for utilizing the leather in an efficient manner. ADPR's manufacturing process could have been performed by any number of leather and footwear manufacturers. ADC, on the other hand, maintained the government contracts and established the agreement with Ro-Search for the leasing of the sole moulds.

Based on the evidence in the record, the court concluded that ADPR should earn a gross profit margin in each of its fiscal years 1985, 1986, and 1987 in an amount equal to the average gross profit margin of ADC for its fiscal years 1986 and 1987, approximately 19.2 percent. (It had earned a three year average gross margin of 22.9 percent). The court stated that this would take into account the lower risks involved for the subsidiary, as well as the fact that the parent procured the government contracts. In isolation, this appears to have produced an adjustment of only 16 percent of ADPR's income.

Two issues remained to be decided. The taxpayer had claimed an amount for location savings. The IRS conceded that some amount of location savings for ADPR was appropriate if the court found that ADPR made a proper cost sharing election. Where location savings exist, the full benefit of those savings is allocated to the possessions corporation and added to the profit that the possessions corporation is permitted to earn under Section 482. The court cited *Sundstrand Corp. v. Commissioner* in this regard.[8]

The IRS conceded that labour rate savings, job training credit, and a land and building rental differential were properly includable in location savings. The IRS disagreed that employee benefit savings, freight costs and state and local taxes should be included in determining location savings. The taxpayer relied on its accountant's computations, without further evidence. The court concluded that the taxpayer failed to prove its claimed location savings and, accordingly, determined the location savings adjustment to be the amounts for each year as conceded by the IRS. While the amounts conceded by the IRS are not set forth in the court's opinion, it would appear that these location savings amounts are approximately equal to the amount of the pricing adjustment.

The final issue was whether interest income should be allocated to ADC from ADPR under Section 482 because the pricing adjustment left "additional" cash in Puerto Rico. Normally, this would be treated as a contribution to capital. Here, however, the IRS argued that the funds transferred as sales proceeds in excess of the arm's length price were in effect a loan to ADPR. Curiously, the taxpayer made no claim that the transfer of excess sales price to ADPR should be characterized as a contribution to capital. Thus, the IRS's interest adjustment was upheld.

The taxpayer appears to have fared quite well following the court's decision. It is unclear from the opinion, however, how much of the Ro-Search payments would have to be charged to ADPR. The amount of the location savings adjustment also is not stated in the court's opinion.

H. *Green Leaf Ventures Inc.*: Section 482 cannot be utilized by the taxpayer

Green Leaf Ventures Inc. v. Commissioner[9] involved a purported loan made by a US parent company to its US subsidiary. The court found that the loan was an equity contribution, not debt. The taxpayer, however, made an alternative argument based on Treas. Reg. § 1.482-2A(b) in an effort to have the subsidiary bear certain claimed interest expense.

The taxpayer argued that under the Section 482 service rules, where one member of a group of controlled entities performs services for the benefit of, or on behalf of, another member of the group without charge, the IRS may make appropriate allocations to reflect an arm's length charge for such services. The taxpayer cited Treas. Reg. § 1.482-2A(b)(6) which states that where an arm's length charge for services has been determined with reference to cost or deductions and a member has allocated such cost or deductions to reflect arm's length charges by employing a consistent method of allocation that is reasonable and in keeping with sound accounting practices, such method will not be disturbed. The taxpayer seemed to be arguing that it had made its own allocation of interest expense to the subsidiary.

The court held, however, that the taxpayer could not invoke the safe harbour provisions of Treas. Reg. § 1.482-2A(b)(6). Treas. Reg. § 1.482-1A(b)(3) states that Section 482 does not grant any rights to a controlled taxpayer to apply its provisions or to compel the IRS to apply those provisions. Thus, a taxpayer may not affirmatively use Section 482.

II. SUBPART F

A. Manufacturing

Bausch & Lomb and the IRS currently are litigating the issue whether Bausch & Lomb's CFC's are engaged in manufacturing for purposes of Subpart F. The case was tried in December 1993.

B. Intangibles elections

The IRS issued temporary and proposed regulations under Sections 197 and 167(f) which provide guidance on how to make the election to apply the intangibles provisions of the 1993 Tax Act to property acquired after 25 July 1991 and on or before 10 August 1993. Once made, the election applies to all property acquired during that period by the taxpayer or a taxpayer under common control with the electing taxpayer. The elections generally must be made on the taxpayer's timely filed (including extensions) income tax return for the tax year that includes 10 August 1993. Taxpayers making the retroactive election must conform all affected prior years'

8. 96 T.C. 226 (1991). Interestingly, Sundstrand did not involve a possessions corporation.
9. T.C. Memo 1995-155.

returns to reflect the application of the intangibles provisions of the 1993 Tax Act.

The rules do not contain provisions specifically applicable to international transactions or to controlled foreign corporations. As noted, if a taxpayer makes a retroactive election, the election applies to each taxpayer that is under common control with the electing taxpayer. The taxpayer is under common control with the electing taxpayer if the two taxpayers would be treated as a single taxpayer under the R&D credit rules. The regulations under those rules look to more than 50 percent of vote or value. They also do not distinguish between US and foreign corporations. Thus, an election made by the US group apparently will apply to foreign subsidiaries where the US group owns more than 50 percent of vote or value of the foreign company. It appears that a special election does not have to be made for controlled foreign subsidiaries.

If the taxpayer makes a retroactive election or another person's retroactive election applies to the taxpayer or to any property acquired by the taxpayer, the taxpayer must amend all previously filed income tax returns as necessary to conform the taxpayer's treatment of transition property to the treatment required under the intangibles provisions of the 1993 Tax Act. While this rule seems clear in the context of a domestic taxpayer, presumably it refers to amending Forms 5471 and/or any Subpart F computations in the context of a foreign subsidiary.

In Notice 94-90, 1994-39 I.R.B. 1, the IRS published modifications that will be incorporated in final regulations under Section 197 relating to the retroactive election to apply the intangible amortization provisions to property that was acquired after 25 July 1991, and on or before 10 August 1993.

A number of questions, however, have arisen in an international context. Notice 94-90 states that the Section 197 retroactive election applies to a foreign corporation under common control with an electing US person, and that the election does not subject the US shareholders of the CFC to the requirements of Treas. Reg. § 1.964-1(c)(3). If necessary (presumably where a CFC is not under common control with the US group), a retroactive may be made on behalf of a CFC pursuant to the election rules under Treas. Reg. § 1.964-1(c)(3). For a retroactive election made pursuant to these rules, the written statement required under Treas. Reg. § 1.964-1(c)(3) must include the information required under the Section 197 regulations. The written statement will be considered timely and treated as a timely filed election pursuant to Section 197 if it is filed on or before 31 December 1994.

C. Earnings and profits (E&P)

Tax Executives Institute followed up on its comments expressing support for proposed regulations using GAAP for inventory and depreciation, but stating that these rules need to be expanded to the computation of Subpart F income.[10] TEI also suggests that all GAAP rules be used, not just those for depreciation and inventories. The regulations were proposed in 1992.

D. Section 956

Tax Executives Institute submitted comments to Treasury addressing the need to clarify that the 1993 statutory amendments to Section 956 did not affect the principles set forth in Notice 88-108, which delineates an exception from the definition of US property for certain short-term loan obligations. The legislative history makes clear that this notice survived the statutory changes to Section 956. It would be good if the IRS were to publish something to that effect.

E. Regulations affecting Form 5471

The IRS adopted final regulations proposed to clarify and simplify some of the rules relating to Form 5471. The regulations were proposed in 1992. A public hearing was not requested and, therefore, a public hearing was not held. The IRS stated that most of the responses to the proposed modification were favourable.

Treas. Reg. § 1.6038-2(h) provides that financial statement and related information required on Form 5471 must be expressed in US dollars with a statement of the exchange rates used. For taxable years ending after 31 December 1994, with respect to returns filed after 31 December 1995, all amounts furnished under the financial statement requirement shall be expressed in US dollars computed and translated in conformity with US generally accepted accounting principles. The corporation's profit and loss statement for the annual accounting period must also be furnished in the foreign corporation's functional currency.

Earnings and profits amounts are to be expressed in the foreign corporation's functional currency except to the extent the form requires specific items to be translated into US dollars. Tax amounts are to be furnished in the foreign currency in which the taxes are payable and in US dollars translated in accordance with Section 986(a). All amounts furnished with respect to specified types of transactions (sales and purchases, compensation paid, etc.) are to be expressed in US dollars translated from functional currency at the weighted average exchange rate for the year as defined in Treas. Reg. § 1.989(b)-1. Certain corresponding changes were made to the Section 6046 regulations.

F. Subpart F: rental income

LTR 9511048 describes a US parent company that owns a number of CFCs which are engaged in leasing fleets of automobiles to major corporations and other commercial lessees. The taxpayer represented that the CFCs currently maintain a significant marketing, remarketing and servicing organiza-

10. *TNT* 6 March 1995.

tion and that they meet the criteria of the active rents exception set forth in the Section 954 regulations.

Currently the leases are treated as operating leases under US GAAP. To have the leases recharacterized as financing leases for US GAAP purposes, the CFCs purpose to purchase "residual value insurance", under which the CFCs would transfer part of the risk related to the fair market value of their automobiles once the automobiles are returned to the CFCs for remarketing or resale. Thus, the residual risk on the CFCs' leased automobiles would be mitigated.

The taxpayer sought a ruling that this change of the characterization of the leases from operating leases to financing leases as a result of the purchase of residual value insurance will not affect the applicability of the active rents exception. The IRS ruled that, provided the CFCs' leases are leases for federal income tax purposes and that the CFCs meet the active rent exception, the characterization of the CFCs' rental income from leasing automobiles as "active rents" will not be affected merely because of the purchase of residual value insurance.

III. FSC/DISC

A. *Archer-Daniels-Midland Company*: DISC "no loss" rule upheld

Archer-Daniels-Midland Company v. United States[11] upheld the DISC regulation's "no loss" rule, reversing the district court which had held the no loss rule regulation invalid.

The no loss rule limitation of Treas. Reg. § 1.994-1(e)(1)(i) precludes use of the 4 percent of gross receipts method if application of that method would result in a loss to the related supplier. ADM filed claims for refund for the years 1975-1978 contending that the no loss rule is contrary to the 4 percent of gross receipts method in Section 994(a)(1) and is therefore invalid. The district court held in favour of ADM, holding that the statute was clear and did not contain a no loss rule.

The Seventh Circuit stated that the congressional committee reports described the 4 percent of gross receipts method as a way of calculating a ceiling on allowable income. Legislative history continues to be relied upon heavily by the courts, stated the Seventh Circuit. The court stated that in cases of statutory language as technical and arcane as that of the DISC provisions, the argument that Congress votes on the bill and not on the committee report "strikes us as pretty empty". Even advised by his personal staff a member of Congress would have great difficulty figuring out the purport of Section 994(a)(1) without the aid of committee reports.

Interestingly, a dissenting judge would have affirmed the District Court. The dissent felt that the Secretary of the Treasury does not have the authority to modify a congressional statute by executive amendment. The dissent stated that if the law is clear and unambiguous, the law should be followed.

B. *Borland International Inc.*

Borland International Inc. v. Commissioner[12] challenges the IRS determination that FSC commissions attributable to reproduction royalties for computer software and related instruction books do not qualify as foreign trading gross receipts. This issue was the subject of LTR 9344002, a technical advice memorandum, which was discussed above.

C. *St. Jude Medical Inc.*

Tax court reversed and affirmed *St. Jude Medical Inc. v. Commissioner.*[13] The Tax Court held in 1991 that, in computing DISC combined taxable income, St. Jude improperly allocated R&D expenditures related to (1) its attempt to develop an insulin pump and cardiac pacemaker and (2) its successful heart valve sales. St. Jude's only exports were sales of heart valves. The insulin pump and cardiac pacemaker R&D efforts were abandoned, never resulting in a product or in any sales receipts.

The Eighth Circuit reversed the Tax Court's holding with respect to the unsuccessful insulin pump and pacemaker R&D expenditures, holding that these R&D expenditures should not be allocated to DISC CTI. The Eight Circuit affirmed the Tax Court's determination that St. Jude must allocate heart valve-related R&D expenditures to DISC CTI. In this regard, the Eight Circuit affirmed the Tax Court's holding that the ERTA (1981) R&D moratorium did not apply for DISC CTI purposes.

Treas. Reg. § 1.861-8(e)(3), which the court held was invalid as applied to DISC CTI computations, requires that standard industrial classification (SIC) codes be used and that gross income derived from successful R&D must bear the costs of unsuccessful R&D in that SIC code. As a result, the regulation deems a definite relationship between an expenditure for R&D and all income reasonably connected with that specific broad product category.

The parties stipulated that cardiac pacemakers, insulin pumps, and artificial heart valves were separate products or product lines under recognized industry or trade usage. Under Treas. Reg. § 1.994-1, a taxpayer-made transaction grouping should control and costs should be allocated and apportioned accordingly. Groupings under that regulation may be based on recognized industry or trade usage. Treas. Reg. § 1.861-8(e)(3), however, requires the allocation of R&D expenditures against broad SIC categories wider in scope than industry-accepted product lines. Thus, the court stated that it was left with a conflict between two Treasury regulations, one of which allows the taxpayer's choice regarding the manner of grouping transactions and the other mandating a specific method of grouping.

11. ____ F.3d ____ (7th Cir. 1994).
12. T.C. Dkt. No. 1605-94,.
13. ____ F.2d ____ (8th Cir. 1994), reversed in part, affirmed in part and remanded the St. Jude case to the Tax Court for further proceedings.

The court stated that mandating the use of SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines. Moreover, stated the court, the deemed relationship mandated by Treas. Reg. § 1.861-8(e)(3) is inconsistent with Congress's intent to "generally allocate to each item of gross income all expenses directly related thereto". The court also stated that requiring gross income derived from successful R&D to bear the costs of unsuccessful R&D is inconsistent with Congress's stated intent to "deduct from the DISC's gross receipts . . . [the] costs of goods sold with respect to the property, the selling, overhead and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property".

The remaining question was whether heart valve R&D should be allocated to DISC CTI, given the ERTA moratorium. The ERTA moratorium required that all R&D expenditures for activities conducted in the United States be allocated to sources within the United States. This applied for "all purposes under the Code". The court stated that DISC foreign export receipts need not be categorized as foreign-source income. It held, therefore, that the CTI computation does not require a taxpayer to allocate R&D expenditures to geographic sources. Thus, the moratorium was inapplicable.

The court recognized that by affecting DISC income, CTI had a significant secondary impact on the foreign tax credit. CTI computations affected the amount of the deemed dividend eventually subject to taxation. This dividend constituted foreign-source income. Thus, St. Jude need not apportion any of its R&D expenditures to the dividend that it was deemed to receive from its DISC (but that has already happened: by reducing CTI, the DISC dividend *is* reduced.)

In contrast, stated the court, DISC foreign export receipts need not be foreign source. The court stated that attempting to categorize CTI as foreign source or domestic source could create potentially disparate results for commission and buy-sell DISCs. The court also stated the moratorium's legislative history indicates that the moratorium was intended to halt the deleterious effects Treas. Reg. § 1.861-8 had on the foreign tax credit and on domestic R&D incentives. In terms of ERTA's double taxation concerns, the court stated that CTI is irrelevant.

I disagree with the latter point. Since reducing CTI reduces the DISC dividend, how can CTI be *irrelevant* in terms of ERTA's double taxation concerns? Moreover, it has been stated to me that the ERTA Conference Committee report's statement that the moratorium applies for "all purposes under the Code" was written with DISC calculations specifically in mind. Senator Glenn's floor statements, cited by the court, also seem directly on point.

The ERTA moratorium issue, in any event, also is pending in the *Intel* appeal to the Ninth Circuit.

IV. FOREIGN TAX CREDITS

A. Section 902 Regulations proposed

The IRS proposed Section 902 regulations on 5 January 1995. The regulations generally incorporate the rules of Notice 87-54, 1987-2 C.B. 363. Issues addressed in Notices 88-70, 1988-2 C.B. 369, and 88-71, 1988-2 C.B. 374, were left for future regulations under Section 960.

In addressing the basic Section 902 qualification rules, the IRS raised an issue in the preamble concerning corporate investors in partnerships to whom Section 902 deemed paid credits will flow when the partnership receives a distribution from a foreign corporation. Rev. Rul. 71-141, 1971-1 C.B. 211, allows two 50 percent domestic corporate general partners of a domestic general partnership to claim a Section 902 credit for foreign taxes paid by a foreign corporation in which the partnership owns 40 percent of the voting stock. The IRS asked whether the holding of Rev. Rul. 71-141 should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, beneficiaries of domestic and foreign trusts and estates, or interest holders in other pass through entities.

The regulations propose to reverse *Vulcan Materials v. Commissioner*[14] for distributions in taxable years beginning after 31 December 1986 out of pre-1987 accumulated profits. The regulations also are intended to make clear that the decision in *Vulcan* is not applicable to distributions out of post-1986 undistributed earnings. The preamble states that the 1986 Act changed Section 902(a) to eliminate the language relied on in *Vulcan* to link taxes to be credited to the particular profits on which they were paid.

Prop. Treas. Reg. § 1.902-1(a)(13) illustrates the special effective date rule of Section 902(c)(3). This rule applies when the first day on which the ownership requirements of Section 902(c)(3) are met with respect to a foreign corporation is in a taxable year of the foreign corporation beginning after 31 December 1986. In such a case, the post-1986 undistributed earnings pool and post-1986 foreign income taxes of the foreign corporation are determined taking into account only the taxable years beginning on and after the first day of the first taxable year of the foreign corporation in which the ownership requirements are met.

Prop. Treas. Reg. § 1.902-1(b)(4) provides that if a foreign corporation makes a distribution out of current earnings and profits that is treated as a dividend under Section 316(a)(2) in a taxable year in which the corporation has a deficit in its post-1986 undistributed earnings pool, then no foreign income taxes shall be deemed paid with respect to the dividend. It would appear that this rule precludes taking the position that the dividend, while paid out of post-1986 Section 316 earnings and profits, can be viewed as "dipping back" into pre-1986 accumulated profits, if any. The example

14. 96 T.C. 410 (1991), *aff'd. per curiam*, 959 F.2d 973 (11th Cir. 1992.

in the proposed regulation illustrates the rule with a corporation that has no pre-1987 accumulated profits. The rule, as proposed, also refers to a corporation that "has zero or a deficit in post-1986 undistributed earnings and *the sum of current plus accumulated earnings and profits is zero or less than zero*". The meaning of the italicized language is unclear.

Prop. Treas. Reg. § 1.902-1(c)(8) is entitled "Credit for Foreign Taxes Deemed Paid in a Section 304 Transaction". Interestingly, this section is reserved. This undoubtedly involves issues under Rev. Rul. 91-5, 1991-1 C.B. 114, which addressed cross chain distributions under Section 304. The revenue ruling held that Section 902 applied, but public statements by IRS spokespersons have indicated that the IRS is rethinking issues in this ruling.

The rule of Rev. Rul. 92-74, 1992-2 C.B. 156, which deals with the effect of a Section 482 adjustment on post-1986 foreign income taxes and post-1986 undistributed earnings is contained in Prop. Treas. Reg. § 1.902-1(c)(9). The regulation refers the reader to Section 905(c) and the regulations under that section. Thus, a Section 482 adjustment, where a foreign tax refund is not obtained, could affect only the CFC's post-1986 undistributed earnings and post-1986 foreign income tax pools. There might not be a loss of previously-claimed foreign tax credits. On the other hand, the failure to obtain a foreign tax refund could have an affect on the US taxpayer's previously-claimed foreign tax credits depending upon how the rules of Section 905(c) apply to the facts.

Dividend distributions are treated as made on a *pro rata* basis out of a CFC's earnings and profits in each Section 904(d) separate category.[15]

Prop. Treas. Reg. § 1.902-1(d)(3) provides that any dividend distributed by a CFC out of earnings and accumulated before the CFC became a CFC is treated as a dividend from a noncontrolled Section 902 corporation regardless of whether the earnings were accumulated in a taxable year beginning before 1 January 1987 or after 31 December 1986. This is consistent with statements in the preamble to the final Section 904(d) regulations, but it does not seem appropriate to treat distributions out of pre-TRA E&P as non-controlled Section 902 corporation earnings.

Special rules pursuant to the grant of regulatory authority in Section 904(d)(2)(E)(i) and consistent with Prop. Treas. Reg. § 1.904-4(g)(3), generally limit the application of Section 904(d)(2)(E)(i) (restricting look-through treatment on dividends out of pre-acquisition earnings of a CFC) to US shareholders that acquire more than 90 percent voting stock ownership in an existing CFC. A US shareholder that acquires stock resulting in ownership of 90 percent or less of an existing CFC is entitled to look-through treatment. In the case of the acquisition of more than 90 percent of the voting stock of an existing CFC, the acquiring US shareholder must begin a new set of post-1986 undistributed earnings and post-1986 foreign income tax pools on the first day of the first taxable year in which it owns more than 90 percent of the voting stock. If, however, the dividend recipient is a member of an affiliated group within the meaning of Section 1504(a), without regard to Section 1504(b)(3), and it acquired its interest in the CFC from a member or members of the affiliated group, and the previous owner or owners were entitled to look-through treatment on distributions from the CFC, then the dividend recipient also shall be entitled to look-through treatment on distributions out of pre-acquisition earnings and profits.

Prop. Treas. Reg. § 1.902-2(a) deals with the carry back of deficits in post-1986 undistributed earnings to pre-effective date taxable years. This incorporates the rules set forth in Notice 87-54. Where there is a deficit in post-1986 undistributed earnings of a foreign corporation and the corporation makes a distribution to its shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit is carried back to the most recent pre-effective date taxable year of the corporation. The deficit then reduces the Section 902 accumulated profits in the most recent pre-effective date tax years of the corporation.

Prop. Treas. Reg. § 1.902-2(b) deals with the carry-forward of deficits in pre-1987 accumulated profits of a foreign corporation to post-1986 undistributed earnings for purposes of Section 902. The amount of a deficit in accumulated profits *determined under Section 902* of the foreign corporation as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after 31 December 1986, or on the first day of the first taxable year in which the ownership requirements of Section 902(c)(3)(B) are met if the special effective date rule of Prop. Treas. Reg. § 1.902-1(a)(13) applies. Foreign income taxes are not carried forward. Post-1986 undistributed earnings are not reduced by the amount of a pre-1987 deficit in earnings and profits computed under Section 964, only a deficit computed under the rules of Section 902.

B. Xerox reversed

Xerox Corporation v. United States[16] upheld Xerox under the US–UK treaty with respect to creditability of ACT. The court rejected Rev. Proc. 80-18, 1980-1 C.B. 623, in a decision which is important to all US corporations with UK subsidiaries. Xerox's US subsidiary remitted a dividend to Xerox in 1974. It paid ACT. It surrendered its excess ACT to its UK subsidiaries in 1980 so that they could use the ACT to offset their mainstream tax. Xerox claimed a foreign tax credit for the amount of the ACT paid in 1974 to the extent of the one-half not refunded under the treaty. The government argued that Xerox could not claim a foreign tax credit for the ACT paid in 1974 because the excess ACT was surrendered to the UK company's UK subsidiaries. The government's argument was based on Rev. Proc. 80-18.

The court held that under the plain language of the treaty, Article 23(1)(c), the ACT paid in 1974 is treated as an income tax imposed on the UK corporation paying the divi-

15. See Prop. Treas. Reg. § 1.904-5(d)(1).
16. ___ F.2d ___ (Fed. Cir. 1994).

dend. Therefore, Xerox can claim a foreign tax credit for the amount of the ACT paid to the extent of the one-half not refunded under the treaty.

The court stated that the terms of a treaty are given their ordinary meaning and that unless the treaty terms are unclear on their face, it should rarely be necessary to rely on extrinsic evidence in order to construe a treaty. It is rarely possible to reconstruct all of the considerations and compromises that led the signatories to the final document. The court stated that nonetheless extrinsic material is often helpful. The ultimate question remains what was intended when the language actually employed was chosen.

The court stated that virtually all of the extrinsic evidence, affidavits by US and UK individuals involved in the US–UK treaty process, supported the plain language of the treaty. Article 23(1)(c) provides a tax credit to the US shareholder for ACT paid by the UK corporation by treating the ACT as an income tax imposed on the UK corporation paying the dividend. The treaty does not permit the United States to reverse that credit unless or until the ACT is offset against mainstream tax in the United Kingdom. The treaty does not mention any such condition.

Insofar as the treaty's technical explanation is concerned, the court stated that a treaty must be construed in accordance with the intent of both signatories. Two UK Ministers for the Treasury stated that they did not accept, or even know of, the position taken by the United States in the technical explanation.

The court also stated that Rev. Proc. 80-18 strains the plain meaning of the treaty. It also would defeat the treaty purpose of avoiding double taxation. The "new theory" offered in Rev. Proc. 80-18 provided that a foreign tax credit may not be claimed for the payment of ACT when the dividend-paying corporation surrenders its excess ACT to lower-tier UK subsidiaries. The court stated that Rev. Proc. 80-18, insofar as it would reverse Xerox's entitlement to the Article 23 credit for the ACT, is declared void.

The court stated that a treaty, when ratified, supersedes prior domestic law to the contrary and is equivalent to an act of Congress. Tacit abrogation of prior law will not be presumed, however, and unless it is impossible to do so, treaty and statutory law must stand together in harmony. In this case, stated the court, there is easy harmony between the treaty and the US law governing foreign tax credits, Sections 901 and 906.

The ACT in issue was for dividends that were paid to Xerox in 1974. The ACT on those dividends was paid by the UK subsidiary in that year and was not refundable or reversible. The second-tier UK subsidiaries did not pay, and had no obligation to pay, the ACT on those dividends. The ACT obligation by the dividend-paying UK subsidiary was completed in 1974 and was not defeasible by whether, when or how the subsidiary used its offset rights under UK law, including whether and when the offset was surrendered to other subsidiaries. In accordance with Sections 901 and 902, Xerox was entitled to the credit when the dividends were distributed to Xerox and the ACT thereon was paid or accrued by the UK subsidiary.

The court also stated that the lower court erred in its reliance on Section 905(c) as substantive basis for the withdrawal of the credit upon the 1980 surrender of the excess ACT. Section 905(c) permits redetermination of the foreign tax credit when any foreign tax is refunded or adjusted. However, the ACT paid in 1974 was not refunded or adjusted in 1980. The tax obligation in the United Kingdom was fixed and paid in 1974 when the dividends were paid to Xerox. The ACT is a separate tax, and is not properly viewed as a prepayment or interim credit or estimated tax of mainstream corporate tax. The ACT does not become provisional by virtue of the offset procedures available under UK law.

The court's decision appears to affect more than Rev. Proc. 80-18's provisions dealing with the surrender of excess ACT. It presumably covers the situation set forth in the treaty's technical explanation where excess ACT is utilized to offset previously paid mainstream tax or subsequent mainstream tax that otherwise would be due. The technical explanation requires a Section 905(c) adjustment. The court's decision, while not addressing this situation, would appear to reject that provision in the treaty's technical explanation as well.

C. *Phillips Petroleum*: Creditability of foreign tax

Phillips Petroleum, Co. v. Commissioner[17] held that Norwegian municipal and national taxes are creditable as income taxes and that a Norwegian special tax is creditable as an excess profits tax under Section 901. The then temporary Section 901 regulations were in issue, as Phillips did not elect to apply the final Section 901 regulations. The years involved were 1979-1982.

The court stated that a foreign charge must satisfy three tests to qualify as a creditable income tax. A foreign charge: (1) must not be compensation for a specific economic benefit, (2) must be based on realized net income and (3) must follow reasonable rules regarding source of income, residence, or other bases for taxing jurisdiction. The parties agreed that (3) was not in issue.

The court found that the municipal and national charges were not compensation for a specific economic benefit. These taxes were modified by the Petroleum Tax Act ("PTA") but those changes did not significantly increase Phillips' liability regarding those charges. They merely added industry-specific tax rules in order to advance Norway's tax policies with regard to the petroleum industry.

The Norwegian special charge was imposed only on petroleum producers and pipeline transporters. The court found the special charges were taxes in the US sense and not a royalty or compensation paid for the right to exploit Norway's petroleum reserves. The court stated its focus was to distinguish between a royalty interest retained by a government as the owner of natural resources, and a tax imposed on the net profits generated predominately from the same government-owned resources. The same fees and royalties that compensated Norway for its petroleum resources before

17. 104 T.C. No. 12 (1995),.

enactment of the PTA continued to be collected thereafter. The special charge was not inextricably interwoven with the grant to exploit Norwegian petroleum resources. Norway intended to impose a tax, did in fact impose a tax, structured the change as a tax, and administered it accordingly. The court stated "if it quacks like a duck and waddles like a duck, it is a duck, unless of course, we determine that it is a decoy, which we do not find".

The court then addressed the realization, net income and gross receipts tests. Norway had a "norm price system" to produce gross receipt prices that approximated fair market value. The court found that norm price procedures were conducted in good faith by the Norwegian Price Board and the resulting norm price determinations resulted in serious evidence of fair market value. Thus, the court found that gross receipts as determined pursuant to the Norwegian norm price procedures during the years in issue, in fact, produced an amount that approximated fair market value.

The court also held that the three Norwegian taxes reached net income in the US sense. Each was computed, without substantial deviation, by reducing the taxpayer's gross receipts with the expenses and capital expenditures attributable thereto, including costs directly related to the exploration for and the exploitation of petroleum resources on the Norwegian Continental Shelf.

The court stated that the IRS's opposition to the special tax may emanate from Norway's imposition of an additional layer of taxation specifically targeted at a particular industry. The court stated that it previously had sanctioned additionally layers of tax that are not generally imposed. In 1917, during World War I, the US itself enacted an excess profits tax, principally to meet the extraordinary large appropriations needed for military and naval establishments and fortifications. A similar tax was enacted during World War II.

V. SOURCE AND EXPENSE ALLOCATION ISSUES

A. Section 863(b): *Intel* and *Phillips*: on appeal

The decisions of the Tax Court in *Intel Corporation v. Commissioner*[18] and *Phillips Petroleum Co. v. Commissioner*[19] are on Appeal.

They involve, of course, Section 863(b) and "independent factory price" issues. See also the "legislation" discussion, below, and note the IRS/Treasury 1995 Business Plan in this regard

B. *Perkin-Elmer*: Treas. Reg. § 1.861-8(e)(3) re R&D upheld

Perkin-Elmer Corp. v. Commissioner[20] upheld the application of Treas. Reg. § 1.861-8(e)(3) requiring the use of SIC categories and look-through sales in allocating and apportioning R&D expenses for purposes of foreign tax credit limitation computations. The taxpayer had challenged the regulation arguing it was invalid because the sales method fails to take into account the R&D expenses of foreign subsidiaries and thus results in an over-allocation of such expenses to foreign-source income.

Perkin-Elmer owned subsidiaries in the United Kingdom and Germany that engaged in basic, strategic, tactical and sustaining R&D activities relevant to the applicable product categories. Treas. Reg. § 1.861-8(e)(3) caused an allocation of the US parent company's R&D expenses to foreign-source income by taking into account sales of the German and UK subsidiaries. The regulation does not take into account the fact that the foreign subsidiaries are also performing R&D activities of their own.

The court traced the history of Treas. Reg. § 1.861-8(e)(3) and discussed the subsequent moratoriums on the application of that regulation. The court stated that *St. Jude Medical Inc. v. Commissioner*[21] has no bearing on the issue because it involved application of those rules only in the context of DISC computations.

VI. TREATY DEVELOPMENTS

The US Treasury Department announced treaty/protocol signings with Canada, France, Sweden, Portugal and Mexico. Eight treaties and protocols were sent to the Senate, including the Ukraine, Kazakhstan and Israel treaties. The Israeli protocol was approved. The others apparently will be the subject of hearings in the spring of 1995.

A. US–Canada treaty

The new US–Canada treaty substantially lowers withholding rates. Withholding on intra-corporate dividends will be reduced to 5 percent, royalties to zero percent and interest to 10 percent. This is a welcome reduction in withholding rates and will help to facilitate the flows of funds between the United States and Canada.

An interesting provision in the US–Canada treaty states a company that was created in Canada, that is a resident of both contracting states and that is *continued* at any time in the United States in accordance with the corporate law in the United States shall be deemed while it is so continued to be a resident of the United States. Other provisions in the treaty include coverage of software in the royalty provision, an arbitration provision in the competent authority article (which needs to activated by an exchange of notes), an expanded limitation on benefits provision and a provision calling for consultation within a three year period with respect to a possible further reduction in withholding rates.

18. 100 T.C. No. 39 (1993).
19. 97 T.C. 30 (1991), later opinion on remaining issues, 101 T.C. 78 (1993).
20. 103 T.C. No. 26 (1994).
21. 97 T.C. 457 (1991) *aff'd and rev'd*, ____ F.3d ____ (8th Cir. 1994).

B. US–France treaty

The new US–France treaty maintains withholding on dividends, interest and royalties at current rates. The treaty covers software royalties in the royalty article, provides for arbitration in its competent authority article (which needs to be activated by an exchange of notes) and contains a substantially expanded limitation on benefits provision. Under an exchange of letters, a "European economic interest group" that is constituted and has its effective management in France, but is not subject to tax in France because its members are residents of a third state, is proposed to be treated by the US as a partnership so that its US income tax liability will be determined under the US tax treaty with the third state in which its members are resident.

C. US–Sweden treaty

The US–Sweden treaty maintains withholding on dividends, interest and royalties at current rates. It contains a provision that states where a company is resident of both contracting states it will be deemed to be a resident only of the state under whose laws it was created. Software is not covered in the royalty provision, nor is there an arbitration provision in the competent authority article. The treaty contains a much less detailed limitation on benefits article than do the US–Netherlands and US–France treaties. It states at the end of the limitation on benefits article that the competent authorities of the contracting states shall consult together with a view to developing a commonly agreed application of the provisions of that article.

D. US–Netherlands treaty issues

IRS Notice 94-85 deals with the US–Netherlands treaty. Article 26 of the treaty (Limitation on Benefits) provides that a person resident in one of the states that derives income from the other state shall be entitled to the benefits of the convention in the other state only if such person meets one of the tests enumerated in Article 26. Thus, a Dutch resident claiming the benefits of the convention may be required to demonstrate its entitlement to those benefits under one of the tests in Article 26.

The Notice states that to assist such a taxpayer in determining whether it is entitled to benefits of the convention, the competent authorities of the US and the Netherlands, in joint consultation, have developed a pilot certification procedure. Pursuant to this procedure, a taxpayer may request, using Form IB 93 USA, that the Dutch tax authorities review evidence presented and certify that one of the tests in Article 26 is met.

The Dutch competent authority will send a copy of each completed form to the IRS along with the statements and documents prescribed in the instructions to the form. The Dutch competent authority, upon request, will furnish to the US competent authority the documentary evidence relied upon by the Dutch tax inspector. Absent material changes in the taxpayer's facts and circumstances, the form is valid for the entire calendar year for which it is used.

Following certification by the Dutch tax inspector, a taxpayer may use the form as an attachment to each Form 1001 or other appropriate US form to support for its position regarding entitlement to the benefits of the convention.

Under current law, a withholding agent may rely on a properly completed and filed Form 1001 with respect to a claim for treaty benefits in the absence of the withholding agent having actual knowledge or reason to know otherwise. Under the "actual knowledge or reason to know" standard, a withholding agent receiving a Form 1001 from a taxpayer may question whether the taxpayer is entitled to the benefits of the US–Netherlands treaty. A Form IB 93 USA attached to the Form 1001 will provide information helpful in determining the validity of the foreign taxpayer's claim. A withholding agent may rely on a properly completed and filed Form 1001 to which a Form IB 93 USA signed by the foreign taxpayer and the Dutch tax inspector is attached in the absence of actual knowledge or reason to know otherwise.

A taxpayer that does not meet any of the tests in paragraphs 1-6 in Article 26 may request a written determination from the US competent authority that it nevertheless is entitled to the benefits of the treaty on the basis of Article 26(7).

In a discussion of the new form, an IRS spokesperson was asked if the lack of an IB 93 USA or an expired IB 93 USA would trigger the "reason to know or actual knowledge" standard. The IRS spokesperson stated that no, lack of an IB 93 USA would not trigger the standard, but that knowledge of a denied IB 93 USA would.[22]

In an IRS news release, the IRS stated that under the 1992 US–Netherlands income tax treaty, as amended by a protocol signed on October 1993, the IRS will entertain requests for competent authority assistance under certain circumstances.

As amended by the protocol, Article 12, paragraph 8 of the treaty provides that for interest arising in the US and beneficially owned by a Netherlands resident, a 15 percent US withholding tax may be imposed if the interest is attributable to a permanent establishment maintained by that resident in a third jurisdiction and the aggregate rate of tax imposed on the interest in the third jurisdiction and in the Netherlands is less than 50 percent of the general rate of company tax applicable in the Netherlands.

This provision, the IRS stated, is an exception to the general rules that interest arising in one of the contracting states may be taxed only in the country in which the recipient is resident. As a general matter, therefore, interest derived by a Netherlands resident is subject only to Dutch income tax. However, under Dutch law and under some taxes concluded by the Netherlands, income attributable to permanent establishments of Dutch residents in certain third jurisdictions is exempt from taxation in the Netherlands. Thus, the IRS addressed situations in which abuse might arise by insuring that a tax of 15 percent will be imposed on the income.

22. See *Tax Notes Today* (8 August 1994).

The IRS stated that certain US corporations have established wholly owned Dutch subsidiaries to conduct financing activities for their multinational group, including the US parent and its US affiliates. The Dutch corporation may have set up a permanent establishment in a third jurisdiction to take advantage of the exemption from Dutch tax. In such a case, under the Subpart F provisions, the US parent generally will be required to include in its US taxable income the Dutch company's interest income. The protocol was intended to apply only to those cases where there was no significant tax paid on the interest income. In the case of a Subpart F inclusion, the US parent is subject to current income tax. Therefore, it may be appropriate for the US and Dutch competent authorities to determine the property interpretation or application of the protocol.

E. IRS proposes new competent authority procedures

The IRS proposed new procedures for requesting competent authority assistance and wishes to receive comments on the proposal. The proposed provisions, which incorporate many of the old rules, contain many new rules that will add flexibility to the competent authority process.

Taxpayers may request a pre-filing conference prior to formally requesting competent authority assistance. The proposed rules also provide that if a taxpayer has previously entered into a binding settlement with the IRS prior to requesting competent authority assistance, the competent authority will endeavour only to obtain a correlative adjustment with the treaty country and will not take any actions that would otherwise amend the settlement.

The IRS proposes to establish a new accelerated competent authority procedure, under which a taxpayer requesting competent authority assistance on an issue may also request that the competent authority attempt to resolve the same issue for subsequently filed return periods. This process is to be used only to the extent that substantially identical facts exist for the subsequent year. The competent authority will consult with the appropriate district prior to accepting such a request, and will confer with the district when considering the issue for the subsequent years. This is intended to parallel the recently published procedures dealing with accelerated issue resolution.

Taxpayers may request the involvement of appeals on issues under the competent authority jurisdiction. The proposed revenue procedure also specifies the circumstances under which simultaneous appeals-competent authority consideration may be requested, when access to the process may be denied or terminated and the role of appeals in the competent authority process if the request is approved. It would be helpful if the revenue procedure, when finalized, addressed the "hazards of litigation" normally considered by appeals. "Hazards of litigation" are not normally considered in a competent authority proceeding. This would be important if an issue involves treaty and non-treaty countries.

The proposed revenue procedure would expand on the circumstances under which taxpayers must take appropriate protective measures with both the US and applicable foreign tax authority to ensure that any agreement reached by the competent authorities is not barred by administrative, legal or procedural barriers. Failure to take such measures may seriously impede the US competent authority's ability to negotiate with the foreign tax authority. Consequently, the proposed revenue procedure specifies that failure to take protective measures in a timely manner may cause the US competent authority to conclude that the taxpayer failed to exhaust its competent authority remedies for foreign tax credit purposes.

The proposed procedures require that any determination as to whether a taxpayer has exhausted its competent authority remedy for purposes of claiming a foreign tax credit must be made in consultation with the US competent authority.

A request for competent authority assistance generally may be filed at any time after an action occurs which would give rise to a claim for competent authority assistance. In a case involving a US initiated adjustment resulting from a tax examination, a request for competent authority assistance may be submitted as soon as practicable after the amount of the proposed adjustment is communicated in writing to the taxpayer.

VII. ENTITY CHARACTERIZATION

A. "Check the Box" proposal

IRS Notice 95-14, I.R.B. 1995-14, announced that IRS and Treasury are considering a proposal that would greatly simplify the current rules for classifying unincorporated business organizations either as partnerships or as associations taxable as corporations. IRS and Treasury also are considering a similar approach for classifying foreign business organizations, but special considerations may apply there.

The IRS/Treasury consideration applies to domestic unincorporated business organizations. Many states recently have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships. For example, some partnership statutes have been modified to provide that no partner is unconditionally liable for all of the debts of the partnership. Similarly, almost all states have enacted statutes allowing the formation of limited liability companies.

The proposal under consideration would allow taxpayers to elect to treat domestic unincorporated business organizations as partnerships or associations for federal income tax purposes. Comments were requested. Under this approach, an election to change the classification of an organization would have the same federal tax consequences as a change in classification under current law. For example, if an organization were classified as an association taxable as a corporation and later elected to be classified as a partnership, the election would be treated as a complete liquidation of the corporation and the formation of a new partnership.

All foreign business organizations are currently considered unincorporated for federal income tax purposes and, therefore, must be analysed under the regulations that apply to domestic unincorporated business organizations.[23] While the IRS and Treasury are considering simplifying the classification rules for foreign organizations in a manner consistent with the approach described above for domestic organizations, they believe they must take into account a number of special considerations that arise in the foreign area.

The first is that presently there is no foreign analogue to a state-law corporation, and therefore, no foreign organization that is automatically treated as a corporation for federal tax purposes. The IRS and Treasury are considering the appropriateness and feasibility of identifying particular forms of foreign organizations that, like state-law corporations, would automatically be treated as corporations.

A second consideration in the foreign area is the possibility of inconsistent, or hybrid, entity classification; that is, classification as a taxable entity in one country but as a flow-through entity (a partnership) under the tax laws of another country. An elective approach could expand the potential that exists under the current classification regulations for hybrid structures. The IRS and Treasury are considering whether it is appropriate to address inconsistent classification in any rules to be proposed and also are considering how the tax benefits or detriments that may result from inconsistent classification can be addressed through the tax treaty process.

A third consideration in the foreign area is that a purely elective approach could have a substantive effect on entity classification by increasing taxpayers' flexibility to achieve their desired classification of certain foreign organizations. Under the present rules, taxpayers holding interests in foreign organizations are not always as able as those holding interests in domestic organizations to achieve their desired result. Thus, the IRS and Treasury are considering whether an elective approach should be modified with respect to foreign organizations.

To the extent that an elective approach is applied to the classification of foreign organizations for federal tax purposes, consideration must be given to the appropriate mechanism for classifying organizations that do not make an affirmative election. The IRS and Treasury believe that it would be appropriate to treat a foreign organization that fails to make an affirmative election as an association (corporation). This rule would avoid inadvertently subjecting taxpayers to the partnership compliance rules and excise tax provisions and is likely in many circumstances to coincide with taxpayers' desired classification. The proposal, called by some the "check the box" approach to entity characterization, certainly would simplify matters. In a domestic context, implementing such a procedure would seem to be fairly easy and would offer a lot in the way of simplification. Given the concerns expressed with respect to such an approach in a foreign area, clearly the issues are more complex. Nonetheless, a "check the box" approach in the foreign area also would provide helpful simplification. The "default" rule where an entity would be characterized as a corporation in the absence of an affirmative election is a good idea in an international context. One comment letter, which stated support for this approach, stated that the only real losers under a "check the box" classification regime appears to be the tax professional. The comment suggested that the professional's billable hours involved in the formation or classification of an entity would be reduced. The commentator also stated that most partnership treatises likely would be shortened by a chapter.

B. Limited liability company ruling guidelines

Rev. Proc. 95-10, 1995-3 I.R.B. 1, sets forth guidelines for when the IRS will rule that a limited liability company (LLC) will be characterized as a partnership for US tax purposes. The guidelines are designed to cover domestic LLCs as well as "all organizations formed under a law other than domestic law (foreign law or foreign statute), where the foreign law or foreign statute provides for or allows limited liability to any of their members (whether or not the foreign organization is "incorporated" under a foreign statute)."

The ruling guidelines are not clear on certain issues because they address both domestic LLCs and certain foreign organizations. Domestic LLC statutes, for example, contain rules for member-managers. It is not clear whether the IRS intends the member-manager ruling guidelines to apply to non-US entities such as GmbHs, UK companies, etc. The guidelines state "if the applicable statute allows for management by one or more designated persons, managers are those persons designated or elected by the members to act on behalf of the LLC". Could one (or both) corporate joint venturers be appointed member-managers in the context of a foreign joint venture entity?

1. Continuity of life

Section 5.01(1) of the revenue procedure addresses dissolution events relating solely to member-managers. If the members of the LLC designate or elect one or more members as managers and the controlling statute, or operating agreement pursuant to the controlling statute, provides that the death, insanity, bankruptcy, retirement, resignation or expulsion of any member-manager causes a dissolution of the LLC without further action of the members, unless the LLC is continued by the consent of not less than a majority in interest of the remaining members, the IRS will generally rule that the LLC lacks continuity of life. However, all member-managers must be subject to the specified dissolution events.

Section 5.01(2) of the revenue procedure deals with dissolution events relating to members. If the members of the LLC do not designate or elect one or more members as managers and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member dissolves the LLC without further action of the members, unless the LLC is continued by the consent of not less than a majority in interest of the remaining members, the IRS generally will rule that the LLC lacks continuity of life.

23. See Rev. Rul. 88-8, 1988-1 C.B. 403.

However, all the members must be subject to the specified dissolution events.

The provision in § 5.01(2), which requires dissolution *without further action* of the members is a statement of the requirement in Rev. Rul. 93-4, 1993-1 C.B. 225, which dealt with the characterization of a German GmbH. It is this requirement ("without further action") that has given rise to an issue with respect to the continuity of life requirement in the context of UK limited liability companies. While the IRS is studying this issue in the context of UK limited liability companies, it is noteworthy that some of the state's LLC rules require further action, similar to the UK company situation, yet the IRS has provided in revenue rulings that those entities lack continuity of life.

Section 5.01(4) states that if the controlling statute, or the operating agreement pursuant to the controlling statute, provides that less than all of the dissolution events listed above with respect to member-managers or members dissolves the LLC, the IRS will not rule that the LLC lacks continuity of life unless the taxpayer clearly establishes in the ruling request that the event or events selected provide a meaningful possibility of dissolution.

2. Free transferability of interests

Section 5.02(1) deals with consent to transfer solely by member-managers. If the members of the LLC designate or elect one or more members as managers, and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that each member, or those members owning more than 20 percent of all interests in the LLC's capital, income, gain, loss, deduction and credit, does not have the power to confer upon a non-member all of the attributes of the member's interest in the LLC without the consent of not less than a majority of the non-transferring members-managers, the IRS will generally rule that the LLC lacks free transferability of interests.

Section 5.02(2) deals with consent to transfer by members. If the members of the LLC do not designate or elect one or more members as managers, and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that each member, or those members owning more than 20 percent of all interests in the LLC's capital, income, gain, loss, deduction and credit, does not have the power to confer upon a non-member all the attributes of the member's interest in the LLC without the consent of not less than a majority of the non-transferring members, the IRS will generally rule that the LLC lacks free transferability of interests.

Section 5.02(4) states that the IRS will not rule that an LLC lacks free transferability of interests unless the power to withhold consent to the transfer constitutes a meaningful restriction on the transfer of the interests. For example, a power to withhold consent to a transfer is not a meaningful restriction if the consent may not be unreasonably withheld.

3. Centralization of management

Section 5.03(1) states that if the controlling statute, or the operating agreement pursuant to the controlling statute, provides that the LLC is managed by the members exclusively in their membership capacity, the IRS generally will rule that the LLC lacks centralized management.

Section 5.03(2) states that if the members of the LLC designate or elect one or more members as managers of the LLC, the IRS will not rule that the LLC lacks centralized management unless the member-managers in the aggregate own at least 20 percent of the total interests in the LLC.

The revenue procedure also states that even if the aggregate ownership requirement is satisfied, the IRS will consider all the relevant facts and circumstances, including, particularly, member control of the member-managers (whether direct or indirect), in determining whether the LLC lacks centralized management. The IRS will not rule that the LLC lacks centralized management if the members-managers are subject to periodic elections by the members, or alternatively, the non-managing members have a substantially non-restricted power to remove the member-managers.

4. Limited liability

Section 5.04 provides that the IRS generally will not rule that an LLC lacks limited liability unless at least one assuming member validly assumes personal liability for all (but not less than all) obligations of the LLC, pursuant to express authority granted in the controlling statute. In addition, the IRS generally will not rule that an LLC lacks limited liability unless the assuming members have an aggregate net worth that at the time of the ruling request, equals at least 10 percent of the total contributions to the LLC and is expected to continue to equal at least 10 percent of the total contributions to the LLC throughout the life of the LLC.

5. Other provisions

Section 4.01 of the revenue procedure states that the IRS will consider a ruling request that relates to the classification of an LLC as a partnership for federal income tax purposes only if the LLC has at least two members.

Certain minimum ownership requirements must be satisfied if the taxpayer requests a ruling that the LLC lacks continuity of life or free transferability of interests, where the limitations pertain only to transfers by members-managers, or limited liability.

Section 4.02 states that if the taxpayer requests a ruling that an LLC lacks continuity of life or free transferability of interests under the member-manager rules, the member-managers in the aggregate must own, pursuant to the express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC's income, gain, loss, deduction or credit during the entire existence of the LLC. If the LLC has total contributions exceeding $ 50 million, there is a lower requirement than the 1 percent standard.

Under § 4.04 of the revenue procedure, if the taxpayer requests a ruling that an LLC lacks continuity of life or free transferability of interests under the member-manager rules, the member-managers, in the aggregate, must maintain throughout the entire existence of the LLC a minimum capital account balance equal to the lesser of 1 percent of the total positive account balances or $ 500,000. The same rule may apply when a ruling is requested under § 5.04 that the LLC lacks limited liability.

VIII. CURRENCY

A. *GM Trading*: Rev. Rul. 87-124; debt-equity swaps

G.M. Trading Corp. v. Commissioner[24] involved a US corporation which has a Mexican subsidiary. The US parent obtained funds for the Mexican subsidiary to use in buying land and in the construction of a plant by entering into a Mexican debt equity swap.

Such a swap typically involved a US corporation purchasing at a discount from face (but at fair market value) an "interest" in a dollar obligation of the Mexican government from the commercial bank which holds the obligation. The discount from face was at a prevailing market rate. As a part of a prearranged four-party transaction involving the US parent, the bank, the Mexican government and the parent's Mexican subsidiary, a restricted Mexican peso amount was credited by the Mexican government directly to the account of the Mexican subsidiary. The debt obligation, over which the US parent never exercised possession or control, was cancelled in the transaction. The Mexican pesos were restricted in that they could be used only for specified purposes; they were not freely transferable.

In *G.M. Trading*, the US parent agreed to purchase from the unrelated bank US dollar denominated debt of the Mexican government in the principal stated amount of $1.2 million. The US company agreed to pay $ 600,000 for the debt, reflecting the prevailing discount rate from face for such obligations. Pursuant to the four-party agreement, the Mexican government credited an agreed amount of pesos to a Mexican government account of the Mexican subsidiary. At the prevailing *open market exchange rate*, the pesos had a US dollar equivalent of $ 1,044,000. The pesos, however, were *restricted* and could only be used in a certain manner, i.e. to acquire the subsidiary's land and construct a plant. Disbursements had to be approved by the Mexican government and were to be spread out over the construction period of the plant.

The court held that the substance of the transaction was the exchange by the US company, either directly or through its Mexican subsidiary, of the US dollar denominated Mexican debt that the US parent had purchased for the Mexican pesos. The court held that the taxpayer's cost basis in the Mexican debt was $ 634,000 (the taxpayer had incurred $ 34,000 of acquisition costs) and that its gain, if any, on the exchange of the debt for the pesos is taxable.

The court also rejected the taxpayer's contribution to capital argument stating that where property is transferred to a corporation by a governmental entity in consideration for specific and direct goods or services, the exclusion under § 118 is not available. In this case, stated the court, the receipt by the Mexican government of specific, direct and quantifiable benefits disqualifies the transaction from qualification under § 118. The benefits to the Mexican government were the surrender by the US company to the Mexican government and the cancellation of the US dollar denominated debt.

The IRS argued that the pesos should not be discounted due to the use restrictions placed on them "because the designated use for the pesos was the intended use all along." The IRS argued that the restrictions on the use of the pesos were not significantly different from restrictions typically placed on loan proceeds by financial institutions in disbursing loan proceeds relating to construction projects or project financing.

The court held that the pesos should be valued at the free market exchange rate. Thus, their value was $ 1,044,000 and the US parent had a taxable gain of $ 410,000. The court also stated that the restrictions on the Mexican subsidiary's stock imposed in the transaction did not justify any reduction in the value of the pesos.[25]

It would seem to me that the transaction should simply be treated as a purchase of restricted pesos for their fair market value. The transaction wherein the taxpayer expended $ 600,000 was an arm's length transaction with an unrelated party. The pesos had substantial restrictions on their use. The IRS, in fact, stated in its revenue ruling that the value should be discounted from a value computed using free market exchange rate. I would think the value of the pesos should be their cost in an arm's length transaction between wholly unrelated parties.

B. Final DASTM Regulations

The IRS issued final regulations relating to the use of the dollar approximate separate transactions method of accounting for operations in hyperinflationary countries. The regulations add a number of welcome new rules, although they make the use of DASTM mandatory.

Under Treas. Reg. § 1.985-1(b)(2)(ii)(A), a qualified business unit that would otherwise have a hyperinflationary currency as its functional currency *must* use the dollar as its functional currency and *must* compute its income and earnings and profits using DASTM for taxable years beginning after 24 August 1994. Some commentators objected to the requirement that use of the dollar and DASTM is mandatory, but that suggestion obviously was rejected. The IRS stated that the use of a hyperinflationary functional currency and the profit and loss method of accounting would not clearly reflect income. Thus, it made DASTM mandatory.

This new rule requiring the use of DASTM applies only to CFCs. In the case of a non-CFC, DASTM may be elected. DASTM also may be elected for open years beginning after

24. 103 T.C. No. 4 (1994), under reconsideration.

25. Curiously, as discussed in *Tax Notes* (11 April 1988), at 167, there were accepted going rate market prices for developing country debt that varied by currency and by month. GM Trading's cost can be identified from the chart that was published as a part of that article, based on GM Trading's date of purchase. These arm's length market prices were not considered by, if submitted to, the court. Certainly, market prices ought to evidence fair market value. The value, using market prices, was $ 600,000. That also was the transaction price.

31 December 1986, but before the effective date of the new regulations. If the election is made, it applies to all subsequent taxable years. The election is made for prior open years by having the US parent amend its tax returns for the applicable years. Taxpayers that elected DASTM and applied the rules under the previous DASTM regulations may elect to apply the rules under the revised regulation. They, too, make the election by amending their tax returns for the applicable years.

The definition of hyperinflationary currency in Treas. Reg. § 1.985-1(b)(2)(ii)(D) was revised to clarify that the cumulative inflation rate during the 36-month base period is based on the *compounded* inflation rate for the base period, and not on the sum of the annual inflation rates. The IRS stated that this change conforms the definition of hyperinflationary currency more closely to that applicable under US general accepted accounting principles. In an example illustrating this clarified rule, the CFC is in a country whose annual inflation rates are 29, 25 and 30 percent for 1991, 1992 and 1993. The cumulative inflation rate for the three year base period is 110 percent and the currency of the country for the QBU's 1994 year is considered hyperinflationary. [((1.29 x 1.25 x 1.3) – 1.0 = 1.10) x 100 = 110%].

Treas. Reg. § 1.985-3(a) provides that, for all purposes of subtitle A, DASTM must be used to compute gross income, income or loss, and earnings and profits. This provision is intended to clarify that DASTM gain or loss is part of gross income for purposes of the de minimis and full inclusion rules of Section 954(b)(3). DASTM gain or loss also must be taken into account in applying the related party interest rules of Section 954(b)(5), among other provisions.

Certain countries with hyperinflation require taxpayers to make adjustments to their balance sheet under a system of monetary correction with respect to fixed assets and capital, with corresponding adjustments to the profit and loss statement. Under US GAAP, these adjustments are reversed. The regulations have been clarified to require reversal of monetary correction adjustments required by local accounting principles.

Taxpayers suggested that they should be permitted to translate certain financial assets and liabilities at the period end exchange rate, rather than at the average exchange rate for the last translation period in order to conform the rules under DASTM to GAAP. To make it clear that the period end exchange rate may be used, the regulation was amended to indicate that use of the spot rate on the last day of the taxable year is a reasonable method, provided that it is consistently used and conforms to the taxpayer's method of financial accounting.

Taxpayers also requested guidance with respect to transactions described in Section 988 that are denominated in a currency other than the QBU's hyperinflationary currency or the dollar. In order to parallel the financial accounting rules for the administrative ease of taxpayers and the IRS, the regulations provide that taxpayers may use any reasonable method of accounting for third currency transactions so long as such a method is consistent with their method of financial accounting.

Several commentators requested that the regulations provide a simpler method of allocating and apportioning DASTM gain or loss for small taxpayers. This suggestion was adopted. Commentators also requested a simpler method for taxpayers with one or two Section 904(d) separate categories. The IRS did not adopt this suggestion because it believes the allocation rules in the regulation more accurately reflect the income of large taxpayers.

The prior regulation provided for the allocation of DASTM gains and losses to Section 904(d) separate categories based on foreign source gross income in each category. There was no attempt to identify DASTM gain or loss with specific assets or liabilities. In a significant improvement, the proposed regulations identified DASTM gain or loss with specific assets and directly allocated it to specific Section 904(d) separate categories based on the income those assets would generate. The proposed regulations provided with respect to liabilities that DASTM gain or loss should be allocated to the Section 904(d) separate categories in the same manner as the allocation and apportionment of interest expense.

Commentators suggested that DASTM gain or loss on certain non-interest-bearing liabilities, particularly short-term non-interest-bearing trade payables, should be directly allocated to the same Section 904(d) separate category as the income produced by the purchased good or service to which the payable relates. In response to this suggestion, the final regulations provide different rules for allocating and apportioning DASTM gain or loss with respect to interest-bearing liabilities and non-interest-bearing liabilities.

Treas. Reg. § 1.985-3(e)(3)(vii)(A) now provides that the amount of DASTM gain on interest-bearing liabilities reduces the interest expense generated by such liabilities. Any DASTM gain in excess of interest expense is sourced or otherwise classified in the same manner that interest expense is allocated and apportioned. Any DASTM loss on interest-bearing liabilities is allocated and apportioned in the same manner that interest expense is allocated and apportioned under Temp.[26]

Treas. Reg. § 1.985-3(e)(3)(vii)(B) provides rules with respect to the allocation of DASTM gain or loss on debt that gives rise to related person interest expense. Section 954(b)(5) requires that related person interest expense must first be allocated to foreign personal holding company income that is passive income to the extent thereof. To prevent distortion, any DASTM gain or loss arising from such related person debt must also be allocated in the same manner that the related person interest expense of that debt is required to be allocated under the rules of Section 954(b)(5).

Treas. Reg. § 1.985-3(e)(3)(vii)(C) provides that, in applying the modified gross income method under Temp. Treas. Reg. § 1.861-9T(j), the gross income in each Section 904(d) separate category should first be adjusted by the amount of

26. Treas. Reg. § 1.861-9T.

DASTM gain or loss attributed to assets and DASTM gain or loss on short-term, non-interest-bearing trade payables.

Treas. Reg. § 1.985-3(e)(3)(viii)(A) provides that DASTM gain or loss on short-term, non-interest-bearing trade payables is allocated to the same category or type of gross income as the cost or expense to which the trade payable relates. For this purpose, a short-term, non-interest-bearing trade payable is a non-interest liability with a term of 183 days or less that is incurred to purchase property or services to be used by the obligor in an active trade or business.

Under Treas. Reg. § 1.985-5(e)(3)(viii)(C), DASTM gain or loss on other non-interest-bearing liabilities is allocated on a gross income basis. However, the taxpayer may demonstrate to the satisfaction of the IRS, or the IRS may determine, that application of the gross income allocation method would result in a substantial distortion of income.

C. Proposed DASTM Regulations to apply when local currency ceases to be hyperinflationary

The IRS proposed regulations that would require a qualified business unit that uses DASTM to change its functional currency and to change its method of accounting to the profit and loss method when the local currency ceases to be hyperinflationary for three consecutive years. Adjustments required under Treas. Reg. § 1.985-5 would have to be made in connection with the change. The regulation is proposed to be effective for taxable years beginning after the date which is 30 days after the publication of this regulation in final form.

D. TEI's comments

TEI's comments on the final and proposed DASTM regulations appear in *TNT* of 6 March 1995. TEI states that the final regulations ("B" above) seriously underestimate the burden in calculating DASTM gain or loss. TEI also remains concerned about the mandatory use of DASTM. With respect to the proposed DASTM regulations ("C" above), TEI strongly objects to the mandatory reversions from DASTM when a currency ceases to be hyperinflationary. TEI states that the proposed regulations impose harsh conversion rules and substantial administrative burdens on taxpayers.

E. Proposed regulations on contingent payment debt instruments: effects under Section 988.

The IRS proposed regulations under Section 1275 dealing with contingent payment debt instruments. The regulations are complex and deal primarily with domestic transactions. Among other rules, they provide for integration of a hedged contingent payment debt instrument under provisions modelled after the integration rules of Section 988(d) and Treas. Reg. § 1.988-5(a). The rules in the proposed Section 1275 integration regulation, however, are slightly different from the rules in Treas. Reg. § 1.988-5(a). They reflect different policy concerns underlying the rules for taking currency gain or loss into account and for taking interest income or deductions into account. The preamble states that the IRS and Treasury intend to make conforming changes to Treas. Reg. § 1.988-5(a) and request comments on the extent to which that regulation should be modified to conform to the proposed Section 1275 regulation.

The primary difference involves the situation where a taxpayer "legs into" integrated transaction treatment. Under Treas. Reg. § 1.988-5(a)(6), exchange gain or loss is realized with respect to the qualifying debt instrument determined by reference to changes in the exchange rate between (1) the date the instrument was acquired by the holder, or the date the obligor assumed the obligation to make the payments under the instrument, and (2) the leg in date. That gain or loss is deferred until the date the qualifying debt instrument matures or is otherwise disposed of.

Under the proposed Section 1275 regulation, the built-in gain or loss is reflected in the accruals on the synthetic debt instrument. The built-in gain or loss on the leg in date is recognized over the term of the synthetic debt instrument. To prevent abuse, the proposed regulation includes a special rule providing that if the taxpayer legs into an integrated transaction with a principal purpose of deferring or accelerating income, the IRS may treat the qualifying debt instrument as sold or otherwise terminated and reacquired or reissued on the leg in date or may refuse to allow integration.

I think it is not necessary to incorporate these rules in the Section 988 regulations as the policy objectives are different. The timing of income or deduction in an interest context raises issues wholly different from those involved in determining the timing of currency gain or loss. Currency gain or loss would seem more appropriately to be associated with maturity or disposition of the debt instrument. For the same reason, there would seem not to be a need under Section 988 to have such an anti-abuse rule.

If a taxpayer legs out, the synthetic debt instrument is treated as sold or otherwise disposed of for its fair market value under the proposed Section 1275 regulation. The income, deduction, gain or loss is taken into account immediately. This is similar to the rule under Treas. Reg. § 1.988-5(a)(6).

The preamble to the proposed Section 1275 regulations also states that the IRS and Treasury are concerned about various issues relating to the treatment of foreign holders of contingent payment debt instruments. For example, the IRS and Treasury are concerned about the possibility for tax avoidance that may arise when a contingent payment debt instrument is structured as payments that approximate the yield on an equity security. The IRS and Treasury invite comments on this issue and other issues concerning the proper taxation of foreign holders of contingent payment debt instruments issued by US persons or US holders of contingent payment debt instruments issued by a foreign person.

F. *Philip Morris*

Philip Morris Inc. v. Commissioner[27] involved a US parent that borrowed in foreign currencies which it converted into US dollars. It later repaid the borrowings in the same foreign currency, which it had purchased with US dollars. The taxpayer reported its gain, represented by the difference in US dollars between the value of the foreign currencies at the time of the borrowings and the US dollar cost of the currencies used for repayment, as income from the discharge of indebtedness and elected to exclude such income from gross income under Section 108.

The Tax Court held that the taxpayer's gain did not constitute income by reason of the discharge of indebtedness eligible for exclusion from gross income under Section 108. While there was a prior case so holding, *Kentucky & Indiana Terminal Railroad Co. v. United States*,[28] the court stated that case "has been sapped of its vitality by *United States v. Centennial Savings Bank FSB* 499 US 573 (1991)".

In *Centennial Savings Bank*, the issue was whether a penalty for early withdrawal of time deposits, in accordance with restrictions in the agreements governing the deposits, constituted income from the discharge of indebtedness eligible for exclusion and reduction in basis under Sections 108 and 1017. The Supreme Court held that it was not so eligible on the grounds that the withdrawal, consisting of the face amount of the deposit less the penalty for early withdrawal, *was in accordance with the terms of the deposit.* The Supreme Court stated that discharge "can only occur if the creditor cancels or forgives a repayment obligation".

The court stated in *Philip Morris* that a teaching of *Centennial Savings* is clear, namely, that the discharge of indebtedness may be an occasion for the realization of income but, unless there is a cancellation or forgiveness of a portion of the indebtedness not reflected in the terms of the indebtedness, such income is not realized "by reason of the discharge of the indebtedness of the taxpayer".

IX. OTHER DEVELOPMENTS

A. Proposed consolidated return regulations

The IRS has proposed significant changes in Treas. Reg. § 1.1502-13, which deals with intercompany transactions between members of a consolidated return group. Generally, US corporations in the consolidated group are treated as divisions of one large, single entity under the proposed regulations. This will have numerous, sometimes significant, consequences. Some of these consequences involve the US international tax rules.

Prop. Treas. Reg. § 1.1502-13(c)(4) ex. 17 illustrates the effect of these new rules on the source of income from an intercompany sale. S manufactures inventory in the US that it sells to distributors for resale to customers. B is a distributor with a foreign branch in country Y that purchases and resells the inventory outside the US S and B are US companies included in the consolidated return. Under the current rules, S would have a Section 863(b) sale if title passed to B in the foreign county and B would have a sale which produced foreign-source income under Sections 861 and 862 provided that title passed in the foreign country on B's sale.

Under the proposed regulation, the income is determined as though S and B were divisions of a single corporation. Thus, Section 863(b) applies to the total sale. As a result, the combined income of the two companies is sourced 50-50 under Section 863(b). Once the total sourcing is calculated, S is treated as earning its share of foreign-source income and B is treated as earning its share of foreign-source income depending upon the appropriate profits earned by each. The result on these facts would be to produce less foreign-source income.

While the example does not discuss FSC issues, there also could be an effect under the FSC rules. Section 924(f)(1) and LTR 9234019 allow a double FSC commission in such a situation provided both entities use the combined taxable income method in calculating the FSC commission. The same amount of foreign-source income apparently will result regardless of where title passes on S's sale to B and thus the proposed new Section 1502 regulation may make it easier for overall qualification under the FSC rules in such a situation.

Prop. Treas. Reg. § 1.1502-13(c)(4) ex. 18 contains a Section 1248 example. It states that S owns a foreign subsidiary with earnings and profits of $ 40 which it sells to B. While B owns the subsidiary, the subsidiary has a deficit in E&P of $ 10. Later, B sells the foreign subsidiary to an unrelated purchaser. The portions of S's gain and B's gain characterized as dividends under Section 1248 is determined on the basis of the foreign subsidiary's $ 30 of earnings and profits at the time of the sale to the third party. The $ 30 is allocated between S and B based on their respective gains.

In an alternative fact pattern in example 18, the foreign subsidiary has no E&P or deficit in E&P while B owns the foreign company. B sells the stock in the foreign company at a loss of $ 10. S had a $ 40 gain on the sale to B. Because S had a gain on its sale of the stock to B and B has a loss on its sale of the stock to the third party, none of the foreign corporation's Section 1248 amount is allocated to B. In addition, because the foreign corporation's $ 40 of Section 1248 amount exceeds the $ 30 net gain for S and B combined, the Section 1248 amount allocated to S is limited to $ 30. Thus, $ 30 of S's intercompany gain is treated as a dividend. The remaining $ 10 of S's gain and all of B's $ 10 loss are treated as capital gain and loss.

TEI's comments on this proposed regulation.[29] TEI states that the proposed rules "are as dauntingly abstruse to apply as they are simple to state" and that they represent a "result-oriented view that is inconsistent with sound economic or tax policy". TEI specifically commented unfavourably on Ex. 17.

27. 104 T.C. No. 3 (1995).
28. 330 F.2d 550 (6th Cir. 1964).
29. See *TNT* (6 March 1995).

B. Corporate expatriations

Notice 94-46, 1994-18 I.R.B. 1, announces important new rules under Section 367 designed to prevent US parent companies from reorganizing their corporate group so that it becomes foreign owned. The Notice states that the IRS is concerned that widely-held US companies with foreign subsidiaries recently have undertaken certain restructurings for tax motivated purposes. These restructurings typically involve a transfer of the stock of the domestic parent corporation to an existing foreign subsidiary or a newly-formed foreign corporation in exchange for shares of the foreign corporation in a transaction intended to qualify for non-recognition treatment. Following the transaction, the former shareholders of the domestic corporation will own stock in a foreign corporation that is not a controlled foreign corporation.

The Notice states that the regulations under Section 367(a), therefore, will be modified to provide that the transfer of stock or securities of a domestic corporation by a US person to a foreign corporation is taxable under Section 367(a) if all US transferors own in the aggregate 50 percent or more of either the total voting power or the total value of the stock of the transferee corporation immediately after the exchange. These provisions will apply to transfers occurring on or after 18 April 1994.

Some corporate taxpayers have considered such an expatriation given the Subpart F rules, particularly after the enactment of Section 956A. Nearly all of these corporations, however, have declined to move forward with implementation given the tax costs and/or for other reasons. Thus, in my view, the IRS's concern is somewhat of an overreaction. After McDermott expatriated a number of years ago, Section 1248(i) was enacted to make that "escape route" taxable. Helen of Troy, a Texas-based company, recently filed with the SEC to implement an expatriation similar to that described in the Notice. Helen of Troy's filing may have been part of the IRS's cause for concern, but the company's facts are different from those of the typical US-based multinational making such expatriation easier in Helen of Troy's situation.

C. Proposed Section 936 Regulation

The IRS issued a new proposed Treas. Reg. § 1.936-6(b)(1) Q&A 12 which deals with a possessions product that is a component product or end-product form. Combined taxable income attributable to the component possessions product will be determined by multiplying the combined taxable income of the possessions corporation and its affiliated group derived from the sales of the integrated product (which includes the possessions product) by a production cost ratio.

Currently, Q&A 12 states that in computing combined taxable income in such a situation, the sales price of the component must be determined in accordance with an independent sales price from comparable uncontrolled transactions, if any. If an independent sales price cannot be so determined, then the possessions corporation must treat the sales price for the component product (or the end-product form) as equal to the same proportion of the third party sales price of the final product which the production costs attributable to the component bear to the total production costs for the final product.

This proposed regulation will affect a number of taxpayers and constitutes a further IRS attack on Section 936. The IRS's interest in modifying the regulation presumably grew out of the pending case of *Coca Cola Company v. Commissioner*.[30] Coca Cola utilized Q&A 12 and its comparable uncontrolled price method in determining its Section 936 benefits for the production of a component (concentrate) in Puerto Rico. The IRS denied Coca Cola the use of Q&A 12 on the grounds that the possessions product is both a final product and component product. The years in issue are 1983 and 1984. The IRS's adjustment reduced Coca Cola's Section 936 combined taxable income from $ 230 million to $ 61 million for the two years in issue.

The proposed regulatory change, however, will affect many taxpayers. The proposed change, by itself, likely will discourage at least one of our clients from moving a new operation to Puerto Rico. The move to Puerto Rico was already under consideration. The proposed regulation likely will kill the project. Combined with OBRA 1993, the proposed change in the regulation also will encourage others to hasten a relocation of their operation away from Puerto Rico. The production costs method usually produces unfavourable results. It was the subject of hearings on July 11, 1994.

It is unfortunate that simply because of litigation on the subject the IRS has chosen to change the rule. Section 936 has taken quite a beating in the past six months.

D. Section 936 change from cost sharing to profit split

Rev. Proc. 94-70, 1994-44 I.R.B. 1, sets forth the procedures pursuant to which a corporation that has elected the cost sharing method permitted under Section 936(h)(5)(C)(i) may change to the profit split method permitted under Section 936(h)(5)(C)(ii), or to the method described under Sections 936(h)(1)-(4) for years to which the amendments made to Section 936 by the 1986 Tax Reform Act apply. A corporation may change its election without obtaining advance IRS consent only if the requirements of Rev. Proc. 94-70 are satisfied.

For elections made before 1987, taxpayers may change their election by filing an amended return for the possession corporation's first year beginning after 31 December 1986. Taxpayers may change an election made after 1986 by filing an amended return for the tax year of the cost sharing election. In both cases, the amended return must be filed not later than 31 December 1994.

The reason for this special permission to change pricing methods: the taxpayer could only make an informed decision as to whether to change its method when final regulations

30. Tax Court Dkt. No. 17171-91.

defining the commensurate with income standard under Section 482 were issued. Final regulations under Section 482 providing this guidance were published on 8 July 1994.

When the taxpayer changes its election pursuant to Rev. Proc. 94-70, subsequent year returns of the taxpayer and all relevant returns for the year of change and subsequent years of the taxpayer's appropriate affiliates or shareholders must also be amended to reflect adjustments resulting from that change. All returns that are required to be amended due to the taxpayer's changing its method must be filed no later than 31 December 1995.

A change in method will only be permitted if, at the time each amended return is filed, the statute of limitations for the taxpayer and its appropriate affiliates or shareholders with respect to the taxable years subject to the change will expire no earlier than three years from the date on which each amended return is filed. In the case of a taxable year for which the adjustments resulting from the change are reflected on an international examiner's report, the statute of limitations for the taxable year must expire no earlier than three years from the date of the international examiner's report on which the change is reflected. Extension of the statute of limitations must cover all issues arising under Section 936 and related or correlative items.

Certain adjustments may be required to ensure that an appropriate cost sharing payment is made. If a taxpayer fails to satisfy the possessions source test or the active conduct of a trade or business test or both tests because the taxpayer elected to change its method pursuant to the revenue procedure, a distribution can be made to prevent disqualification. The distribution will not qualify for a dividends received deduction.

E. *Brown Group*: Subpart F partnership issue

Brown Group Inc. v. Commissioner[31] is the decision on reconsideration by the full Tax Court. The court reached a conclusion different from that which it previously reached. The court's reconsideration was at the request of the IRS.[32]

Previously, the court held that where a controlled foreign corporation is a partner in a partnership, income is characterized at the partnership level. Since a partnership cannot have Subpart F income, neither can the foreign corporate partner in the partnership have Subpart F income.

The court reversed itself, applying the principles of Rev. Rul. 89-72, 1989-1 C.B. 257, and held that the "aggregate" nature of the partnership must be emphasized. Thus, whether Subpart F income exists is tested at the CFC level, not the partnership level. That is, the income's character is sales income, in this case, and whether or not that sales income constitutes Subpart F income is determined at the CFC level, as though the CFC received the income from the same sources that the partnership received it.

The court felt that any other conclusion would lead to the very type of problem Congress was concerned with when it subjected foreign base company sales income to the rules of Subpart F. The court stated it was not dealing with computation of the partnership's income but with the consequence to the partners stemming from their rights under the partnership agreement to share in that income.

The decision was "reviewed by the court," with seven judges joining in the majority. There were three concurring opinions and three judges dissented. While the issue may be resolved in the Tax Court, as discussed in the various opinions, it is not clear that the issue is fully resolved. *MCA Inc. v. United States*[33] addressed a similar argument by the government and stated "if the omission of income received from controlled partnerships has indeed created an unjustified loophole in the tax laws, the remedy lies in new legislation, not in judicial improvisation." Brown Group's appeal rights do not lie to the Ninth Circuit, however.

F. Partnership anti-abuse regulations

The IRS issued final regulations providing anti-abuse rules with respect to the use of partnerships. The final regulations significantly recast the widely criticized proposed anti-abuse regulations.

The regulations state that the intent of the partnership rules is to permit taxpayers to conduct joint business (including investment) activities to a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of the partnership rules are the following requirements: (1) The partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose, (2) the form of each partnership transaction must be respected under substance over form principles, (3) the tax consequences under the partnership rules to each partner of partnership operations and of transactions between the partner and the partnership generally must accurately reflect the partner's economic agreement and clearly reflect the partner's income.

The regulation states that the partnership rules must be applied in a manner that is consistent with their intent, as set forth above. Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of the partnership rules, the IRS can recast the transaction for federal income tax purposes as appropriate to achieve tax results that are consistent with the intent of the partnership rules.

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of the partnership provisions is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transac-

31. 104 T.C. No. 5 (1995).
32. For a discussion of the court's previous opinion, see 8 *Tax Notes International* (30 April 1994) at 876-6.
33. 685 F.2d 1099 (9th Cir. 1982).

tion. A number of factors are set forth in the regulations for consideration.

Most of the examples in the regulation involve domestic tax issues. Two, however, involve international tax fact patterns. In example No. 2, A and B form partnership X to conduct a bona fide business. A is a corporation that has elected to be treated as an S corporation under subchapter S. B is a non-resident alien. Because the S corporation rules prohibit B for being a shareholder in A, A and B chose partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of subchapter S treatment for A and its shareholders. The partnership rules are intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement. The structure is consistent with that intent. Therefore, the IRS cannot invoke the anti-abuse regulations to recast the transaction.

In example No. 3, X, a domestic corporation, and Y, a foreign corporation, form partnership Z under the laws of country A to conduct a bona fide joint business. Each owns a 50 percent interest in the partnership. X and Y chose partnership form to enable X to qualify for direct foreign tax credits under Section 901, with look-through treatment under the Section 904(d) regulations. This structure enables X to avoid the non-controlled Section 902 corporation basket for purposes of foreign tax credit limitation computations. The partnership rules are intended to permit taxpayers to conduct business activity through a flexible economic arrangement without incurring entity-level tax. This structure is consistent with that intent. The IRS therefore cannot invoke the anti-abuse regulations to recast the transaction.

In another section of the regulations, the IRS can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purposes of any provision of the Internal Revenue Code or the regulations promulgated thereunder. This section does not apply to the extent that a provision of Internal Revenue Code or the regulations thereunder prescribe the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax result, taking into account all relevant facts and circumstances, are clearly contemplated by that provision.

In an example under this rule, X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign country A. They form a US partnership in which X owns a 40 percent interest and Y owns a 60 percent interest. The partnership holds 100 percent of the voting stock of Z, a country A corporation. X seeks to obtain the benefit of the look-through rules of Section 904(d) and, as a result, maximize its ability to claim credits for its proper share of country A taxes. It wishes to avoid the foreign tax credit limitation category for dividends from non-controlled Section 902 corporation. Sections 957(c) and 7701(a)(30) prescribe the treatment of a domestic partnership as an entity for purposes of defining the term US shareholder, and thus, for purposes of determining whether a foreign corporation is a controlled foreign corporation. Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime. Accordingly, the IRS cannot treat the partnership as an aggregate of its partners for purposes of determining X's foreign tax credit limitation.

G. Conduit regulations

The IRS proposed regulations under the authority of Section 7701(l) that would permit the IRS to disregard, for purposes of Sections 871, 881, 1441 and 1442, the participation of one or more persons in a conduit financing arrangement. Section 7701(l) was enacted as a part of the 1993 Tax Act. The proposed regulations contain a number of definitions and examples. Some of the examples illustrate relatively sophisticated approaches to financing transactions that obviously no longer will work to avoid conduit treatment.

A "financing arrangement" generally means two or more financing transactions in which one person (the financing entity) advances money or other property to another person (the intermediate entity) and the intermediate entity advances money or other property to a third person (the financed entity). The term also includes two or more financing transactions that achieve substantially the same result through any other series of steps (for example, a loan from a foreign person to a US person, followed by an assignment of the loan by the foreign person to another person in exchange for a note issued by the assignee).

A "financing transaction" generally means any advance of money or other property in exchange for debt; any advance of money or other property in exchange for certain types of stock or a similar interest in a partnership or trust; any lease or licence; any other advance under which the transferee is obligated to repay or return a substantial portion of the money or property advanced (or the equivalent value); and any transaction by which a person becomes a party to an existing financing transaction.

An advance of money or other property in exchange for stock will be treated as a financing transaction only if the issuer or holder of the stock has rights, or there are arrangements in place, that are intended to ensure that payments on the instrument will be made as contemplated. Therefore, an exchange for common stock or ordinary perpetual preferred stock will not be included. However, an exchange for certain instruments, such as dividend-linked notes or other perpetual subordinated debt, will be included if those instruments provide for normal creditors' rights.

A "conduit entity" means an intermediate entity whose participation in a financing transaction is disregarded.

The standard to be applied by the IRS in determining whether an intermediate entity is disregarded for purposes of § 881 depends upon the relationship of the parties in the financing arrangement. If the intermediate entity is related to the financing entity or the financed entity, the financing arrangement will be subject to recharacterization if two conditions are satisfied: (1) the participation of the intermediate entity in the financing arrangement reduces the tax imposed by Section 881, and (2) the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A tax avoidance plan is defined as a plan one of the principal purposes of which is the avoidance of tax imposed by Section 881.

If the intermediate entity is unrelated to both the financing entity and the financed entity, the financing arrangement will be subject to recharacterization if the two conditions described above are satisfied and, in addition, the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity. If the financing entity guarantees the liability of the financed entity to the intermediate entity, it will be presumed that the intermediate entity would not have participated in financing arrangement on substantially the same terms but for the fact the financing entity engaged in the financing transaction with the intermediate entity. The taxpayer may rebut this presumption by producing clear and convincing evidence to the contrary.

A "guarantee" is any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another person's obligation with respect to a financing transaction.

In determining whether one of the principal purposes of the plan is tax avoidance, all facts and circumstances will be considered. The only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement, not those pertaining to the existence of the financing arrangement in general. The fact that an intermediate entity is resident of a country that has a treaty with the US that significantly reduces the tax that otherwise would have been imposed under Section 881 is not sufficient, by itself, to establish the existence of a tax avoidance plan. The proposed regulation lists several non-exclusive factors that are relevant to the determination of whether the intermediate entity's participation is pursuant to a tax avoidance plan.

It will be presumed that the participation of an intermediate entity (or entities) in a financing arrangement is not pursuant to a tax avoidance plan if the intermediate entity is related to the financing entity or the financed entity and the intermediate entity performs significant financing activities, as defined, with respect to the financing transactions forming part of the financing arrangement to which it is a party. The IRS may rebut the presumption by establishing that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan.

Where the financing entity is unrelated to the intermediate entity and the financed entity and is actively engaged in a substantial trade or business (other than in the business of making or managing investments, except pursuant to a banking, insurance, financing or similar trade or business, the income from which is earned predominantly in transactions with unrelated persons), it will be presumed that the participation of the intermediate entity in the financing arrangement is not pursuant to a tax avoidance plan.

Where a financing entity is unrelated to the financed entity and the intermediate entity, the financing entity will not be liable for tax under Section 881 pursuant to the proposed regulations unless the financing entity knows or has reason to know that the financing arrangement is subject to recharacterization under the conduit rules.

The recharacterized portion in a financing transaction is proportionate to the ratio of the principal amounts of the financing transactions that comprise the financing arrangement. In a financing arrangement that involves multiple conduit entities, the ratio is based upon a comparison of the smallest financing transaction between a conduit entity and a party other than the financed party. In this regard, however, the IRS may treat certain related persons as a single intermediate entity.

Payments made by a financed entity pursuant to a financing arrangement that is recharacterized under the conduit regulations are subject to tax at the rate applicable to payments made directly to the financing entity.

The proposed regulations are intended to provide anti-abuse rules that supplement, but do not conflict with, the limitation on benefits articles of US income tax treaties. The preamble states that treaty limitation on benefits articles commonly limit the tax benefits of the treaty to those residents of the other contracting state that have a substantial business nexus with, or otherwise have a significant business purpose for residing in, the other contracting state. These articles generally provide objective, bright-line rules for determining whether an entity has a sufficient nexus to the contracting state to be treated as a resident for treaty purposes. It has been recognized, states the proposed regulation's preamble, that contracting states may supplement these rules by transactionally-based domestic anti-abuse rules, including rules under which a particular transaction may be recast in accordance with the substance of the transaction. The proposed conduit regulation, which reflect common law substance over form principles as applied to conduit financing arrangements, complement the limitation on benefits provisions of income tax treaties and are not precluded by the inclusion of such provisions, just as those provisions have not overridden the applicability of existing anti-conduit rulings such as Rev. Rul. 84-152.

The preamble also states that Section 7701(l) authorizes the issuance of regulations applying to financing arrangements involving equity investments. The proposed regulations, however, generally do not include investments in common stock (or investments in ordinary perpetual preferred stock) in the definition of financing transaction for several reasons. First, because a corporation has no legal obligation to make distributions with respect to its common stock, inclusion of ordinary common stock in the definition of financing transaction could add significant uncertainty and complexity to the application of the regulations. Second, there are substantial questions about the extent to which common stock and ordinary perpetual preferred stock can be used in a conduit financing arrangement to avoid US withholding tax. The preamble states that if the IRS and Treasury determine that taxpayers are structuring conduit financing arrangements with such stock to avoid US withholding tax, the regulations may be extended to cover such stock.

The preamble also states that the IRS and Treasury are considering the circumstances under which the recharacterization should be extended to Code sections in addition to Sections 871, 881, 1441 and 1442.

A financed entity that is a reporting corporation within the meaning of Section 6038A(a), or that is required to report pursuant to Section 6038(a), must comply with certain reporting requirements with respect to any financing transaction to which the financed entity is a party that it knows or has reason to know forms part of a financing arrangement.

The proposed regulations are to be effective for payments made after the date which is 30 days after publication of the final regulations.

H. IRS early referral procedures

Announcement 94-41 contains the final procedures that will allow taxpayers to request early referral of an issue from examination to Appeals. The early referral procedures allow taxpayers whose returns are being examined by the IRS to request the transfer of developed, unagreed issues to Appeals while the other issues in the case continue to be developed in Examination. These procedures previously were published in proposed form and were the subject of a public hearing held on 28 January 1994. The competent authority procedures, also published in proposed form, will be finalized in a separate document.

The proposed procedures were changed in response to suggestions made at the public hearing. Changes include the following: early referral may be extended to non-Coordinated Examination Program cases, early referral is available for Joint Committee cases but any closing agreement will not be finalized until after Joint Committee review, taxpayers can request an informal conference to discuss the denial of an early referral request, taxpayers generally will be advised of an early referral approval or denial within 45 days of the date the CEP case manager receives the request from the taxpayer, regular Appeals procedures will apply, and there will be no requirement that only a closing agreement for specific matters will be used to secure a taxpayer's agreement.

The early referral procedures are optional. Once a taxpayer requests an early referral, it must be approved by both Appeals and the district handling the examination.

This is a very good new procedure, one that was widely applauded at the January 1994 hearing.[34]

I. *Tate & Lyle*: Section 267

Tate & Lyle Inc. v. Commissioner[35] rejected the Section 267 regulation that bars a US company from claiming a tax deduction for accrued interest owing to its UK parent. The regulation requires that the interest be deducted in the period in which it is actually paid. The court held that under the US–UK treaty interest payable to a UK company is exempt from tax and not includible in the UK company's gross income for US tax purposes. Thus, the court held that the interest can be deducted on an accrual basis and that in such a situation the Section 267 regulation is invalid. The court also held that the regulation was an invalid retroactive application of a rule since it applied to interest accruals made many years before the regulation was issued.

Section 267 generally requires taxpayers to defer deductions for amounts payable to a related person until the payment is includible in the recipient's gross income. The purpose underlying Section 267 is to prevent the use of different methods of reporting income for federal tax purposes in order to obtain artificial deductions. In 1986, two years after it had enacted the controlling version of Section 267(a)(2), Congress enacted Section 267(a)(3) which provides that the IRS shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a US person. Regulations were issued on 31 December 1992. Those regulations apply the matching principle "regardless of whether the related foreign person is exempt from US taxation on the amount owed pursuant to a treaty obligation of the United States" In the interim, Notice 89-84, 1989-2 C.B. 402, had stated that the matching principle requires that an accrual basis taxpayer is not entitled to deduct an accrued item if the accrued item is payable to a related person, and the item is not currently includible in the payee's gross income because of the payee's method of accounting.

The court agreed that, to the extent that the withholding provisions determined when a foreign payee must include interest in gross income for federal tax purposes, the timing provisions of those sections constitute the method of accounting for such interest income under Section 267. The problem in applying the method of accounting inherent in the withholding tax sections to the facts of this case is that the interest payable to the UK company is not subject to tax under those provisions. This is because the interest is not includible in the UK company's gross income pursuant to the US–UK treaty. The item is not includible in the payee's income for US federal income tax purposes not by reason of the payee's method of accounting, but by reason of the US–UK treaty.

A statement in the legislative history indicated that regulations could require a US subsidiary to use the cash method of accounting with respect to the deduction for amounts owed to its foreign parent for services. The court stated that this statement is troublesome, but noted that the final regulations reject applying such a rule to services. Only taxpayers who accrue interest payable to a related foreign party are subject to the cash method rule. Presumably, stated that court, the persons responsible for drafting the regulations, upon reflection, did not believe that the matching principle applied to services which were not taxable in the US because the foreign company is not engaged in business in the US. The court felt that the only discernible reason that the IRS wished to treat interest deductions in this manner was to treat the similar to deductions for original issue discount. However, there is no provision in Section 267 that refers to Sec-

34. See, for example, the TEI comments published at *TNT* (23 February 1994).
35. 103 T.C. No. 37 (1994).

tion 163(e)(3), nor is there any reference to Section 163(e)(3) in the legislative history of Section 267(a)(3). There is simply no provision that permits the IRS to expand the reach of the regulations under Section 267(a)(3) beyond the matching principle of Section 267(a)(2).

The court's holding in this regard would seem to apply only where interest paid to the foreign company is exempt from US tax under a treaty. It would seem not to apply where there is a reduced rate of withholding.

The court also stated that even if the regulations were found to be a reasonable implementation of the congressional mandate, it believed that the retroactive application of the regulations to this case (involving 1985-1987) violates the Due Process Clause of the Fifth Amendment to the Constitution. In 1986, two years after it had enacted Section 267(a)(2), Congress enacted Section 267(a)(3) and made it applicable to all taxable years beginning after 31 December 1983. Thus, Congress intended that the IRS issue regulations and that those regulations could apply retroactively. However, the regulations were not issued until 31 December 1992, approximately seven years after Congress enacted Section 267(a)(3). The portion of the regulations applicable to this case applies retroactively to all taxable years beginning after 31 December 1993 – a nine year period. The court felt that the length of time involved in the retroactive application led to a violation of the Due Process Clause.

The decision was "reviewed by the court". Four judges agreed with the majority opinion, which was discussed above. Four wrote a concurring opinion in which they generally agreed with the majority on the substantive issue, but disagreed with respect to the majority's view on retroactive application of the regulation. Seven judges dissented.

J. Penalty regulations

The IRS proposed regulations under the accuracy-related penalty rules dealing with the reasonable cause and good faith exception. Section 6664(c) provides that the accuracy-related penalty will not be imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to that portion. The GATT-implementation bill substantially broadened potential applicability of the corporate tax shelter penalty. The only "out" would be reasonable cause and good faith, which is the subject of the proposed regulations. They focus on the substantial underpayment penalty attributable to a tax shelter item of a corporation.

Prop. Treas. Reg. § 1.6664-4(e) sets forth rules for determining whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item. The determination is based on all pertinent facts and circumstances. There must be substantial authority for the tax treatment of the item. The taxpayer must also have reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper tax treatment. These are described as "minimum requirements". However, satisfying the minimum requirements is necessarily dispositive.

A corporation is considered reasonably to have believed that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) – (1) the corporation analyses the pertinent facts and authorities, and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS; or (2) the corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of all the pertinent facts and authorities and unambiguously states that the tax advisor concludes that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS.

The regulations are proposed to be effective for returns the due of which (determined without regard to extensions) is after the date on which final regulations are published in the Federal Register.

K. FSAs

Tax Notes commenced a Freedom of Information Act proceeding against the IRS to have communications such as field service advices released under FOIA. Among the items sought are formal FSAs and certain other items. In late January 1995, the IRS released a large number of *informal* FSAs that relate to international transactions. These were released in response to a FOIA request by Tax Notes. I will discuss here only a few of them.

One indicates that the amount of accrued interest that is deferred under Section 267(a)(3) through 1989 and that is paid to a foreign person in 1990, is not eligible for grandfathering under Treas. Reg. § 1.163(j)-10(b)(2). The IRS stated that Treas. Reg. § 1.163(j)-7 states that interest is not "paid or accrued" for Section 163(j) purposes until it is otherwise deductible. Consequently, if the interest payable is delayed until 1990, there is no grandfathering. The advice was given to an international examiner in Pittsburgh. The FSA is undated.

Where a US corporation owns 50 percent of a foreign corporation, the two firms probably are not part of a controlled group for Section 267 purposes. Section 267(f), the advice notes, provides a definition of a group of controlled corporations for Section 267 purposes that is the same as the definition of Section 1563, except that "more than 50 percent" must be substituted for "at least 80 percent". This advice was given to an international examiner in St. Louis. The FSA is dated 9 September 1992.

The Section 267(a)(3) regulations, which provide that an otherwise deductible amount of interest owed to a foreign person may not be deducted until the interest is actually paid, do not violate non-discrimination provisions in certain tax treaties.

This advice was given to an international examiner in San Francisco. The FSA is dated 12 March 1993.

In an FSA to Tim Tuerff of Arthur Andersen, the IRS denied rumours that it was considering revoking Rev. Rul. 91-5, 1991-1 C.B. 114. Under Rev. Rul. 91-5, a domestic corporation may compute foreign taxes deemed paid under Section 902 on dividends deemed received in a Section 304 stock sale. The FSA is dated 11 January 1993.

The IRS gave advice to Jay Levinson of the Petroleum Institute that income that arises as a result of outbound bargain sales, which are treated as taxable exchanges under Sections 367(c)(2), 367(a) and 1001, is subject to normal sourcing rules. No modification to the sourcing rules is required as a result of Section 367's application. The FSA is dated 27 August 1993.

The IRS is maintaining its position, stated in Rev. Rul. 82-45, 1982-1 C.B. 89, that foreign law limiting certain types of payments from foreign entities to US entities does not prevent a Section 482 allocation. The advice was given to an international examiner in St. Paul. The FSA is dated 19 May 1992.

Under the pre-1988 Section 482 regulations, the 180-day safe harbour, describing when interest need not be charged, applies when the receivable is paid off outside the safe harbour period. This advice was given to an examiner in the North Atlantic region. The FSA states that interest is only charged from the first day after the six month period.

The commensurate with income standard applies to taxable years beginning after 31 December 1986. A cost sharing agreement that was considered "bona fide" before that time will not necessarily be deemed to be "bona fide" under the commensurate with income standard. Therefore, the transitional rule of the proposed cost sharing regulations does not automatically exempt from examination pre-1987 cost sharing arrangements. This advice was given to an international examiner in Boston. The FSA is dated 30 November 1992.

Under the cost sharing rules, all of the direct and indirect costs of the relevant R&D must be shared, even if the costs are not deductible. If part of an engineer's compensation is in stock options which can be valued, then the cost of those options should be shared. This advice was given to an international examiner in San Jose, California. The FSA is dated 9 June 1993. It also addresses a second issue. The FSA states that the standard by which intercompany transactions are judged under Section 482 is the arm's length standard. If a company doing business at arm's length with a contract manufacturer would not reimburse that manufacturer for VAT paid, then a Section 482 issue may exist with respect to a company which reimburses a related contract manufacturer for VAT paid.

The IRS indicated that it will not contest a consent dividend deemed paid by a foreign subsidiary to a US parent company that results in a large foreign tax credit and a stepped up basis. The FSA states that for years ending before 15 December 1987, the IRS will not attack such transactions, but that regulations prohibit such transactions for tax years ending after that date. The advice was given to an international examiner in Philadelphia. The FSA is dated 1 July 1993.

In apportioning expenses under the gross receipts method under Treas. Reg. § 1.861-8, gross receipts do not include interest and dividends, but only sales and service income. The IRS stated that "expenses associated with small passive income amounts would have to be separated and isolated". The advice was given to an international examiner in Detroit. The FSA is dated 11 June 1993.

An asset must have a cost basis, after amortization is taken into account, in order for the asset to draw an interest expense apportionment under Section 861 under the tax book value method. This principle applies to tangible as well as intangible assets. The advice was given to an international examiner in Columbus, Ohio. The FSA is dated 14 October 1992.

A taxpayer may not allocate R&D expenses on a basis narrower than the SIC categories mandated in Treas. Reg. § 1.861-8(e)(3). The advice was given to an examining agent in St. Paul. The FSA is undated.

Accounts receivable from foreign sales corporation sales are not added to the numerator for purposes of asset based apportionment of interest expense for FSC combined taxable income purposes. The FSA states that these assets do not contribute to earning FSC combined taxable income. The advice was given to an international examiner in Kansas City. The FSA is dated 10 March 1993.

The IRS stands behind the anti-disaffiliation rule of Treas. Reg. § 1.861-11T(d)(6) where a CFC has been interposed between domestic affiliates. The advice was given to an international examiner in Manhattan. The FSA is dated 17 September 1993.

Losses incurred on sales of stock are sourced on the basis of the residence of the corporation, not the residence of the owner of the stock. The IRS stated that under Treas. Reg. § 1.861-8(e)(7), dividends would be foreign source if they were paid by a foreign corporation. Therefore, the loss is a foreign source loss. It is not clear what taxable year was involved in this FSA. The advice was given to an international examiner in Boston. The FSA is dated 16 November 1993.

A foreign parent liquidated a US subsidiary, which holds stock of a foreign subsidiary. The foreign subsidiary's stock was treated as sold. The FSA indicates that the gain on the sale of the foreign subsidiary's stock should be US source unless it is re-sourced under Sections 865(f) or 1248. It is unclear to which district the advice was given. The FSA is dated 15 September 1993.

Tax-exempt income is not included in computing apportionments of general and administrative expenses. The advice was given to an international examiner in Manhattan. The FSA is dated 19 March 1993.

Part of the basis of stock owned by a US parent company in a CFC that generates US source income under Section 904(g) is treated as an asset that generates Section 904(g) income for interest expense allocation purposes. The advice was given to an international examiner in Dallas. The FSA is dated 19 November 1993.

Where an asset is idle for the year in question, expenses are sourced on the basis of past earnings of that asset, rather than future earnings of that asset. The advice was given to an international examiner in Atlanta. The FSA is undated.

A net operating loss may not be carried from a non-DISC year to a DISC year to reduce combined taxable income. The FSA explains that expenses giving rise to the net operating loss are apportioned on the basis of the year in which they arose. Since there was no DISC combined taxable income in that year, nothing is apportioned to the DISC. The advice, which is consistent with LTR 8911002 (dealing with FSC), was given to an appeals officer in Denver. The FSA is dated 22 June 1992.

A contribution to a charity in a foreign country is deductible only if such deductions are provided for in a US tax treaty with the foreign country. It is unclear to which district the advice was given. The FSA is dated 20 November 1993.

L. IRS-Treasury 1995 business plan

1. Foreign tax credit

(a) Final regulations under Sections 905(c) and 6689 on notification requirements, necessary adjustments, and the civil penalty relating to foreign tax redeterminations.
(b) Final regulations under Section 904(i) limiting use of deconsolidation of corporations to avoid foreign tax credit limitations.
(c) Guidance on the computation of foreign tax credits on Section 1248 dividends of earnings and profits accumulated in both post-1986 and pre-1987 taxable years.

2. Subpart F/deferral

(a) Final regulations under Section 954 regarding the definition of foreign base company income and foreign personal holding company income of a controlled foreign corporation.
(b) Notice concerning guidance to certain specified foreign corporations to switch their US taxable year back to the year they had prior to the enactment of Section 898.

3. Inbound transactions

(a) Revisions to withholding rules on payments made to foreign persons and changes to reporting requirement regulations under Sections 1441, 1461-1464.

4. Outbound transactions

(a) Proposed regulations concerning characterization of income received by a foreign bank or securities dealer in the US for purposes of the tests of the PFIC provisions and other PFIC guidance.
(b) Proposed regulations under Section 367(a) with respect to the transfer of stock of a domestic corporation by a US person to a foreign corporation in an exchange that is subject to Section 367(a).
(c) Final regulations under Section 367(b) governing the application of subchapter C non-recognition provisions to foreign-to-foreign and inbound transactions involving controlled foreign corporations.
(d) Guidance under Section 936 concerning determination of income under various elections.

5. Sourcing and expense allocation

(a) Proposed regulations under Section 865 to provide guidance with respect to the source of gain and loss on the disposition of personal property.
(b) Final regulations under Section 864(e) on allocation of interest expense.
(c) Proposed regulations under Section 864(a) on allocation and apportionment of interest expense: hedging and interest equivalents.
(d) Final regulations under Section 863(e) concerning the source of scholarship and fellowship grants.
(e) Proposed regulations revising the independent factory price rules.

6. Treaty

(a) Notice addressing the extent to which property reparations made by the German government are exempt from taxation under the US–Germany income tax treaty.
(b) Guidance on issues concerning income from software.
(c) Revision of Rev. Procs. 91-23 and 91-24 relating to procedures for obtaining assistance of the competent authority.
(d) Guidance on APA methodologies.

7. Other

(a) Final regulations under Section 482 implementing the "commensurate with income" standard in the context of cost sharing.
(b) Final regulations determining when to ignore conduit arrangements in multiple-party financing transactions under Section 7701(1).
(c) Finalize temporary regulations under Sections 6662(e) and (h) that set forth the rules implementing the imposition of the accuracy related penalties in the context of Section 482.
(d) Revision of Rev. Proc. 91-22 providing guidance to taxpayers submitting a request for an Advance Pricing Agreement.
(e) Update revenue procedures to reflect final regulations under Section 482.
(f) Proposed regulations under Section 6109 to provide a TIN for taxpayers who are not eligible for a social security number.
(g) Final regulations addressing an election to use a mark-to-market method of determining exchange gain or loss and additional integrate hedging rules.
(h) Regulations under Section 482 to conform loan and service rules to final regulations under § 1.482-1.
(i) Section 404A regulations.

M. Section 898

In Notice 95-13, the IRS announced that final Section 898 regulations will provide that a specified foreign corporation may change to the taxable year it used immediately before changing to its "required year" for returns on Forms 5471 or 1120F due after 14 March 1995, and no later than 15 March 1997.

Prior to the enactment of Section 898, a "specified foreign corporation" could elect a taxable year that resulted in deferral of US tax on its Subpart F or foreign personal holding income. Section 898 was enacted to minimize the opportunities for such deferral.

Proposed Treas. Reg. § 1.898-1(c)(1) provides that a specified foreign corporation is not required to conform its taxable year to the required year so long as its US shareholders do not have any amount includable in gross income pursuant to Section 951(a) and do not receive any actual or deemed distributions attributable to amounts described in Section 553 with respect to that corporation. The concern to which Section 898 was directed is absent when a specified foreign corporation does not have Subpart F or foreign personal holding company income.

Many foreign corporations changed their US taxable years to those that their majority shareholders had under Section 898 before the proposed regulation was published. In their US taxable years beginning after 10 July 1989, some have not generated any includable Subpart F or foreign personal holding company income. The Notice states that the regulations will allow, in such a case, the foreign corporation to change back to its pre-change year. The change to the pre-change year will create a short taxable period for the foreign corporation for which a Form 5471 must be filed.

If the taxpayer has received written notice from an IRS representative citing as an issue whether a US shareholder of the specified foreign corporation has any amount of Subpart F or foreign personal holding company income includable in its gross income attributable to that foreign corporation, and this issue has not been resolved, the foreign corporation may not change to its pre-change year without the written consent of that IRS representative.

If a US shareholder of the foreign corporation, with respect to any US taxable year beginning after 10 July 1989, includes in income any amount of Subpart F or foreign personal holding company income attributable to that foreign corporation, then the foreign corporation must change to the "required year" under Section 898 beginning with its first taxable year subsequent to the taxable year to which the shareholder's income is attributable. Where the inclusion in income in a taxable year resulted from an IRS examination, filing of amended returns for years thereafter is required.

N. Estimated tax rules for individuals and corporations dealing with Sections 936(h) and 951(a)

The GATT implementation legislation, enacted last year, provides new estimated tax rules dealing with Section 936 and Subpart F. Rev. Proc. 95-23, I.R.B. 1995-18, provides guidance regarding the estimated tax rules for individuals and corporations as a result of this change. Under these rules, which apply to determine underpayments of estimated tax for taxable years beginning after 31 December 1994, estimated tax payments determined by annualizing income generally must take into account income under Sections 936(h) and 951(a) (and credits properly allocable thereto) as that income is earned.

The taxpayer may elect to use a safe harbour provided in the revenue procedure, and thereby determine the estimated tax instalments based on the amount of income under Sections 936(h) and 951(a) (and credits properly allocable thereto) as shown on the taxpayer's tax returns for the two preceding taxable years.

If an eligible individual makes a safe harbour election, then for purposes of computing any annualized income instalment, the individual will be treated as having received ratably during the taxable year items of income under Sections 936(h) and 951(a) (and any credits probably allocable thereto) in the amount of such items shown on the individual's return for the preceding taxable year (the second preceding taxable year in the case of the first and second required instalments of a taxpayer that filed an income tax return for its second preceding taxable year).

If an eligible corporation, other than one that is a non-controlling shareholder, makes the safe harbour election, then for purposes of computing any annualized income instalment, the corporation will be treated as having received ratably during the taxable year items of income under Sections 936(h) and 951(a) (and credits properly allocable thereto) equal to 115 percent of the amount of such items shown on the return of the corporation for the preceding taxable year (the second preceding taxable year in the case of the first and second required instalments of a taxpayer that filed an income tax return for its second preceding taxable year). A non-controlling shareholder should base its computations on 100 percent, rather than 115 percent.

X. PFIC

A. Treasury study opposes permitting CFCs and PFICs to capitalize intangibles created by marketing

The 1993 Tax Act enacted special asset rules for purposes of the PFIC and Section 956A rules with respect to research expenditures and certain licensed intangibles. The 1993 Conference Committee Report stated that taxpayers argued that marketing expenditures may also enhance the corporation's ability to generate active business income over an extended period. Treasury, thus, was directed to study the question whether similar basis adjustments should be made for this type of expenditure and to provide a report to Congress.

Treasury submitted a report to Congress published on 30 December 1994, strongly opposing the capitalization of marketing expenditures for this purpose. The report states that, first, the marketing expenditures that create lasting assets would have to be identified. Second, a hypothetical basis would have to be constructed to represent the basis the expenditures would have created if they had been capitalized and amortized rather than expensed. A difficulty in measuring advertising benefits, states the report, involves determining their economic lifetimes. Lifetimes vary greatly by industry, and estimates of lifetimes are subject to a great deal of error.

The report addresses capitalizing marketing *expenditures*. The report does not affect the rule dealing with certain licensed intangibles. In the case of any intangible property (defined in Section 936(h)(3)(B)) with respect to which the CFC is a licensee and which is used by such foreign corporation in the active conduct of a trade or business, the adjusted basis of the foreign corporation's total assets are increased by an amount equal to 300 percent of the payments made during the taxable year by the foreign corporation for the use of the intangible property. A basis can be constructed for licensed marketing intangibles included in the definition of Section 936(h)(3)(B) under this rule. Marketing *expenditures*, on the other hand, such as advertising expenses, cannot be capitalized under the current rules. It is these expenditures to which the report is addressed.

B. Loss company not a PFIC

LTR 9447016 held that a foreign subsidiary, which experienced operating losses in two years, did not become a passive foreign investment company under the gross income test of Section 1296(a)(1). The vast majority of the foreign subsidiary's gross receipts in the years in issue arose in the active conduct of its business. The business operated at a loss (after deducting the cost of goods sold from gross receipts). Some amount of the subsidiary's income constituted income from other sources. A portion of the subsidiary's income was attributable to interest income from time deposits. Interest income of this type constitutes passive income under Section 1296(b). In both years, the loss from the subsidiary's business exceeded its income from other sources. The IRS stated that the subsidiary's total gross income from all sources if computed pursuant to the principles of Treas. Reg. § 1.61-3(a) resulted in zero gross income for both years.

The IRS stated that the PFIC regulations do not specify how gross income is to be determined. Accordingly, the IRS stated that it is appropriate to apply the principles of Sections 11 and 61. Thus, the gross income of a foreign corporation for any taxable year is determined by treating the foreign corporation as a domestic corporation and by applying the principles of Section 61 and the regulations thereunder. Thus, "gross income" of a manufacturing business, like the subsidiary's business, means total sales less cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

The PFIC gross income test applies to the total gross income of a corporation for the taxable year. The gross income test does not apply where a foreign corporation has no gross income determined pursuant to the principles of Section 61. In the subsidiary's case, its non-passive loss exceeded its passive and non-passive income for the taxable year, so that it had zero gross income for both years. Accordingly, the subsidiary was not a PFIC under Section 1296(a)(1) in either year.

C. Leasing FSC/PFIC

LTR 9447024 describes a FSC which was incorporated in the Virgin Islands. The FSC purchased certain aircraft and aircraft engines for $ 130 million with funds contributed to it by its US parent company. It then entered into a lease agreement with a lessee pursuant to which the FSC leased the equipment to the lessee for a term of approximately 11 years. The lessee will use the equipment in international transportation.

It was assumed (apparently by the taxpayer, as well as by the IRS) that the FSC was a PFIC within the meaning of Section 1296.[36] A QEF election under Section 1295 was not made. The parent had contributed $ 141 million to the capital of the FSC in exchange for all of its stock. As noted, $ 130 million was used to purchase the equipment. Three months after the contribution, the FSC distributed $ 10.5 million to its US parent. In its next year, 1992, the FSC received rent from the lessee in the amount of $ 13 million, all of which it distributed to its parent. The purpose of the 1991 distribution of $ 10.5 million was to avoid the PFIC excess distribution rules. There is an excess distribution if the amount of distributions during the year exceed 125 percent of the average amount received during the preceding three taxable years (or if, shorter, the portion of the taxpayer's holding period before the taxable year).

The ruling requested (in 1991; the requested was pending for three years) was that the $ 10.5 million distribution was a distribution for purposes of Section 1291. The IRS recognized the taxpayer's interest in avoiding having excess distribution treatment on subsequent distributions to the US company. Thus, the US company contributed $ 10.5 million in excess of what the FSC needed to purchase the equipment and pay transaction expenses. The IRS stated that the contribution and distribution had no economic substance apart from its intended tax consequences. Therefore, the contribution and subsequent distribution will be disregarded for federal income tax purposes.

The IRS stated that as a result of disregarding the $ 10.5 million distribution, the entire $ 13 million distributed in 1992 is an excess distribution. As provided in Section 1291, the 1992

36. This seems erroneous. The FSC appears to have been in receipt of shipping income which does not constitute Sec. 954(c) income. See Sec. 954(b)(6). Thus, it should not constitute passive FPHC income for PFIC purposes.

distribution is allocated *pro rata* to each day in the US company's holding period that is treated as ending on the date of the 1992 distribution. The amount allocated to 1992 is included in gross income as ordinary income, but not as a dividend. The amount allocated to 1991 is not included in income, but is subject to the special tax and interest charge rules of Section 1291(c). For purposes of determining the portion of the 1993 and subsequent years' distributions, stated the IRS, only the portion of the excess distribution allocated to 1992 and included in income is treated as a distribution made in a preceding year for purposes of determining the 125 percent amount after 1992.

Interestingly, the IRS stated that the taxpayers could have found alternate means of increasing the first year distribution base without undertaking a transaction devoid of economic substance. For example, the FSC could have borrowed the funds with which to make a distribution from a bank. Assuming that the FSC was the true borrower, the loan and subsequent distribution would have been respected for federal income tax purposes.

The taxpayer also requested a ruling that the rental income that the FSC receives from the lessee will be excluded from the FSC's gross income under Section 883 of the Code. Section 927(e)(4) provides that a FSC may not claim any benefits under an income tax treaty between the US and any foreign country. Thus, if the exemption is granted pursuant to a treaty, Section 883 will not apply to the FSC. However, if the foreign country grants the exemption by statute, Section 927(e)(4) does not render Section 883 inapplicable. The application of Section 883 to the FSC's rental income is determinative of whether Section 887 applies. Section 887 imposes a 4 percent tax each taxable year on the foreign corporation's US source gross transportation income for that year. The 4 percent tax does not apply to income of a kind that is exempt under Section 883.

The US Virgin Islands is treated as a foreign country for purposes of Section 883.[37] Because of the operation of the Virgin Islands' "mirror code", the Virgin Islands and the United States each meet the equivalent exemption test of the other's law. Therefore, Section 927(e)(4) does not apply and, accordingly, the lessor's rental income derived from the international operation of aircraft is exempt from federal income tax under Section 883.

XI. LEGISLATION

A. Technical Corrections Bill

H.R. 1121, the Tax Technical Corrections Act of 1995, was introduced in the House on 3 March 1995. It subsequently was incorporated as Title VI in H.R. 1215, the Republicans' "Contract with America Tax Relief Act of 1995". These technical corrections include the technical corrections that were in last year's Tax Simplification and Technical Corrections Bill, H.R. 3419. The bill (hereinafter referring to H.R. 1121 as introduced or as incorporated in H.R. 1215) does *not* include H.R. 3419's simplification proposals. It also contains three additions to the technical corrections that were in H.R. 3419. One of these modifies Section 904(d).

The bill contains three parts: technical corrections to the 1993 Act, technical corrections to the 1990 Act, and other technical corrections. Among the technical corrections to the 1993 Act, the bill clarifies that a US shareholder's inclusion of a controlled foreign corporation's earnings invested in excess passive assets is treated like a dividend for purposes of the foreign tax credit limitation. Section 904(d)(3)(G) is modified accordingly. Thus, an inclusion under Sections 951(a)(1)(C) and 956A is characterized by reference to the underlying earnings and profits of the CFC. Without this technical correction, such an inclusion would be general basket income. This was not in H.R. 3419.

The other technical corrections to the 1993 Act were in H.R. 3419. Section 956A is amended to clarify that the accumulated earnings and profits of a CFC, taken into account for purposes of determining its earnings invested in excess passive assets, do no include a deficit in accumulated earnings and profits, and do not include current earnings (which are taken into account separately). It was clear from the 1993 Act's legislative history that this was intended, but Sections 956A(b), defining "applicable earnings", did not achieve this result. Thus, the so-called nimble dividend rule applies under Section 956A where there is an accumulated deficit for taxable years beginning after 30 September 1993 but positive current year earnings and profits. An income inclusion will result if the CFC has excess passive assets. Further, Section 956A(b), as currently written, adds accumulated earnings and profits (which includes current earnings and profits) and current earnings and profits to determine applicable earnings. Clearly, the two should not be added. This is corrected in the bill.

The bill clarifies that regulations are authorized under Section 956A to coordinate the CFC group treatment and look-through rules. The concern is that the Section 956A rules might permit the assets of a foreign corporation to be taken into account more than once through a combination of CFC group and look-through rules. There also is a concern that the rules might permit the assets of a foreign corporation to be taken into account more than once through membership of the foreign corporation in more than one CFC group. The Joint Committee Explanation states that pending the promulgation of regulations, it is intended that taxpayers be permitted to coordinate such treatment using any reasonable method of taking assets into account only once, so long as the method is consistently applied to all CFCs (whether or not members of any CFC group) in all taxable years.

The bill clarifies that in the case of any item of property leased by a foreign corporation and treated as an asset actually owned by the foreign corporation in measuring the assets of the foreign corporation for purposes of the PFIC asset test, the amount taken into account with respect to the leased property is the amount determined under the 1993 Act's special measurement rule, which is based on the unamortized

37. See Sec. 872(b)(7).

portion of the present value of the payments under the lease for the use of the property. The special measurement rule of the 1993 Act applies to all PFICs, regardless of whether they are permitted to measure their assets by fair market value or adjusted basis.

The "Other Technical Corrections" portion of the bill contains provisions which were in H.R. 3149.

The most interesting of these provisions is a seemingly innocent change in Section 865(b) which conceivably could have major consequences with respect to Section 863(b). The change modifies Section 865(b)(2) so that the cross reference is to Section 863, instead of Section 863(b). While this change in a cross reference would seem not to accomplish much, the Joint Committee Explanation is both enlightening and confusing. It states that the bill clarifies that, to the extent that the Secretary of the Treasury had general regulatory authority to provide rules for the sourcing of income from the sales of personal property prior to the 1986 Act, the Secretary of the Treasury retains that authority under present law with respect to inventory property. It further states:

> The bill is not intended to increase the Treasury Secretary's regulatory authority under § 863(a) beyond the authority that he had under the law in effect prior to the enactment of the 1986 Act. It is intended that no inference be drawn from this provision either as to the correctness of, or as to the post-1986 Act implications of, any judicial decision interpreting the scope of that pre-1986 Act authority.

The IRS argued in *Phillips Petroleum Co. v. Commissioner*[38]and *Intel Corporation v. Commissioner*[39] that the export sales source rule is governed by Section 863(a) and that, therefore, a mixed source result is not mandated. The Tax Court rejected this argument, stating in *Phillips*:

> We ... constru[e] the Section 863(b) sourcing rules as not contradicting, but modifying and necessarily constraining the Section 863(a) delegation of authority. We base this conclusion on the statutory precept that general provisions of law must yield to specific ones.... Section 863(b)(2) states that income from the sale of personal property produced within and sold without the United States shall be treated as mixed source.

While the Joint Committee Explanation states that the bill is not intended to increase the Secretary's regulatory authority beyond that which he had under the law in effect prior to the 1986 Act, the Joint Committee Explanation is confusing. It states that no inference should be drawn either as to the correctness of, or as to the post-1986 Act implications of, any judicial decision interpreting the scope of that pre-1986 Act authority.

If the technical correction is not to increase the Secretary's regulatory authority, why should an inference not be drawn as to the correctness of *Phillips Petroleum v. Commissioner*? That case interpreted the Secretary's Act authority under Section 863(a) *vis-à-vis* Section 863(b). Further, why should no inference be drawn as to the post-1986 Act implications of *Phillips*? The 1986 Tax Act did not change the export sales source rule. How could the Secretary's authority have increased as a result of the 1986 Act? Is this a "technical correction", or is it an effort to reverse *Phillips* and *Intel*?

The IRS recently announced a regulations project on this very subject. The 1995 Treasury/IRS business plan also includes "proposed regulations revising the independent factory price rules." This (the export sales source rule) would seem to be an issue that will never go away. Congress rejected an Administration proposal to change the export sales source rule in 1986. The courts have rejected the IRS's attempt to change the rule by rulings and notices (namely, Notice 89-10). Last year, the Administration unsuccessfully tried to change the rule by adding it to the GATT Implementation Bill. Now, we have a regulations project and a purported "technical" correction dealing with the issue.

Other changes in the "Other Technical Corrections" portion of the bill include a change dealing with withholding on distributions from US real property holding companies. The bill clarifies that FIRPTA withholding requirements apply to any Section 301 distribution to a foreign person by a domestic corporation that is or was a USRPHC, which distribution is not made out of the corporation's earnings and profits and is therefore treated as an amount received as a sale or exchange of a US real property interest.

The bill clarifies that in determining the *pro rata* unified estate tax credit required by treaty, property exempted by the treaty from US estate tax is not treated as situated in the US Under this rule, a treaty granting a *pro rata* unified credit would allow a non-resident alien the unified credit allowed a US citizen or resident multiplied by the percentage of the gross estate subject to US tax, as modified by the treaty. This is not intended to affect existing treaties that already have *pro rata* exemptions.

The bill provides that the debt-equity threshold under Section 163(j) does not apply for purposes of applying the earnings stripping provision to a carryover of excess interest expense from a prior taxable year. Thus, the bill clarifies that excess interest carried forward from a year in which the debt-equity ratio threshold is exceeded may be deducted in a subsequent year in which that threshold is not exceeded, but only to the extent that such interest would not otherwise be treated as excess interest expense in the carry-forward year.

The bill provides that the branch level interest tax on interest not actually paid by the branch applies to any interest which is allocable to income which is effectively connected with the conduct of a trade or business in the US Similarly, in the case of interest paid by the US branch, the bill provides regulatory authority to limit US sourcing, and hence US withholding, to the amount of interest reasonably expected to be allocable to income which is effectively connected with the conduct of a trade or business in the US. Thus, where an interest expense of a foreign corporation is allocable to US effectively connected income, but that interest expense would not have been fully deductible for tax purposes under another Code provision had it been paid by a US corporation, the bill clarifies that such interest is nonetheless treated for branch level interest tax purposes like a payment by a US corporation to a foreign corporate parent. Similarly, with regard to the Treasury's regulatory authority to treat an interest payment by a foreign

38. 97 T.C. 30 (1991).
39. 100 T.C. 616 (1993).

corporation's US branch as though not paid by a US person for source and withholding purposes, the bill clarifies that the authority extends to interest payments in excess of those reasonably expected to be allocable to US effectively connected income of the foreign corporation.

In the section of the bill dealing with technical corrections to the 1990 Tax Act, three changes are made with respect to the repeal of the General Utilities doctrine that affect the Code's international provisions. First, Section 1248(f) is amended to add a reference to Section 355(c)(1), which provides generally for the non-recognition of gain or loss on the distribution of stock or securities in certain subsidiary corporations. The Joint Committee Explanation states that this retains the substance of the law as it existed before the conforming changes to Section 355(c) made by the 1990 Act. Thus, a spin-off by a domestic corporation of stock in a CFC is subject to Section 1248(f).

The second technical correction with respect to the repeal of the General Utilities doctrine modifies Section 1248 to clarify that, notwithstanding the conforming changes made by the 1988 Act, with respect to any transaction in which a US person is treated as realizing gain from the sale or exchange of stock of a CFC, the US person shall be treated as having sold or exchanged the stock for purposes of applying Section 1248. Thus, if a US person distributes appreciated stock of a CFC to its shareholders in a transaction in which gain is recognized under Section 311(b), Section 1248 shall be applied as if the stock had been sold or exchanged at its fair market value. Under Section 1248(a), part or all of the gain may be treated as a dividend. Under the bill, the rule treating a distribution for purposes of Section 1248 as a sale or exchange also applies where the US person is deemed to distribute the stock under the provisions of Section 1248(i). Under Section 1248(i), gain will be recognized only to the extent of the amount treated as a dividend under Section 1248.

The third General Utilities-related change involves Section 897(f), relating to the basis in a US real property interest distributed to a foreign person. This provision is repealed as dead wood. The basis of the distributed property is its fair market value in accordance with Section 301(d).

The other provision dealing with technical corrections to the 1990 Act that affects international transactions addresses Sections 6038A and 6038C. The bill modifies the rules in these sections that suspend the statute of limitations to clarify that the suspension applies to any taxable year the determination of the amount of tax imposed for which is affected by the transaction or item to which the summons relates. The Joint Committee Explanation states that it is intended that a transaction or item would affect the determination of the amount tax imposed for the taxable year directly at issue, as well as for any taxable year indirectly affected through, for example, net operating loss carry-backs or carry-forwards. It is not intended that a transaction or item would affect the determination of the amount of tax imposed for any taxable year other than the taxable year directly at issue solely by reason of any similarity of issues involved. It also is not intended that a transaction or item would affect the determination of the amount of tax imposed on any taxpayer unrelated to the taxpayer to whom the summons is directed.

B. GATT implementation

The GATT implementation legislation includes the change in the estimated tax provisions dealing with Subpart F and Section 936.

It also enacted the modification of the substantial understatement penalty for corporations participating in tax shelters. In the case of any tax shelter, it will be irrelevant whether there was substantial authority or whether the item was adequately disclosed on the return or whether there was a reasonable basis for the tax treatment or whether the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment. The only defence will be reasonable cause and a showing that the taxpayer acted in good faith. "Tax Shelter" is defined to include a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if the principal purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. This obviously will cause substantial disputes over what is the principal purpose of various partnerships, etc. This seems quite clearly to me to be an unwise provision.

C. President's Budget

The President's Budget announced changes in expatriation and foreign trust rules.

UNITED STATES

CURRENT TAX TREATY ISSUES

Mary C. Bennett

Mary Bennett is a partner in the Washington, D.C. office of Baker & McKenzie, where she specializes in representing both US and foreign-based multinational corporations on international tax matters. Ms Bennett publishes and speaks frequently on international tax issues. Together with colleagues from the Washington and Amsterdam offices of Baker & McKenzie, she has authored the treatise, *A Commentary to the US–Netherlands Income Tax Convention*, to be published in 1995.

From 1985 to 1990, Ms Bennett served in the US Treasury Department's Office of Tax Policy, including the last three years of that period as the Deputy International Tax Counsel.

From 1979 to 1985, Ms Bennett practised international tax law with firms in Boston and London. She received an A.B. *cum laude* from Radcliffe College in 1976 and a J.D. from Colombia Law School as a Harlan Fiske Stone Scholar in 1979. She was also awarded an LL M in Taxation by Boston University in 1985. She is a member of the Bar of Massachusetts, New York and the District of Colombia.

I. PROPOSED US MODEL INCOME TAX TREATY

On 17 July 1992, the Treasury withdrew for review and revision the proposed US Model Income Tax Treaty of 16 June 1981 and the US Model Income Tax Treaty of 17 May 1977, both of which had become outdated as a result of changes to US statutory law and treaty policy.[1] Treasury is expected to publish a revised Model Treaty, together with a technical explanation, during 1995.

Historically, one purpose of a US Model is to serve as a starting point for US negotiators. Treasury acknowledges that negotiations with developing countries frequently result in significant deviations from the US Model, and the proposed revision is not expected to address those issues. Query whether the existence of a US Model creates unrealistic expectations about the extent to which US negotiators should be prepared to offer or to demand a deal that conforms precisely with the Model.

For example, despite the old Model's coverage of the insurance premium excise tax, Treasury's actual negotiating policy is to analyse the particular treaty partner's domestic taxation of insurance companies before deciding whether such coverage is warranted. On the other hand, the Joint Committee on Taxation's explanations of pending treaties prepared for the Senate Foreign Relations Committee's ratification hearings have come to include a litany of the differences between each individual treaty and the US Model, perhaps creating the impression that each failure to conform to the US Model reflects a measurable concession by the US negotiators.

Another purpose of the US Model is to harmonize treaty language from one US treaty to another and between US treaties and the OECD Model. The desire to conform the US Model language to the OECD Model language reflects the realistic expectation that it is easier to reach agreement on a commonly accepted text, as well as the desire to promote certainty and consistency in interpretation of treaty terms.

US courts and the IRS frequently refer to the OECD Model and Commentary in interpreting provisions of US treaties.[2] Moreover, to the extent US treaties contain language similar to that found in treaties between foreign countries, foreign court decisions interpreting the latter treaties may provide a useful source for interpreting US treaties under appropriate circumstances.[3]

The objective of harmonizing language from one US treaty to another similarly reflects the desire to achieve certainty and consistency in application of treaty terms. US courts and the IRS also have a tendency to refer to interpretations of similar language in other US treaties in determining the meaning of terms used in a particular US treaty.[4]

Publication of a Treasury Technical Explanation to a US Model Treaty is a potentially valuable step in providing guidance as to the US Government's interpretation of treaty terms. Query what effect such a document would have on interpreting similar provisions of existing US treaties.

1. Treasury News Release NB-1900, 17 July 1992.
2. See e.g. *United States v. A.L. Burbank & Co., Ltd.*, 525 F.2d 9, 15-16 (2d Cir. 1975), *cert. denied*, 426 US 934 (1976); *Kimball v. Commissioner*, 6 T.C. 535 (1946), *affd.*, 157 F.2d 816 (1st Cir. 1946) (referring to 1928 League of Nations Model and Commentary in interpreting 1935 US–France Treaty); Rev. Rul. 86-145, 1986-2 C.B. 297 (interpreting dependent services article of US-U.K. Treaty); PLR 9421027 (24 February 1994) (interpreting residence article of US–Australia Treaty); G.C.M. 39373 (24 June 1985) (interpreting permanent establishment article of US–Netherlands Treaty); TAM 8030005 (interpreting non-discrimination article of US–Netherlands Treaty).
3. See American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation II – Proposals on United States Income Tax Treaties* 38, 55-56 (1992) [hereinafter "ALI"].
4. See e.g. *Kimball, supra* note 2 (referring to US treaties with Sweden and Canada in interpreting US–France Treaty); G.C.M. 39595 (8 January 1987) (referring to US treaties with France, Belgium, Japan, Iceland, Korea, and the United Kingdom in interpreting royalties article of US–Netherlands Treaty); G.C.M. 39373; TAM 8030005.

II. TREATMENT OF PASS-THROUGH ENTITIES

One of the issues that has been the subject of considerable Treasury attention in the development of the new US Model is the treatment of partnerships and other pass-through entities. Under US law, a significant number of entities qualify for some level of pass-through treatment, including partnerships, estates, trusts, S corporations, regulated investment companies (RICs), real estate investment trusts (REITs), and real estate mortgage investment conduits (REMICs) – this outline focuses on issues relating to partnerships.

The 1992 OECD Model, like earlier OECD Models, contains no special provisions relating to partnerships – instead, it suggests that contracting states may examine the relevant issues and agree on such special provisions relating to partnerships as they may find necessary and appropriate.[5]

The 1981 US Model contained the following language relating to partnerships in Article 4 (Residence):

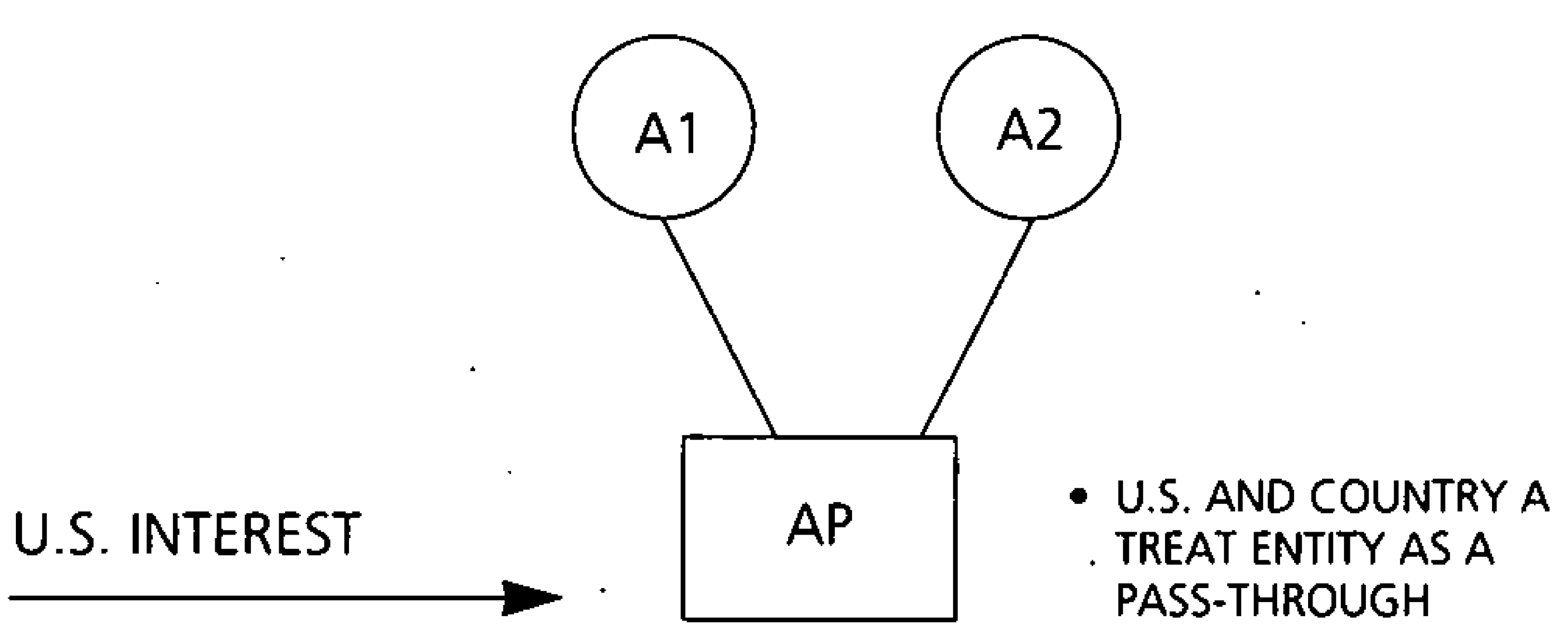
> (1) For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature,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

According to Treasury Technical Explanations of a number of recent treaties that have adopted this rule, the rule means that "the question of whether income received by a partnership is received by a resident will be determined by the residence of its partners (looking through any partnerships which are themselves partners) rather than by the residence of the partnership itself".[6]

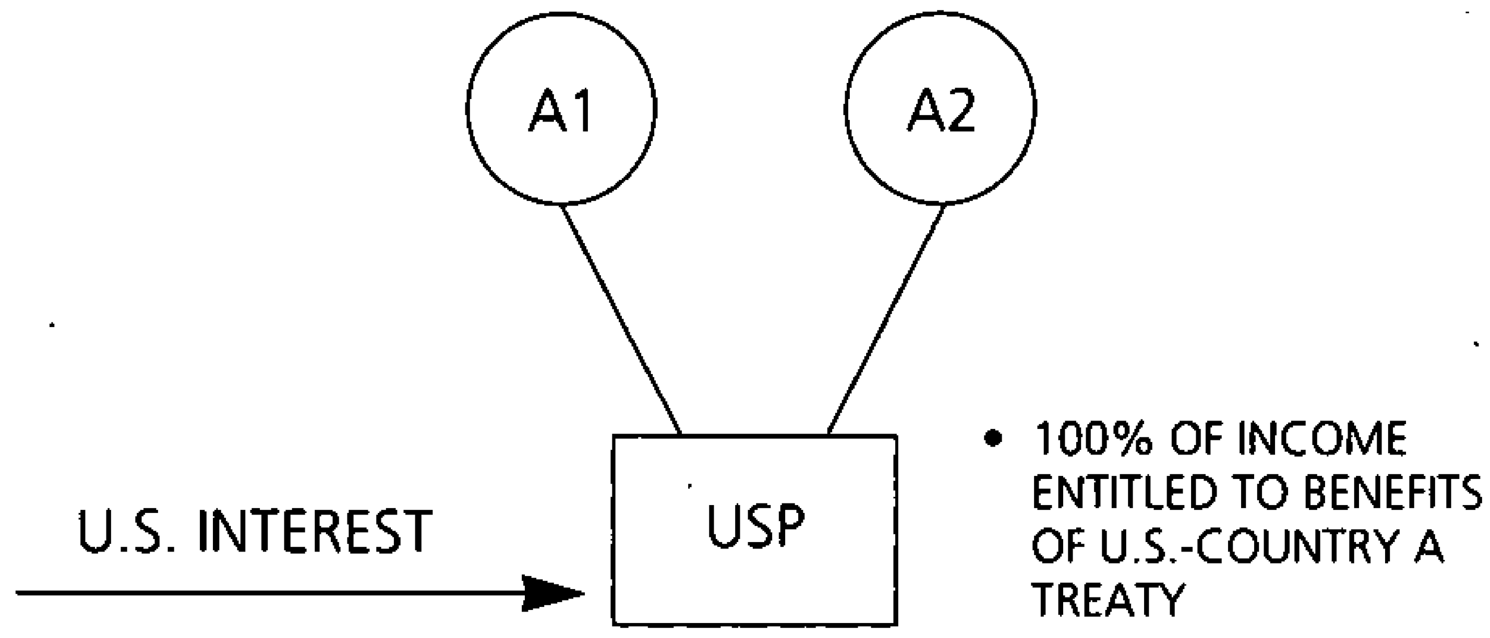
The rule seems fairly straightforward where both the United States and the treaty country regard the entity as a partnership entitled to pass-through treatment.

Example 1
A partnership (AP) is formed in treaty country A by two residents of that country, (A1 and A2). AP derives US source interest income which is taxable to A1 and A2 under both US and country A tax principles. The interest will be considered derived by residents of country A for US tax purposes.

Presumably, the rule should apply in the same way, regardless of where the partnership is created.

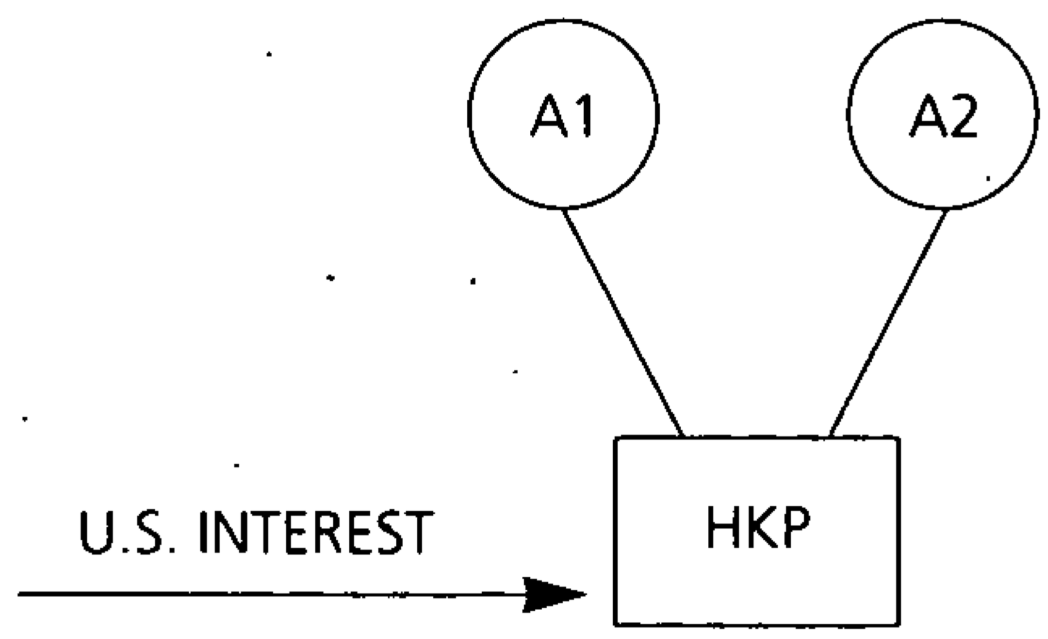


Example 2
Same as Example 1, except that the partnership is formed in the United States – same result.



Example 3
Same as Example 1, except that the partnership is formed in Hong Kong – same result.

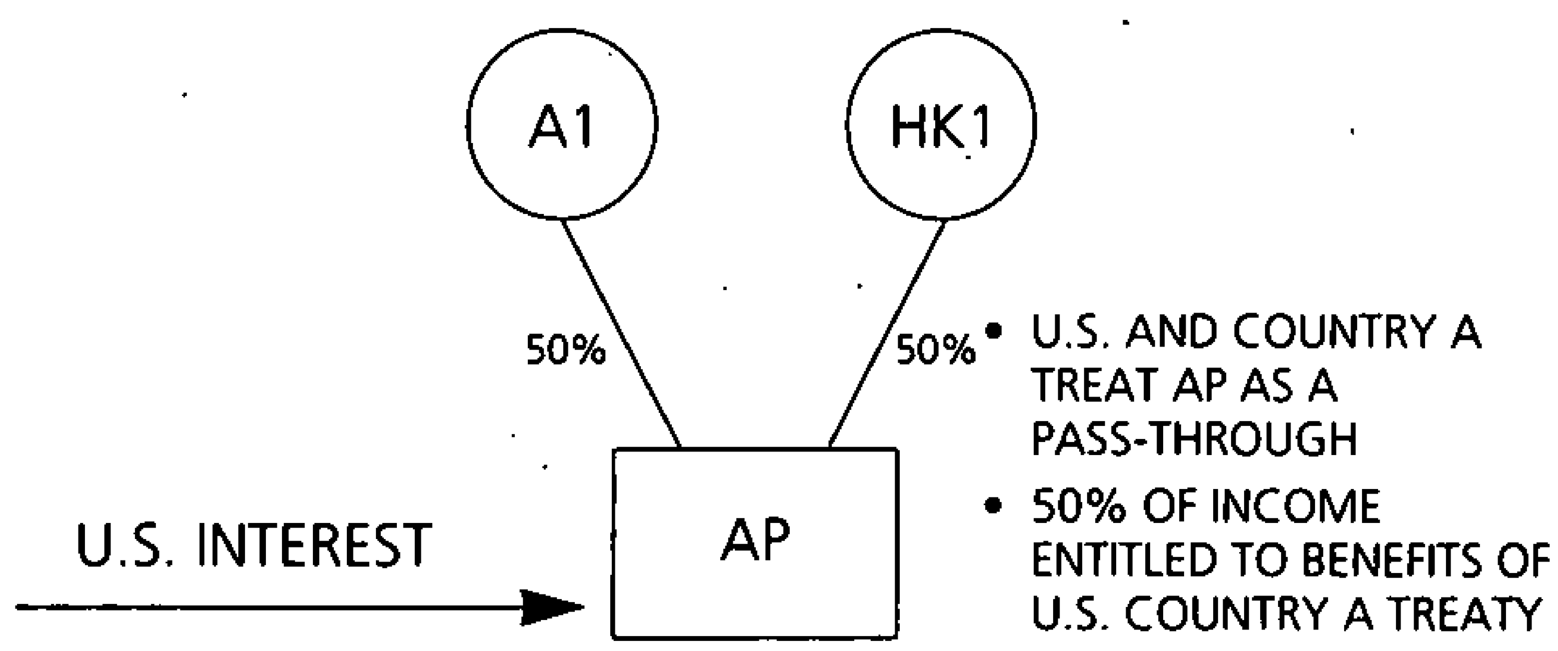
The rule clearly indicates that treaty benefits will not be available with respect to any portion of the partnership's income that is not taxable to a resident of the treaty country under that country's principles.



Example 4
A 50-50 partnership (AP) is formed in treaty country A by a resident of A (A1) and a resident of a third country (say, Hong Kong) which does not have a treaty with the United States (HK1). AP derives US-source interest income which is taxable to A1 and HK1 under both US and country A tax principles.

Only 50 percent of the interest will be considered derived by a resident of country A for US tax purposes.[7]

Questions begin to arise in the case of hybrid entities (i.e. where the United States and the treaty country have differing classifications of the entity).



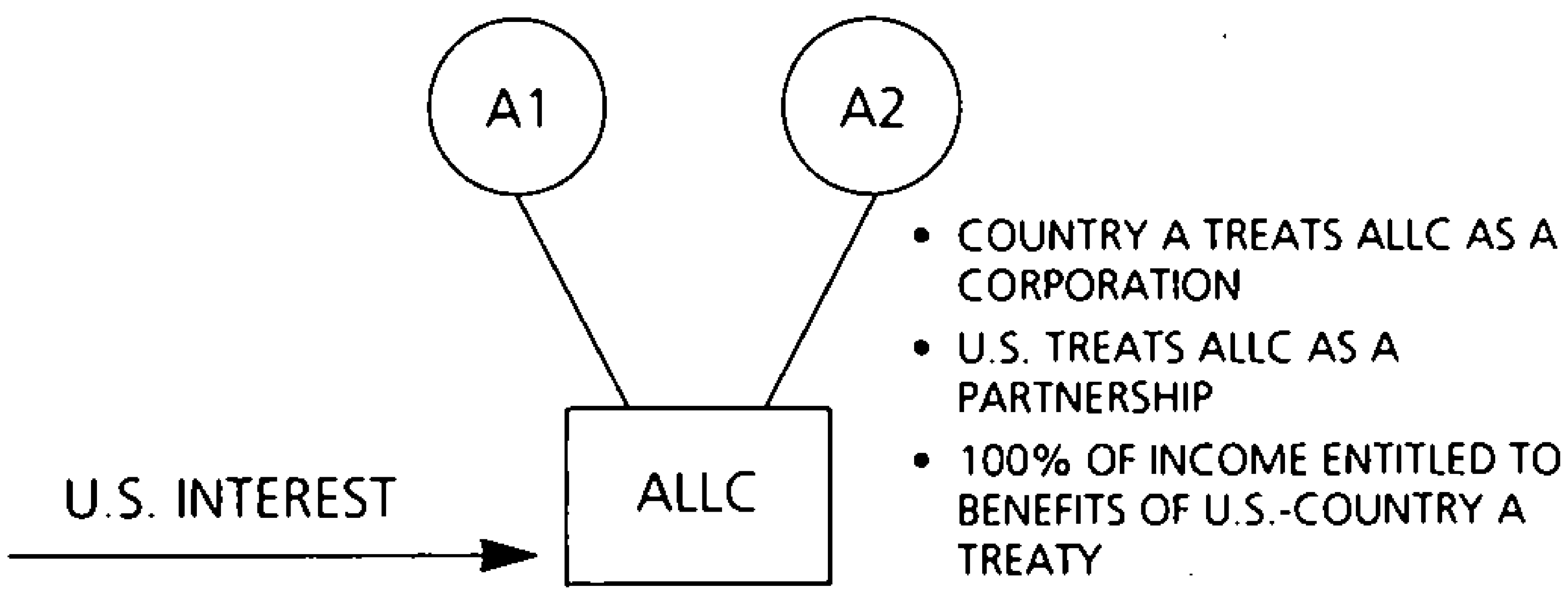
5. 1992 OECD Model, Commentary on Art. 1 (Personal Scope), paras. 2-6.
6. Treasury Technical Explanation to US–Germany Treaty; see also e.g. Treasury Technical Explanations to US–India and US–Mexico Treaties.
7. See e.g. Treasury Technical Explanation to US–Jamaica Treaty.

Example 5

An entity (ALLC) is formed in treaty country A by two residents of country A (A1 and A2). Country A characterizes ALLC as a corporation subject to country A corporate tax by virtue of its formation under country A law. The United States characterizes ALLC as a partnership. ALLC derives US source interest income.

Under these circumstances, ALLC presumably should be entitled to US treaty benefits as a "resident" of country A, since it is a "person" liable to tax in country A on the basis of its place of incorporation. Alternatively, if the special language relating to partnerships in the 1981 US Model is applied to ALLC, US treaty benefits should nevertheless apply to ALLC's interest income because that income is subject to tax in ALLC's hands in country A as the income of a resident.

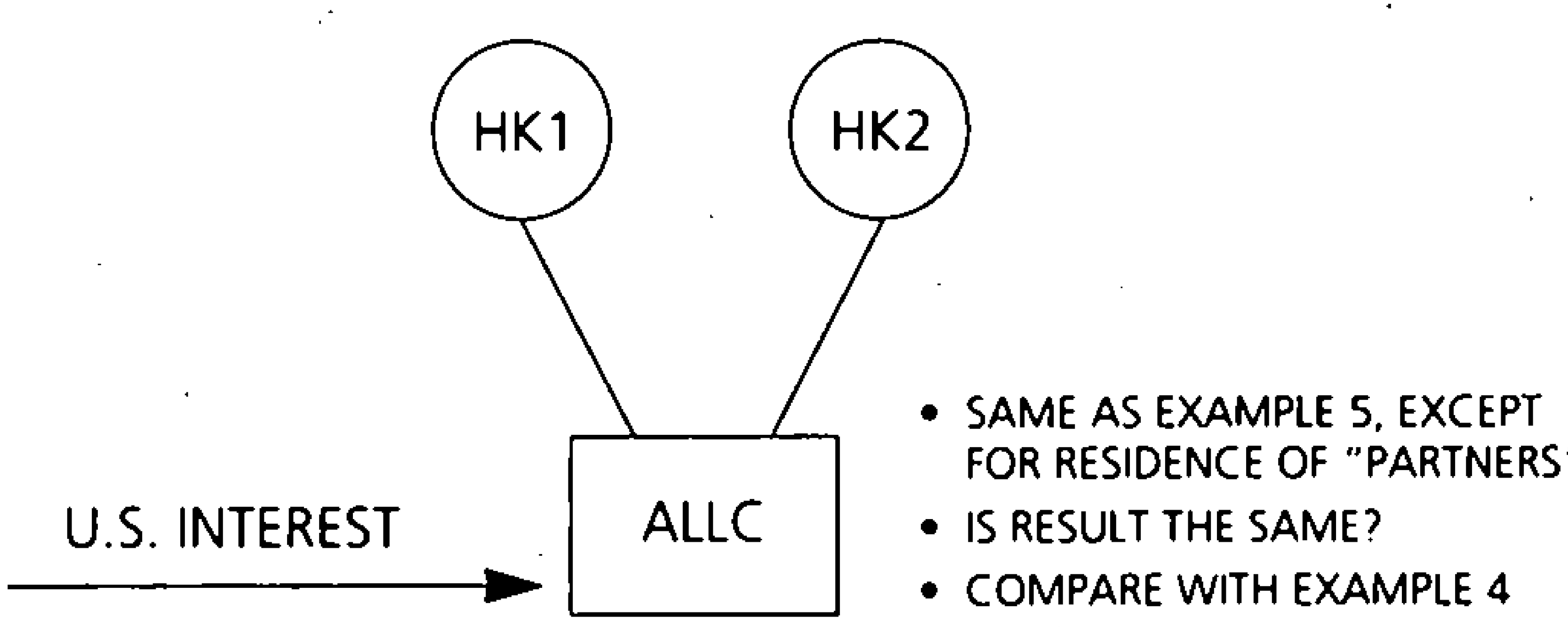
Query what result should apply if ALLC's US source income is a dividend from a wholly-owned US subsidiary (i.e. would the portfolio or direct investment dividend rate apply)?



Example 6

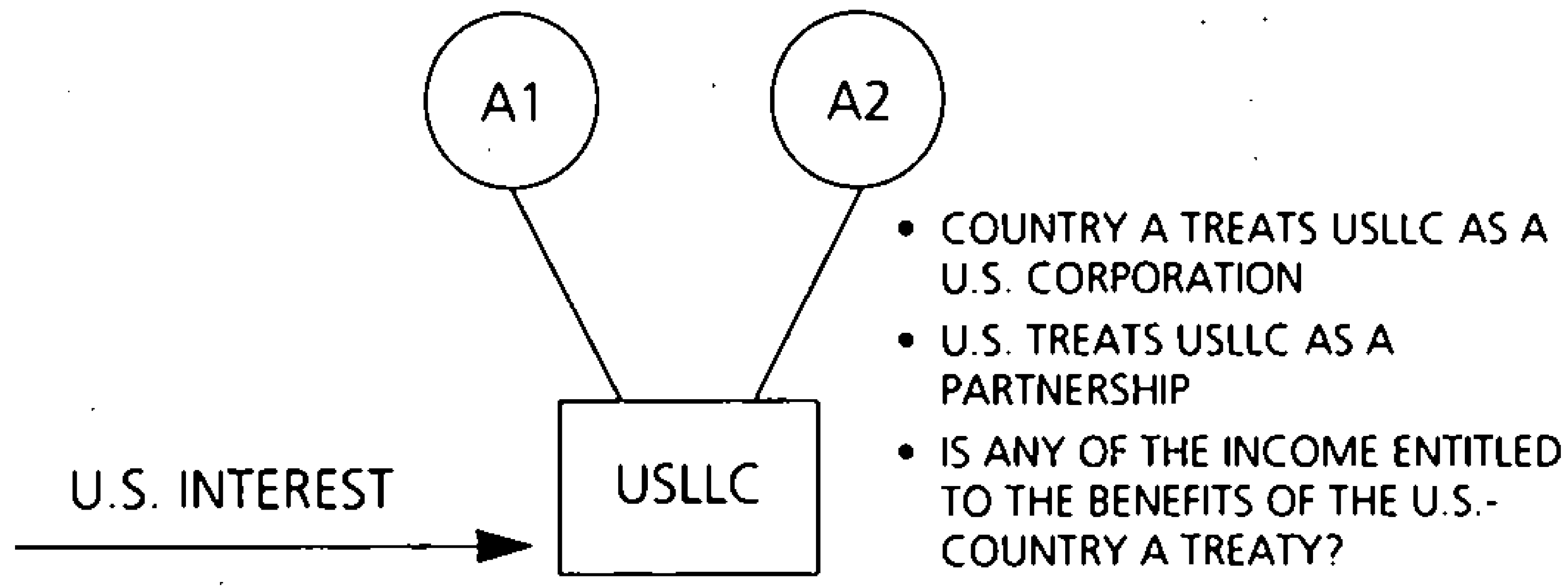
Same as Example 5, except that ALLC is formed by two residents of Hong Kong (HK1 and HK2).

Putting aside limitation on benefits concerns, is ALLC's income entitled to US treaty benefits as the income of a "resident" of country A? Presumably it would be, either because it is received by a person that is a "resident" of country A under the general rule of Article 4(1), or because, even under the special language relating to partnerships, the interest income is subject to tax in ALLC's hands in country A as the income of a resident.



Example 7

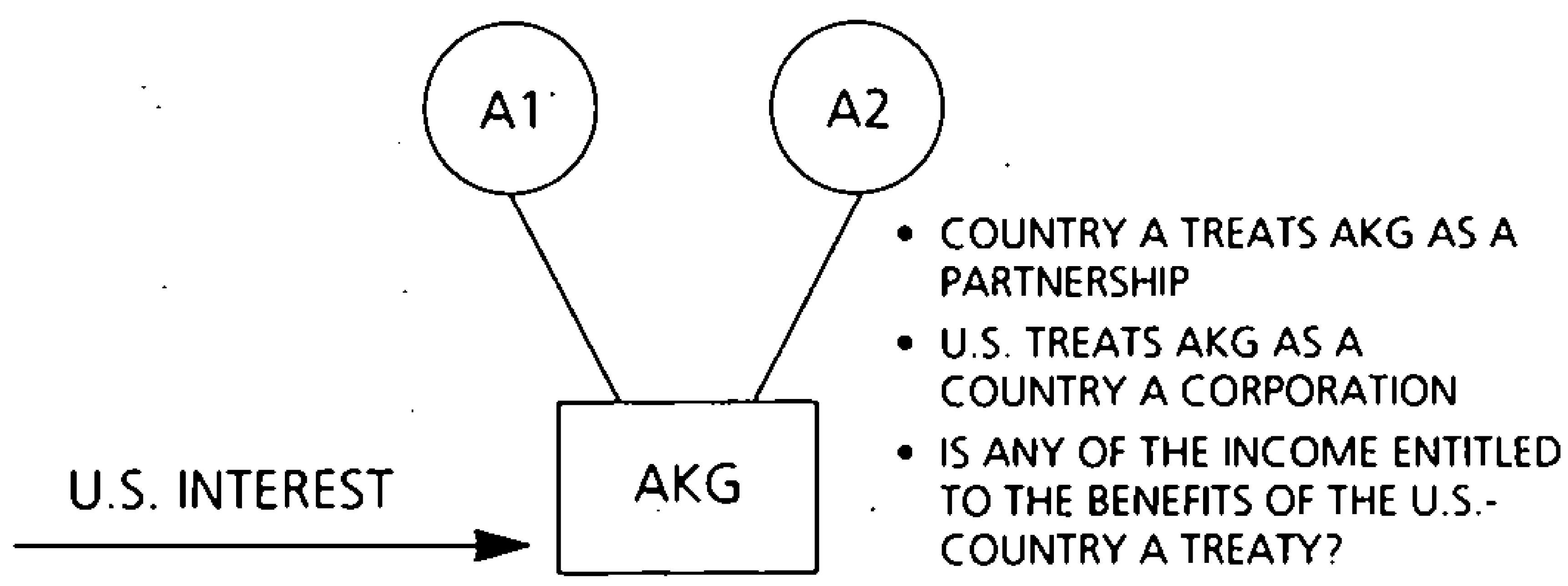
An entity (USLLC) is formed in the United States by two residents of treaty country A (A1 and A2). Country A characterizes USLLC as a US corporation not generally subject to country A corporate tax, although A1 and A2 are taxable on distributions from USLLC. The United States characterizes USLLC as a partnership. USLLC derives US source interest income. Is USLLC's interest income entitled to treaty benefits as the income of a "resident" of country A?



Example 8

An entity (AKG) is formed in country A by two residents of country A (A1 and A2). Country A characterizes AKG as a partnership and taxes A1 and A2 on their distributive shares of AKG's income. The United States characterizes AKG as a corporation. AKG derives US-source interest income. Presumably, AKG could not be treated as a "resident" of country A under the general rule of Article 4(1), because it is not "liable to tax" in country A as a resident.

Will the special language relating to partnerships apply to treat AKG's income as the income of residents of country A on the grounds that AKG is a "partnership" whose income is subject to tax in A1 and A2's hands in country A as the income of residents? Or will the United States as the source country take the position under Article 3(2) (General Definitions) that the term "partnership" must be interpreted under US law to exclude AKG?



III. THE RATIFICATION PROCESS

Seven treaties are currently before the Senate waiting for ratification: Canada (Protocol), Portugal, France, Sweden, Ukraine, Kazakhstan and Mexico (Protocol). Under current practice, US tax treaties, like other US treaties, enter into effect only upon ratification, which requires the advice and consent, through a two-thirds majority vote, of the US Senate.[8]

Certain disadvantages associated with this procedure have been identified. The House of Representatives, which has the authority under the Constitution to initiate all tax legislation,

8. See U.S. Const., Art. II, sec. 2, cl. 2.

has no formal role in the tax treaty approval process.[9] Approval of pending tax treaties is under the jurisdiction of the Senate Foreign Relations Committee, a body for whom tax treaties generally have a very low priority. The Senate Finance Committee and the House Ways and Means Committee on occasion are involved in the ratification process, as are their staffs and the Staff of the Joint Committee on Internal Revenue Taxation, but there are not clearly established procedures for this coordination.

Over the years, there frequently have been delays in achieving ratification, which has resulted in unfavourable repercussions for the US tax treaty programme and taxpayers affected by those treaties.

Consideration should be given to alternative procedures for entering into international tax agreements. For example, US tax information agreements are Executive agreements specifically authorized by Congress.[10] Another example of an alternative procedure is the US social security agreement programme, specifically authorized by Section 233(e)(1) of the Social Security Act.

These agreements are negotiated by the Executive Branch and then submitted to both Houses of Congress. They enter into effect after a fixed number of legislative days unless either House of Congress takes action to object. Some 17 agreements have been enacted without objection. The scope of negotiating flexibility that would be allowed under any such alternative procedure would be specified by the enabling statute. Such alternative procedures would be likely to specify the requirement for revenue estimates with respect to proposed agreements.

International tax agreements may increasingly require multinational agreements, including at some point the creation of a permanent multinational organization to administer such agreements. Whether the United States would be willing to enter into such agreements is problematic.[11] The ratification process, by treaty or executive agreement, could be important to the outcome of such issues.[12]

IV. PROPOSED COMPETENT AUTHORITY PROCEDURES

A. Background

In recent months, the IRS has published numerous final and proposed revisions to existing procedures for handling disputes with taxpayers through the Appeals Office and the competent authority process.

These revisions could fundamentally affect taxpayers' strategic approach to resolving such disputes.

These revisions include the following:

(a) Announcement 95-9, 1995-7 I.R.B. 1, two proposed revenue procedures relating to assistance provided by the US competent authority. The first proposed revenue procedure revises the general procedures concerning competent authority requests set forth in Rev. Proc. 91-23, 1991-1 C.B. 534. The second proposed revenue procedure revises the conditions set forth in Rev. Proc. 91-24, 1991-1 CB. 542, for claiming relief under Rev. Proc. 65-17, 1965-1 C.B. 833.

(b) Announcement 95-2, 1995-2 I.R.B. 59, describing a one-year test of a mediation procedure to be used by Appeals.

(c) Announcement 94-41, 1994-12 I.R.B. 7, setting forth an early referral procedure by which taxpayers whose returns are being examined may request the transfer of developed, unagreed issues to Appeals while other issues remain in Examination.

(d) Rev. Proc. 94-67, 1994-44 I.R.B. 13, describing an Accelerated Issue Resolution ("AIR") process by which a Coordinated Examination Programme ("CEP") taxpayer that has resolved an issue arising from an audit may enter into a closing agreement with the IRS to apply that settlement to one or more other taxable periods.

(e) Delegation Order 236 (Rev. 1), 1994-26 I.R.B. 12, delegating to District Directors, case managers, et al. the authority to accept settlement offers for "roll-over" and "recurring" issues in CEP cases in which a settlement on the merits has been reached for the same taxpayer in an earlier or later taxable period.

This outline describes these developments and potential issues they raise in connection with the settlement of disputes with the IRS.

The last complete revision of the procedures for requesting US competent authority ("CA") relief was published as Rev. Proc. 91-23, 1991-1 C.B. 534, clarified by Rev. Proc. 91-26, 1991-1 C.B. 543. Rev. Proc. 91-23 generally endorses an "Appeals first" approach to CA issues. It provides that taxpayers who do not agree with the correctness of a proposed adjustment generally must pursue their right of administrative review with Appeals before requesting CA assistance.

The US CA may accept a request for assistance involving an unagreed case prior to its consideration by Appeals if it determines that it is in the best interests of the parties (e.g. where the taxpayer's disagreement is limited to the amount of the proposed adjustment, or, in the case of a section 482 adjustment, to the methodology used by the IRS). As a condition of accepting a case before it is considered by Appeals, the CA can require the taxpayer to waive any future administrative review in Appeals. If Appeals considers a matter before its acceptance by CA and CA is later unable to reach an agreement on the matter, the taxpayer can have the matter referred back to Appeals only with the consent of the US CA, the Associate Chief Counsel (International), and the National Director of Appeals.

In December 1993, the IRS proposed a revised procedure, pursuant to which taxpayers could request CA assistance and

9. See U.S. Const., Art. I, sec. 7, cl. 1.
10. See Internal Revenue Code Secs. 274(h)(6)(C) and 927(e)(3)(A); see also ALI, at 23-25.
11. Cf. recent GATT agreements and the creation of the World Trade Organization.
12. Cf. recent enactment of NAFTA and GATT agreements.

simultaneous Appeals involvement in an issue, either from Exam or after the issue has advanced to Appeals.[13]

B. Announcement 95-9 – proposed revisions to CA process

1. Coordination with Appeals

Unlike Rev. Proc. 91-23, Announcement 95-9 does not encourage taxpayers to pursue unagreed issues through Appeals before requesting CA assistance; instead, Section 7.02 of the proposed revenue procedure states that taxpayers who disagree with a proposed US adjustment may either pursue their right of administrative review with Appeals before requesting CA assistance or may request CA assistance immediately. If a taxpayer pursues a potential CA issue through Appeals first, Appeals is directed, as was previously the case, to consider the issue without regard to other issues or considerations that do not involve potential CA issues. Thus, Appeals is to avoid "horse trading" with respect to potential CA issues.[14] Apparently, Appeals may still follow its traditional approach of considering hazards of litigation in attempting to reach a settlement with the taxpayer on a potential CA issue.

In a major change from prior practice, however, Announcement 95-9 proposes that if a taxpayer signs a closing agreement with the District (whether or not contingent upon CA relief) with respect to a potential CA issue or reaches a settlement with Appeals or Counsel pursuant to a closing agreement or other written agreement (presumably including a Form 870-AD), the US CA will thereafter try only to obtain a correlative adjustment from the treaty country and will not negotiate any modifications to the agreement.

In the past, this "take it or leave it" approach to CA negotiations had been employed by the US CA only in cases where the taxpayer's US tax liability had been finally determined by a US court.[15] US CA officials have openly acknowledged in the past that a country's unwillingness to negotiate with respect to its domestically determined adjustment can destroy the possibility of a successful CA proceeding.[16] Thus, the proposed policy introduces a significant risk of ultimate double taxation for those taxpayers who may be inclined to follow the traditional "Appeals first" route all the way to a written agreement before invoking CA assistance.

This change apparently reflects growing IRS disenchantment with the "Appeals first" route, possibly based on the following factors:

- the amount of time required to complete the Appeals process may make it harder to obtain a correlative adjustment from the treaty country;
- the factors Appeals may have taken into account in reaching its agreement with the taxpayer (e.g. hazards of litigation) may result in an adjustment that is difficult to defend to a foreign CA on a principled basis.

2. Simultaneous appeals procedure

Announcement 95-9 incorporates the simultaneous Appeals-CA procedure described in Announcement 93-144. Under this procedure, a taxpayer may request Appeals consideration of an issue under the jurisdiction of the US CA. This procedure may be invoked regardless of whether the taxpayer has requested CA assistance from Exam, immediately upon filing a protest with Appeals, or after some Appeals consideration (although taxpayers are "encouraged" to invoke the procedure as soon as possible after the first Appeals conference, at the latest). The proposal says that the Appeals representative will consult with the taxpayer and the US CA with a view towards reaching agreement on the issue before it is submitted to the foreign CA. Established Appeals procedures will apply for this purpose. The taxpayer may submit a written "memorandum" (presumably in the nature of a protest brief). Query whether the context will induce taxpayers to be less adversarial in their handling of an unagreed adjustment than they would be in a pure Appeals process.

The taxpayer may request conferences with the Appeals representative to discuss the merits and terms of a possible resolution. The Appeals representative is required to consult with the US CA during this process "to insure appropriate coordination of the Appeals process with the competent authority procedure, so that the terms of a tentative resolution and the principles and facts upon which it is based are compatible with the position that the US competent authority intends to present to the foreign competent authority". Query whether this means that the Appeals representative will not be able to propose a resolution based on the traditional "hazards of litigation" factor.

Is there any reason the US CA should feel compelled to negotiate with a foreign CA to accept a larger US adjustment than one to which the IRS would be prepared to agree with a taxpayer in a non-treaty context?

Any agreement reached among the taxpayer, the Appeals representative, and the US CA during this process will not be reflected in a written agreement but will be reflected in the position paper presented by the US CA to the foreign CA. If no agreement is reached with the foreign CA, the taxpayer will be permitted to refer the issue back to Appeals for further consideration – presumably, the hazards of litigation (and even horse trading) can be considered at that point.

If the taxpayer had invoked the Simultaneous Appeals procedure as part of a CA proceeding begun with respect to an issue that was still in Exam, presumably the issue would be

13. See Announcement 93-144, 1993-39 I.R.B. 12.
14. See Internal Revenue Manual ("IRM") 8732(4).
15. See Rev. Proc. 91-23, Sec. 6.02.
16. See e.g. Stanley E. Novack, "Resolution of competent authority issues", in *Transfer Pricing for Intangibles* 48 (Fred de Hosson, ed., 1989) ("Both sides should be willing to make reasonable accommodation, and in doing so, make adjustments which otherwise might not be made. If either country is generally unwilling to alter its adjustments, or maintains that its domestic rules supersede the treaty, then the negotiation process will eventually fail, to the detriment of both countries and the taxpayers involved.").

referred back to Exam before making its way back up to Appeals in the normal course.[17]

The Simultaneous Appeals procedure has several potential advantages for taxpayers. Like the Early Referral Procedures finalized in Announcement 94-41, it allows a taxpayer to obtain Appeals consideration of an issue before the issuance of a 30-day letter, and, thus, before the so-called "hot interest" begins to run on the taxpayer's "large corporate underpayment" under Code Section 6621(c) (i.e. a rate that is 2 percentage points higher than the normal interest rate on deficiencies). To the extent that it reduces the amount of time that passes before the US CA presents a case to the foreign CA, it may increase the chances of avoiding double taxation and reduce the overall time required to achieve full resolution of the issue. Query whether it will significantly reduce the amount of time that will be required to complete Appeals' consideration of the CA issue. To the extent that it enhances coordination between the Appeals and CA functions, it may allow the US CA to present a more persuasive case to the foreign CA, thereby increasing the chances of achieving an agreement to avoid double taxation. Query whether the problems cited by the US CA have significantly impeded the ability to achieve agreements (or have merely reduced the amount of the ultimate US adjustment). Query whether the US CA's desire to negotiate based on proposed US adjustments that do not reflect any discounting for hazards of litigation will make it harder to achieve agreements with the foreign CA.

The proposed Simultaneous Appeals procedure also presents certain potential disadvantages for taxpayers. It may inhibit the taxpayer's ability to have the proposed adjustment subjected to examination in a truly adversarial proceeding. It may restrict the extent to which hazards of litigation are taken into account by the IRS in determining the amount of the adjustment for which correlative relief will be sought.

3. Obtaining correlative relief for foreign-initiated adjustments

Announcement 95-9 acknowledges that taxpayers who receive foreign-initiated adjustments while their taxable years are under the jurisdiction of the District or Appeals will sometimes request correlative relief from those offices without filing a request for US CA assistance. Confirming formally what is understood to be the current informal practice, Announcement 95-9 says that in such cases the District or Appeals office will consult with the US CA to determine whether such correlative relief can appropriately be granted without initiating a full CA proceeding. Those offices are authorized to ask the taxpayer for information comparable to that which would be submitted with a CA request. If the US CA agrees, those offices may grant correlative relief without a full CA proceeding. If the US CA does not authorize such relief, the taxpayer will be advised to request CA assistance (in the absence of which, foreign tax credits may be denied).

4. Rolling forward CA settlements

Announcement 95-9 sets forth a proposed procedure by which a taxpayer may ask the US CA to seek the foreign CA's agreement to resolve a particular CA issue for the taxable year covered by the request and for later taxable years for which returns have been filed and in which the issue recurs. The US CA is directed to seek the District's consent before pursuing such a request. This proposed procedure is analogous to the Accelerated Issue Resolution ("AIR") process described in Rev. Proc. 94-67.

Under the AIR process, a CEP taxpayer may ask the District Director to apply an agreement reached with Exam or Appeals with respect to an issue in one taxable year to the same issue in other open taxable years. In the case of an agreement reached with Appeals, this effectively allows Exam personnel to resolve issues based upon an agreement that reflects the hazards of litigation (i.e. an authority otherwise typically restricted to Appeals).

Taxpayers should note that they are precluded from invoking the standard AIR process in connection with any issues with respect to which the taxpayers have received CA assistance in prior years;[18] accordingly, a roll-forward should be sought, if at all, through the CA process itself. It is not clear whether the CA roll-forward procedure is meant to be subject to the various limitations applicable to the standard AIR process; for example, under Delegation Order 236, District personnel are authorized to extend a settlement to an open year only if the facts surrounding the transaction or taxable event in the open year, including the relative amounts at issue, are substantially the same as the facts in the settled period.

The actual text of the proposed revenue procedure contains no such restriction, but Announcement 95-9's summary of the proposal states that the procedure should apply "only to the extent that the substantially identical facts and issues exist for subsequent years."

The proposed CA roll-forward procedure is also, in a sense, the flip side of the roll-back approach that has evolved for purposes of applying agreements reached for prospective years through the Advance Pricing Agreement ("APA") process to prior open years.

5. Conditions for obtaining Rev. Proc. 65-17 relief

Rev. Proc. 65-17 provides for tax-free repatriation of certain amounts following an allocation of income between related US and foreign corporations under Section 482. Under existing Rev. Proc. 91-24, Rev. Proc. 65-17 relief is conditioned on seeking CA assistance where an intercompany pricing adjustment relates to a country with which the United States has a tax treaty containing a CA provision.

The original IRS motivations for this requirement were reportedly to achieve administrative consistency in applying the standards for Rev. Proc. 65-17 relief and to minimize foreign tax withholding on repatriating payments under Rev. Proc. 65-17. Various commentators suggested that the requirement was broader than necessary to satisfy those goals.

17. This is what would happen to an issue that had been referred from Exam to Appeals under the recently finalized Early Referral Procedures if Appeals could not reach a settlement with respect to the issue. See Announcement 94-41.
18. See Rev. Proc. 94-67, Sec. 3.03.

Announcement 95-9 responds by eliminating the blanket requirement of requesting CA assistance in order to obtain Rev. Proc. 65-17 relief in treaty cases. Instead, it provides that Rev. Proc. 65-17 relief can be granted only with the consent of the Assistant Commissioner (International) (i.e. the US CA). Further, it encourages taxpayers who do intend to request CA assistance to file their request for Rev. Proc. 65-17 relief in conjunction with their CA request, and it requires taxpayers who have filed for Rev. Proc. 65-17 relief before filing for CA assistance to forward a copy of their Rev. Proc. 65-17 request to the US CA.

6. Other aspects of Announcement 95-9

Consistent with current IRS policy, the proposed revenue procedure confirms that taxpayers may have pre-filing (and post-resolution) conferences with the US CA. Rev. Proc. 91-23 had indicated that a taxpayer should seek US CA assistance with respect to a US-initiated adjustment as soon as practical after the adjustment had been "determined and communicated in writing" to the taxpayer – Announcement 95-9 says that a request filed before the US adjustment is communicated in writing (i.e. before a Form 5701 is issued) will generally be denied as premature. Query whether this approach will be modified if a failure to initiate CA proceedings at that point could endanger the ability to obtain relief in the treaty country.

Announcement 95-9 says that, in the case of a reallocation of income between related parties, a CA request should not be filed until the taxpayer can establish that there is "the probability of double taxation" (see Section 4.01). Query what this means in a situation where actual double taxation may be deferred because of, for example, operating losses in the treaty country.

Announcement 95-9 generally reinforces the position expressed in Rev. Proc. 91-23 to the effect that a taxpayer must take those protective measures with US and foreign tax authorities as are necessary to ensure that implementation of a CA agreement will not be prevented by administrative, legal, or procedural barriers. It goes further by stating that a taxpayer is expected to take protective measures, even before a country has proposed an adjustment, if the taxpayer is on notice that an adjustment is likely to be proposed (e.g. in the case of a recurring issue). It also states that a taxpayer is expected to file a protective claim in the United States before the US statute expires in situations where the related party in the foreign country is in the process of contesting a foreign-initiated adjustment through the administrative or judicial process there. In addition, Announcement 95-9 states that the US CA will consider whether a taxpayer has filed a protective US claim as required in determining whether to accept that taxpayer's request for CA assistance.

Announcement 95-9 introduces a new ground on which the US CA may deny a taxpayer's request for assistance – where CA assistance was previously granted to the taxpayer with respect to an issue and the taxpayer rejected the CA resolution of that issue. Announcement 95-9 confirms that any denial of CA assistance is final and not subject to administrative review, although it drops the statement from Rev. Proc. 91-23 that such denial is not subject to judicial review. Query whether this means the IRS now believes that there is some scope for judicial review of such a denial.[19]

The proposed revenue procedure in Announcement 95-9 does not include any of the references to "partial" CA agreements that had been in Rev. Proc. 91-23. Query whether this reflects an IRS policy decision that the US CA will not enter into CA agreements that achieve only partial relief from double taxation. For the first time, Announcement 95-9 includes a reference to the possibility of arbitration, under appropriate treaty provisions, in cases where the competent authorities fail to agree.

19. Cf. *Yamaha Motor Corp. v. United States*, 779 F. Supp. 610 (D.D.C. 1991), appeal dismissed (D.C. Cir. 1 December 1992).

UNITED STATES

IRS & Treasury Considering TINs for NRAs

Chip K. Collins

Price Waterhouse LLP, Washington, D.C.

The IRS and Treasury are considering a proposal that would require taxpayer identification numbers (TINs) for foreign investors receiving US source income.[1] The proposal would represent a fundamental change in the tax procedures relating to foreign investment in US securities.

The 1993 "White Paper" released by IRS and Treasury discussed the potential for legislation that would require TINs for non-resident aliens (NRAs). Apparently, IRS and Treasury feel that legislation is unnecessary, and that a TIN requirement could be handled through regulations alone.

Details of the proposal are not entirely clear and are subject to change. Nevertheless, the proposal warrants the full attention of any financial institution making payments to foreign investors. The discussion below no doubt will raise many questions that are beyond the scope of this memo.

I. REQUEST FOR COMMENTS

It is anticipated that proposed regulations will address not only TIN requirements, but also a variety of other withholding rules. Any final rules would certainly need to have a sufficient amount of transition time. The IRS is very well aware of the fact that financial institutions would need a significant amount of time to implement the changes discussed below.

The IRS also has expressed a willingness to receive comments from financial institutions that would be affected by this proposal, particularly foreign financial institutions.

II. PROBLEMS WITH CURRENT RULES

Before discussing the proposal, it is somewhat helpful to understand the current problems as perceived by the IRS.

- Legal and illegal aliens cannot obtain social security numbers (SSNs) in order to satisfy income tax reporting requirements.
- The IRS has to issue a temporary number (beginning with a "9") to an alien in order to process the alien's tax return.
- The IRS has witnessed an increase in earned income credit (EIC) fraud, and other fraudulent refund claims, due to the lack of permanent SSNs for aliens.
- An IRS internal audit reported weakness in the IRS's audits of non-resident alien withholding, and indicated there also appears to be significant non-compliance in this area by US withholding agents.
- Financial institutions currently have exposure to IRS liabilities due to the uncertainty of current rules and potential non-compliance.
- The current NRA withholding rules are difficult to implement, yet foreign investment in US securities represents a growing part of the financial services industry.
- The NRA compliance problems are not limited just to banks. Colleges, universities and entertainment companies also face difficulties in implementing these rules.
- Current regulations generally provide that non-resident aliens and other foreign persons investing in US securities are not required to obtain US TINs.[2]

III. PROPOSAL

The IRS proposal generally would require all foreign investors receiving US-source income to obtain a TIN from the IRS. Without such a TIN, payments of interest, dividends and (probably) gross sales proceeds to the foreign investor would be subject to 31 percent backup withholding.

The scope of this proposal is extremely broad. It would apply to all foreign investors – including non-resident alien individuals, foreign corporations, and foreign trusts and estates.

It appears that the proposal would apply if a foreign investor receives any type of US-source income. Payments currently not reportable on Form 1042-S (such as bank deposit interest)

1. Since this article was written the IRS has decided to rethink its proposal to require non-resident alien (NRA) and other foreign investors to obtain taxpayer identification numbers (TINs), according to Christine Halphen, the IRS Assistant Chief Counsel (International). Ms Halphen's comments were made during a recent meeting of the Information Reporting Program Advisory Committee (IRPAC) in Washington, D.C.

Ms Halphen stressed that Treasury and IRS have not made any final decisions to abandon the idea of requiring TINs for NRAs that invest in US securities. Nevertheless, her comments appear to signal that the IRS is retreating from the concept of TINs for NRA investors. At this point, it seems unlikely that the Treasury and IRS will push forward with a broad-based TIN requirement for NRAs.

Ms Halphen noted the strong objections to the TIN proposal from various financial institutions.

The IRS confirmed that regulations will be issued shortly that will require TINs for NRAs that file a tax return (e.g. Form 1040NR), including tax returns filed for claiming refunds. This regulation would enable NRAs who are ineligible for Social Security numbers to obtain TINs directly from the IRS. The TIN requirement in these regulations, however, would not apply to NRA investors generally.

2. See Treas. Reg. § 1.6109-1(g).

also appear to be "on the table", but the application of the proposal to these types of payments is not entirely clear. It also appears unlikely that the proposal would apply to portfolio interest payments on foreign-targeted bearer obligations (which are not subject to the usual Form W-8 and Form 1042-S requirements for portfolio interest), but these payments are under consideration.

IV. OBTAINING A TIN

A foreign investor could obtain a TIN in one of two ways:

A. Submitting an application directly to the IRS

A foreign investor could submit an application for a TIN directly to the IRS, either by mail or by walking in to an IRS Field Office or Overseas Office. The application would have to be submitted with some type of supporting documentation, such as a birth certificate, etc, as well as the investor's local country identification number (if any). The IRS will designate the documentary support to be required.

After reviewing the documentation, the IRS would issue a TIN – a nine-digit number beginning with "8" – to that foreign investor. The IRS also would return the supporting documents to the investor. An EIN-type number would be assigned to foreign non-individuals.

B. Application submitted by "acceptance agent"[3]

A foreign investor could apply for a TIN through an "acceptance agent". Possible acceptance agents include financial institutions, treaty partners, embassy personnel, practitioners, and notary publics.

An acceptance agent would accept and review the documentation provided by the foreign investor, and then send an application to the IRS. The IRS would provide the TIN to the acceptance agent for the foreign investor. The acceptance agent would retain a copy of the documentation received from the foreign investor.

It appears that the type of documentary evidence required could vary country-by-country (depending, e.g. on local "know your customer" rules). Procedures also could vary on an agent-by-agent basis per a bilateral agreement with the IRS.

The IRS anticipates that an acceptance agent could submit the TIN applications either by mail or electronically.

As discussed below, foreign financial institutions acting as acceptance agents would play a big role for so-called "omnibus accounts" (where the foreign institution receives US-source income as a nominee for its customers). Foreign financial institutions residing in either treaty or non-treaty countries could qualify as acceptance agents.

US financial institutions that deal directly with foreign investors also would be able to act as acceptance agents.

V. OMNIBUS ACCOUNTS

The proposal addresses the special problems of omnibus accounts. Under current regulations, a Form W-8 is required from each beneficial owner in order for interest payments to qualify as portfolio interest (assuming non-targeted obligations). A Form W-8 from a foreign nominee is insufficient.

Under the proposal, a US custodian could accept a single certification from a "qualifying" foreign financial institution for purposes of the portfolio interest rules. An FFI will "qualify" under this rule by entering into a centralized withholding agreement with the IRS. However, in order for a foreign financial institution (FFI) to make this single certification (in lieu of providing Forms W-8 for each customer to the US custodian), the FFI must have TINs for all of its foreign customers.

US withholding agents could rely on a single "omnibus" certification from the qualifying FFI. It appears that the FFI would make the omnibus certification by either: (1) checking a new box on the Form W-8; or (2) providing a different form to the US withholding agent (possibly a Form W-8/FFI, or some other derivative of the Form W-8). A US withholding agent could rely on an omnibus certification unless the agent knew or had reason to know that the certification was false. If an FFI is not making an omnibus certification because the FFI is the beneficial owner of the income, it appears that the FFI would certify its status as the beneficial owner.

If a US withholding agent receives an omnibus certification from an FFI, the US withholding agent would report payments to the FFI on a single Form 1042-S.

Procedures for verifying that an FFI is a "qualified" FFI are a little unclear at this time, but the IRS may use Form 1042-S information to verify an FFI's qualified status. For example, the Form 1042-S probably will identify those payees that are FFIs making an omnibus certification. The IRS probably will verify that such FFIs are "qualified" FFIs based on the IRS's own records. If the IRS finds a "mismatch" here – i.e. that an FFI has improperly made an omnibus certification – the IRS probably would notify the US withholding agent that the omnibus certification from that FFI is invalid. Presumably, the notification would permit the FFI an opportunity to cure the problem, but withholding eventually could be required.

VI. RESPONSIBILITIES OF THE FOREIGN FINANCIAL INSTITUTION

The FFI would face two primary compliance requirements in order to make a single omnibus certification to the US custodian.

3. See the discussion under "Procedures for Claiming Treaty Benefits" for additional requirements that may be imposed.

A. Have a TIN for each foreign customer

The FFI would be required to have a TIN for each foreign customer. The customer may provide the TIN directly to the FFI (i.e. the customer already received a TIN from the IRS), or the FFI may act as acceptance agent and obtain the TIN for the customer.

B. Annual information reporting to IRS

In addition, the FFI would have to do some type of annual reporting to the IRS. The IRS also may request on-site audits and security arrangements with the FFIs.

VII. PROCEDURES FOR CLAIMING TREATY BENEFITS

A foreign investor claiming treaty benefits may face additional requirements when applying for a TIN. The requirements apparently would differ depending on how the foreign person obtains a TIN.

If the foreign person submits an application for a TIN directly to the IRS, the IRS's current thinking is that the foreign person would be required to have the local tax authorities certify to the IRS that the person is eligible for treaty benefits. The certification from the local tax authorities apparently would be similar to IRS Form 6166 (which essentially is a "fact of filing" certification used by US persons claiming treaty benefits). Once the local tax authorities submit the certification to the IRS, the foreign investor could certify that it is eligible for treaty benefits.

If the foreign person applies for a TIN through an acceptance agent, the acceptance agent may be able to determine that the foreign person is eligible for treaty benefits. An acceptance agent's decision to grant treaty benefits would have to be supported by documentation provided by the foreign person. The type of documentary evidence required could vary on a country-by-country or agent-by-agent basis.

VIII. CERTIFYING FOREIGN STATUS AND TIN

Once a foreign investor obtains a TIN, that investor would be required to provide that TIN to its financial institution (whether an FFI or a US institution). If the foreign investor is NOT in an omnibus account arrangement described above, and the investor's FFI therefore does not make an omnibus certification, the foreign investor would need to certify its foreign status and TIN on a Form W-8 or Form 1001 (or possibly a combined Form W-8/1001). Thus, US withholding agents would need to receive TIN and foreign status certifications on the Form W-8 or Form 1001 (or combined Form W-8/1001) from their foreign customers.

IX. APPLICATION TO MUTUAL FUNDS

Mutual funds paying dividends to foreign shareholders would not be able to withhold at treaty rates simply because the shareholder's address is in a treaty country. The so-called "address rule" for treaty rate withholding on dividends, therefore, would be repealed under the proposal.

A mutual fund would be required to obtain a Form W-8/1001 from either: (1) the beneficial owner of shares in the fund (and the fund presumably could act as an acceptance agent and request a TIN for the shareholder); or (2) a foreign financial institution making an omnibus certification (as described above).

The application of the proposal to offshore mutual funds (i.e. funds that are not US entities) is unclear at this time. It appears that an offshore fund investing in US securities would need a TIN, just like any other non-US investor. However, it does not appear that each shareholder of the off-shore fund generally would be required to have a TIN. The IRS could require TINs from these shareholders in certain situations (e.g. if the fund was closely-held).

X. BENEFITS TO IRS OF TINS FOR FOREIGN INVESTORS

The has IRS identified a number of benefits from requiring TINs for NRAs and other foreign investors. Such benefits include:
- verifying treaty benefits claimed by foreign investors;
- B notice-type matching of the name and TIN of the foreign investor;
- preventing US persons from claiming NRA status;
- eliminating EIC fraud; and
- providing illegal aliens with an avenue for meeting US tax obligations when they cannot obtain an SSN (the IRS will not and cannot share this information with INS, nor does the IRS feel that a nine-digit number beginning with "8" indicates that a person is an illegal alien).

With respect to the last item, we have suggested that the IRS discuss this issue with INS so that INS *might*, perhaps, make this same statement to employers in the instructions for Form I-9.

XI. IRS PROCEDURES

The IRS would have to establish a new workforce to review TIN applications from foreign investors. The IRS anticipates that these employees will have significant skills in foreign languages and country specific documentation requirements. In addition, the employees would be available on a 24-hour basis and would strive for a quick turn-around of TIN applications.

XII. FOLLOW-UP PROCEDURES

There are a multitude of follow-up questions, but some that immediately come to mind include the following:

- If the Forms 1001 and W-8 are obtained with the TIN, is there any need to have the forms recertified since the IRS will go through some B notice type matching and verification of treaty benefits? Form W-8 recertifications may still be necessary for non-treaty investors, but the need to recertify Form 1001 (for treaty benefits) is uncertain since the IRS could verify an investor's treaty status by exchanging information with the treaty country.
- It is also unclear if the proposal would modify the rules relating to Form 4224 requirements for effectively connected income (ECI) of a foreign person. Since the IRS appears ready to perform all types of Form 1042-S matching, it seems feasible that a withholding agent would need to get only one Form 4224 from a foreign payee. Since ECI is reported on Form 1042-S with the foreign payee's US TIN (already a requirement), the IRS could match the Form 1042-S information against the US tax forms (e.g., Form 1120F) filed by the foreign payee. If the payee files returns, the withholding agent should not need to continue requesting a new Form 4224 every year.
- Although not entirely clear how treaty rate withholding would apply to omnibus accounts, foreign nominees presumably would make a single certification that all customers in a particular account are entitled to the same rate of withholding. A separate account would be needed for customers subject to a different rate. Withholding probably would still be done by the US withholding agent.
- The foreign financial institution may not have TINs for 100 percent of their foreign customers. If not, it is unclear if the FFI's omnibus account certification to a US withholding agent would no longer be valid. It appears that such an FFI would be required to segregate its no-TIN accounts into a separate omnibus account that would be subject to full 31 percent backup withholding.

XIII. POTENTIAL IMPACT ON US WITHHOLDING AGENTS

A. Benefits

Withholding agent risks (assuming a clear "baseline" of the documentation required from foreign persons, including those foreign financial institutions making a blanket omnibus certification) could be greatly reduced.

In certain situations, such as omnibus accounts, the burden of obtaining documentation moves from the US withholding agent to the FFI (which has the relationship with the foreign investor). Although a benefit to US withholding agents, FFIs may see their added compliance duties as an unacceptable burden.

B. Detriments

A major issue coming out of all this is whether foreign financial institutions will want to invest in registered (non-targeted) US securities. Given the additional compliance burdens facing foreign financial institutions – getting TINs for each customer and filing information returns each year – the attractiveness of US securities may diminish significantly. Clearly, if FFIs no longer find US securities desirable due to increased compliance burdens, US financial institutions could see a significant drop in business from FFIs.

XIV. COLLATERAL RAMIFICATIONS

There are a number of ramifications from the above proposal that could affect US and/or foreign financial institutions.

A. B notice type matching

Reporting the foreign investor's name and TIN to the IRS will enable the IRS to perform some type of B notice matching to determine if the TIN is correct. If a name/TIN mismatch occurs, the IRS would notify the withholding agent to somehow correct the problem. Although unclear at this point, some withholding requirements could be triggered as a result of such a notice. The potential for a withholding requirement here is even greater for foreign customers identified more than once on the B notice (similar to the current two-in-three rules). However, withholding probably would not be required during the initial phase-in period of these rules.

B. Treaty verification (quasi C notice matching)

As noted above with respect to treaty benefits, the IRS may receive certifications from tax treaty countries that a particular investor is entitled to treaty benefits. The Forms 1042-S received by the IRS also will identify those payments subject to treaty benefits. The IRS could match these two sources of data to ensure that a foreign investor receives treaty benefits only when permitted to do so. If the IRS determines from its records that a foreign investor is not eligible for treaty benefits, the IRS could inform the US withholding agent that full withholding is required for the investor.

All the methods ultimately used by IRS to verify treaty benefits will develop over time.

C. Audits of foreign financial institutions

The IRS probably would implement some type of audit programme for those FFIs that make a blanket certification for an omnibus account. The IRS presumably would want to check if the FFI either: (1) received a TIN directly from its foreign customer; or (2) received the appropriate amount of documentation in order to request a TIN for that customer (i.e. as acceptance agent). The exact procedures for these audits probably will vary country-by-country or even institution-by-institution.

D. Claiming treaty benefits

With respect to a foreign investor that applies for a TIN directly from the IRS, any requirement for the investor to have its local tax authorities certify – to the IRS – the customer's eligibility for treaty benefits raises several issues. For example, if the local tax authorities must send the certification before the investor can claim treaty benefits, significant processing delays could result, and the issue of refunds also would need to be explored. The marketability of equities to foreign investors in treaty countries also could diminish.

If a TIN were obtained through an acceptance agent, other issues arise. An FFI acting as acceptance agent would be responsible for making decisions regarding a customer's eligibility for US tax treaty benefits. It is not entirely clear how this decision would be made, or what type of additional documentation/certifications the FFI would need from its customers. Furthermore, US institutions acting as acceptance agents also could be required to receive and review additional documentation or certifications from their foreign customers claiming treaty benefits.

XV. CONCLUSION

Keep in mind that this is in the proposal stage, and particular aspects are subject to change. Nevertheless, financial institutions should make some initial determinations on how their businesses and operations could be affected by the proposal described above.

CUMULATIVE INDEX – 1995

I. ARTICLES

Conference diary

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

AUGUST 1995

Course on the principles of international taxation, Amsterdam, 21 August through 1 September 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Actual issues regarding corporate income taxation, Hannover, 26 August 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

SEPTEMBER 1995

Transfer of business or private assets in order to create usufruct and annuities or other permanent encumbrances, Mainz, 1 September 1995 and München, 7 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

Seminar on corporate income tax, Frankfurt/Main, 2, 9, 23 and 30 September 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

Practical cases regarding the change of a legal form, Frankfurt/Main, 8 September 1995 and München, 6 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

49th Congress of the International Fiscal Association, Cannes, 17-22 September 1995 (simultaneous translations into French, English, German and Spanish):

Novatours Congres IFA – Official Congress Agent, rue de Lille, F-06400 Cannes, Tel.: 33-93-694 747, Fax: 33-93-464 483.

Taxation of non-profit clubs, Köln, 25 September 1995 and München, 9 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

International Tax Avoidance/Anti-Avoidance, Amsterdam, 28-29 September 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1995

Meeting of the International Tax Planning Association, Monte-Carlo, 19-20 October 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-173-276 2910, Fax: 44-173-276 3762.

NOVEMBER 1995

Double Taxation Relief, Amsterdam, 2-3 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Asia-Pacific Tax Conference, Singapore, 13-14 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

UNITED STATES

US Withholding Tax Issues under Section 1441

Edward Tanenbaum

Mr Tanenbaum is a partner in the law firm of Walter, Conston, Alexander & Green, P.C., specializing in international taxation. He is a graduate of the Fordham University School of Law (JD 1974) and received his Masters in Taxation (LL M 1980) from New York University Law School.

Mr Tanenbaum is a frequent lecturer in the field of international tax and has spoken before the World Trade Institute, Tax Executive Institute, International Tax Institute, IFA and the American Tax Institute in Europe on all aspects of international taxation. He has also written extensively on various international tax subjects including most recently, a portfolio on "Effectively Connected Income and Branch Profits Tax" and has co-authored a chapter on "Transfer Pricing and Customs Related Issues".

I. BACKGROUND

A. Withholding on payments to foreign persons

A withholding tax of 30 percent is imposed on certain types of passive income from US sources paid to foreign persons. Statutory and treaty exemptions from, and reductions in, the 30 percent withholding rate are available but differ greatly depending on the type of income involved and the basis for the exemption or reduction.

B. Specific categories of withholding

1. Dividends

For US source dividends, the "address system" applies – for example, a person having an address in a country which is a party to an income tax treaty with the United States is generally presumed to be a resident of that country. If a withholding agent has knowledge to the contrary, the address cannot be relied on.[1]

2. Interest

The benefits provided by an income tax treaty may be obtained by filing Form 1001 with the withholding agent. Neither the regulations nor the *earlier* Form 1001 required disclosure of the identity of the beneficial owner of the income.

Proposed regulations under Section 1441 would extend the requirement to file Form 1001 to dividends, as well as interest, and would require the Form 1001 to be executed, under penalties of perjury, by the foreign beneficial owner. A new Certificate of Residence (Form 8306) would be required to be issued by the foreign competent authority establishing the fact of the beneficial owner's residency in the foreign country.

The proposed regulations were widely criticized for creating, amongst other things, procedures which could not be practically administered by the securities industry and by banks in many countries, thus creating a negative foreign investment climate and, to date, the regulations have not been adopted and have de facto been withdrawn.

The IRS published a revised Form 1001 requiring the disclosure of the name of the beneficial owner of the income. Many taxpayers continue to be unaware of this modification which came without any significant public notice.

3. Portfolio interest

Withholding tax exemption exists for "portfolio interest", generally defined as interest payable to a foreign person (owning less than 10 percent of the corporate obligor) with respect to an obligation issued after 18 July 1984.

(a) Registered obligations

(1) Non-targeted
If a non-targeted obligation is in registered form, withholding is not required if the withholding agent is provided with a statement that the beneficial owner of the obligation is not a US person. According to current regulations, if the statement is furnished by a securities clearing organization or other financial organization, the statement must disclose and incorporate W-8's received from beneficial owners.[2] Interestingly, no mention is made in Section 871(h)(4)B of the requirement to disclose the identity of the beneficial owner.

(2) Targeted
For foreign targeted obligations, a withholding agent may treat interest as portfolio interest if it receives appropriate statements from a financial institution. Unlike non-targeted registered obligations, the name of the beneficial owner need not be disclosed.

(b) Bearer obligations

If an obligation is in bearer from, interest payable with respect to such obligation is portfolio interest, and not subject to withholding, if: (1) there are arrangements reasonably

1. Treas. Reg. § 1.1441-3(b); IRS Publication 515.
2. Treas. Reg. §35.a.9999-5(b), Q&A 8,9.

designed to ensure that the obligation will be sold only to foreign persons, (2) interest is payable only outside the United States, and (3) there is a legend on the face of the obligation that any US holder of such obligation will be subject to limitations under the US income tax laws.

4. Gross proceeds on sales of securities

In the case of gross proceeds from the sale of securities, 30 percent backup withholding is not required if the recipient of the proceeds furnishes the broker with an exempt foreign person statement.[3] If the payee is a financial institution, the regulations do not require the disclosure by such financial institution of the identity of the beneficial owner.

II. PROBLEMS IDENTIFIED WITH CURRENT PROCEDURES

A. Perceived taxpayer abuses

- US citizens and residents;
- treaty shopping problems;
- address system regarding dividends;
- fraudulent refund claims.

B. Compliance problems for foreign financial institutions

Present certification procedures involve different rules, forms and requirements pertaining to withholding and backup withholding for dividends, interest, portfolio interest and securities sales proceeds. Rules are confusing and burdensome so as to be administratively difficult to comply with. The current and proposed procedures place securities of US issuers at a distinct competitive disadvantage in the international marketplace.

Omnibus custodial accounts involving a multi-layered structure consisting of custodians, depository institutions, financial banks and ultimately the beneficial owners of the securities present additional complications. Securities are often held for collective safekeeping, with ownership transferred by bookkeeping entries along a chain of intermediary financial institutions. Strict compliance with the rules requires multiple filings of Form 1001 and Form W-8 for separate blocks of securities held by the depository banks on behalf of each beneficial owner.

Payment of income to the ultimate beneficial owner along the chain of intermediary financial institutions is delayed if certifications are obtained from the ultimate owners or if treaty country certifications are required.

Disclosure of the identity of the beneficial owner to withholding agents compromises the banks in relation to their competition and can result in the public disclosure of confidential financial information and transactions.

Many foreign investors will not divulge their identity in conjunction with ownership of their assets as a matter of principle to protect their financial security.

Bank secrecy rules of various jurisdictions prohibit disclosure of confidential banking information.

Increased cost involved in compliance make the omnibus custodial account business more unprofitable.

III. FOREIGN FINANCIAL INSTITUTION COMMENTS AND PROPOSALS

A. Coordination and consistency

Foreign financial institutions have recommended that the IRS publish a consistent set of rules governing payments to foreign financial institutions holding securities on behalf of foreign beneficial owners for purposes of withholding and backup withholding.

The suggested procedure should coordinate reporting forms and withholding rules for dividends, interest, portfolio interest, all forms of backup withholding and certification of entitlement to treaty benefits.

B. Refund procedures

Suggestions have also been made to simplify and expedite refunds of excess tax withheld. One suggestion is to enable a financial institution to submit to the beneficial owner for signature a preapproved, preprinted, computer generated, simplified multi-language refund claim form that would be filed directly with the IRS.

C. Alternative substitute certification

A number of US and foreign financial institutions have made specific proposals involving the use of a substitute certification procedure. In essence, the foreign financial institution would be able to provide a US withholding agent with a single certification involving its customer base, identifying by categories those pools of funds entitled to reduced or exempt rates of withholding tax.

The banks' substitute certification, in turn, would be based on either self-certification statements of customers or information obtained under "know your customer" rules of a particular country. Various suggestions also have been made in connection with these proposals as to how the IRS might verify the accuracy of the procedure and as to what sanctions might be imposed if the system is not properly being administered.

3. Form W-8 or a substantially similar statement.

IV. DEPARTMENT OF THE TREASURY AND IRS PROJECT

A. Reform of foreign withholding area

The US government is actively involved in reforming the Section 1441 withholding rules generally. It is also sympathetic to the applicability of these rules to omnibus custodial amounts and to the needs of foreign financial institutions.

While some form of blanket certification by foreign financial institutions may be possible, the IRS has also proposed the use of taxpayer identification numbers (TINs) as a way in which to track and combat abuses in the area. In the absence of obtaining a TIN, foreign investors would be subject to a 31 percent back-up withholding regime. Details of these proposals have not been published but they are likely to include specifics regarding reporting and, more importantly, verification.

B. Foreign reaction to proposals

Concerns have been expressed as to costs of compliance (initial and ongoing) for the financial institutions. Issues involving bank secrecy rules and confidentiality have been raised insofar as the impact on marketability of US securities is concerned. The specifics of IRS audit verification will be of major interest to foreign financial institutions.

CZECH REPUBLIC

THE "MANAGEMENT SERVICES" PERMANENT ESTABLISHMENT

David Roach

Partner, Tax & Legal Services, Price Waterhouse, Prague, Czech Republic.

I. INTRODUCTION

The Czech Republic continues to move rapidly away from its communist past, and back towards its status of 60 years ago, when it had one of the strongest and most sophisticated economies in Europe. One facet of this development has been the introduction in January 1993 of an entirely new set of tax laws, and, since then, an ongoing process of improvement in the drafting of legislation to make the law clearer and less susceptible to tax planning. Ministry of Finance officials have in many areas dealt with practical problems with ability and creativity, and this is particularly the case with some aspects of international tax issues.

One specific issue, which has been of great relevance to multinational companies investing into the Czech Republic, is the way in which Czech domestic legislation, and ministerial interpretation of double tax treaties, seeks to define the level of activity which gives rise to a taxable presence of a foreign company in the Czech Republic.

This article looks particularly at the area of the provision of consultancy services or management services in the Czech Republic. This area is unusually important for two reasons:

- as Czech companies are competing more and more with West European companies for business, and continue to adapt (with much success) to free market business methods, many foreign companies are providing consultancy services to assist this process;
- many Czech companies are now either partly owned by multinational groups through joint ventures, or have been set up entirely with foreign capital. Such investors frequently second management to their Czech subsidiary or part-owned company. Until now, in order to be certain that management personnel can continue to be paid in fully convertible currency, the management personnel have usually insisted that their employer remains the foreign company. The foreign company therefore supplies management to the Czech company as a service.

Typically such services will involve one or more consultants or managers working at the office or factory of the Czech company receiving the services provided for a period of at least one year. The Ministry of Finance have, since late 1992, held firmly to the view that a company, whose sole contact with the Czech Republic is to provide such services, creates a permanent establishment under both Czech domestic legislation and under any applicable double tax treaty.

References to legislation within this article are to the Czech Act on Income Tax (586/1992 Sb as amended, most recently by 259/1994 Sb, effective from 1 January 1995) unless stated otherwise. References to Articles in double tax treaties are, for convenience, made to the form of wording used by the OECD Model Treaty. Most of the 25 or so double tax treaties entered into by the Czech Republic, or whose rights and obligations were recognized as assumed by the Czech Republic on dissolution of the former Czech and Slovak Federative Republic (Czechoslovakia) on 31 December 1992, follow this form of wording closely.

II. ANALYSIS

A. Domestic legislation

The Czech Commercial Code (Article 21 (3)) treats a foreign company as having a business activity in the Czech Republic if it has "a business or its organizational component" in the country. This is however subject to Article 2 (1) of the Commercial Code, which provides that business activity is "any systematic activity carried out ... for the purpose of gaining profit." It is now a well accepted principle under Czech Commercial Law that to be "systematic", activity has to be more than occasional, and involve more than supplies based on a single contractual relationship. Hence foreign companies can in some circumstances be active in the Czech Republic, but not be required to register in the Commercial Register.

The Czech tax legislation casts its net much wider in looking to bring foreign companies into the Czech system. Under Article 17 (4) of the Income Tax Act foreign companies are liable to Czech tax on income "from services in the territory of the Czech Republic". Czech source income is defined as including, in Article 22 (1)(a), "income from activities exercised in a permanent establishment".

A "permanent establishment" is defined in Article 22 (2). As well as several clearly defined types of sites of activity such as offices, several other activities are deemed or considered to create a permanent establishment. The activities are:

- building sites;
- execution of building or assembly projects;
- service activities provided in the Czech Republic;
- business, technical or other consultancy provided in the Czech Republic;

– management or agency service activities provided in the Czech Republic.

The activity will create a permanent establishment if carried on either by employees of the entity, or by others (such as employees of other group companies, or free-lance workers or consultants) who are working for the entity. However, the permanent establishment is only definitely created once the activity has been carried on for more than six months, aggregating periods divided by interruption of activity (unless the interruption exceeds 12 months in duration).

It is these "deemed" permanent establishments – where a presence is considered to exist for tax purposes because management or consultancy activities are carried on in the Czech Republic, but for which there is no requirement to register formally with the Commercial Register – on which, as noted above, attention is focused.

B. Double tax treaties – general

It is of course necessary to consider the interaction of the Czech Income Tax Act with the many double tax treaties to which the Czech Republic is party. Article 37 confirms that the provisions of a double tax treaty will override the Income Tax Act in situations where the two sources of the law conflict.

Article 7 of the OECD Model Treaty is very important. This provides that the profits of a foreign company shall only be taxable in its home country unless the enterprise carries on business in the other state through a permanent establishment situated in that other state.

Hence a "deemed" permanent establishment existing under Article 22 of the Income Tax Act will only be subject to Czech tax if the nature of the presence or activity of the permanent establishment also falls within one or more of the OECD Model Treaty definitions of "permanent establishment" set out in Article 5 of the OECD Model Treaty.

Article 5(1) gives one head under which may permanent establishments arise, and this definition has several elements. There must be a "fixed place of business". According to the OECD commentary this would include any premises or facilities used for carrying on the business whether or not they are used exclusively for this purposes. All that is needed is that the foreign company has a space at its disposal. It has been said that the desk and telephone of a consultant or manager at the Czech company represent a "place of business" of the foreign company. This is at best arguable: one leading commentary notes that the mere fact that the foreign company uses a place of business is not sufficient to constitute a permanent establishment, and much German juridical practice supports this line. The place of business must qualify as the foreign company's place of business. This would only be the case if the foreign company could not be prevented from making use of the premises or facilities. Indirect evidence can be considered too – typically the foreign company whose only activity is to provide management or consultancy services would not have stationary, letterheads, or bank accounts using the address of the Czech company, or an external sign showing its name at the Czech company. This all points away from there being a place of business.

The reference to an "office" in Article 5 (2), which confirms certain examples which will always be a permanent establishment, is also relevant. It is however again noted that the "office" must be the foreign company's office for Article 5 (2) to apply.

Lastly, to fall within the Article 5(1) definition of a permanent establishment, the fixed place of business must be one "through which the business of the enterprises is carried on". In order to be "the business" of the enterprise it is not sufficient for the activity simply to play some part in contributing to the profit of the overall enterprise. Were this to be the case any activity would fall to be treated as "the business". As the OECD Model Treaty commentary notes:

> ... it is ... axiomatic to assume that each part (of a business organization) contributes to the profitability of the whole. It does not, of course, follow in every case that because in the wider context of the whole organization a particular establishment has a productive character it is consequently a permanent establishment....

In considering the provision of consultancy and management services the individuals working in the Czech Republic are at the point of delivery, not at the point of sale, unless they use their Czech presence to try to sell further services to other customers. The point of delivery ought not inevitably to be regarded as the point through which business is carried on.

The way in which the treaty is construed is also important. The term "business" is not defined in the treaty – hence one has to apply Article 3 (2), which requires the term to be given the meaning "which it has under the law of (the Czech Republic) concerning the taxes to which the Convention applies". It must be remembered that the term to be considered is "business", not permanent establishment. The Czech tax legislation gives no direct definition, although Article 17 (3) of the Act on Income Tax directs one to use the definition of business activity set out in Article 2 (1) of the Commercial Code. If this approach is followed, then any activity which does not have to register with the Commercial Court ought not to be a "permanent establishment" under Article 5 (1) of the OECD Model Treaty.

C. Double tax treaties – United States

The Czech Republic – US treaty, ratified in late 1993, has been widely commented on in this area. Most unusually it contains a specific clause dealing with this issue. A permanent establishment exists under this treaty if there is:

> the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, but only if activities continue...for periods aggregating more than nine months within any 12 month period.

There are two ways of looking at this – as must have become apparent during negotiation of the treaty! On the one hand the US treaty wording agreed can be seen as representing a concession from the normal situation, if it is recognized that the Czech Income Tax Act definition of "permanent establishment" is not otherwise overridden by the provisions of an OECD model type treaty. This would certainly be the approach of the Czech Ministry of Finance, who appear to regard the "six month" test imposed by the Czech Income Tax Act as the sole test of permanency. On the other hand, perhaps because it was strongly desired to have such arrangements create a taxable presence, and it was felt that because the OECD Model Treaty wording did not achieve this objective, an additional clause had to be inserted. This latter view supports the argument that where management or consulting services are provided in the circumstances outlined above, no permanent establishment exists under most of the Czech tax treaties with countries other than the US, which do not include this clause.

D. Comparative approaches to this issue

It would be wrong to suggest that this issue is unique to the Czech Republic. However, the steadfast insistence by the Czech Ministry of Finance that the provision of management services by a multinational group to a local affiliate creates a taxable presence of the service provider does represent a major departure from the normal approach previously taken in other jurisdictions. In protecting the tax revenue of the jurisdiction where the service receiver is based the usual approach has more usually been:

- by denying a tax deduction for any excessive fee by using transfer pricing legislation (e.g. Article 23 (7) in the Czech legislation);
- by ensuring full reporting of income at the individual employee level by ensuring that all salary and benefits are dealt with through the payroll of the service receiver. This could be done in the Czech Republic by applying Article 2 (7) Act on Administration of Taxes and Fees to force the *local entity* to recognize the substance rather than legal form of the arrangements and deal with the seconded managers as if they were employees of the service receiver. Support for this line would come from the OECD Model Treaty Commentary where it comments on what it refers to as the "international hiring out of labour" (15.8). Alternatively the position could be made clearer by an extension of Article 38(h) to make it apply to individuals acting under the direction and control of a payroll operator as well as its own employees.

The situation where consulting services are provided at an independent client's premises has received wider international attention. Some countries in effect treat consulting projects as analogous to construction projects, and aim to regard a permanent establishment as existing if the activity exceeds a specific life span. US practice seems to be to use a two year rule. On the other hand, countries such as Norway take a view similar to the Czech view, and regard the client's facility as giving the consultant the right of use to facilities, hence creating the fixed place of business.

III. PRACTICAL IMPLICATIONS

A. Foreign company supplying services

Despite the arguments set out above, which mostly run contrary to the Ministry of Finance view that virtually all management support or consulting contracts lasting for more than six months give rise to a permanent establishment, most multinational groups active in the Czech Republic have, since 1993, accepted that the approach desired by the authorities must be complied with. Considerable experience of dealing with the practical issues arising has been gained, and guidance in a number of practical areas has been given by the Ministry of Finance.

1. Creation of permanent establishment

The Ministry of Finance recognizes that there is a period of time between the commencement of supplying services and it becoming clear that a permanent establishment exists. During this period it is the stated practice of the Ministry to seek to tax such entities as follows:

- If the foreign company is not resident in a jurisdiction with which the Czech Republic has concluded a double tax treaty, then fees the foreign company derives from the provision of services in the Czech Republic will be subject to withholding tax at a 25 percent rate (Article 36(1)(a)). This is a final, non-refundable tax.
- If the foreign entity can claim the benefit of an applicable double tax treaty, and can provide the entity receiving the services with a certificate of tax residence to demonstrate this, the fee income is provisionally exempt from Czech tax, whether collected by way of withholding or otherwise. If however a permanent establishment is subsequently created, the income and (if appropriate) expenses attributable to the activity in the Czech Republic since the first day of activity will have to be included in the tax return for the final period in which the permanent establishment exists.

2. Registration with financial office

As soon as the aggregate duration of periods in which services are provided in the Czech Republic exceeds six months (or the longer period of time specified in an applicable double tax treaty) then an obligation arises (Article 33 Act on Administration of Taxes and Fees) to register the permanent establishment with the Financial Office responsible for the location at which services are performed. If activities are provided at several locations, the foreign entity may choose to register at the Financial Office responsible for any one location at which services are performed, and this will satisfy entirely the obligation for registration.

Penalties for failure to make a timely registration are high.

The Ministry of Finance has confirmed that it is possible for a foreign entity to register a permanent establishment prior to it becoming certain that a taxable presence will be created.

3. Attributable profits subject to Czech tax

Once the permanent establishment has been registered, it will be necessary for the basis upon which attributable profits to be subject to Czech corporate income tax (the "tax base") to be agreed with the Financial Office. It would be usual, as part of this process, for the Financial Office to request sight of the service agreement under which services are supplied. The legislation (Article 23 (11)) imposes a requirement that the tax base cannot be lower than would be the case if a Czech company, trading at arm's length, provided the services. The tax base will be subject to Czech corporate income tax at the ruling rate, which for 1995 is 41 percent.

In practice, to date the Financial Office for Prague 1 (responsible for all permanent establishments with activities located in the city of Prague) has adopted a pragmatic view and generally agreed tax bases at 1 to 2 percent (often 1.2 percent) of the fees charged to the Czech entity receiving the services, on the grounds that this is the commission an independent agent would charge for arranging such services. This has often been the case even if the service agreement has specified that the fee payable is computed by reference to costs directly incurred by the service provider, either without any mark-up, or in some cases with a mark-up of 4 or 5 percent – i.e. significantly more than the agreed tax base. However in other situations where the fee is calculated as equal to costs incurred, without any mark-up being applied, a senior Ministry of Finance official has indicated that a nil tax base would be appropriate, and this has been accepted by the Financial Office. On the other hand, there has been a disappointing lack of consistency amongst Financial Offices elsewhere in the Czech Republic in agreeing the tax bases of permanent establishments of this type, with some offices insisting on a tax base calculated as the difference between income (being the fees charged to the Czech company) and fully documented expenses (e.g. salary reported by the individual for income tax purposes, no relief for allocated head office overhead, etc.) to the extent that they are deductible under general Czech corporate income tax rules (e.g. no deduction for the costs of employer provided accommodation).

4. Record-keeping obligations and payrolls

The permanent establishment is not a "unit of account" for the purposes of the Czech accounting legislation and is thus not automatically obligated to keep a full set of books and records which satisfy the detailed and onerous requirements of this legislation.

In submitting the tax return for the permanent establishment, it would be normal to include copies of the invoices substantiating the fee income, and a brief analysis of the expenses attributable, even if the basis of taxation has been agreed at a percentage of fee income.

However, as noted above, a Financial Office has powers to impose on any taxable entity an obligation to maintain records necessary for the proper assessment of the tax base of the entity. Such a ruling, which must give specific details of the records to be kept, cannot be appealed against. (Article 39 Act on Administration of Taxes and Fees 337/1992 Sb as amended).

The permanent establishment is not required to operate a payroll and make monthly tax withholdings (Article 38 g(3)). This has only been the case since 1 January 1995 – prior to this date a dispensation from the Financial Office had to be sought.

5. Value added tax

The services supplied by the permanent establishment do not fall within the scope of Czech VAT. This is because *only* entities registered with the Commercial Court of Trade Register in the Czech Republic are regarded as operating within the framework of entrepreneurial activity, which is a pre-requisite for the making of taxable supplies (Article 2(1) Act on VAT).

B. Services receiver

1. Reporting obligation

Compliance by foreign entities supplying services to the Czech Republic is enforced principally by placing strict obligations on the service receiver. In particular a Czech service receiver, which concludes any contract with a foreign entity which could be the basis for the creation of a permanent establishment by that foreign entity, must immediately notify the local Financial Office of this contract (Article 34(17) Act on Administration of Taxes and Fees 337/1992 Sb as amended). Penalties for failure to comply with this legislation can be severe – the maximum penalty is CZK 2,000,000 (US$ 80,000).

The service receiver is also obligated to make payments of Czech corporate income tax on account for the foreign service provider. The obligation applies to all Czech source income of the foreign service provider, and thus applies to any income from management services provided in the Czech Republic through a permanent establishment (Article 22(1)(a)) or otherwise (Article 22(1)(c)), unless this income has already been subject to a final withholding tax (Article 38 e (4). The rate of "on account" withholding is 10 percent of the liability. Since 1 January 1995, the "on account" payment of tax must be made to the Financial Office by the end of the month for liabilities accounted for (i.e. accrued) in the preceding month. Payments of tax not made on a timely basis attract a penalty of 0.2% per day late, if discovered by a Financial Office review. This Draconian legislation is rigorously imposed, and has been the principal instrument for ensuring compliance with the Ministry of Finance view on whether the international provision of management or consulting services gives rise to a permanent establishment.

Financial Offices have discretion to reduce, or waive, the level of "on account" withholding (Article 38 e (8)). The procedure involves the foreign service provider which has registered a permanent establishment, and is in good standing with the Financial Office, applying for a certificate confirming the relief granted by the Financial Office, and a copy of this certificate being presented to the service receiver.

If "on account" payments are made on behalf of the foreign service provider, these are credited in computing the final tax liability of the permanent establishment, and repayments made where appropriate.

2. Value added tax

The Czech Republic does not have VAT legislation which requires service receivers to account for input VAT (the "reverse charge") on services imported. Hence no VAT considerations arise for the service receiver.

C. Employees

1. Short-stay visitors

Foreign employees who earn income from activities carried out at a permanent establishment will be subject under Czech domestic legislation to personal income tax on such income, however short their period of duties at the permanent establishment. The exclusion for income earned during visits of less than 183 days (Article 6 (9) (ch)) can only apply if the activities are not carried out at a permanent establishment.

The position is only modified slightly by double tax treaties. The dependent personal services article will exempt short-stay visitors who remain treaty resident outside the Czech Republic only in cases where the salary for the stay in the Czech Republic is not borne by a permanent establishment of the employer. Once it is accepted by the foreign service provider that a permanent establishment exists under the applicable double tax treaty, then the short-stay employee can only use the treaty to escape Czech tax if either:

- the permanent establishment is created by a group company other than his employer. [It should be noted that not all treaties contain the requirement that the permanent establishment must be operated by the employer. Also, if challenged, the authorities may take the view that the operator of the permanent establishment is the de facto employer.]; or
- his salary cost is not borne by the permanent establishment. This is a difficult area, as the negotiated tax base of the permanent establishment (see III A 3 above) may not require the salary cost to be accounted for by the permanent establishment. Nonetheless, if the fee charged to the service receiver includes an element for the activities of the short-stay visitor, then it would probably have to be accepted that the permanent establishment also bore his salary costs. The only safe situation would be if it could be clearly demonstrated that no charge was made for the short-stay visitor.

2. Long-term assignees

Such individuals will be unaffected by the existence of the permanent establishment, as they will in any event be subject to Czech personal income tax on all duties performed in or related to the Czech Republic. In particular the existence of the permanent establishment will not cause them to be subject to payroll withholdings, and the individuals will retain their personal obligation to submit personal income tax returns.

3. Social and health insurance contribution liability

Foreign individuals who do not have an employment contract governed by Czech labour law are excluded from contributions liability, as are their employers. The existence of a permanent establishment of their employer does not affect this situation.

IV. CONCLUSION

The trend amongst multinational groups will probably be to circumvent the many problems of creating a permanent establishment by transferring expatriate managers into contractual employment with the local Czech group company for the period of their secondment. Currently there is still a reluctance to do this, but only because of currency of salary payment issues. A clear statement by the Czech National Bank that a Czech company can pay foreign employees in fully convertible currency without being in breach of foreign exchange regulations would assist the situation greatly.

It is noted that the concept of the "international services" permanent establishment is gaining ground, and it may well be that the Czech Republic has been a leader in this field. Nevertheless, the aggressive attitude of the Czech Ministry of Finance, coupled with the burdensome domestic legislation, in this area, has been very troubling for international inward investment to the Czech Republic, and has been seen as a deterrent both to the seconding of international management, into the country, and to consulting firms looking to do business with (rather than in) the Czech Republic.

SOUTH AFRICA

TAX REFORM OF THE KATZ COMMISSION

Marius van Blerck

Mr van Blerck is group tax consultant with Anglo American Corporation, chairman of the Scientific Committee of the South African branch of IFA, chairman of the South African Fiscal Think Tank, member of the Income Tax Special Court, member of the statutory Financial and Fiscal Commission, founding editor of the SA Tax Review and originator of the Taxfax World Wide Web site on the Internet.

I. INTRODUCTION

Following the first budget of the newly democratic South Africa last year, a Commission of Inquiry into certain aspects of the tax structure of South Africa was set up, with Professor Michael Katz as chair (the "Katz Commission"). In December 1994 this Commission delivered its first interim report, and this article is based on the report's own summary of its findings.

A. Limitation on the raising of taxes

The question of imposing some form of statutory limitation on the total amount of taxes that may be raised by Government or on the aggregate of Government spending should be further investigated.

B. Reliance on indirect taxation

The rate of indirect tax in South Africa should not be increased at this stage, but the extent to which greater reliance is placed on indirect taxes will need to be examined in the context of the longer term tax reform.

II. OVERVIEW OF RECOMMENDATIONS

A. Fundamental aspects of tax reform

In the implementation of tax reform, the following fundamental aspects of the Commission's proposals should not unduly be altered:

- a personal income tax structure which avoids discrimination on the basis of gender or marital status, imposes an equitable fiscal burden and prevents unnecessary bracket creep;
- corporate rates of tax which, whilst being internationally competitive, are also domestically appropriate;
- an efficient VAT system;
- adequate poverty relief with effective delivery to overcome the existence of poverty which is widespread in South Africa, compensating also for the regressive effect of VAT;
- an efficient tax administration which prevents distortion and secures proper collection of taxes that are legally due, in a manner which, from a procedural point of view, is fair, constitutionally defensible and promotes certainty for proper planning by the business community;
- a tax system which, while not discriminating against domestic investment and trade, will be friendly to foreign participants in our economy;
- a tax system which, whilst not being burdensome or interventionist, will provide the fisc with revenues for necessary Government expenditure.

III. TAX ADMINISTRATION

A. Status and organizational autonomy of the Commissioners

Urgent attention should be given to the enhancement of the status and to the administrative autonomy of the Commissioner for Inland Revenue and the Commissioner for Customs and Excise.

B. Provincial and regional tax collection

The sections of existing Regional Services Councils and Joint Services Councils responsible for collection of levies should be incorporated into Inland Revenue. With regard to provincial tax collection, provincial authorities should not establish their own revenue collection structures, and Inland Revenue and, as appropriate, Customs and Excise, should adapt their structures and information systems so as to facilitate provision of an efficient revenue service to provincial governments.

C. Expenditure on tax administration

South Africa's expenditure on tax administration should be raised to about 1.2 percent of revenue collected in order to achieve cost-effective prosecution of the responsibilities of the revenue authorities.

D. Principles for reform of tax administration

The following broad principles should guide Government's restructuring of tax administration;

- independence of the revenue authorities, including responsibility for their own budgetary allocation and control, administrative policies and objectives, and recruitment, training, remuneration and codes of conduct for personnel;
- oversight by statutory boards responsible for Inland Revenue and Customs and Excise, appointed by and answerable to Parliament through the Minister of Finance;
- maintenance of unified Inland Revenue and Customs and Excise departments, with responsibility both to the national and provincial governments for all aspects of tax collection; and
- contracting out, where appropriate, of certain administrative functions, such as computer services, warehousing of documentation and customs merchandise, printing and distribution of tax returns and notices, preparation of tax manuals and documentation and collection of minor taxes.

E. Structure and powers of Revenue Boards

The proposed revenue boards should have the following broad responsibilities and powers:

- ensuring that tax laws are enforced with the highest degree of integrity;
- ensuring that revenue departments coordinate and share information where appropriate;
- establishment of an overall pay and job classification structure;
- provision of guidance in internal resource allocation;
- ensuring that appropriate personnel and programme management practices are in place;
- recommending legislative and other changes needed in the interests of improved tax administration to the Minister of Finance;
- establishment of an internal audit function within the tax administration;
- provision of revenue estimates on existing and proposed tax measures to the Minister of Finance; and
- establishment of a written code of conduct for employees of revenue departments and the board.

The membership of the envisaged boards of Inland Revenue and Customs and Excise should comprise no more than six senior and distinguished civil servants, with full-time executive responsibilities for revenue administration.

IV. TAX COLLECTION

A. Taxpayer education and customer services

A systematic programme of enhancement of customer services should be undertaken by the revenue authorities, as an integral aspect of personnel development and organizational change initiatives. Amongst the possible elements of an improved orientation in tax administration are the following:

- formulation of a customer service policy and guidelines;
- regular surveys of taxpayers, with the purpose of monitoring taxpayer satisfaction with revenue services and priorities for improvement;
- streamlined procedures for dealing with taxpayers' complaints;
- establishment of public relations offices in both the Inland Revenue and Customs and Excise Departments;
- publication of simple and informative leaflets aimed at the general public and specific interest groups on pertinent aspects of revenue practice and tax policy;
- publication of Codes of Practice which set out the inspection procedures of the revenue authorities and taxpayers' rights;
- publication of practice notes;
- improvement of telephonic and postal tax enquiry services; and
- on-going attention to the design and wording of all tax forms in use.

The Commissioner for Inland Revenue should consider the use from time to time of a survey of selected aspects of tax compliance and the inclusion in tax forms of a question on the time taken by taxpayers to complete tax returns, in order to gauge whether increased administration costs are offset by savings to taxpayers and the legal system.

Customer service units should be established in all regional offices, and a deliberate campaign of taxpayer education should be launched nationally. The first priority of Inland Revenue's customer service orientation should be the provision of assistance to the small business sector.

B. Tax amnesty

A once-off tax amnesty should be introduced, granted on the following basis:

- a limited time period be granted to all persons not previously registered as taxpayers to accept the amnesty;
- it will apply only to those people who, in the limited period, voluntarily come forward and not to those who are detected by the authorities;
- the consequence of acceptance of the amnesty is that the persons accepting will only be liable for tax for the period of three years before the introduction of the amnesty, and liability in respect of prior periods will be forgiven;
- the liability in respect of the three year period will not be accompanied by interest or penalties and, if necessary, terms to pay off the liability will be granted if the Com-

missioner is satisfied that the extension of such terms is necessary to alleviate hardship; and
- it will not be compulsory to accept the amnesty, allowing people who have suffered losses which they wish to carry forward, for example, to do so.

V. PERSONAL INCOME TAX

A. Single schedule of tax rates

As gender discrimination is probably unconstitutional and discrimination on the basis of marital status is no longer appropriate, a single schedule of tax rates is recommended.

B. Child rebates

Child rebates should be eliminated.

C. The old-age rebate

The old-age rebate should either be more carefully targeted or slowly phased out.

D. Employee pension fund contributions

Qualifying pension fund contributions by employees should, in addition to the present restrictions, be limited to a maximum of R 9,000 per year.

E. Employer pension fund contributions

Qualifying employer contributions to a pension fund should be limited to twice the aggregate of qualifying employee pension fund contributions. The maximum employer limit will thus be R 18,000 per employee.

F. Retirement annuity fund contributions

The present 15 percent limitation on income derived other than from retirement funding employment should be increased to 22.5 percent, but subject to a maximum of R 27,000 per annum. This should be applicable to all categories of taxpayer.

G. Employer contributions to medical aid funds

It is recommended that this deduction be continued.

H. Unified rate structure

A single unified rate structure is favoured with a reduction in the present number of brackets to five, beginning with a flat rate of tax of 9 percent up to R 30,000. A primary rebate of R 900 should apply up to R 10,000 and should be reduced to zero at an even rate over the range of R 10,000 to R 20,000.

VI. VALUE ADDED TAX

A. Zero rating of basic goods

In South Africa's present circumstances, further erosion of the VAT base through extending the number of zero rated items should be avoided.

B. Targeted poverty relief

Targeted poverty relief and development programmes should receive renewed priority in the restructuring of Government expenditure, bearing in mind that poverty relief cannot effectively be addressed through the tax system. Particular attention should be given to the extension of the existing social grants system to include categories of indigent individuals or households presently not provided for.

C. Review of zero-rated items

A review of the present list of zero-rated basic foodstuffs should be undertaken with a view to the possible redefinition of certain items or substitution of presently zero-rated goods with alternative items. As progress is made with the implementation of reconstruction and development initiatives, the possible termination of the zero rating of particular items should be reviewed.

D. Multiple VAT rates

A higher VAT rate on luxury goods or a multiple VAT rate system should not be adopted.

E. Impact of the tax system on small and medium-sized enterprises

1. Definition of small enterprises

Assistance via the tax system to small businesses should be limited to small and micro-enterprises only, defined according to stringent criteria.

2. Cash accounting

An order to reduce the cash flow constraints and thereby ease the magnitude of the working capital requirements of small enterprises, qualifying businesses should be granted the option of being taxed on a cash flow basis which would allow revenues and expenditures to be recognized only when cash is received or payment is made.

VII. COMPANY TAXATION

A. Tax rate on companies

Measures to broaden the income tax base need to be pursued but an increase in nominal corporate tax rates is not recommended.

B. Secondary tax on companies (STC)

STC should be retained in its present form but various forms of imputation tax should be investigated in order to determine whether an imputation system could replace STC.

C. Group taxation

The question of group taxation is of great importance and it is recommended that it be investigated further.

D. The structure of corporate income taxation

A careful examination should be made of the principles of the structure (i.e. the basis of calculating taxable income) of the South African Income Tax Act, particularly in the light of the consultative document by the Tax Advisory Committee on tax treatment of financial arrangements.

E. Marketable securities tax and stamp duties

Marketable securities tax should be abolished as soon as the resources of the fisc can accommodate such a measure. Corresponding amendments to the Stamp Duty legislation would be required.

F. Debt versus equity financing

It is recommended that further attention be given to the issue of the impact of taxation on debt versus equity financing.

G. Foreign investment in financial instruments

The exemption contained in Section 10(1)(s) of the Income Tax Act relating to foreign investment in financial instruments, should be codified so that it can operate automatically.

H. Black economic empowerment

The impact of tax on black economic empowerment should be investigated further.

VIII. TAXATION AND THE NON-GOVERNMENTAL SECTOR

A. Tax-exempt status

The provisions of Sections 10(1)(f) and 10(1)(fA) of the Income Tax Act which relate to the tax-exempt status of charitable, educational and religious institutions, should be amended so that the criteria to be contained therein for obtaining tax-exempt status harmonize more closely with the objectives of the Reconstruction and Development Programme and result in greater certainty as to who qualifies for such exempt status.

B. Business activities of tax-exempt bodies

If an organization which enjoys tax-exempt status carries on other activities outside of those to which the tax-exempt status applies, including the carrying on of a business, then the Commissioner may disregard the tax-exempt activities from the other activities, and require that separate financial records for the tax-exempt and other activities be kept.

IX. TAX INCENTIVES

A. Audit of incentives

Immediate steps should be taken to provide the necessary facilities and staff to undertake a comprehensive audit of all incentives, and if deemed necessary by Inland Revenue, changes should be made to the income tax return form so as to ensure that Inland Revenue obtains the necessary information to undertake a costing of incentives.

B. Regular reporting to Parliament

An auditing approach similar to the United States and Australia should be adopted in South Africa. Tax incentives should be treated in the same fashion as government expenditure in that estimates of costs and the objectives thereof should be tabled publicly in Parliament.

X. FOREIGN FINANCE, INVESTMENT AND TRADE

A. General incentives

General incentives aimed purely at encouraging foreign investment should not be introduced, and the emphasis at this interim stage should fall on measures that will remove any specific anomalies or inhibitions that may cause the tax system to be an actual disincentive to foreign investment. Where incentives are introduced for purposes other than promoting foreign investment, they should be designed taking into account domestic and foreign investment considerations.

The possibility of encouraging foreign investment through tax measures should be reviewed from time to time in the light of changing economic conditions, the removal of non-fiscal inhibitions to foreign investment, and the capacity of the fisc for adoption of such incentives.

B. Export incentives other than export processing zones

Development of a coherent and appropriate national export incentive strategy, encompassing fiscal, trade and other measures, requires an investigation in which all interest parties, including the export community and responsible government departments, should participate.

C. Export processing zones

Should tax-exempt export processing areas be introduced in South Africa, it is recommended that they should initially admit only foreign investors, with consideration to be given to local participation, especially in the form of joint ventures, as experience is gained regarding appropriate control measures.

If special economic zones are allowed to operate, they should run on an enclosed EPZ basis. Export processing units should not be established since they are difficult to control. The introduction of EPZ's should be done by way of a pilot EPZ project.

D. Regional holding, finance and service company location

Attention should be given to the removal of any tax disincentives for foreign companies who wish to use South Africa as a base for regional holding, finance and services companies.

A particular incentive should be introduced to facilitate the establishment by non-resident investors of wholly owned regional base companies in South Africa which provide managerial and financial support services to related companies in other African countries. The type of services qualifying for the special treatment should be clearly defined, and the combined rate at which the income derived from such activities is taxed (i.e. basic income tax plus STC) should be in line with the tax rates generally applicable in most of our trading partner jurisdictions. Mechanisms to counter abuse should be considered.

Provision of relief in respect of withholding taxes imposed on services should be taken into account in future treaty negotiations with African countries.

E. Non-resident shareholder's tax

In order to provide a measure of interim relief from the high overall corporate tax rate facing foreign investors, it is recommended that NRST be abolished in respect of a foreign investor who has a minimum 25 percent control of a company, subject to the following:
- the onus to prove qualification for the relief should rest on the shareholder;
- companies and not individuals, regardless of their holdings, should qualify for the relief;
- relief should not be restricted by a fixed date of introduction which would introduce unnecessary complexity.

To avoid abuse of this measure, a proviso should be included into the legislation to enable the Commissioner to deny the exemption if an intermediary South African holding company is interposed in order to take up the holding in the South African company of less than 25 percent. This wording may have to be considered in the treaty context as well.

F. Secondary tax on companies

Developments regarding the STC will need to be closely monitored from the viewpoint of their international impact, keeping in mind that the costs of international unfamiliarity may outweigh the domestic advantages of the STC innovation.

With regard to branches of foreign companies operating in South Africa, a provisional withholding tax should be instituted to cover the collection of STC or any similar deferred corporate tax which may replace it. Such a tax should be collected upon the remittance by the branch to the head-office of branch profits.

G. Exchange control relaxation

The current source-based system of taxation could without undue complications be retained as exchange controls are relaxed, and it should not be abandoned before a proper inquiry has been completed.

H. Thin capitalization rules

Thin capitalization rules should be introduced into the tax system, applicable to non-resident controlled companies. These should be based on a "safe harbour" statutory debt/equity ratio, with investors free to apply for exceptions to be made on the basis of objective evidence of arms length relationships in their particular circumstances. A debt/equity ratio of 5:1 should be the maximum gearing within which investors would be safe from any thin capitalization sanction, with consideration to be given to a ratio of 8:1 in the case of financial institutions. The sanction for being outside the prescribed norms should be the treatment of excess interest fully as a dividend.

Any thin capitalization rules which are introduced will have to provide for a phase-in period in respect of those few instances where foreign companies currently fall outside the new limits. The introduction of these rules should not be left until after the relaxation of the relevant exchange controls.

I. Transfer pricing

Measures to counter tax avoidance through transfer pricing should be introduced, based on arms length concepts of acceptable pricing practices, such as the UK approach, and utilizing a relationship definition that accords with international understanding.

A facility enabling multi-national companies to obtain Advance Pricing Agreements (APAs) should be established along with the introduction of measures to counter transfer pricing. Until a suitable capacity has been built in Inland Revenue, evaluation of such APA's could be contracted out and financed through a user charge.

Attention should be given to the effective pooling of experience and resources within Inland Revenue and Customs and Excise and the current exchange control authorities in the area of exchange control.

J. Foreign investments by South African residents

In order to counter possible adverse tax consequences of an abolition of exchange control over residents, a limited extension of deemed source provisions to include all foreign interest and royalties for the use of intangible property derived by a domestic company or individual who is ordinarily resident in South Africa is proposed. The existing credit mechanism, Section 6quat of the Income Tax Act, should also be extended to provide relief in those cases where tax is imposed abroad on South African sourced income.

1. Publication of the Revenue handbook

This should be edited for publication and made accessible to the potential investor.

2. Facility to give greater tax certainty

A facility to provide potential foreign investors with greater tax certainty, such as the Australian practice of providing "private rulings" or "advance opinions" is needed. Consideration could be given to making such a facility available only to potential foreign investors initially and to levying a service charge for the facility. Use could also be made by the revenue authorities of private consultants for this purposes.

K. Capital gains tax uncertainty

With regard to uncertainty regarding a future capital gains tax, a formal statement should be issued to the effect that, in the event of the introduction of such a tax, it will apply to assets acquired only after the date on which the tax is announced.

L. Harmonization of the former TBVC tax systems

The harmonization of the tax systems of the former TBVC States with the South African system should be resolved as a matter of urgency.

XI. IMPACT OF THE TAX SYSTEM ON INVESTMENT AND SAVING

A. Tax incentives to stimulate saving and investment

Further tax incentives to stimulate saving and investment should not be introduced, while existing incentives ostensibly introduced for the purpose of stimulating saving or investment should be reviewed and preferably abolished, subject to due notice being given of an intended change to the existing measures.

B. Tax and labour

1. Human resource development

In view of the importance of human resource development for reconstruction and development, tax aspects of education and training should be targeted for further scrutiny.

2. Employee share ownership and participation

Detailed discussion should be held with employer and employee representative bodies regarding the encouragement of employee share ownership and participation schemes.

XII. MISCELLANEOUS

A. Dedicated taxes

Attention should be given to the use of dedicated taxes (taxes which generate revenue wholly or mainly to predetermined expenditures) as a budgetary mechanism and the use of dedicated taxes in a new social security system.

B. Demergers and unbundling

The scope of existing fiscal provisions to facilitate unbundling provisions should be expanded beyond listed companies.

C. Annual presumptive tax

1. Introduction of a presumptive tax

It is proposed that a presumptive tax be introduced at a low rate on the gross assets of companies, close corporations and inter-vivos trusts, the basic amount to be set at R 1,500 per annum, payable when the first provisional tax return is filed. The proposed presumptive tax should be graduated, the graduation being based on the balance sheet value of the taxpayer's gross assets, with the tax levied at the rate of R 1,500 per annum for the first R 10 million or part thereof on gross assets and thereafter at the rate of R 1,500 per annum for each additional R 10 million or part thereof. The long-term assets of life assurers should be excluded in the calculation of assets for the purpose of this tax.

2. Exempt bodies

Testamentary trusts, unit trusts and taxpayers which qualify for the exemption in terms of Section 10(1)(f)(4) of the Income Tax Act should be exempt from the presumptive tax or, alternatively, should not be subject to a graduated fee.

3. Branches of foreign companies

In respect of branches of foreign companies, the tax should only be imposed on the assets of the South African branch operations.

4. Deductibility

The presumptive tax should be deductible for income tax purposes.

5. Deregistration of delinquent firms

Where reasonable steps fail to trace delinquent close corporations, companies and inter-vivos trusts, immediate steps to deregister them should be implemented.

COLOMBIA

Cross-Border Leasing

Leif Weizman

Cross-border leasing is an important means of financing, and a strategic tool for the development and stimulation of investments in new industries and technologies. Cross-border leasing has experienced a marked growth in Colombia, and this trend is bound to continue in the future.[1] The opening of the economy, coupled with a broad range of legal and fiscal measures, should foster the continued development of cross-border leasing in Colombia.

This article briefly highlights the type of leases used in Colombia and surveys the various tax and customs incentives available to investors (less restrictive exchange control rules are applied to cross-border leasing; these rules, which are generally seen as incentives, are not discussed).

I. TYPES OF LEASES

The term "leasing" is defined under Colombian law as: "the delivery under the title of leasing of goods acquired for such a purpose, financing its use and enjoyment in exchange for payments to be received during a set time period, granting the lessee the right to exercise the option to buy at the end of the period.[2] International – cross-border – leasing, which is not specifically defined by law, is generally understood to be in accordance with the definition contained in the Ottawa Convention of 1988.

Three types of cross-border leasing are commonly used in Colombia: intermediation or brokerage lease, subleasing and syndication. An intermediation or brokerage lease results where a national leasing company acts as an intermediary between the foreign leasing company and the client in Colombia. In a sublease a Colombian leasing company acts as financial lessee of the goods for the foreign leasing company in order to perform a leasing subcontract with the user of the goods. A syndication results where the foreign leasing company and the Colombian company jointly finance the client in Colombia and the national company administers the contract locally.[3]

II. TAX RULES

A. Income tax

Colombian tax law is based on the worldwide principle, and residents are taxable on their domestic and foreign income. Non-residents are taxable only on their Colombian-source income. The TC contains a definition of domestic and foreign-source income.[4] Domestic-source income is defined by law to include, *inter alia*, income "originated in movable property which is exploited in the country".[5]

Cross-border leasing falls under this definition. Cross-border leasing typically involves a foreign lessor who leases property to a Colombian lessee. Because the property leased by the lessor is located in Colombia the payments made by the lessee to the foreign lessor will be classified as Colombian-source income and therefore be subject to Colombian tax for the non-resident lessor company.

The TC, however, provides that income derived by a non-resident lessor from a leasing contract may be deemed not to constitute Colombian-source income. In order for the cross-border leasing income to qualify under this exception the leasing contract must either concern the financing of machinery or equipment which is to be used in processes for export, or concern activities which are considered to be of interest to the economic and social development of Colombia.[6]

The National Council of Economic and Social Policy (known as "CONPES") determines whether activities qualify under the latter exception.[7] CONPES has determined that farming and fishing activities, manufacturing and services are activities which are of interest to the social and economic development of Colombia.[8] The term "services" is defined broadly, and includes activities such as transportation, hotels and tourism, health, housing construction and engineering.

B. Remittance tax

In addition to the general income taxes, a remittance tax is levied on the remittance of income.[9] It generally applies to

1. Cross-border leasing was one of the subjects of the 1990 IFA-Congress in Stockholm; see International Fiscal Association, *Taxation of Cross Border Leasing* (Vol. 75a, 1990). The national reporter for Colombia then concluded (at 309) that cross-border leasing did not have any practical application in Colombia. Today, some four years later, domestic and cross-border leasing has emerged as a major business sector, and it has become a primary means of financing and obtaining technology.
2. Decree 913/1993.
3. See Oscar Ecuardo Gómez, "Consideraciones sobre el leasing internacional en Colombia", *Impuestos Revista de Orientacion Tributario* (No. 57 1993), at 15-16.
4. Estatuto Tributario (hereinafter "TC"), Arts. 24 and 25.
5. TC Art. 24, no. 3.
6. TC Art. 25, c), as adopted by Law 49/1990.
7. The leasing contract typically includes a fiscal indemnification clause for the foreign leasing company. See Oscar Ecuardo Gómez, *supra* note 3, at 16. This clause is particularly important if there is doubt as to whether a particular contract qualifies for the exemption because if the contract is disqualified by CONPES, the foreign investor will not qualify for beneficial tax treatment. The indemnification clause ensures that the foreign investor will be indemnified by the domestic leasing company if the contract is disqualified.
8. Contracts which are considered of interest to the economic and social development of Colombia are also exempt from taxation on interest income paid to a non-resident on a loan which relates to such activities. TC Art. 25, a), no. 5.
9. TC Title IV, Arts. 319-328.

any type of transfer abroad of income and capital gains derived in Colombia, and applies to the recipient of the income or capital gains. The remittance tax was recently reduced to 8 percent.[10] However, the remittance tax does not apply to income derived from cross-border leasing, because the tax only applies to income or capital gains derived in Colombia, and since income from qualified cross-border leasing is deemed to be foreign-source income it is not subject to the remittance tax. Thus a foreign lessor who receives payments from a Colombian lessee is not subject to remittance tax, and may receive the payments free of income and remittance tax.

C. Withholding tax

Likewise, because income derived from cross-border leasing is not considered domestic-source income it is not subject to withholding at source, and the payer of the income is not required to withhold taxes. Regulations provide that to "enjoy the treatment provided in Article 25, c) of the TC, withholding must be made for payments or bonds on account of income from domestic sources for the beneficiary, which are made for acquisition of the goods and services necessary for carry out the leasing contract".[11] In such a case the contracting leasing company must withhold tax at source and must declare and pay the withholding tax.

D. Value added tax

Special tax treatment is also provided for cross-border leasing with respect to the value added tax. The Colombian value added tax was enacted for the first time ten years ago. The general tax rate was increased from 12 to 14 percent in 1992.[12] The tax is imposed on most goods and services, although certain goods and services are exempt, and special tax rates apply to special types of goods and services. Beginning 1 January 1993, financial leasing has been excluded from the value added tax.[13]

E. Stamp tax

The TC provides for a stamp tax imposed at different rates on commercial and non-commercial documents, share issues and transfers.[14] The tax, which is assessed primarily through withholding, is generally imposed at the rate of 0.5 percent on the total value of the contract, and applies to private or public documents which are issued or accepted in Colombia or issued or accepted outside Colombia with effect within the territory of Colombia.

It has been the general view that cross-border leasing was to be considered foreign indebtedness in accordance with the definition applied by the Bank of the Republic for exchange control purposes. If this definition was applied for tax purposes, cross-border leasing would be exempt from stamp tax.[15] On 3 March 1994, the National Tax and Customs Administration ruled that a different definition was to be applied for tax purposes thereby subjecting cross-border leasing to the stamp tax.[16]

F. Double dipping

As a result of the above rules, cross-border leasing payments made by a domestic leaseholder to a foreign leasing company will not be subject to any type of Colombian taxes, and may be remitted without taxation or restrictions. The Colombian leaseholder will then generally be allowed to deduct payments made to the foreign leasing company. If, however, the foreign leasing company and the Colombian leaseholder are affiliated, consideration should be given to Colombian transfer pricing rules.[17]

Like many Latin American countries, Colombia has adopted transfer pricing rules which "block" the deduction of certain intercompany payments.[18] In addition, limitations are imposed on the deduction of expenses which are paid abroad, limitations which also apply in cases where there is no affiliate relationship between the foreign and domestic company. The TC generally provides that the deduction for expenses which have been paid abroad for Colombian-source income generally may not exceed 10 percent of the taxpayer's net income determined before deducting such expenses.[19]

III. CUSTOMS RULES

Cross-border leasing involves the importation of property which has been leased, and thus the general rules for importation are applicable. Generally, no prior import licence is required, and all products may be imported into Colombia. Two types of import duties are applicable:

10. Before 1991, the rate was 20%; it was reduced to 19% for 1993, 10% for 1994, 8% for 1995, and 7% for 1996 and thereafter. TC Art. 321-1, as adopted by Law 6/1992. For a discussion of these tax reductions as part of Colombia's program for the opening of the economy and integration, see Leif Weizman, "Colombia's Tax Reforms for Economic Openness", 9 *Tax Notes Int'l* (11 July 1994), at 105.
11. Decree 407/1993.
12. Law 6/1992, substituting TC Art. 468. The increased rate was originally to be applied from 10 January 1993 to 31 December 1997. However, on 18 April 1995 the Colombian Government presented a long-awaited tax reform, which provides, *inter alia*, that the VAT rate will not return to 12%; according to the proposal, the general rate will remain at 14% and the rates for vehicles, aircraft and yachts will be increased. See Leif Weizman, "Colombian Congress to Present New Tax Reform", 10 *Tax Notes Int'l* (March 1995).
13. TC Art. 476, no. 3, as adopted by Law 6/1992, Art. 25. The rate for such services was 10%.
14. TC Arts. 514-554.
15. TC Art. 529 provides that instruments of constitution, modification or extinction of obligations related to foreign indebtedness are not subject to the stamp tax.
16. DIAN-Decision No. 010498 of 3 March 1994, discussed by Leif Weizman, "Colombian National Tax Administration Rules Stamp Tax Applies to Cross-Border Leasing Contracts", 9 *Tax Notes Int'l* (26 September 1994), at 959.
17. For a discussion of Colombian transfer pricing rules, see Leif Weizman, "An Examination of Transfer Pricing in Colombia", 10 *Tax Notes Int'l* (9 January 1995), at 114.
18. Such payments are disallowed for deduction purposes by virtue of TC Art. 124, which have the following content:
The affiliates, subsidiaries, branches or agencies in Colombia of foreign companies, shall not be entitled to deduct from their income, as a cost or deduction, any amount paid or recognized directly or indirectly to their parent companies or offices abroad, for expenses, commissions, administrative or management fees, royalties and exploitation or acquisition of any kind of intangibles.
19. TC Art. 122.

- value added tax, which is based on the full cost, including customs duties and fines; as indicated above, this rate is generally 14 percent; and
- custom duties which are assessed on the basis of the law or international trade agreements; these duties vary depending on the type of product.

Due to the temporary character of the importation, however, cross-border leasing is subject to special rules. Cross-border leasing transactions are not exempt from value added tax (only financial leasing are exempt – see above),[20] so that the importation of leased property is subject to both types of import duties. Colombian custom laws provide for a special temporary importation regime, which allows the importer to defer the payment of the import duties.

A. Types of temporary importation

A distinction is made between short-term and long-term temporary importation. Short-term importation is defined as property imported for a maximum term of six months (with a possible three month extension).[21] Short-term temporary importation is not subject to customs duties.

Long-term temporary importation is defined as property imported for more than six months, which has not been granted an extension.[22] It applies to capital goods, such as machinery, equipment, transportation material and its accessories, parts and replacement parts, that arrive with the same shipment.

The National Tax and Custom Administration ("DIAN") has the authority to establish the type of merchandise that may be object of long or short-term temporary importation.[23] The maximum duration of any temporary long-term importation is five years,[24] although this term may be extended in special cases when the purpose of the importation so requires.[25]

B. Benefits of temporary importation

Short-term temporary importation is not subject to import duties.[26] The advantage of long-term temporary importation is that payment of the import duties may be deferred in instalment payments for the term of the duration of the temporary importation.[27]

In the case of long-term temporary importation of leased property the tax benefits are in the deferment of the payment of customs duties during the duration of the contract by distribution in quotas with the same payment schedule as that established in the lease contract for the corresponding payments. The quotas will be payable 15 days before the date in which payment abroad of lease payments must be made, in Colombian currency payable at the existing exchange rate at the moment of payment.[28]

C. Procedural rules

Importation of products in Colombia requires an import declaration which must contain information such as the identity and location of the importer and declarer, information on the mode of import and transport documents, description of the goods, self-assessment of import duties and applicable fines, and the form of payment.[29] The presentation of the import declaration and the payment of import duties and fines must be made to a bank or authorized institution. The importation declaration must be filed within two months after the arrival of the goods, although this deadline may be extended in certain cases.

If during the course of the long-term cross-border leasing contract a decision is made to permanently import the products then the importation declaration must be modified before the expiration of the term, and all import duties must be paid.[30] The same is the case for short-term importation. If the product is not imported on a permanent basis, it generally follows that the leased product at the end of the leasing contract will go back to the foreign lessor.[31] It is in this respect important to notice that in such cases there is no right of repayment of import duties paid during the leasing period.[32]

IV. CONCLUSION

Cross-border leasing is an important means to achieve the open economy policy, and the Colombian Government has recognized this fact by providing a tax and customs regime favourable to both parties in a cross-border leasing contract. For the foreign company it is important that income paid under a qualified leasing contract be deemed foreign-source income so the foreign lessor company is not subject to Colombian income and withholding taxation, and he can avoid remittance taxation. For the Colombian lessor it is important that import duties are either avoided or deferred, and for Colombian companies who act as intermediaries between the lessor and lessee the exemption from value added tax is important. The Colombian incentives to promote cross-border leasing provide significant benefits for both foreign investors and domestic companies, and are an important tool which serves the Colombian efforts to develop and stimulate new investments and technologies.

20. Previously, no value-added tax was imposed on "goods imported through the method of "temporary importation". TC Art. 428, a). This rule was repealed by Law 49/1990, Art. 26.
21. Decree 1909/1992, Art. 40, a).
22. Decree 1909/1992, Art. 40, b).
23. Decree 1909/1992, Art. 40 in fine.
24. Decree 1909/1992, Art. 40, b).
25. Decree 1909/1992, Art. 40 in fine.
26. Decree 1909/1992, Art. 41.
27. *Id.*
28. Resolution 473/1992, para. 3.4.2.
29. Resolution 473/1992, para. 3.2. The preparer must also state the basis for any exemption or preferential customs treatment in the declaration. Exemption is applicable to short-term temporary importation, and preferential treatment is applicable to long-term temporary importation. The basis for the exemption or preferential treatment will most likely be the contract and the determination of the leasing period to less than six months or five years, respectively. Short-term importation is not subject to custom duties, and long-term importation customs duties must be paid in US dollars at the exchange rate at the moment of payment. Resolution 473/1992, para. 3.4.2.
30. Decree 1909/1992, Arts. 44 and 45. TC Art. 258-1, which was enacted by Art. 20 of Law 6/1992, is in this respect important. It provides that the taxpayers may deduct from their income taxes the VAT paid for the acquisition or nationalization of capital goods, computer or transportation equipment.
31. Resolution 473/1992, para. 4 contains the procedural rules for re-exportation.
32. Decree 1909/1992, Art. 45 in fine.

CROATIA

OVERVIEW OF THE TAX SYSTEM

Prof. Dr Barbara Jelcic

University of Zagreb, Croatia

I. INTRODUCTION

In actual fact Croatia has only had its own tax system since 1 January 1994. Although an independent state, Croatia continued to apply the tax system and regulations of the former Yugoslavia. However, on 1 January 1994 the Income Tax Law and the Profit Tax Law came into force, thus paving the way for the future development of the Croatian tax system. However, both laws were substantially amended in 1994.

Croatia levies the following taxes:
- Income tax
- Profit tax
- Tax on the transfer of goods and tax on the rendering of services
- Excise taxes
- Tax on the transfer of property
- Various local taxes, such as inheritance and gift tax, motor vehicles tax, tax on vehicles for water transport, entertainment tax, etc.

This article overviews the various taxes levied in Croatia.

II. TAX ON INCOME OF INDIVIDUALS

The income tax was initially introduced by the Income Tax Act applicable as of 1 January 1994,[1] and subsequently amended[2] applicable from 1 January 1995. This new unified income tax system replaces the schedular tax system which taxed each kind of income separately.

A. Taxpayers

All natural persons are subject to income tax. Since income tax liability is based on the worldwide principle, the law defines resident and non-resident taxpayers. A resident taxpayer is one whose domicile or habitual place of abode is in Croatia for at least 183 days.[3] A non-resident taxpayer is one who has neither domicile nor a habitual place of abode in Croatia.

B. Taxable base

The taxable base for resident taxpayers is the total income earned by the taxpayer in Croatia and abroad from employment, self-employment, property and related rights, reduced by the personal allowances (for the taxpayer, spouse, children, taxpayer's and spouse's parents, etc.), as well as any losses incurred.

The taxable base of non-resident taxpayers is the same as for resident taxpayers insofar as the sources are concerned, but differs in respect of deductions. A non-resident taxpayer is only entitled to the basic personal allowance in addition to deduction of losses incurred.

The taxable period is a calendar year, and the taxable base may be computed either for the calendar year, or for a shorter period. The shorter assessment period may be used if during the calendar year a non-resident taxpayer becomes a resident taxpayer or vice versa, or if tax liability commences or terminates during the year due to the birth or death of the taxpayer.

C. Exemptions

The following income is exempt from tax in Croatia:
- interest on domestic and foreign currency savings accounts, on domestic and foreign currency current accounts, on loans and credits, on securities, dividends and profit shares from enterprises liable to the profit tax, on profits arising from the disposal of financial assets and on profit shares in foreign enterprises which are subject to the Profit Tax;
- certain amounts received as benefits, allowances, bonuses and welfare, and income received from insurance companies.[4]

1. Published in the Official Gazette No. 109 of 7 December 1993, and came into force on 15 December 1993.
2. Published in the Official Gazette No. 95 of 27 December 1994, and came into force on 4 January 1995.
3. A Croatian citizen who is neither domiciled nor has a habitual place of abode in Croatia, but who is employed as a civil servant of Croatia is also subject to income tax.
4. For example, invalids' support, support for immediate family members of soldiers killed in the war between the former Yugoslav states, compensation for destruction and damage of property caused by war, natural disasters and other force majeure events, child benefits according to special legislation, amounts received by the disabled according to health and retirement security regulations, with the exception of salaries, pensions, and state awards.

D. Employment income

Income from employment includes wages, salaries, pensions, certain allowances, benefits and bonuses exceeding amounts stipulated by the Minister of Finance, as well as all other income arising from the employment regardless of whether it is paid in cash or in kind.

E. Income from self-employment

Income from self-employment comprises income from handicrafts, professional work, agriculture, forestry and any activities which are permanently or occasionally undertaken for the purpose of earning income.

Any individual who is liable to pay tax on income from handicrafts or income from professional work may opt to pay profit tax rather than income tax. To exercise this option, the taxpayer must submit a request to the tax authorities. As from 1 January 1995, a taxpayer who has exercised this option to pay profit tax may revert to income tax liability by submitting a written request to the tax authorities.[5]

The taxable base for income from handicrafts and income from professional work is the difference between total receipts and total expenditure. Business receipts include assets (money, objects, material rights, services rendered and other) derived by the taxpayer during the tax period. Business expenditure comprises expenditure directly related to the earning of income; for example, write-offs of fixed assets which have been sold or disposed of in the course of the business or upon liquidation of the business. Losses may generally be carried forward for five years.

Taxpayers who derive income from handicrafts or professional work are required to keep records for purposes of calculating their income. The law also contains specific rules on how records relating to fixed assets are to be kept.

F. Income from farming and forestry

Income derived by individuals from farming and forestry is assessed to tax on the cadastral income (according to special regulations), or in accordance with special regulations applicable to taxpayers performing handicraft and professional work.

G. Income from property and related rights

Income from property and related rights includes income from renting or leasing real estate or movable property, as well as copyrights and other property rights. Income derived from the disposal of immovable property and related rights also falls within this category of income if disposed of within three years of acquisition. Income from property and related rights is subject to income tax only if the taxpayer does not pay the profit tax or income tax on income from self-employment.

The taxable base is the income earned by renting or leasing real estate, movable property or the income earned by copyright or industrial property right holders.

H. Personal allowances

Personal allowances are given in the form of deductions expressed as units of the minimum annual salary. Resident taxpayers are entitled to the following deductions:
(1) a basic personal allowance of 700 kunas for each month of the assessment period;[6]
(2) 0.3 percent of the basic allowance for a dependent spouse or other member of the taxpayer's immediate family, including the first child;
(3) the allowance in (2) increased by 0.1 percent of the basic allowance for each additional child (i.e. for the second child 0.4 percent, for the third child 0.5 percent, etc.);
(4) the allowance in (2) increased by 0.2 percent of the basic allowance for a dependent disabled member of the taxpayer's immediate family;
(5) amounts paid for health insurance by a resident taxpayer up to the amount of the obligatory contributions for health insurance as paid by the employer and the employee, provided the taxpayer has no other forms of health coverage.

Non-resident taxpayers are entitled to the same basic personal allowance as for resident taxpayers and to deductions of contributions for national health insurance, up to the amounts set for employers and employees.

I. Other relief

Non-coverable losses can be carried forward for five years. Such losses are deducted before personal allowances. The deduction of losses in the current tax period is permitted only if they could not have been deducted in previous tax periods. Carried over losses are deducted in the order in which they were incurred.

J. Tax rates

Croatia imposes only two rates of tax: the lower rate is 25 percent, which is applied on the taxable base up to three times the basic personal allowance. The higher rate is 45 percent on taxable income exceeding three times the basic personal allowance. The taxpayer is additionally liable to a municipal surcharge, of which the taxable base is the amount of income tax paid.

K. Assessment and payment of income tax

Income tax is assessed and paid on an annual basis. At the end of the tax period the taxpayer is required to file a tax

5. Both options are obligatory for three years, unless a shorter period is granted for good cause. It should be noted, however, that practice regarding these options remains unclear.
6. Retired persons are entitled to a personal deduction of 1.750 kunas.

return, unless the taxpayer's sole source of income was from salaries or pensions.

Prepayments of income tax are due during the year, but the final amount of tax due is assessed on the basis of the tax return. In the case of taxpayers deriving their income from salaries or pensions, the prepayments are considered a final tax; however, if a taxpayer in this category wants to claim personal deductions, he may file a tax return.

Employment income tax is in the form of a withholding tax. However, taxpayers receiving income from employment abroad are required to assess and make the prepayments within seven days following receipt.

III. PROFIT TAX

The existing profit tax system has been in force since 1 January 1994, as amended, and is applicable as from 1 January 1995.[7]

A. Taxable person

Entrepreneurs are subject to the profit tax, i.e. legal entities and individuals who independently and permanently engage in activities for the purpose of making a profit. Entrepreneurs are required to keep business books and submit financial reports according to the accountancy regulations and other regulations.

All entrepreneurs who have a business seat or place of management in Croatia are considered to be resident entrepreneurs. A non-resident entrepreneur is one who has no business seat or place of management in Croatia.

As mentioned above, an individual who earns income subject to income tax may opt to pay the profit tax instead, provided he makes such a request to the tax authorities and maintains books in conformity with the rules on accountancy.

Further, the Profit Tax Law requires an individual entrepreneur to pay profit tax in the following cases:
- if in the preceding calendar year he had a total revenue exceeding 2,000,000 kunas; or
- if in the preceding calendar year his income exceeded 300,000 kunas; or
- if he has fixed assets with a value exceeding 2,000,000 kunas; or
- if in the proceeding year he employed on average more than 30 employees.

B. Taxable base

The taxable base for the profit tax is the difference between the equity invested in the business at the end and at the beginning of the tax period, increased or decreased according to the Profit Tax Law.[8] The taxable base for profit tax liability includes the profit accruing from division, liquidation, sale and change of legal status of the taxpayer. Since resident taxpayers are subject to profit tax on their worldwide profits, the taxable base includes profits realized in Croatia and abroad. The taxable base for foreign entrepreneurs is limited to profits derived in Croatia.

The taxable base is reduced by the following items:
- receipts and entries arising from shares and dividends;
- protective interests (by calculating interest on equity at the protective interest rate, i.e. industrial producer price increases, increased by 3 percent per annum in real terms); and
- investment (the increase of equity in accordance with regulations).

The taxable base is increased by the following:
- pay outs (payments based on internal regulations on profit sharing (public) and other (hidden) pay-outs of profit);
- exemptions, i.e. using products, goods and services for the owner's own purposes rather than for purposes directly related to the business activity);
- the amount of depreciation which exceeds the maximum allowable rates;
- excess interest paid;
- other expenses exceeding stipulated amounts, such as payments to employees for expenditures, allowances and bonuses, expenses for per diem costs and business travelling expenses abroad, representation expenses (e.g. for gifts, entertainment, sports, recreation, car rentals and similar expenses);
- fines and all payments of a punitive nature;
- 30 percent of expenses for personal automobiles and other vehicles for the transport of the entrepreneur, managers and other employed persons, as well as expenses for car rental services;
- all other expenses not directly related to the earning of profit; and
- the amount of interest charged when equity is negative.

C. Depreciation

Straight line depreciation may be taken on tangible fixed assets and intangible assets at specified rates.

D. Losses

Losses may be carried forward for five years.

E. Assessment and collection

The profit tax is assessed for a business year, for a part of a business year and for the liquidation period. Profit taxpayers are required to make prepayments of tax based on the previous year's tax return. The tax return must be submitted to the

7. Published in the Official Gazette No. 95 of 27 December 1994, and came into force on 4 January 1995.

8. The Profit Tax Law defines equity as the net value of the property calculated by subtracting total liabilities from assets.

tax authorities within four months after the close of the period for which the profit tax has been calculated.

F. Rate of tax

The rate of profit tax is 25 percent on the taxable base.[9]

IV. TRANSACTION TAXES

Transaction taxes are governed separately by the law on the sales tax on goods and the taxation of the supply of services.[10]

A. Tax on the sale of goods

The sales tax on goods is levied on the sale of goods intended for final consumption. Taxable transactions include all sales of goods, unless otherwise stipulated in the legislation, and importation, including temporary importation.

1. Taxable person

Legal entities and individuals who sell goods to final consumers are subject to this tax, and in certain cases specified by statute the buyer is liable to pay the sales tax.

2. Taxable base

The taxable base is the sales price, which is the gross amount paid to the seller, including all ancillary expenses charged to the purchaser. The taxable base includes the excise tax paid in accordance with the special sales tax.

3. Exemptions

The sales tax contains numerous exemptions for items such as foodstuffs, medicines, medical appliances, certain goods intended for export, imported goods exempt from customs duties, etc.

4. Rate of tax

The table of rates for the sales tax on the sale of goods is divided into four "tariff groups", each dealing with a particular item or group of items. The tax rates are determined as a percentage of the taxable base, and reflect the so-called selective proportionate taxation:

Tariff 1: This category, taxed at 20 percent, includes all taxable sales of goods intended for final consumption.

Tariff 2: This category includes a variety of taxable objects, such as works of art, computer equipment, electrical power, films, video tapes and cassettes, petroleum products and natural gas and coal. These items are taxed at 15 percent;

Tariff 3: This category, taxed at 10 percent, includes the sale of construction products; and

Tariff 4: This category includes a broad range of goods such as agricultural goods, certain cosmetics and toiletries, children's clothing and toys. These items are taxed at a rate of 5 percent.

B. Tax on the sale of services

This tax liability arises in respect of services rendered for remuneration.

1. Taxable person

Legal entities and individuals providing taxable services are subject to this tax. However, if an individual provides services for a legal entity, the legal entity pays the tax.

2. Taxable base

The taxable base is the remuneration received for the services, whether paid in cash or in kind.

3. Exemptions

The tax on the sale of services is not payable on the following:
- services related to the granting of loans and taking deposits;
- various maritime services;
- health, veterinary and social welfare services;
- services provided by humanitarian organizations;
- educational and cultural services;
- services provided by religious institutions;
- services provided by bodies of the State;
- services connected with scientific research;
- services provided by legal entities and individuals to the Croatian army, police, the management of state reserves and to humanitarian associations;
- life insurance;
- export services as defined in the law;
- transportation services provided by domestic legal entities and individuals in international transport;
- certain construction services; and
- services provided by legal entities and individuals to diplomatic and consular representation and employees (under certain conditions).

4. Rates of tax

The tax rate for all sales of services is 10 percent, unless exempt.

V. EXCISE TAXES

Excise tax is levied on domestically produced and imported alcohol, non-alcoholic drinks, tobacco products, new cars and oil products and on the self-supply of such products. Per-

9. However, a tax exemption or tax relief may be granted in order to stimulate reconstruction and development of certain regions.
10. Published in the Official Gazette No. 95 of 27 December 1994, and came into force on 4 January 1995, applicable from 1 January 1995.

sons subject to excise tax are those persons producing or importing dutiable goods.

VI. TAX ON THE TRANSFER OF PROPERTY

The tax on the transfer of property is levied on the seller at the rate of 5 percent of the market value of the property.

VII. LOCAL TAXES

Taxes are also levied in Croatia at the county level, the commune level and the municipal level.

A. County level taxes

1. Inheritance and gift tax

This tax is levied on individuals and legal entities who have inherited property or received property as a gift in Croatia.[11] The taxable base is the market value of the property at the moment tax liability arises, after deducting debts and expenses related to the property. The Croatian inheritance and gift tax is levied at a flat rate of 5 percent.

2. Tax on motor vehicles

Legal entities and individuals who own registered passenger automobiles and motorcycles are subject to this tax. The amount of tax due depends on the engine capacity and the year the vehicle was produced, and exemptions are granted for certain vehicles.[12]

3. Tax on vehicles for water transport

Legal entities and individuals who own vehicles for water transport are subject to this tax. The taxable base depends on the length, type of equipment and year of production of the vehicle, and the rates of tax vary.

4. Entertainment tax

Persons who organize performances such as movies, sporting events, etc. for which an admission is charged are subject to this tax. The rate of tax is 5 percent. Theatre performances, museums and other cultural performances are exempt from the entertainment tax.

B. Commune and municipal level taxes

1. Tax on "weekend houses"

Legal entities and individuals who own weekend houses are subject to this tax, which is assessed depending on the size (square metres) of the house.

2. Advertising tax

Legal entities and individuals who place advertisements in public places are liable to the advertising tax, which is assessed at an amount not exceeding DM 200 per advertisement. Advertisements appearing in newspapers and public media are not liable to this tax.

3. Firm tax

Legal entities and individuals liable to income tax or profit tax must pay the firm tax, which is levied at an amount not exceeding 500 DM.

C. Tax on games of chance

Two taxes are levied in connection with games of chance. Natural persons are subject to tax on their winnings from games of chance. The taxable base is each winning and the applicable tax rate is 15 percent. Natural persons and legal entities organizing games of chance and other games on premises precisely defined in the law are liable to the profit tax – payable in varying lump sum amounts, depending on the types of table and slot machine, etc. They are also liable to a sales tax on services rendered levied at rates of 10 and 15 percent.

D. Local surcharges

Municipalities having more than 40,000 inhabitants may levy a surcharge on the income tax up to 30 percent.

11. Certain heirs/donees are exempt from the tax, i.e. those related to the testator/donor in the first degree of kinship, former spouses, parents inheriting or receiving gifts from their children or other descendants in direct line, taxpayers ceding inherited or donated property without remuneration to the state or units of local government, Red Cross organizations, institutions, foundations and other humanitarian organizations.
12. For example, the following are exempt: vehicles used by the medical corps, Croatian military and police forces, fire-fighting units, undertakers as well as vehicles used for taxi services or other registered transportation activities.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 48-52 of the January 1995 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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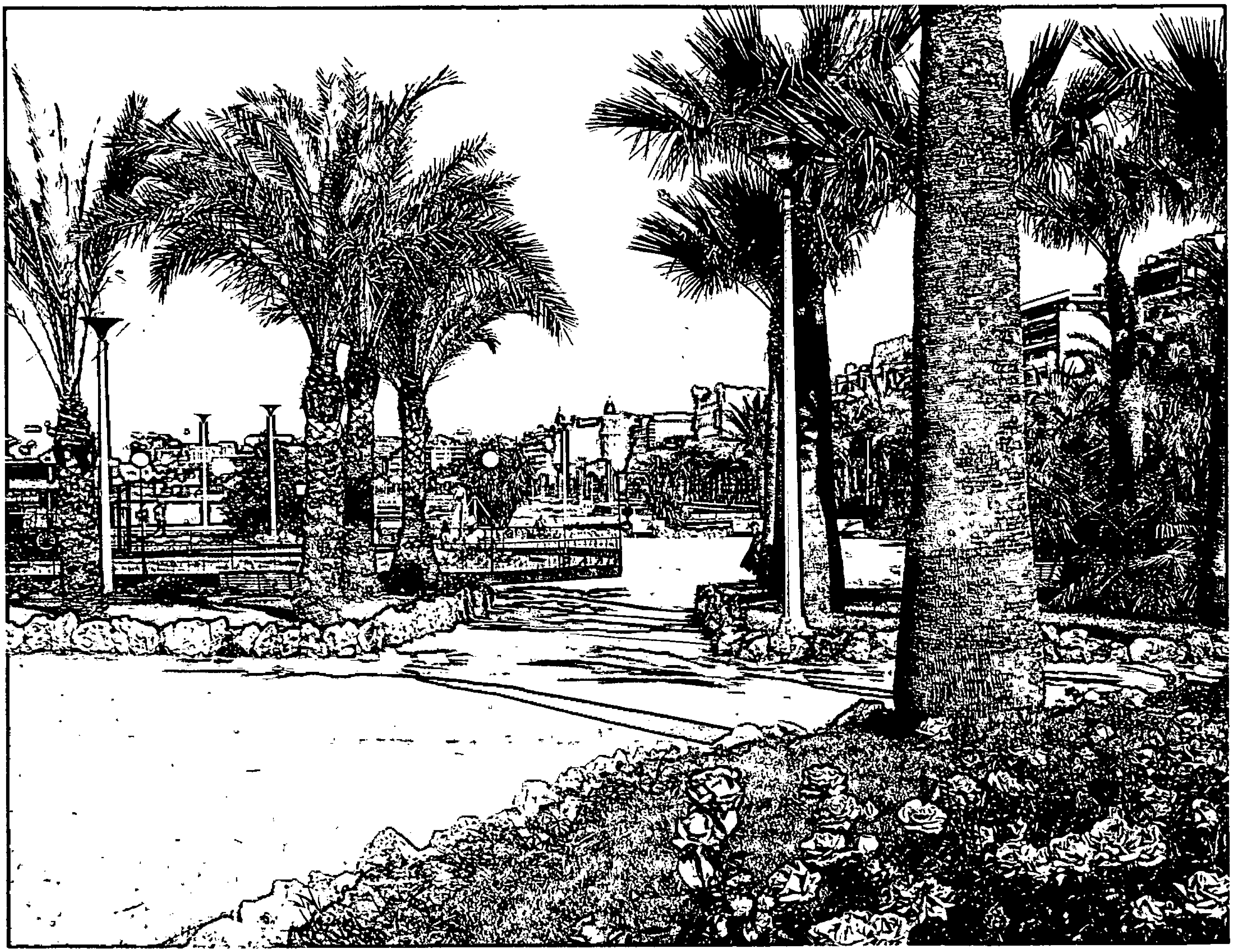
1995 IFA CONGRESS IN CANNES

Prof. Avv. Pietro Adonnino



IFA's annual Congress returns to France this year for its 49th Congress. This is actually the third time our French branch is hosting the event, and having twice regaled IFA's worldwide membership with the marvels of Paris, our hosts have now chosen the French Riviera – the 49th Congress is going to be held in Cannes.

Compared to Paris Cannes is a very small town but it holds great charm nonetheless. In fact, Cannes is a highly sophisticated and exclusive resort situated on the famous Côte d'Azur. It is a major tourist attraction situated in a region that has been a Mecca for renowned representatives of humanist disciplines – arts, literature and music. The vestiges of these disciplines endure to the benefit of the thousands of visitors to Cannes. Cannes is also the forum for the International Film Festival.

Having enumerated the delightful attributes of this year's venue, let us now turn our attention to the topics and seminars of the Congress. The Permanent Scientific Committee, which is responsible for selecting the topics and appointing the speakers, has competently performed these tasks ensuring, as usual, the possibility of reaching an effective exchange of opinions and constructive suggestions from the audience.

The two main topics certainly reflect pressing needs in the arena of international economic activities. Enterprises are increasingly resorting to partnerships even when the development of the enterprises extends beyond national borders. The choice of the partnership form is not merely dictated by the size the enterprises take on but also by the fact that, like large enterprises, even medium and small enterprises are now opting more and more for the partnership vehicle. Therefore, the issues that must be examined are the different qualifications that such companies may have, the fiscal transparency that is likely to result, the problems connected with the company's nationality, i.e. the residence status of the participants. These interesting and provocative issues can be settled by making use of the rules contained in the tax treaties where they exist.

Recent times have witnessed the surge of new and complex economic activities that have taken place next to the traditional activities of production and exchange of goods and services, both on a domestic and an international level. Financial activities have taken on a substantial role both as a means to support traditional activities and as a creation of an independent source of income. Derivatives have come into existence and we are now compelled to acquaint ourselves with all their peculiar characteristics before attempting to confront the issues concerning their taxation. Derivatives nearly always consist of mixed deals and it is important to define the elements of which they are comprised in order to assess the taxation involved and to ascertain the correct tax incidence when evaluating their rentability.

The above are the two main topics that will be discussed in Cannes. The seminars will also prove of great interest, and each participant will be free to attend the seminar of his/her choice.

One seminar that deserves particular mention, both because of the nature of its subject and the effort that its organization required, is the seminar on double tax treaties. IFA has long debated the possibility of institutionalizing in its Congresses a seminar on current issues of double taxation. Given that treaties are by and large based on the OECD Model, which is constantly being revised and updated, it seemed only natural to invite OECD Fiscal Affairs Committee representatives to join IFA's Permanent Scientific Committee to assist in organizing this seminar. Our plan met with approval and last year, in Toronto, an experimental seminar was set up. This year the seminar will be held for the first time and will be repeated in future annual Congresses.

The seminar will begin by focusing on the latest developments in updating the model and presenting the related commentaries; a discussion will then follow led by three OECD representatives, together with three IFA members debating some current issues of special interest.

The other seminars will deal with the following topics: dividend access shares; European and non-European experiences of VAT in internal markets; general taxing regimes of headquarters, i.e. the main offices in which a company's management and business coordination is actually performed; fiscal treatment of income produced by sports and show business professionals, and finally an illustration of the recent fiscal reforms carried out in some North African countries.

I expect that many IFA members will want to participate in this Congress as they have done in the past. Cannes will certainly supply all the elements for an interesting and welcoming meeting and I am sure that everyone will be extremely glad they came.

See you in Cannes!

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A COMMENT ON FRENCH TREATY POLICY IN THE CONTEXT OF INTERNATIONAL ECONOMIC INTEGRATION[1]

Patrice Forget

Directeur, Chef du Service de la Législation Fiscale[2]

France is a nation at the forefront of tax treaty developments. Nevertheless, like most of its partners, France has not set a formal framework for its treaty policy. In fact, treaty negotiations are often dictated by the necessity to facilitate economic growth *vis à vis* cross-border trade. It is also a fact that the very nature of international taxation has led nations, from the outset, to develop their treaty policies in a multilateral context and the OECD has been instrumental in facilitating this process since the end of the war.

A new development has been the debate questioning the very usefulness of tax treaties. This debate has arisen because the difficulty inherent in implementing tax treaties may cause taxpayers to favour placing reliance on the domestic tax rules. In addition, the effectiveness of tax treaties in preventing international tax evasion has become a matter of some doubt.

The problems are well known. Far from being an obstacle to the freedom of movement of capital and services, the tax status attaching to non-residents is, in certain cases, more favourable than that attaching to residents. This has led to the phenomena of "fiscal dumping" with a plethora of low-tax regimes reserved to foreign controlled entities or certain group structures (such as financing and services) lacking any real economic added value. In such cases, the advantage of treaty law in comparison to domestic legislation becomes insignificant or, at best, accessory; recourse to treaties being a simple means of optimizing the tax return on transactions which could have been conducted under domestic rules as well. Finally, the mobility of capital and economic actors and the abolition of the regulatory obstacles thereto may create an environment in which treaty shopping can flourish.

It is in this framework that we will examine the two fundamentals of French treaty policy, namely the extension of our treaty network and its continuous modification.

I. THE EXTENSION OF THE TREATY NETWORK

A. An active treaty policy

On 1 July 1995, the French treaty network consisted of 86 income tax treaties currently in force (60 of which also cover taxes on capital) and 12 inheritance and/or gift tax treaties (see Annex). This network has been consistently developed over the past 30 years. These figures place France, together with the United Kingdom, in the first rank within the OECD as far as income tax treaties are concerned (86 for both countries as against 64 for Germany, 52 for the Netherlands and 44 for the United States); and in a good ranking in the inheritance tax treaties category (15 for the United States, 9 for the United Kingdom, 6 for the Netherlands and 5 for Germany). Furthermore, 10 additional treaties (9 of which cover income tax and the remaining one inheritance and gift tax) are being negotiated.

A close examination of the recently concluded treaties and of those currently being negotiated reveals new markets in which France had hitherto little presence: Latin America (treaties with Mexico and Venezuela have lately entered into force, other treaties have been recently concluded with Bolivia and Jamaica); English-speaking Africa (treaties have recently been concluded with Ghana, South Africa, Namibia and Zimbabwe); and the former USSR (treaties have recently been initialled with the Baltic States, Ukraine and Kazakhstan).

B. A policy essentially dictated by the classical treaty concerns

While a major phenomenon since the end of the war, the growth in international trade has accelerated in the 1980s, particularly in France. A recent study by the *observatoire des investissements internationaux*, published in the *notes bleues de Bercy* summed up the issue as follows: the 1980s have witnessed a spectacular growth in cross-border investment flows between France and the rest of the world. These investments have increased tenfold during the decade in what can be termed a "double great leap forward in the opening up of our economy".[3]

In this context, tax treaties play a major role in creating a tax environment conducive to inbound and outbound investment flows. Their purpose is threefold.

1. To foster the economic development of France in the context of the global market

The first aim is to encourage the growth of French investors and enterprises in foreign markets by creating a framework

1. This is a translation of the official French text. The original version can be obtained on request from the IBFD.
2. Under the direct authority of the Minister of Finance, the Service de la Législation Fiscale (SLF) prepares and interprets tax legislation. It also negotiates and implements tax treaties.
3. Note bleue de Bercy, No. 67, 16-31 July 1995.

characterized by legal stability and the mitigation of excessive tax costs.

The importance of new treaty provisions to economic actors is evident whether one highlights the resolution of dual residency cases, the allocation of the right to tax between the Contracting States or the crediting of foreign withholding taxes. In fact, tax treaties eliminate a significant part of the obstacles to the movement of capital and, as such, their impact on financial flows is undeniable. They allow French investors to achieve substantial tax savings, whether as a result of the mitigation of the tax liability or through the elimination of withholding taxes.

The second aim is to encourage foreign investments in France. In this context, France strives to apply a neutral tax policy *vis-à-vis* foreign investors. This policy is particularly evident in the case of stock holdings. Features designed to ensure foreign stock holders are not unfairly discriminated against include:

- taking into account both direct and indirect participations for the attribution of the nil or reduced withholding tax on parent-subsidiary intercompany dividends (direct and indirect participations are also taken into consideration for the transfer of the *avoir fiscal* tax credit, where the aggregate holding is lower than the minimum threshold required for parent-subsidiary treatment;
- the elimination of the economic double taxation of dividends not qualifying for a participation exemption regime in the country of residence of the beneficiary. This measure essentially benefits individuals as well as companies whose participation in the French distributing company does not exceed certain thresholds. Its application, almost always in the form of a transfer of the French *avoir fiscal* tax credit, is subject to the condition that the recipient be effectively subject to tax on the aggregate of the dividend and the transferred *avoir fiscal*. The aggregate amount received by the non-resident shareholder is higher than that which would result from a simple abolition of the withholding tax on dividends;
- the refund of the *précompte* equalization tax to non-resident recipients of French dividends who are not entitled to the transfer of the *avoir fiscal* tax credit.

2. Encouraging the international development of the economy within the constraints of a responsible fiscal and budgetary policy

Tax treaties compel the state to forego or limit certain assessments, in particular withholding taxes. These sacrifices are required in order to foster international economic growth, the importance of which we highlighted earlier. Moreover, the imposition of withholding tax at the ordinary domestic rates on gross income flows may deter a significant portion of foreign investments, hence the need for tax treaties.

However, tax treaties also help states safeguard their fiscal revenues by:

- re-emphasizing the taxation of residents as a counterpart to the restrictions on source taxation; and
- providing for mutual assistance between the competent authorities in order to prevent international tax evasion and avoidance.

3. Providing an adequate response to the fear of treaty abuse

These fears are based on the hypothesis that treaty concepts are no longer an effective means of preventing international tax evasion and avoidance, or even treaty abuse. Such an argument would implicitly lead to the unilateral revocation of certain treaties where renegotiation was not possible. Taken to its logical conclusion the approach would emphasize the benefits of a restricted treaty network.

In this context, it ought to be noted that the decision by certain states to restrict their treaty network to those countries which accept a "Model" treaty, suffers from its own limitations, since those other Contracting States may themselves pursue an active treaty policy. It is undoubtedly a fact that the extension of treaty networks can increase the risks of treaty shopping. This is particularly so where major differences remain as to the scope and contents of the relevant treaties. However, such risks will not be reduced by the isolated actions of one State limiting or calling into question its own treaties. On the contrary, it will be necessary for such a State to renegotiate its existing treaties in order to restrict, in as far as possible, access thereto by third country beneficiaries and thus limit the possibility of treaty shopping.

France's position on this issue is that the treaty concepts of resident and beneficial owner should be sufficient to effectively combat the abuse of treaties in situations where the interposition of an intermediate structure in a treaty partner is only justified by the benefit of a net withholding tax advantage, or is carried out in order to achieve additional advantages for an international tax evasion structure based on a foreign low-tax regime.

It is by re-adapting concepts and treaties to the economic and legal changes and the evolution of tax constructions and schemes that France provides replies to those fears.

II. CONTINUOUS ADJUSTMENTS TO THE TREATY NETWORK AND TREATY CONCEPTS

Similar to the reforms affecting domestic tax laws, treaties are also subject to continuous re-adjustments, the conceptual framework of which is partly influenced by the works of the OECD. This process takes the form of ad hoc modification of the treaty network and the introduction of new treaty concepts.

A. Ad hoc adjustments

These "factual" adjustments stem from the need to react to various developments. This is the case when the partner state substantially modifies its domestic legislation. One example is the abolition by Canada of its estate tax and its replacement by a tax on capital gains. Another example is the setting up, in the United Kingdom, of new structures for collective investments in securities which are not subject to corporation tax.

More generally, they are equally required by the need to insure that French residents are entitled to the best treaty treatment.

In fact, treaties are an important factor of economic competition, whether as a means of facilitating the expansion of French enterprises abroad or of attracting inbound investments. This competition is necessarily relative and implies ascertaining that French residents are not less favourably treated than those of France's partners. This leads to a "guard duty" the purpose of which is to ensure that French enterprises do not have to operate without treaty coverage in third-country markets where their competitors are treaty protected, and to ensure that the treaty protection available to French residents is of the highest quality.

Finally, readjustment is also required by the need to reconsider certain advantages attributed in the past, and which are no longer justified as a result of the evolution of domestic rules. This is, for example, the case for provisions for the elimination of the economic double taxation of dividends, in favour of entities or recipients which are exempt in the treaty partner, in particular in view of the substantial increase in the French *avoir fiscal* tax credit since 1986. It is also the case for the review of the sparing tax credits available under a number of treaties.

For one or other of these reasons, France is engaged in a continuous renegotiation process with important partners such as the United States, Germany, the United Kingdom, Italy, Sweden or Japan and also with developing countries.

B. Conceptual adjustment

In contrast to ad hoc adjustments, conceptual adjustment consists of improving the treaties and their technical adaptation in the context of the evolution of their environment. Recent major developments in this field can be categorized as follows:

1. Improving the economic effectiveness of treaties

(a) *Extension of the resident and beneficial owner concepts*

The treaties recently concluded by France have modified these concepts in two ways:

- in order to extend the treaty benefits accruing to dividends to certain investment structures essentially held by residents of the treaty partner (e.g. pension funds, or even non-profit organizations such as in the new treaties with Japan and the United States); and
- in order to recognize French partnerships as persons under the treaty, as a counterpart to the recognition of foreign structures characterized by transparency and the absence of a "fiscal personality".

(b) *Inclusion in recent treaties of "exceptional" clauses in favour of foreign investors*

A number of treaties provide specific rules for individuals who are treaty partner nationals without being nationals of France and who take up residence in France. Property situated outside France and owned by such individuals on 1 January of each of the five years following the calendar year during which they take up French residence, are excluded from the French net wealth tax. Such specific rules are included in the treaties with Germany, Austria, the United States and Italy.

(c) *Recourse to arbitration*

This mechanism is conceived as a means of completing the implementation of the arm's length rules derived from Art. 9 of the OECD Model Convention. It is intended to improve the solution of double taxation occurrences deemed too complex to be resolved by the classical mutual agreement procedures. Such clauses are included in the treaty with Germany as modified in 1989, and in the new treaty recently signed with the United States. Furthermore, the Member States of the European Union have concluded a multilateral arbitration convention which entered into force on 1 January 1995.

(d) *Review of the practical implementation of treaties*

France has modified the practical implementation of treaties in three respects:

- institution of mechanisms whereby the reduced treaty withholding tax rate is directly applicable to royalties, as well as to dividends not entitling the recipient to the *avoir fiscal* tax credit. Previously a refund mechanism had existed;
- acceptance of requests submitted by intermediaries on behalf of the beneficiary for the application of these reduced treaty rates; and
- institution of a simplified procedure for dividends to which the *avoir fiscal* is attached whereby the beneficiary benefits from a cash flow advantage.

2. Prevent double exemptions and the improper use of treaties

The purpose of the adjustment mechanisms is also to upgrade the recourse to treaties in comparison with recourse to domestic rules, bearing in mind that the purpose of treaties is to reduce additional tax costs in the source country, while ensuring that foregoing the right to tax by the source state does not translate into a double exemption.

The position of France on this issue is that, as a corollary to the principle of no double taxation, tax should be levied at least once. As a result, we strive to:

- limit access to treaty benefits to those subject to effective taxation in the residence state. France considers that, the residence definition in the OECD Model only applies to a taxpayer who is effectively subject to tax. Therefore, entities which are exempt from tax, or which are within the scope of application of the tax without being effectively subject to tax, are in principle not considered to be residents under the treaty.

The appreciation of such cases can be quite a delicate matter in a situation where one is faced with a low-tax regime instead of a pure exemption. In such cases, France considers that the non-resident is outside the scope of application of the tax ordinarily applied by the treaty partner which had been the basis for the conclusion of the treaty;

- prevent treaty abuse: the concept of beneficial owner. The concept of beneficial owner introduced by the 1977 OECD Model is systematically included in the treaties concluded by France after that date in order to prevent the abuse of the said treaties. France furthermore considers that this concept should also be included in the "Other Income" article, as the scope of application of the latter is potentially vast. A clause to this end is included in a number of recently concluded treaties.

Peculiarities specific to certain treaty partners has also led to the exclusion of certain categories of beneficiaries, in particular in treaties concluded prior to 1977, (e.g. exclusion of 1929 Luxembourg holdings by the protocol to the France–Luxembourg treaty of 1970); or to the inclusion of a condition of non-control by third country residents.

The latter type of clause is only found in a limited number of treaties such as those concluded with Cyprus (1981), Malta (1977), or, in particular, Switzerland (1966). It ought to be noted that it is this last treaty which has influenced the US thinking on treaty abuse. However, such a clause constitutes, for France, an exception dictated by a specific situation (Swiss legislation itself provided for such a restriction), and to a treaty conception phase which, very probably, belongs to the past.

In this context, France, as a source state, does not favour the inclusion of detailed clauses which attempt, through various criteria, to determine the categories of beneficiaries. Such necessarily incomplete clauses can reduce the effectiveness of the "beneficial owner" and "subject to tax" concepts. Finally, doubts exist as to whether they can be implemented therefore, their usefulness, is, at the very least, questionable;

- reaffirm the principle of taxation in the residence state, in order to avoid the risks of double exemption. The residence state should take into consideration foreign taxes which justify the elimination of double taxation. In this framework, France has modified, in recent treaties, the elimination of double taxation article in order to cover certain items of income which can be taxed without limitation by the source state (e.g. gains on real estate, attendance fees, remuneration of sportsmen and artistes). Should the domestic legislation of that state provide for an exemption, the elimination of double taxation article attributes to France, as the state of residence, a secondary taxation right with a credit for foreign taxes up to the amount of French tax on the relevant income.

The purpose of such a clause is to ensure taxation of such income categories in France, in cases where they might be subject to reduced taxation abroad, as opposed to a classical exemption.

In the context of reinforcement of the principle of residence taxation, domestic law measures designed to assess, at the domestic rates and under domestic rules, income derived by foreign controlled entities benefiting from tax exemptions, appear to us perfectly compatible with treaty obligations.

III. CONCLUSION

France has an active treaty policy. This policy is based on the necessity to create a tax environment conducive to internationally-oriented economic development. France considers that the solution to the difficulties engendered by international taxation, or even by tax treaties themselves, must be found in the treaties, through an in-depth review of the concepts and consequential adjustments to the texts.

ANNEX

France has entered into double tax conventions in respect of income and/or capital with the following countries (P. = protocol; Ag. = agreement; AS = agreement of specific nature, and under the heading Taxes Covered: I = taxes on income; C = taxes on capital; RD = registration duties; NC = non-comprehensive, specific agreement).

Country	Taxes covered	Date of signing	Date of entry into force
Algeria	I-RD	17 May 1982	1 February 1984
Argentina	I-C	4 April 1979	1 March 1981
Australia	I	13 April 1976	21 September 1977
P.		19 June 1989	19 July 1990
Austria	I-C	26 March 1993	1 September 1994
Bahrain	I-C	10 May 1993	1 August 1994
Bangladesh	I	9 March 1987	1 September 1988
Belgium	I	10 March 1964	17 June 1965
P.		15 February 1971	19 June 1973
Benin	I-RD	27 February 1975	8 November 1977
Brazil	I	10 September 1971	12 May 1972
Bulgaria	I	14 March 1987	1 June 1988
Burkina Faso	I-RD	11 August 1965	15 February 1967
P.		3 June 1971	1 October 1974
Cameroon	I-RD	21 October 1976	19 July 1978
Canada	I-C	2 May 1975	29 July 1976
P.		16 January 1987	1 October 1988
Quebec (AS)	I	1 September 1987	19 September 1988
Central African Republic	I-RD	13 December 1969	1 March 1971
China (People's Rep.)	I	30 May 1984	21 February 1985
Comoro Islands[1]	I-RD	27/3-08/6 1970	23 June 1971
Congo	I-RD	27 November 1987	1 September 1989
Cyprus	I	18 December 1981	1 April 1983
Czechoslovakia[2]	I	1 June 1973	25 September 1975
Denmark	I-C	8 February 1957	30 April 1958
Ecuador	I	16 March 1989	25 March 1992
Egypt (UAR)	I	19 June 1980	1 October 1982
Finland	I-C	11 September 1970	1 February 1972
French Polynesia (AS)	NC	28/3-28/5 1957	19 September 1957
Gabon	I-RD	21 April 1966	7 March 1969
P.		23 January 1973	1 May 1973
P.		2 October 1986	1 November 1989
Germany	I-C	21 July 1959	4 November 1961
P.		9 June 1969	8 October 1970
P.		28 September 1989	1 October 1990
Greece	I	21 August 1963	31 January 1965
Hungary	I-C	28 April 1980	1 December 1981
Iceland	I	29 August 1990	1 June 1992
India	I-C	29 September 1992	1 August 1994
Indonesia	I-C	14 September 1979	13 March 1981
Iran	I	7 November 1973	10 April 1975
Ireland	I	21 March 1968	15 June 1971
Israel	I	20 August 1963	1 September 1964
Italy	I-C	5 October 1989	1 May 1992
Ivory Coast	I-RD	6 April 1966	1 October 1968
P.		25 February 1985	1 January 1989
P.		19 October 1993	1 May 1995
Japan	I	27 November 1964	22 August 1965
P.		10 March 1981	14 October 1981
Jordan	I	24 May 1984	1 April 1985
Korea (Rep.)	I	19 June 1979	1 February 1981
P.		9 April 1991	1 March 1992
Kuwait	I	7 February 1982	1 September 1983
P.		27 September 1989	1 July 1991
P.		27 January 1994	1 March 1995
Lebanon	I	24 July 1962	28 December 1963
Luxembourg	I-C	1 April 1958	9 February 1960
P.		8 September 1970	15 November 1971
Madagascar	I	22 July 1983	1 October 1984
Malawi[3]	I	14 December 1950	n.a.

Country	Taxes covered	Date of signing	Date of entry into force
Malaysia	I	24 April 1975	23 July 1976
P.		31 January 1991	6 May 1992
Mali	I-RD	22 September 1972	1 January 1975
Malta	I-C	25 July 1977	1 October 1979
Mauritania	I-RD	15 November 1967	1 March 1969
Mauritius	I-C	11 December 1980	17 September 1982
Mexico	I	7 November 1991	31 December 1992
Monaco (AS)	NC	18 May 1963	1 September 1963
P.		25 June 1969	
Morocco	I-RD	29 May 1970	1 December 1971
P.		18 August 1989	1 December 1990
Netherlands	I-C	16 March 1973	29 March 1974
New Caledonia (AS)	I-RD	31/3-05/5 1983	27 July 1983
New Zealand	I	30 November 1979	19 March 1981
Niger	I-RD	1 June 1965	1 July 1966
P.		16 February 1973	1 January 1974
Nigeria	I	27 February 1990	2 May 1991
Norway	I-C	19 December 1980	10 September 1981
P.		14 November 1984	1 October 1985
Oman	I	1 June 1989	1 August 1990
Pakistan	I	22 July 1966	13 February 1969
Philippines	I	9 January 1976	24 August 1978
Poland	I	20 June 1975	12 September 1976
Portugal	I	14 January 1971	18 November 1972
Qatar	I-C-RD	4 December 1990	1 December 1994
Romania	I	27 September 1974	27 September 1975
St. Pierre et Miquelon (AS)	I-RD	30 May 1988	5 January 1989
Saudi Arabia	I	18 February 1982	1 March 1983
P.		2 October1991	1 July 1995
Senegal	I-RD	29 March 1974	24 April 1976
P.		16 July 1984	1 January 1986
P.		10 January 1991	1 February 1993
Singapore	I	9 September 1974	31 July 1975
Spain	I-C	23 June,1973	10 March 1975
P.		6 December 1977	4 April 1979
Sri Lanka	I	17 September 1981	18 November 1982
Sweden	I-C	27 November 1990	1 April 1992
Switzerland	I-C	9 September 1966	26 July 1967
P.		3 December 1969	24 September 1970
Thailand	I	27 December 1974	29 August 1975
Togo	I-RD	24 November 1971	1 April 1975
Trinidad and Tobago	I	5 August 1987	1 April 1989
Tunisia	I-RD	28 May 1973	1 April 1975
Turkey	I	18 February 1987	1 July 1989
Venezuela	I	7 May 1992	15 October 1993
Vietnam	I-C	10 February 1993	1 July 1994
United Arab Emirates	I	19 July 1989	1 July 1992
P.		6 December 1993	1 June 1995
United Kingdom	I	22 May 1968	29 October 1969
P.		10 February 1971	7 May 1971
P.		14 May 1973	2 August 1973
P.		12 June 1986	7 April 1987
P.		15 October 1987	23 December 1987
United States	I-C	28 July 1967	11 July 1968
P.		12 October 1970	21 February 1972
P.		24 November 1978	27 September 1979
P.		17 January 1984	1 October 1985
P.		16 June 1988	1 January 1989
USSR (CIS)	I	4 October 1985	28 March 1987
Yugoslavia (Former)	I	28 March 1974	1 August 1975
Zambia[3]	I	14 December 1950	n.a.

1. The application of the treaty is restricted to Mayotte.
2. The treaty applies to both the Czech Republic and Slovakia.
3. Extension, by exchange of notes, of the France–UK treaty of 14 December 1950.

TAX-LEVERAGED LEASING

Jean-Marc Tirard

Avocat à la Cour; Partner, Clifford Chance, Paris

I. INTRODUCTION

Tax leasing is a financing technique which consists of an investor acquiring the ownership of an asset intended to be used by an operator, when the latter does not have sufficient tax capacity to benefit from all the investment tax incentives, and, in particular, accelerated depreciation allowances.

The interest payable relating to the financing of the purchase, together with the accelerated depreciation allowances, produces initial losses for the investor and therefore, a deferral of taxation which is only reversed when the accumulated rental income starts to exceed the aggregate of the accelerated allowances and accumulated interest payable.

The asset so financed is then leased to the user, who benefits indirectly from the lessor's tax savings *vis-à-vis* lower rental charges. There are two main reasons why France lends itself particulary well to this form of tax-leasing.

The first reason is that France has a specific framework for financial leasing transactions (*crédit-bail*) which categorizes them as hire operations coupled with a purchase option.[1] More precisely, from a legal standpoint, a crédit-bail is an agreement entered into between the lessor and the lessee which provides for the lease or hire of a asset by the lessor to the lessee for a specified period together with an option to purchase the asset exercisable by the lessee at the end of the lease or hire period. The purchase price payable for the asset on the exercise of the option is fixed from the outset in the leasing agreement and takes into account at least part of the rental payments made thereunder. Thus, title to the asset remains with the lessor until the option to purchase is exercised by the lessee.

The second reason is that in contrast with the situation in many other countries, the French accounting and tax treatment of a financial lease as described above (i.e. falling under the definition of crédit-bail) does not reflect the economic realities of this type of leasing arrangement. Thus, in a crédit-bail the lessor remains the legal owner of the asset until the termination of the lease or the exercise of the lessee's purchase option.

The fact that legal ownership of an asset subject to a finance lease (crédit-bail) rests with the lessor was recently confirmed in the context of the law specifically concerning the prevention and treatment of company problems.[2]

The first part of this article explains the French tax regime's approach to domestic leasing transactions. The second part of this article will deal with the tax implications of cross-border leasing and in particular, the favourable tax opportunities that exist when the lessee can avail of accelerated depreciation allowances in his own country. The third part discusses the most suitable French legal structures for leasing transactions, both domestic and international.

II. TAX REGIME APPLICABLE TO DOMESTIC FINANCE LEASING TRANSACTIONS

As explained above, the tax treatment of a finance leasing transaction does not reflect the economic realities; rather, it follows the legal framework of the transaction. Thus, during the period of the lease, the relationship between the two parties is that of owner and lessee. It should, however, be noted that the lessee acquires certain rights against the original supplier of the leased equipment, which would normally be vested in the owner (e.g. right to delivery of the equipment and rights under warranties and guarantees relating to the condition of the equipment). Aside from these differences, for legal and tax purposes the lessor is still treated as the legal owner of the equipment.

A. Tax treatment of the lessor

The main taxes involved in finance leasing transactions are VAT, corporation tax and business tax.

1. VAT

The purchase, lease and sale by a lessor of the leased equipment gives rise to a number of VAT consequences. VAT paid on the purchase of an asset is normally deductible, provided the purchaser carries on a wholly or partially taxable activity and the asset is not used in the carrying on of an exempt activity. In principle, the leasing of movable assets is a taxable activity for VAT purposes so that VAT paid by the lessor in respect of the purchase of such assets should constitute input tax.

The French tax authorities indicated in a letter dated 7 November 1989 to the French Banks Association ("AFB") that leasing activity will be treated as constituting a separate trade. Accordingly, French banks, which normally carry on a partially taxable activity, are not limited in the credit or refund they may obtain in respect of input VAT incurred on the purchase price of equipment which is to be leased.[3]

1. Law No. 66.455 of 2 July 1966.
2. Law No. 94.475 of 10 June 1994. Confirmation that the lessor is owner of the asset has also been provided by the Ottawa convention dated 28 May 1988 which came into force on 1 May 1995.
3. See Documentation Administrative 3-CA-94, Instruction of 8 September 1994.

It should be noted that the lessee's deposit is not subject to VAT until it belongs to the lessor. This only happens when, or if the lessee does not fulfil his obligations. Nevertheless, where the amount of the deposit is excessive in comparison with the risk assumed by the lessor the French tax authorities consider the excess to be income liable to VAT. (Administrative Instruction of 7 October 1986 3B-7-86)

If the lessee exercises his option to purchase the equipment at the end of the lease, the sale by the lessor is subject to VAT and therefore the lessor is not required to repay the VAT for which it obtained a credit on the purchase of the equipment.

Pursuant to Article 262 II(2) and (4) of the French Tax Code (hereinafter "CGI"), the supply, repair, charter and lease of certain ships and aircraft are exempt from VAT because they are deemed to be export transactions. The following types of ship and aircraft are covered by this provision:
- ships used in a commercial business and ships used for commercial fishing, sea rescue and deep sea industrial activity; and
- aircraft used by French or foreign airlines whose flights from or to foreign countries (or French overseas territories) represent at least 80 percent of their total flights.

When the supply or lease of equipment benefits from these exemptions, the lessor remains nevertheless entitled to recover input VAT under a concession available to export transactions.

2. Corporation tax

The corporation tax consequences for a lessor reflect the fact that he is both the owner and the lessor of the equipment. Broadly speaking, the taxable income of the lessor is determined by deducting from the rental payments received under the lease, depreciation allowances in respect of the equipment, interest paid on loans used to acquire the equipment, and any other arm's length expenses incurred in the leasing business. However, the lessor is not allowed to deduct, from its taxable income, an amount which represents the shortfall between the net book value of the equipment and the sale price agreed in the option purchase agreement (CGI, Article 39C). The net taxable income is subject to corporation tax at a rate of 33.33 percent.

(a) *Depreciation of the equipment*

The equipment purchased will be recorded by the lessor as an asset in its balance sheet. During the term of the lease, the lessor, being the legal owner of the equipment, is, under *French law* the only person entitled to depreciation allowances in respect of the asset. This contrasts with the position in some other countries where the economic owner of the equipment i.e. the lessee, is entitled to the depreciation allowances.

Pursuant to CGI, Article 39C the leased equipment is depreciated over its normal useful life, which is determined by reference to "current practice" in the lessee's industry, regardless of the duration of the lease.

"Current practice" is not defined by law. The Supreme Administrative Court (Conseil d'Etat), in a decision of 11 March 1988,[4] considered that a practice which may be taken into account for these purposes is one which is widespread in the industry concerned, and which has been used for a certain period of time. In certain cases, current practice in this regard is set out in the accounting principles applicable to the particular industry.

The French tax authorities have argued that an asset must be depreciated over its normal useful life. The Supreme Administrative Court has not, however, accepted the Revenue's view; instead it has ruled that the depreciation period need only comply with current practice. Consequently, it is possible to depreciate an asset according to the current practice of an industry, even though the actual useful life of the asset is longer.

For example, the normal useful life accepted under current practice is:
- from eight years to ten years for narrow-bodied aircraft;
- from ten years to twelve years for wide-bodied aircraft;
- fifteen years for Atlantic TGV high speed rolling stock. (This period, shorter than the normal useful life of the asset which is estimated to be between 30 and 35 years, has been approved by the tax authorities); and
- from eight years to fifteen years for ships.

The French tax authorities[5] do not challenge depreciation taken over a different period, provided the period chosen is based on specific circumstances and varies by no more than 20 percent from the normal useful life of the asset, determined in accordance with current practice.

Depending on the type of asset, the method of depreciation applicable is either the straight-line or the declining-balance method.

Straight-line depreciation

Under the straight-line method of depreciation, the value of an asset is written down to zero over its normal useful life by deducting from the acquisition cost the same depreciation allowance each year.[6] The annual rate of depreciation is determined by dividing 100 by the number of years of the normal useful life of the asset. The rate would be for example:
- between 8.33 percent and 12.5 percent for aircraft, depending on their capacity;
- between 6.66 percent and 12.5 percent for ships; and
- between 10 percent and 20 percent for plant and equipment;
- between 20 percent and 25 percent for cars.

Declining-balance depreciation

CGI, Article 39 A(1) allows enterprises to depreciate certain assets using a declining-balance method. The principal

4. Supreme Administrative Court (Conseil d'Etat, hereinafter "CE") 11 March 1988, Nos. 46,415, 50,774, 80,363 and 80,365; *Revue de Jurisprudence fiscale* (hereinafter "*RJF*") (April 1988), Nos. 385 and 386.
5. Documentation Administrative 4D-1-88.
6. CGI, Article 24(1), Annexe II.

advantage of this method is that larger allowances are available in the early years. The declining-balance method, may be applied to equipment used in the manufacturing, processing and transportation industries. It is therefore not surprising that the most frequent use of leasing transactions has been for aircraft, trains, ships or computers. Although in principle the declining-balance method is only available for new equipment, the French tax authorities accept that second-hand ships may be depreciated using this method, provided the ship has a useful life of at least eight years (six years for fishing boats).

The allowances available under the declining-balance method of depreciation are calculated on the basis of the normal useful life of the asset and the corresponding straight-line rates. The straight-line rate is multiplied by 1.5 if the normal useful life of the asset is three or four years, by 2 if the normal useful life is five or six years and by 2.5 if the normal useful life is more than six years; the resulting rate is applied each year to the original cost as reduced by the allowances given in the previous years.

Thus, the declining balance method of depreciation increases the amount of depreciation in the earlier years while decreasing it in later years.

(b) *Rental payments made under the lease*

The lessor is subject to corporation tax on rental payments received from the lessee. Thus, the tax treatment ignores the fact that, from an economic viewpoint, the rental payments represent a partial refund of the capital used to purchase the equipment.

Rental payments that increase in size over the term of the lease are acceptable provided they remain within reasonable limits. Thus, it is possible to maximize the opening year's tax losses.

(c) *Sale of the equipment at the end of the lease*

In principle, the gain or loss arising from the sale of the equipment should follow the regime applicable to business capital gains, under which long-term gains (i.e. gains realized on assets which have been held for more than two years) can benefit from the reduced rate of 19 percent (instead of the normal corporation tax rate of 33.33 percent).

However, pursuant to CGI, Article 39 duodecies (7), the gain or loss arising on the sale of the equipment by the lessor following the exercise by the lessee of the option to purchase is not subject to the business capital gains rules. It is, instead, treated as ordinary income (taxed at 33.33 percent), insofar as the lessor is a company whose purpose is, either exclusively or partially, to perform on a professional basis a leasing activity (whether a financial or a commercial lease) and provided the equipment sold has been leased to the purchaser. This exclusion from business capital gains rules does not apply to an Economic Interest Grouping (hereinafter "GIE").[7]

(d) *Conclusion*

As a result of the high depreciation allowances available in the opening years of the lease under the declining-balance method, the deductible expenses of the lessor (which include both the depreciation allowances as well as any interest paid by the lessor on funds borrowed to acquire the equipment being leased) will normally exceed the rental payments received from the lessee. The resulting loss may be offset against other income of the lessor, thus generating a tax saving. The cash flow advantages which result from the deferral of taxation are normally partially passed on to the lessee, *vis-à-vis* a reduced rental charge.

3. Business tax

Business tax is levied on any company or enterprise which carries on a professional activity, even if the activity is, in fact, non-profit-making. Business tax is based on the rental value of tangible assets used in the course of the business and on a proportion of the salaries paid by the company to its employees. The business tax rate varies from 11 percent to 20 percent, depending on which district the business is carried on in. However, for these purposes, a lessor is not required to include when computing the rental value of assets used in its business the value of equipment leased under a leasing agreement.[8]

B. Tax treatment of the lessee

Although from a financing viewpoint, the lessee may receive some benefits by entering into a finance leasing agreement, the tax treatment of the lessee is intended to be neutral between the lease or purchase decision.

1. VAT

Unless the equipment is an aircraft or a ship benefiting from the specific exemption provided by CGI, Article 262 II(2) and (4), VAT will be charged on the rental payments and the sale price. The lessee is entitled to a credit for the VAT, provided he is a taxable person and the equipment is used in carrying on taxable activities. As a cautionary note, when dealing with the manufacturer, care should be taken that the lessee is clearly identified as the lessor's agent, so as not to incur double VAT taxation.

2. Corporation tax

(a) *During the lease*

The lessee, not being the legal owner of the equipment, is not entitled to depreciation allowances. However, the rental payments made under the lease are fully deductible from the lessee's taxable income, even though a part of each payment represents a refund of capital.

7. Documentation Administrative 4B 2111, Nos. 2 to 30. An Economic Interest Grouping is a legal entity introduced by Ordinance 67-821 of 13 June 1989. Designed to further the activities of its members, a GIE has a legal personality of its own but is fiscally transparent. A European Economic Interest Grouping (GEIE) modelled on the French GIE, was introduced by Council Regulation EEC No. 2737/85 of 25 July 1985.

8. Réponse de Préaumont, No. 30,039, *Official Journal of the Lower House of Parliament* (hereinafter "*AN*") (16 November 1987, at 6,338.

The tax deduction of rental payments paid under the lease may be denied if, on the basis of the terms of the leasing agreement, the French tax authorities consider that the equipment is purchased by the lessee at the outset of the lease. If so, the rental payments are treated as part of the acquisition cost of the equipment. They are, of course, not tax deductible, being recorded on the asset side of the lessee's balance sheet. In principle, the lessee is not allowed to deduct from the previously deducted rental payments, the depreciation allowances he would have claimed had he been the legal owner of the equipment, as he will not have provided for depreciation in his accounts.[9] However, in cases where tax avoidance is not an issue, the tax authorities accept[10] that after the asset has been capitalized, its acquisition cost is depreciable over its remaining normal useful life.

The Administrative Documentation of 1 October 1992[11] provides that the French tax authorities may treat as sales certain transactions which are structured as leasing arrangements on the basis of Article L 64 of the Tax Procedures Code (*Livre de procédures fiscales*), which penalizes abuse of law.

The following are among the characteristics relevant when determining whether a transaction may be deemed to be a sale:

- an abnormally short lease period; or
- an abnormally low option price as compared with the normal useful life of the asset and the duration of the lease.

Thus, in a decision of 20 May 1981,[12] the Supreme Administrative Court found that a transaction, under which a company acquired trucks whose purchase price was paid in instalments over 24 months, but which were registered in the name of the purchaser from the beginning of the transaction, was not a leasing transaction. In another case,[13] the Supreme Administrative Court stated that the purchase option granted to the lessee is an essential characteristic of a leasing arrangement, and that without it the leasing transaction may be treated as a sale. It should be noted, however, that there have not been many reported cases on this question.

(b) *On the exercise of the option*

Upon the exercise of the option, the lessee becomes the legal owner of the equipment. The equipment is recorded as an asset in its balance sheet at a value equal to the purchase price specified in the leasing agreement.

As legal owner of the equipment, the lessee would then be entitled to depreciation allowances. The depreciation allowances are calculated by using the straight-line method, the declining-balance method not being available for second-hand goods (other than ships). The life of the asset for this purpose is the remaining normal useful life of the equipment measured from the date the option is exercised. In practice, as the purchase price under the leasing agreement will be close to zero, the tax advantage of depreciating the equipment will be quite nominal.

(c) *On a sale by the lessee of the equipment*

When the lessee sells the equipment, the gain realized is subject to the business capital gains tax rules as modified for this purpose. The tax treatment of business capital gains depends on whether the asset disposed of has been held for more than two years. If the asset has been held less than two years, any gain or loss is short-term and taxable or deductible at the normal rate of 33.33 percent.

In the case of depreciating assets, if the asset has been held for more than two years, any loss is allowable against profits taxable at the normal rate, whereas gains are taxable at the normal rate to the extent of depreciation allowances previously claimed, any excess being taxed at a reduced rate of 18 percent. However, the reduced rate applies only if the after-tax gain is recorded in a special reserve account as a liability in the balance sheet. There is no obligation to reinvest the gain in another asset, but the reserve cannot be distributed to shareholders unless additional corporation tax is paid. The additional rate is calculated so as to increase the total rate of tax on the gain to that which equates to the normal corporation tax rate on distributed profits.

The normal business capital gains legislation has been amended by CGI, Article 39 duodecies A (4), introduced by the 1990 Finance Bill. The Bill's objective was to put the lessee in the same position as if he had purchased the equipment at the beginning of the lease. Pursuant to this provision, the part of the gain which corresponds to both the depreciation allowances for which the lessee has obtained a deduction since its purchase of the equipment and the straight-line depreciation allowances which the lessee would have obtained during the period of the lease if he were the owner of the equipment is treated as a short-term gain (i.e. subject to the 33.33 percent corporation tax rate).

For tax purposes, the depreciation allowance given in respect of the period of the lease is that which would result from the depreciation of the purchase price paid by the lessor, less the option price payable under the lease, using the straight-line method over the duration of the lease.

(d) *Tax consequences of an assignment by the lessee of its interest in the leasing agreement*

Tax consequences for the seller

Prior to the 1990 Finance Bill, the Supreme Administrative Court and the revenue authorities had conflicting views regarding the tax treatment that should apply to the gain realized by the lessee on the sale of its interest in the leasing agreement. The tax authorities considered that the interest in

9. CGI, Article 39(1)(2) authorizes the deduction of depreciation allowances provided they have been provided for in the accounts.
10. Documentation Administrative 4 D-122 and Réponse Sergheraert, No. 8121, *AN* (26 April 1982), at 1,704.
11. Documentation Administrative 4 C-4512, No. 16. Instruction of 17 June 1991, Documentation Administrative 4 A-7-91 No. 6. See also Documentation Administrative of 1 September 1993, 4A-2162, No. 1.
12. CE 20 May 1981, No. 21,495, *RJF* (July-August 1981), No. 651.
13. CE 7 October 1987, No. 49,774, *RJF* (November 1987), No. 1,085.

a lease agreement was an intangible asset and therefore subjected the gains to business capital gain tax rules. On the other hand, the Supreme Administrative Court held[14] that this interest was not an asset and that the gains should be taxable as ordinary income. The 1990 Finance Bill introduced Article 39 duodecies A into the CGI, which confirms the tax authorities' interpretation. Pursuant to this provision, as from 1 January 1990, a lessee who sells his interest in a leasing agreement is treated as having sold an intangible asset. Accordingly, the gain derived from the sale is subject to the business capital gains tax regime as modified for this purpose.

The calculation of the capital gain depends on whether the lease is sold by the original lessee or by someone who has purchased the original lessee's interest in the lease. When the vendor is the original lessee, the capital gain amounts to the entire sale proceeds received. Alternatively, if the vendor has purchased the original lessee's interest in the lease, the capital gain amounts to the difference between the sale price and the net book value of the lease as shown in the vendor's balance sheet.

The capital gain realized on the sale of a lease, entered into (or acquired) more than two years prior to the sale, is regarded as a short-term gain and treated as ordinary income to the extent of the depreciation which the lessee could have obtained had he been the owner of the equipment from the date of the lease (notional depreciation allowances). The notional depreciation allowance is calculated using as its basis the purchase price of the equipment paid by the lessor less the option price payable. The rate to be applied to this sum is the straight-line rate determined by reference to the duration of the lease.

Where a lessee who purchased the interest in the leasing agreement from a previous lessee sells that interest, the capital gain that arises may consist of both a short-term and long-term component. The short-term gain is equal to the amount of the theoretical depreciation allowance determined as above for the period during which the lessee benefited from the lease, plus the depreciation allowance he obtained on the interests acquired in the lease. The balance of the gain is treated as a long-term gain.

The entire capital gain realized on the sale of a leasing agreement entered into (or acquired) less than two years prior to the sale is treated as a short-term gain.

Tax consequences for the purchaser

Pursuant to CGI, Article 39 duodecies A(2), an interest in a lease constitutes an intangible asset, the cost of which is depreciable over the remaining normal useful life of the equipment established at the date of the purchase of the interest in the lease. It should be noted that the remaining normal useful life of the asset is calculated without regard to either the duration of the lease or the rate of depreciation used by the lessor.

3. Business tax

As previously mentioned, the business tax is payable on tangible assets used in the course of a business. Accordingly, for these purposes, the lessee is required to include in its taxable base, the rental value of the equipment leased. The rental value of leased assets is 16 percent of the acquisition cost of the equipment (as shown in the balance sheet of the lessor).

It should be noted that the business tax applies only to a French lessee. Consequently, when the lessee is located abroad, there is no business tax due in France.

III. TAX IMPLICATIONS OF CROSS-BORDER LEASING

The development of cross-border leasing transactions has not been driven exclusively by tax considerations. In some cases, finance for large leasing transactions may not be available in the lessee's own country, or may be more expensive than equivalent financing from overseas sources. For example, Japanese leasing companies are allowed to borrow from the Export-Import Bank of Japan at low interest rates for the purposes of funding cross-border leases of aircraft to foreign airlines. However, notwithstanding the economic aspects, cross-border leasing can offer many tax planning opportunities which can substantially reduce the cost of financing the acquisition of major assets.

Under French law, only the lessor is entitled to depreciation allowances, since he remains the legal owner of the equipment. In contrast, some countries recognize the concept of economic ownership and only the lessee, as the economic owner of the leased equipment, is entitled to the relevant tax allowances or deductions. This is the position in, for example, Germany, Japan, the Netherlands and the United States.

The differences in the tax treatment of leasing transactions between countries can be exploited by cross-border leasing structures, designed to obtain tax advantages in more than one jurisdiction. These leasing structures are known as "double dip" leases.

A. Outward cross-border leasing transactions

This kind of transaction involves a leasing agreement between a French resident lessor and a foreign resident lessee.

1. VAT

Whether VAT is due in France on rental payments made under the lease depends on the type of equipment being leased and/or where it is used. Pursuant to CGI, Article 259 B, a lease of tangible assets, other than a means of transport, by a French lessor to a foreign lessee is subject to French VAT only if the lessee is located in an EC Member State and is exempt from VAT in that country. If the lessee is either

14. CE 26 January 1979, No. 9,713, *RJF* (March 1979), No. 117.

located outside the European Union or located in an EC Member State but is a taxable person in that state for VAT purposes, VAT will not be charged in France.

Pursuant to CGI, Article 259 A, a lease of a means of transport between a French lessor and a foreign lessee is subject to VAT in France when the leased equipment is used by the lessee either in France or within the EC, unless it can benefit from the specific exemptions provided by CGI, Article 262 II(2) and (4) (see above).

2. Corporation tax

(a) *Depreciation*

Provided the leasing agreement satisfies the conditions set out in the law of 2 July 1966, the lessor is treated as the legal owner of the equipment being leased and is, therefore, entitled to a tax deduction for depreciation allowances. The allowances are calculated using either the straight-line or the declining-balance method depending on the category of asset. The fact that the equipment is leased to a foreign lessee has no relevance to the depreciation rules. Nevertheless, a cross-border leasing transaction must be carefully structured so as to mitigate the risk that the French tax authorities will consider it to be a sale and therefore refuse the benefit of depreciation allowances.

(b) *Rental payments*

In principle, a French lessor is subject to French corporation tax on rental payments received from a foreign lessee. In addition, it is necessary to consider whether the French lessor will be treated as having a permanent establishment in the country in which the lessee is located, in which case it will be liable to tax there also.

Leasing as defined under the Law of 2 July 1966 does not create, once supplied, any obligation on the part of the lessor towards the lessee in connection with the equipment. All responsibility for the equipment, including maintenance and repair, is passed to the lessee. Therefore, in practice, the lessor plays no active role *vis-à-vis* the equipment leased; he merely receives the rental income. The act of leasing equipment to a foreign lessee and receiving passive rental income from that lessee will not, of itself, constitute a permanent establishment of the lessor in the country in which the lessee is located.[15] The position might be different if the lessor were to carry out maintenance or repairs on the equipment, particularly if this involved the establishment of an office or workshop in the foreign country.

3. Withholding tax

Even if the lessor is not subject to tax in the other country, the rental payments may be subject to a withholding tax there. Withholding taxes are generally imposed if the rental payments are treated as royalties under the domestic law of the country of source and under any double tax treaty in force between that country and the country of residence of the lessor.

Article 12 of the 1977 OECD Model Treaty (hereinafter "OECD Model") defines royalties as payments of any kind received in consideration of the use of the right to use industrial, commercial or scientific equipment. The definition of royalties in the majority of tax treaties to which France is a party follows that contained in the OECD Model; as a result, the tax regime that applies to royalties also applies to rental payments.

However, some tax treaties provide that royalties are taxable only in the state in which the recipient is located. This is the case, for example, in the French tax treaties signed with Belgium, Germany, Ireland, Italy, the Netherlands, Norway, the United Kingdom and more recently with South Africa. Rental payments from a lessee located in any of these countries would therefore be received free of any withholding tax. (It should be noted that although the present tax treaty between France and Japan provides for a withholding tax of 10 percent on gross rental payments paid under a lease for the use of industrial or commercial equipment, this obligation will be removed when the new treaty comes into force.)

Rental payments derived from a leasing operation may, in certain countries, be treated as business profits rather than royalties, so that the rental payments are taxed in the state of source only if the lessor has a permanent establishment there. This is the case, for example, under the double tax treaty between France and the United States or under the new treaty between France and Japan where the definition of royalties does not include rental payments made under a leasing agreement.

Another possible taxation treatment is that the transaction would be treated as a conditional sale. In this case the rental payments will be broken down into principal and interest. Under many double tax treaties, interest is not subject to withholding tax, particularly when it is charged in respect of a credit sale of equipment (this is the position, for example, under the treaty between France and Japan) or in respect of certain qualifying loans.[16]

In principle, provided that credit is available for any withholding taxes levied on rental payments against the domestic tax liability of the lessor on that income, the withholding tax merely constitutes a cash flow disadvantage. However, withholding taxes can constitute a real tax cost for the lessor. For a French lessor, this would occur if the foreign withholding tax exceeds the French corporation tax payable on the rental income, as the excess is not refundable.

This situation arises if the French lessor realizes a loss or a nil return during the opening years of the lease. This may well occur if, as discussed above, the leased equipment is depreciated according to the declining-balance method, and particularly if the lessor has financed the acquisition of the equipment through external loans. In this scenario, as there is no corporation tax liability against which the foreign tax credit

15. Report of the OECD Committee on Fiscal Affairs, 1977, commentaries on Article 5.
16. See, for example, Article 11(3) of the tax treaty between France and Malaysia.

may be offset, the withholding tax is a real tax cost for the lessor.

To avoid this tax cost, leasing transactions are normally structured so as to ensure that rental payments are received "gross", although any rules in a relevant double tax treaty preventing artificial structures designed to take advantage of treaty provisions (treaty shopping) must be carefully considered.

4. Business tax

As mentioned in II. in the context of domestic leasing, the lessor is not required to include the equipment leased under a finance lease in its taxable base for French business tax purposes. This exemption also applies when the equipment is leased to a foreign lessee. Therefore, a French lessor who enters into a finance lease agreement with a foreign lessee is exempt in France from business tax on the equipment leased.

B. Inward cross-border leasing

This section analyses leasing transactions entered into between foreign lessors and French lessees.

1. VAT

The VAT consequences of a leasing transaction between a foreign lessor and a French lessee depend on the equipment leased (a means of transport including aircraft, or other tangible assets). Unless the leasing operation can benefit from the exemptions provided for by CGI, Article 262 II(2) and (4), rent paid in respect of a lease of a means of transport by a French lessee to a foreign lessor is subject to VAT in France, if the lessor is located outside the EC and the equipment is used in France (CGI, Article 259 A). From 1 January 1993 until 31 December 1994, when the lessor was established in the EC, the rent paid by a French lessee was not subject to VAT in France, even if the equipment was used in France. As a consequence, situations might exist where a cross-border leasing transaction was free of VAT both in France and in the lessor's Member State if it was considered in the latter country to be an EC delivery.

To counteract this, the French tax authorities laid down, under CGI, Article 259 A (1° bis), that the rent paid by a French resident lessee to an EC lessor is subject to VAT in France if the leasing transaction is exempt from VAT in the other country, and the leased means of transport is used either in France or in the European Union. This provision in this regard is probably contrary to EC directives.

Recently, the French tax authorities, in an instruction dated 7 April 1995, specified that the rental from a lease of a means of transport used partially within the European Union (France or another Member State) and partially outside, is subject to French VAT in proportion to the rent derived from EC use.

In the case of a finance lease involving a non-EC lessor, an EC lessee and a French sub-lessee using the equipment in France, CGI, Article 259 A provides for the imposition of French VAT on rents paid by the EC lessee to the non-EC lessor if French VAT had not been levied on rents paid by the French sub-lessee to the EC lessee.

Until 31 December 1994, pursuant to CGI, Article 259 B, a lease of tangible assets other than a means of transport was only subject to VAT in France when the lessee was a taxable person.

As from 1 January 1995, if the lessor is located in an EC Member State where a cross-border leasing transaction with another EC country is considered to be an EC delivery, and therefore exempted from VAT, the rental payments are subject to VAT in France even if the French resident lessee is not a taxable person, this again is likely to be contrary to EC rules.[17]

When the leasing transaction is subject to VAT in France, a foreign lessor must designate a fiscal representative in France (which can be the lessee) responsible to the French tax authorities for the payment of VAT and for any VAT obligations.[18]

2. Corporation tax

(a) *Depreciation of the equipment*

In principle, a French lessee is not entitled to depreciation allowances in respect of the equipment, as he is not considered to be the legal owner of the equipment under French law. Accordingly, it may be necessary to consider an alternative structure for the financing, so as to ensure that the relationship between the foreign lessor and the French lessee is such that the French lessee is treated as the legal owner of the equipment. One such alternative structure may be a sale with reservation of title (*vente avec réserve de propriété*), provided that the agreement is structured to ensure that a "double dip" is available.[19]

(b) *Deductibility of the rental payments*

If, as a consequence of a particular transaction, the lessee or user of the equipment is considered to be the legal owner of the equipment under French law, e.g. if the transaction is a sale with reservation of title or the leasing transaction has been recharacterized as a sale, the rental payments are treated as forming part of the acquisition cost of the equipment, i.e. as capital expenditure. Capital expenditure is not deductible, but is required to be recorded as an asset in the lessee's balance sheet.

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17. CGI, new Article 259 C(2) and (3), Administrative Instruction 7 April 1995, Documentation Administrative 3A-5-952.
18. Instruction 7 April 1995, Documentation Administrative 3 A-5-95.
19. Under a Ministerial Reply which requires confirmation (Rép. Delahais, *AN*, 11 February 1991), the tax administration indicated that it will disallow depreciation taken on immovable property acquired with reservation of title until the title of ownership is effectively transferred. This position, therefore, should not concern *movable* property which should remain depreciable as of the date of delivery, even if acquired under reservation of title. Moreover, the position of the tax administration, as it now stands, is contrary to French accounting standards and earlier administrative practice.

On the other hand, if the lessee is not considered to be the legal owner of the equipment, rent paid to a foreign lessor is fully deductible in computing the lessee's taxable income.

3. Withholding tax

Under French domestic law, if the equipment leased is used in France, rent paid by a French lessee to a foreign lessor is treated as French-source income and is therefore subject to a withholding tax of 33.33 percent. However, the French tax authorities consider that the leasing to a French lessee of an aircraft used for international flights does not constitute a service used in France and is therefore exempt from withholding tax.[20] If the aircraft is used on both international and domestic routes, the withholding tax is due on a *pro rata* basis (calculated according to miles or hours of flight).

Even when the above exemption does not apply, the domestic withholding tax of 33.33 percent is often reduced or eliminated by virtue of the relief afforded in the relevant double tax treaty. For example, the French tax treaties with Belgium, Germany, Italy, the Netherlands and the United Kingdom provide that royalties and, by implication, rental payments, are taxable only in the state in which the lessor is resident. Further, the double tax treaty between France and the United States provides that rental payments constitute business income which would therefore only be taxable in the state of source (i.e. in France) if in this regard the lessor has a permanent establishment in France. The same treatment will apply to payments made to a Japanese lessor when the new treaty between France and Japan comes into force.

4. Business tax

The French lessee is subject to French business tax on the equipment leased under a finance lease agreement as explained in II.

IV. FINANCING VEHICLES USED IN LEASING TRANSACTIONS

An investor wishing to participate in a leasing transaction may wish to establish a special purpose vehicle (hereinafter "SPV") to act as the lessor. An SPV is often appropriate if the equipment to be leased is of high value, e.g. an aircraft or train, because, in practice, it is unlikely that a single investor would be in a position to purchase the equipment by itself. An SPV is also appropriate for guarantee purposes in case of bankruptcy, as it allows an investor to isolate the relevant asset so that its balance sheet is not adversely affected. Moreover, French banking law provides an additional reason to use an SPV to hold the ownership of a leased asset. This is because companies which habitually carry out crédit-bail operations, fall within the scope of banking law and must therefore be duly registered as a credit institution. In this context, operations become habitual when the same entity carries out more than one such operation.

In selecting the optimum legal form to be adopted by the SPV, it is essential to select a structure which ensures that each investor is in a position to obtain the benefit of a part of the tax saving which, as explained above, should result from the utilization of the depreciation allowances given to the owner of the equipment. In order to achieve this, an entity which is fiscally transparent is established as the lessor, so that its members are able to offset, against their own profits, a proportion of the losses incurred during the first years of the lease.

A. Suitable French structures

The *groupement d'intérêt économique* (GIE) and the *société en nom collectif*, (hereinafter "SNC") which is a general partnership, are two types of French entity which are particularly suitable as investment vehicles in leasing transactions. The GIE and SNC have similar characteristics in that each entity has legal personality, their members have joint and several liability for the debts of the entity, and they are both fiscally transparent.

In practice, however, the GIE has certain advantages over the SNC and tends to be preferred, particularly for aircraft leasing transactions, for the following reasons :

- the transfer by a member of a GIE of his interest is not subject to registration tax, instead it is merely subject to a fixed duty of FF 500. In comparison, a transfer of shares in an SNC is subject to registration tax at a rate of 4.80 percent;
- withdrawal from membership of an SNC requires the prior authorization of all the other members; if no requirement is included in the agreement to form the GIE, withdrawal from membership is unrestricted;
- the GIE may, under certain conditions, issue bonds whereas an SNC may not; and
- an SNC's purpose (as with any company) is to realize profits, whereas the GIE's purpose is simply to develop the business activity of its members.

However, it should be noted that the objectives for which a GIE may be established are defined by law. The principal purpose of a GIE must be to extend and benefit the economic activity of its members. Where a GIE is established by a number of investors in a leasing transaction, it is essential to ensure that, in relation to the respective activity of *each* investor, the GIE effectively facilitates and develops that activity. When the business activity of each investor is different, the GIE may not be used as the leasing vehicle. In these circumstances the SNC may be a more suitable alternative.

B. Tax implications of a GIE or SNC as the leasing vehicle

1. Tax regime applicable to the GIEs and SNCs

According to CGI, Articles 8 and 239 quater, GIEs and SNCs are both fiscally transparent entities, i.e. taxable income is

20. Documentation Administrative 5B-7111, No. 24, 1 December 1986.

determined at the level of the vehicle but any tax which is payable is assessed on the members or shareholders.

In principle, the taxable income of a GIE or SNC is determined using the rules appropriate to its activity. However, when the members or shareholders of a GIE or SNC are either enterprises or companies, the taxable income of the entity is determined by applying the business income rules appropriate to the members activity (i.e. *bénéfices industriels et commerciaux*, *bénéfices non commerciaux* or *bénéfices agricoles*) for unincorporated enterprises and corporation tax rules for companies. In determining its taxable income, the GIE or SNC is allowed to deduct from the rental payments received from the lessee, depreciation allowances and the interest paid on loans.

In practice, a GIE or SNC is usually established by two or more banks, which then lend to it the funds required to purchase the equipment. The following points should be made regarding the interest payable by the GIE or SNC. Firstly, provided certain conditions are met, interest paid by a French company to a foreign lender is exempt from withholding tax (CGI, Article 131 quater). Thus, all interest paid by the entity to a foreign lender is paid "gross". Secondly, French tax rules restrict the deductibility of interest paid to a shareholder (or a member). CGI, Article 39(1)(3) provides that interest at a rate in excess of the annual average rate of gross returns on bonds issued by private companies is not deductible. In addition, CGI, Article 212 provides that interest paid to shareholders or partners who, in law or in fact, control the management of a company or who hold more than 50 percent of its financial or voting rights, is only deductible in as much as the loans granted by all the associated shareholders do not exceed one and a half times the amount of the company's capital assets. However, the author is of the opinion that these two limitations, which specifically concern companies, should not apply to loans granted to a GIE by its members. Nevertheless, in order to avoid any unnecessary exposure in this respect, the loan could be made by lenders other than members of the GIE or SNC.

Once the taxable income of the entity is determined, the members are liable to pay tax (income tax for non-corporate entities and corporation tax for companies) on their proportionate share of that income. If the GIE or SNC realizes a loss, the loss is available to the members for offset against their own profits.

2. Tax regime applicable to the foreign members of a GIE or SNC

The tax regime described above applies to both French and foreign members of a GIE or an SNC. In this respect, the French tax authorities, in an Instruction dated 30 May 1968,[21] stated that foreign entities carrying on a taxable activity through a GIE are subject to French income tax on their share of the GIE's profits. Their liability is not a consequence of having a permanent establishment in France as would normally be required by tax treaties, but a consequence of their membership in the GIE. This position has been reinforced by the Instruction of 10 May 1991,[22] which applies to a GEIE (European GIE). For French tax purposes, the foreign members are treated in the same way as the French domestic entity to which their management structure or memorandum and articles of association is most similar. Consequently, foreign members are subject to French income tax or to French corporation tax on their proportionate share of the profits of the GIE or the SNC.

Following from the above, losses incurred by the GIE or SNC during the opening years should be available for offset against the profits of the foreign members. The question which then arises is whether the losses incurred by the GIE or SNC are available in France or in the foreign member's home country. The losses incurred by the GIE or SNC are available in France for offset against either the French profits of any permanent establishment of the foreign member in France, or the profits realized by another fiscally transparent French entity in which the foreign member is a shareholder. In the absence of profits, the losses incurred by the GIE or SNC can be carried forward in France in the hands of each foreign member. It should be noted that those losses representing the depreciation allowances claimed may either be carried forward indefinitely in the hands of the GIE or SNC, or carried forward by the members as ordinary losses subject to being utilized within five years.[23]

The availability of the losses incurred by the GIE or SNC in the home country of the member or shareholder depends on the tax regime applying in that country.

3. Position of a GIE or SNC as regards tax treaties

Under some French tax treaties, withholding tax is levied on rental payments in the country in which the lessee is resident. If the lessor is a French GIE or SNC, the question arises as to whether the lessor is entitled to the benefit of any reduced withholding tax rates and/or any tax credits provided for by the relevant tax treaty.

(a) *Is a GIE or SNC a "resident" of France for purposes of double tax treaties?*

The OECD Model defines "resident" as any person that is liable to tax in a country by reason of his domicile, residence, place of management or any other criterion of a similar nature. The French tax authorities consider that both a GIE and SNC are entities which are liable to tax in France, although the tax may be assessed on the non-resident members. The French tax authorities therefore, accept that a GIE or SNC is entitled to the benefit of any relevant French double tax treaty. However, the question arises as to whether the tax authorities in the lessee's home country accept that a GIE or SNC is covered by the relevant tax treaty.

The foreign tax authorities may take one of two approaches. Either they can accept that the GIE is a resident of France and consequently implement the treaty drawn up between its own country and France or, alternatively, they can treat it as not being French resident and therefore refuse it the benefit of

21. *Bulletin Officiel de Contributions Directes* 1968-II-4141.
22. Documentation Administrative 4 F-3-91.
23. Réponse Derosier, *AN* (6 June 1983), at 2,514, No. 21,606.

treaty relief. In the latter hypothesis, all one can do is to hope that they will agree to apply the tax treaties which may exist between their own country and those countries in which the members of the GIE reside.

For example, the new tax treaty between France and the United States concluded on 31 August 1994[24] considers that a partnership, or a similar pass-through entity, is a resident of a Contracting State where the income realized by such partnership, or similar entity, is subject to taxation in the Contracting State as the income of a resident, either in the hands of such partnership, or in the hands of its partners, beneficiaries or grantors.

This convention has expressly laid down that a "*société de personnes*, *groupement d'intérêt économique*, or *groupement européen d'intérêt économique* that is constituted in France and has its place of effective management in France and which is not subject to French company tax shall be treated as a partnership for the purposes of US taxation under the convention" (Article 4-2b(iv)).

On the other hand, the French and US governments have agreed that with respect to the above-mentioned provision of the new treaty, to the extent that the members of a French GIE are residents of a third State, the US income tax liability shall be determined under the US tax treaty, if any, with that third State. The double tax treaty between France and Austria dated 26 March 1993, and that between France and South Africa of 8 November 1993, contain the same procedures with regard to a *société de personnes* (partnership) or a *groupement similaire* (similar pass-through entity). The same rule will also apply in Japan when the new treaty between France and Japan comes into force.

(b) *Is a GIE or SNC entitled to tax credits?*

The tax credit being considered here is any tax credit which is available under a tax treaty. Thus, if the GIE or SNC is not recognized as a resident entity for the purposes of a particular tax treaty, the foreign tax authorities may apply the domestic rate of withholding tax on rental payments, the only tax credit available to the GIE or SNC in France being a credit for the withholding tax rate provided for under the relevant tax treaty.

For example, if the gross rental payment is 100 and the foreign domestic withholding tax is 25 percent, the French GIE or SNC receives a net rental payment of 75. The French tax authorities will grant to the GIE or SNC a tax credit corresponding to the withholding tax provided for in the tax treaty (e.g. 5 percent). The tax credit granted to the GIE or SNC is then 3.94 (i.e. 78.94 minus 5 percent equals 75).

If the GIE or SNC is treated as French resident, it should, in principle, be entitled to benefit from any tax credits allowed under the relevant treaty. Since the GIE or SNC does not itself pay any tax against which the tax credit could be offset, the French tax authorities have ruled that the credit should be passed on to the members of the GIE or SNC in proportion to their respective interests. The members are then theoretically able to deduct that part of the tax credit which they are entitled to from the French tax liability arising on their individual share of the profits. However, in practice, due to the losses incurred by the GIE or SNC during the opening years, there would have been no liability to corporate income tax and thus the tax credit would be lost.

In conclusion, therefore, it is clear that the use of a GIE or SNC as the leasing vehicle in a leasing operation involving a number of investors can be tax-efficient in that no tax is paid by the leasing vehicle. The ability of such a structure to pass on to its investors the tax advantages arising from the depreciation of the asset and the deductions for any interest paid on borrowings used to acquire the asset is also an attractive feature.

On the other hand, a tax transparent structure can give rise to difficulties in cross-border operations *vis-à-vis* the availability of treaty benefits in respect of cross-border income flows. However, in practice certain foreign tax authorities are willing to provide rulings recognizing the fiscal transparency of the structure and the availability of treaty relief either to the leasing vehicle itself or to its members.

V. CONCLUSION

France offers a very favourable environment for tax oriented leasing resulting in double dip opportunities for cross-frontier arrangements. In contrast to some other countries, French law does not contain any provision limiting the tax benefits available to French investors through leveraged leasing.

Moreover, no legal provision allows the French tax authorities to challenge a deduction for depreciation merely on the basis that depreciation has also been claimed by other parties to the transaction. However, care should be taken not to enter into over-aggressive transactions which the French tax authorities could seek to challenge by applying the doctrine of "abuse of law"

Current French law establishes that where the French tax authorities intend to challenge a transaction on the grounds of abuse of the law, they must be able to show that the transaction in question is either artificial in nature or, failing this, that the elements making up the transaction have as their sole object the avoidance, or reduction, of a liability to tax.

24. The new treaty between France and the USA was not yet in force at the time of publication of this article.

CFC LEGISLATION: AN ANALYSIS OF ARTICLE 209B THE NET WIDENS![1]

Pierre-Jean Douvier

Partner, Bureau Francis Lefebvre; Lecturer in International Tax Law, University of Paris

Under Article 209B of the French Tax Code (Code Général des Impôts, "CGI"), it is possible that a French taxpayer will be subject to French corporation tax in respect of the foreign profits of a foreign entity (subsidiary or a branch), whether or not these profits are distributed or remitted to France.

Before Article 209B may apply, a French entity subject to French corporation tax must either manage a foreign establishment or hold, either directly or indirectly, 10 percent or more of the stock, share capital, financial or voting rights in a foreign legal entity. An investment in an entity is also caught where its cost of acquisition is at least FF 150 million ($ 30 million).

These provisions apply whether the foreign legal entity mentioned above is a company, partnership or other foreign "grouping". It is a further condition that Article 209B may only apply where it can be shown that the foreign entity benefits from a privileged tax regime, within the meaning of Article 238A CGI. Where the foreign entity is a company or a grouping, its taxable profits are assessed *pro rata*, according to the financial rights held. Voting rights are ignored for this purpose.

Article 209B applies to enterprises set up or acquired on or after 30 September 1992:
- where the stock, shares, interests, financial rights or voting rights acquired, or subscribed for, on or after 30 September 1992, give the French corporation ownership of at least 10 percent of the foreign entity(ies) considered, or, where such 10 percent ownership already existed, to maintain or increase its participation;
- any acquisition of enterprises, or subscription for stock, shares, or rights, which brings the quantum of the French corporation's investment to the FF 150 million threshold or increases it if the threshold had already been reached.

For enterprises set up or acquired before 30 September 1992, the old CFC regime continues to apply (subject to certain conditions) to companies established in a foreign country benefiting from a privileged tax regime, provided the French entity directly or indirectly owns at least 25 percent of the stock, share interests, financial rights or voting rights. This transitional regime is to be maintained until 31 December 2002.[2]

Even if an entity otherwise comes within the scope of the CFC legislation, it may avoid the application of the provisions, provided it can establish that the creation or the acquisition of the foreign enterprise does not have as its main purpose (*effet*) the transfer of income to a privileged tax regime.

This condition is deemed to be satisfied:
- where the foreign entity mainly carries out a commercial or industrial business activity; and
- it predominately carries out its operations in the so-called local market.

It should be noted that the CFC legislation derogates from normal French taxation principles as, under French tax law:
- a foreign subsidiary, being an independent legal entity, may not be consolidated[3] for tax purposes;
- French corporations are not taxable on their worldwide income contrary to the standard international rule, but rather pursuant to the territoriality concept, they are only liable to French corporation tax on profits derived from a business carried on in France (*entreprise exploiteé en France*).[4] Under this rule, income attributable to a foreign permanent establishment (an enterprise carried on outside France) is not subject to corporation tax in France, even if it is remitted to France; however, the so-called *précompte* (equalization tax) applies where this income is distributed to the shareholders of the French company instead of being reinvested.[5]

Article 209B was enacted by a law dated 18 January 1980. It was modified twice by amendments proposed by the government, the last of which was introduced by the 1993 Finance Act. However, the fact that up until 1993, no case law had been published on the subject tends to demonstrate that the French tax administration was not comfortable with the application of the provision, since the drafting of the legislation was unsatisfactory.

However, the last amendment certainly gave the administration more scope. As a result, investments acquired in treaty countries have since December 1994 started to be challenged by the French tax authorities.

In this article we will address the rules of the French CFC tax regime as amended by the Decree of 5 April 1994. This new regime applies to any investments acquired after 30 Septem-

1. This article is based in part on the author's "Doubts on French CFC Laws", published in *International Tax Review*, March 1995.
2. On equality of taxpayers' rights before the tax, see P. Dibout, *Droit Fiscal*, 1994, No. 11, at 480.
3. A worldwide tax consolidation exists under French tax law. However, it is subject to a prior approval from the tax administration and it applies, in practice, to a very limited number of groups (about 15).
4. See *Taxation of Permanent Establishments*, (Amsterdam: IBFD).
5. The equalization tax is not due upon distribution where the French recipient entity is consolidated for taxation purposes.

ber 1992, or before that date if the investment has since been modified .

I. DEFINITION AND SCOPE OF THE CFC REGIME

A. Computation of the interest in the foreign entity

The Decree sets out the conditions for the ownership test and the cost price threshold. These rules have been outlined earlier. The new rules for the computation of indirect holdings also apply to corporations governed by the transitional provisions until 31 December 2002.

1. Principles

To determine whether or not the 10 percent threshold or the amount of 150 million FF is reached, the percentage, or the cost price, of the participation, determined as at the end of the corporation's accounting period, is relevant. This rule also applied to the old regime.

However, where a French legal person has remained within the scope of the provision for at least 183 days over the fiscal year concerned, it is subject to tax even if the relevant thresholds are no longer exceeded at the end of the fiscal year.

For tax purposes, the highest percentage held, or cost price incurred, either during the 183-day period mentioned above or as at the close of the fiscal period, will be the relevant percentage for the purpose of applying Article 209B.

According to the tax authorities, the period of ownership need not be continuous.

Examples:

(i) P., a corporation acquired after 30 September 1992, whose accounting period coincides with the calendar year and which enjoys a privileged tax regime, has been 20 percent owned by a French corporation for the period 1 January to 15 December. If, from that date onwards, this percentage is reduced to 5 percent, the French corporation falls within the scope of Article 209B on a taxable basis of 20 percent since that shareholding has been held for at least 183 days. If, starting from that same date, the percentage of share capital held falls to 15 percent, Article 209B applies on the highest taxable basis, i.e. 20 percent. If, from 15 December, the percentage rises to 30 percent and remains at that level until the end of the financial year, it is that latter rate which must be taken into consideration.

(ii) 80 percent of P's share capital has been held by a French company for a discontinuous period of 8 months spread over the corporation's accounting period; it transfers the entirety of its holding to a legally unrelated French company subject to corporation tax which holds it until and including the end of the fiscal year.

The assignor and the assignee will, in principle, be subject to taxation pursuant to Article 209B (by reason of the same profits), each of them on the basis of a 80 percent holding in the foreign corporation: the transferor by reason of a holding of at least 10 percent held for more than 183 days, the transferee as the holder of the shares at the end of the fiscal year.

Note: As shown in (ii) above, the new rules may lead to the same foreign profits being taxed twice in France. The French tax authorities may reasonably be expected to rectify this situation.

B. Powers of enforcement

If the tax authorities can demonstrate that at any time during the fiscal year other than at the end of the year the tests (ownership or cost price) were satisfied, it may ask the enterprise to indicate the period of holding during the fiscal year and the date and conditions attaching to the acquisition and transfer of the participation (identity of the transferor and the transferee, price of acquisition and transfer, percentage of the participation acquired and transferred).

If the enterprise or the legal person does not defer to this request within one month or provides an insufficient response, the tax authorities address a formal notice to communicate the requested information within the same deadline (Article 102 Z of Annex II to the CGI), failing which they will issue an ex officio assessment.

If the taxpayer still fails to provide the necessary information, the tax authorities will be entitled to implement the procedure of treaty administrative assistance, or to levy taxes based on the information it has been able to gather.

The duties are increased by late payment interest and a penalty of 40 percent or 80 percent failing compliance within 30 days of a second formal notice (Article 1728 of the CGI).

II. TARGETED ENTITY AND NATURE OF THE PARTICIPATION

A. Foreign entity: enterprise, company or grouping

In the absence of any applicable income tax treaty, the enterprise is considered to be an autonomous establishment (the wording permanent establishment being reserved for treaty situations), i.e. any professional body with a certain degree of permanency and autonomy, dependent agent or the habitual exercise of commercial activity (the so-called complete business cycle).[6]

The new legislation inserted this rule because it was easy to circumvent the former CFC rules by setting up a branch instead of a subsidiary in a foreign country. The new wording *grouping* was also introduced, even though no definition is provided, which may allow for a wide application of the rule.

At the time the Bill was being debated, a comprehensive report had been issued by Mr Richard, a member of the French Parliament. This report indicated that, to the extent

6. *Id.*

that it appeared that the wording *company* did not cover certain situations, the term *grouping* should be used to widen the scope of the provision. It refers to any legal person, distinct from the legal body established in France, and directly or indirectly controlled at least 10 percent by the latter.

B. Nature of the holding

Article 209B aims at indirect as well as direct holdings.

The term "indirect holding" includes:
- a chain of ownership. The successive holding rights must be multiplied to work out the final percentage;
- rights held directly or indirectly by:
  - salaried employees or officers (de jure or de facto) of the company;
  - individuals, their spouses, and direct line ascendants or descendants, where at least one of these persons is directly or indirectly the owner of rights in the company;
  - a company or a grouping that has in common with the French legal entity a stockholder or a holder of financial or voting rights who directly or indirectly has the highest number of voting rights in such company or grouping and in that legal entity;
  - sister companies. Although the tax authorities referred in their Commentaries dated 15 February 1983 to sister companies over 50 percent owned by a third company, the new wording takes into consideration the de facto control, which includes sister companies holding along with the French company a participation in the foreign company or grouping; and
  - a commercial partner of the legal entity where the nature of the relationship creates an economic dependency.

III. DETERMINATION OF PROFITS

Article 3 of the Decree (new Article 102 T of Annex II CGI) determines the proportion of the profit of an accounting period of the foreign corporation which is to be treated as accruing to the French taxpayer.[7]

For the calculation of the proportion, three elements are to be taken into account:
(i) the proportion which is to be taken into account when determining whether or not the French enterprise falls within the scope of the provision;
(ii) the financial rights owned by "connected persons", included in (i) but excludable when it comes to determining the profit assessable on the French taxpayer;
(iii) the financial rights excludable for the purposes of the determination of the profits taxable in France under Article 209B because they are held indirectly by other legal persons already subject to corporation tax in France under Article 209B in respect of the same profits.

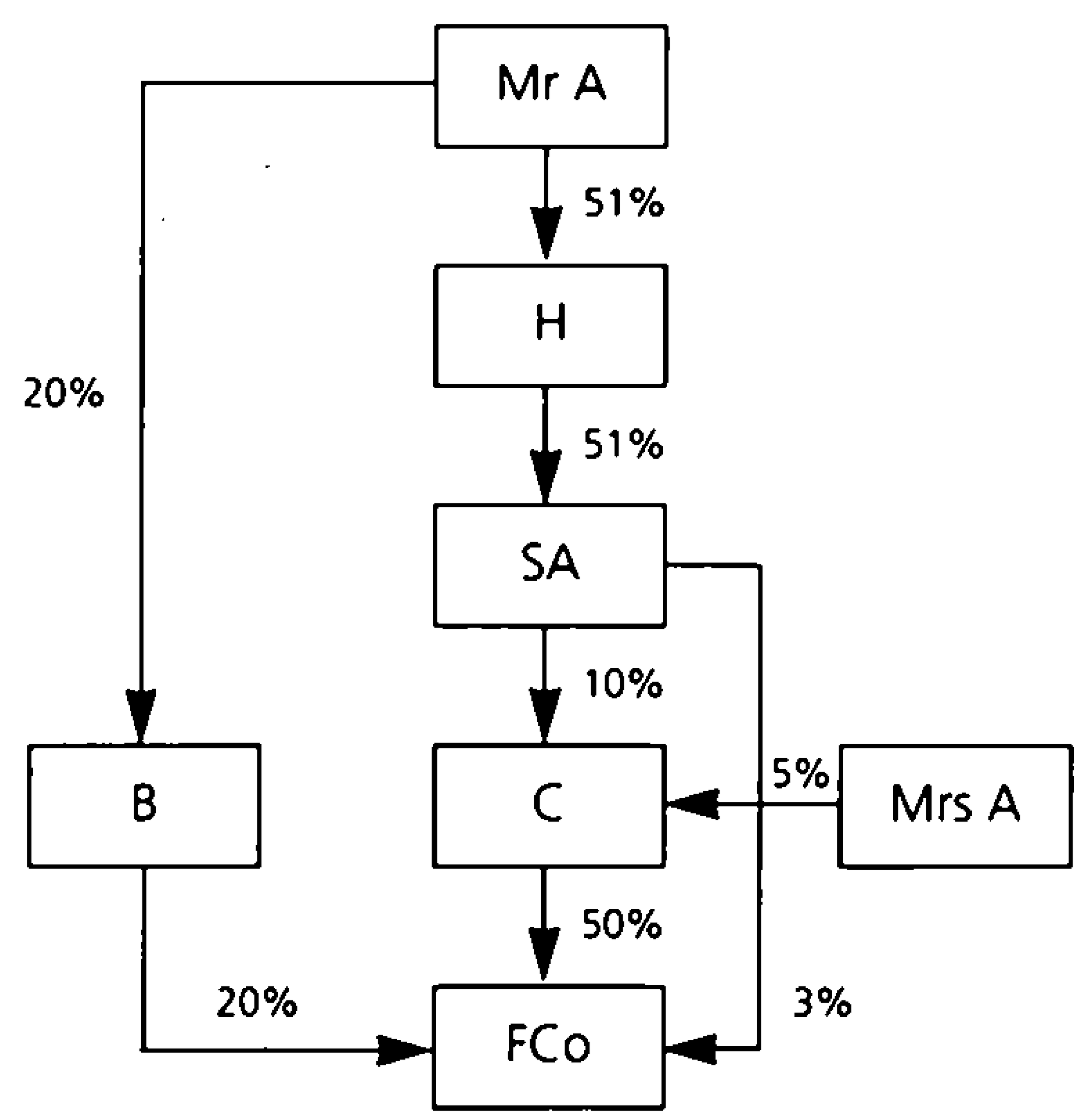
The relevant proportion is the percentage of financial rights (voting rights which do not entitle the holder to a distribution of profit are ignored) held directly or indirectly in the foreign structure. Such proportion can be:
- such percentage as is held at the end of the fiscal year of the corporation or the foreign group, or if higher,
- such participation as has been held for 183 days or more over the same fiscal year,
- failing any response from the French legal entity to the tax authorities, such percentage as was held at any time during the fiscal year prior to the end thereof.

The taxpayers' financial rights together with those of persons "connected" to him are aggregated for the purposes of determining whether he falls within the scope of Article 209B, i.e. owns a holding of (25 percent or) 10 percent in terms of stocks, interest shares, etc. But stocks, interest shares etc., held by such connected persons are not taken into account for the calculation of the percentage of the profit attributable to the taxpayer.

Moreover, the proportion of profits to be taken into account for the purpose of computing the legal entity's liability does not include stocks, interest shares, financial rights held indirectly through other legal persons subject to corporation tax in France, under Article 209B in respect of the same profits.

Indeed, this rule excludes from the calculation of the proportion to be taken into account, the financial rights held separately or attaching to stocks or interest shares and already taken into account for that calculation, for other legal persons assessed by virtue of Article 209B.

Example:
- Mrs A is the daughter of Mr A;
- SA is subject to corporation tax in France;
- H, B and C are foreign corporations not benefiting from a privileged tax regime;
- FCo is a foreign corporation subject to a privileged tax regime;
- the percentages indicate a holding of both the voting and the financial rights.



7. If the structure benefiting from a privileged tax regime is an enterprise (i.e. a permanent establishment), the entirety of its result is taxed separately.

Calculation of the financial and voting rights held by SA in FCo:

1. Direct holding	3%
2. Indirect holding	
a) Chain of shareholding (10% x 50%)	5%
b) Associated persons	
– through Mr A, indirect stockholder of SA (20% x 20%)	4%
– through Mrs A, daughter of an indirect stockholder of SA (5% x 50%)	2.5%
Total	14.5%

Therefore, SA is deemed to hold 14.5 percent of the financial and voting rights of FCo, 6.5 percent of this being held by associated persons. The percentage of profits of FCo to be taken into account for the purpose of Article 209B is thus 8 percent.

Note: If H was established in France, it would also fall within the scope of Article 209B.

1. Indirect holding of H in FCo	
a) Chain of rights through SA	
– 51% x 10% x 50% =	2.5%
– 51% x 3% =	1.5%
b) Persons connected with Mr A, direct stockholder of H, and his daughter –	same i.e. 6.5 %
2. Total rights held:	10.5%

This percentage would, in principle bring H within the scope of Article 209B; however, in such a situation, in pursuance of the provisions of Article 3 of the Decree, the rights held through SA (which is already subject to Article 209B) (4 percent) would not be taken into account when determining the percentage of profit to be taken into account by reason of FCo.

The rights that H is deemed to hold in FCo by reference to the connected persons provisions i.e. those of Mr A and his daughter (6.5 percent) would not be taken into account when calculating the proportion of profits to be allocated. Therefore, although it is within the scope of Article 209B, H should eventually not be subject to tax, as the proportion of profit to be taken into account would be nil.

Thus, in this example, H and SA would both be within the scope of Article 209B:
- SA would be taxed on 8 percent of FCo's profit; and
- H would have no liability to tax in respect of FCo's profits .

IV. PRIVILEGED REGIME

Article 209B refers to privileged regimes within the meaning of Article 238A CGI. The report issued by Mr Richard indicates that France has no monopoly on the fight against fiscal evasion. If the United States was the first country to provide anti-tax haven provisions (in 1937), all industrialized countries have since adopted similar measures which appear to be more or less comparable to the French CFC regime: Germany, Canada, Italy, Japan, Great-Britain.

A privileged tax regime is deemed to exist where the foreign entity is not subject to tax or where it is subject to tax at a rate that is substantially lower than that which would apply in France (as a practical rule, this occurs where the foreign tax is less than $^2/_3$ of the French tax that would be assessed on the same profits).

Under its previous wording, Article 209B was aimed at the privileged tax regime of a jurisdiction considered as a whole, although the French tax authorities had indicated that the individual regime applying to the foreign subsidiary itself was relevant. If the tax authorities interpretation was correct, why was an amendment to the legislation necessary? In practice, the modification to the legislation effective from December 1994 does not cover the old regime, which means that the courts may have to be the final arbiter when determining whether the old rule applies at the level of the tax regime of the state, or the tax regime specific to the foreign subsidiary.

In this regard it is important to note that the Richard Report indicates that, notwithstanding the provisions of Article 92 of the EC Treaty, several EU members have created specific tax regimes that may jeopardize competition. The following regimes are mentioned: Dutch holdings, Belgian holdings as from 23 October 1991, Belgian Coordination Centres, Dublin Docks and Shannon companies in Ireland.

The new wording of Article 209B allows the tax authorities to fight more effectively against tax avoidance involving the transfer of income to EU tax haven countries. General Reporter Richard indicates he shares the concern of the Ruding Committee about the trend in EU Member States to create tax breaks specifically designed to attract international investment.

V. PERSONS BENEFITING FROM THE EXEMPTION CLAUSE

Article 209B may be avoided if the French company can demonstrate that the operations of the foreign establishment, corporation or grouping do not have as their main effect the transfer of profits to a state or territory offering a privileged tax regime.

This test is deemed to be met, *inter alia*:
- when the main activity of the foreign enterprise, corporation or grouping is industrial or commercial; and
- when it carries out its operations predominantly in the local market.

Accordingly, the motives for the set-up abroad are irrelevant and only the *effects*, i.e. the consequences of setting-up abroad must be examined. More precisely, the main consequences of the operations of the foreign entity must be established.

As the fiscal, economic or other consequences of transferring activities to a tax haven country are difficult to predict, the legislation has created the above tests which are practical rather than subjective in nature.

A. Nature of the activities

Commercial activities include: the purchase for sale of goods or raw materials, and the provision of services except those being civil or liberal activities (accordingly leasing of unfurnished premises, consulting services, expertise, etc. are excluded from the benefit of this measure).

The local activity must be predominant. As a practical rule, this is satisfied where the turnover represented by the local industrial or commercial activities exceeds 50 percent of the total turnover realized by the foreign entity. The local activities may be manufacturing, trading of goods, or the performance of services.

B. The foreign activity must be effective

If the foreign entity has no substance, i.e. if it is artificial in nature, it may not enjoy the exclusion rule.

VI. EFFECTS OF THE CFC REGIME

A. Means of taxation

Where a company falls within the scope of Article 209B, then the person subject to corporation tax in France is the owner, either of the permanent establishment, or of the share capital of the subsidiary. The taxable income is determined according to French rules. Once a foreign entity comes within the scope of Article 209B, a first balance sheet must be drawn up and filed with the French tax authorities. These documents will serve as a basis for the taxation of the first and subsequent financial years.

1. Computation of taxable income

The items must be recorded at their book value as defined by the local legislation. The first balance sheet must be drawn up at the beginning of the first financial year in which the income falls within the provisions of Article 209B.

There can be no step-up of asset value. The operating profits are to be converted into francs at the close of the financial year. Certain French domestic reliefs are not available under Article 209B, e.g. the deductibility of certain reserves etc. The exchange rate to be used is that prevailing at the end of the accounting period.

2. Separate taxation

The fact that the foreign entity is taxed separately makes any offset of its taxable income against the French company's impossible. This has serious adverse tax consequences where a French company is in a loss position and must pay tax under Article 209B.

3. Filing requirements

The Decree of 1994 has added some specific filing requirements.

Transitional regime

The legal entity falling within the scope of Article 209B by virtue of it triggering the 25 percent ownership threshold must produce, together with its annual return, a list including the name and the address of the registered office of the foreign corporations created or acquired before 30 September 1992 benefiting from a privileged tax regime.

The list must include, for each foreign corporation, the following information: name, or corporate name, object and activity, address of the registered office and percentage of participation held directly or indirectly.

The new regime

Corporations or groups must produce, within the time-limit applying to its own income tax return, a list showing the name and address of the registered office of each foreign corporation or group, created or acquired on or after 30 September 1992, which enjoys a privileged tax regime and in which it holds, directly or indirectly, either at least 10 percent of the stock, interest shares, financial or voting rights, or a participation the cost price of which is equal to or exceeds 150 million French francs.

For establishments without any separate legal personality, the head office must provide a document mentioning the place of activity of each of its foreign enterprises.

Accounting and tax documents

The following must be provided to the French tax authorities:
- balance sheet and profit and loss accounts complying with French law;
- balance sheet and profit and loss accounts provided to the local tax authorities, (where such documents must be filed with the local tax authorities);
- a French corporation tax computation. The legal person must draw up a document showing the results of the foreign structure reprocessed so as to be in conformity with the provisions of French tax legislation, (minor deviations from French revenue law are permissable, e.g. certain amortizations or depreciations, proceeds of industrial property, group relief regime, etc.);
- report showing the amount of taxes levied and tax credits that may be offset against the corporation tax owed by the legal person; and
- report of profits taxed and profits distributed. For each foreign corporation, the French company must provide a report showing the aggregate amount of profits subject to taxation under Article 209B and the aggregate amount of distributions received from those corporations.[8]

8. As the adding back of the 5% services charge no longer applies, no double taxation exists on distributions received in the course of fiscal years commencing 1 January 1993. This report shall therefore only deal with the distributions that may not benefit from the participation exemption regime.

Even if they assume that they qualify for the exemption clause, French legal entities subject to corporation tax are nevertheless under an obligation to provide the information mentioned above concerning their foreign entities (the unfairness of this requirement is discussed later in the article).

B. Double taxation relief

1. Method of granting relief

Double taxation relief is available both at the time the income falling within Article 209B is subject to tax and upon distribution of the income via the payment of dividends.

The relief can be given by:
- offsetting against the French corporation tax the local income tax paid;
- an exemption of the profits corresponding to the rights owned directly or indirectly by other French corporations already taxed on the same profits. This rule was set out by the administration in its commentaries dated 15 February 1983. The amendments introduced into the CFC legislation by the 1994 Decree may be expected to be commented on in the future by the tax authorities;
- upon distribution, the offsetting under the relevant treaty provisions, of the foreign withholding tax against the French corporation tax payable. This offset is available only under tax treaties as French legislation does not permit the offset of foreign tax credits in the absence of a treaty.

2. Elimination of double taxation upon distribution of Article 209B profits

Based on the participation exemption regime applicable in France, a possibility exists of distributing dividends without suffering the so-called *précompte mobilier*. Under French law, a tax credit (*avoir fiscal*) equal to half of the dividend attaches to any regular distribution made by entities subject to corporation tax at the standard rate. However, if the income is distributed out of reserves which have been retained for more than five years (even where they were at that time subject to corporation tax at the standard rate) or out of profits which have not been taxed to corporation tax at the standard rate ($33^1/_3$ percent), an equalization tax is levied so as to allow for the avoir fiscal to be granted. The précompte is not due on distributions made out of profits subject to Article 209B.

3. Foreign CFC legislation

As most developed countries also provide CFC legislation (subpart F in the United States, FAPI in Canada, CFC in the United Kingdom, or Außensteuergesetz in Germany), double taxation may occur. The French tax authorities indicated in their Commentaries (Paragraph 79, 15 February 1993) that this should be resolved under the competent authorities procedure.

VII. COMMENTS

Although the new wording gives the French tax authorities more scope, most of the difficulties regarding the application of the legislation remain.

A. Derogation provision

Firstly, it should be kept in mind that French CFC legislation derogates from the normal French principles of taxation. This should mean that the French courts will interpret Article 209B strictly.

In this respect, three issues need to be addressed:
(i) Indirectly held permanent establishments. If a foreign subsidiary is located in a treaty country and owns a permanent establishment in a foreign third treaty jurisdiction, the question arises as to whether Article 209B applies, as the provision aims at permanent establishments directly owned (whether a link is direct or indirect is, from a strict reading, determined by looking at the participation involved). There is no clear-cut answer to this question. If the courts decide to apply a strict interpretation of the Article, it is possible that they will hold that it does not apply to indirectly held permanent establishments. The French tax authorities, however, are likely to contend that Article 209B is applicable at any tier; accordingly, as the income must be determined under French tax rules, Article 209B also applies at the level of the foreign subsidiary. This issue may well have to be resolved before the French courts.

(ii) The interaction of Article 209B and Article 209OA. Foreign Unit Trusts directly or indirectly owned by French corporations (Article 209OA of the CGI). Article 209OA provides that French resident companies holding directly or indirectly shares or interests in French or foreign investment funds (OPCVMs – *Organismes de Placement Collectif en Valeurs Mobilières*, i.e. UCITS) must include each year in their taxable profit any increase or decrease in the market value (*valeur liquidative*) of their participation in the investment fund during that given tax year (mark-to-market rule). As a consequence, unrealized capital gains arising on the fund's assets together with increases in the fund's retained earnings are subject to taxation even where the French taxpayer does not realize any of his investment.

Should Articles 209B and 209OA apply simultaneously, then a risk of double taxation would arise. The tax administration has dealt with an example in which a risk of double taxation appeared to exist due to the potential simultaneous application of Articles 209B and 209OA. Briefly, a French enterprise held a participation in a foreign subsidiary established in a low-tax jurisdiction, which itself held shares in a UCITS. As the foreign subsidiary fell within the scope of Article 209B, the French parent was therefore taxed on its share of the profit pursuant to French domestic tax law: the profit of the foreign subsidiary must be reviewed and computed according to French tax rules, i.e. taking into account the mark-to-market rule of Article 209OA by reason of the holding of shares in an OPCVM by the subsidiary. In addition, Article 209OA theoretically applies to indirect holdings of stock/interests in an OPCVM so that a French company holding a indirect participation in an OPCVM must include each year any increase in value proportionate to its percentage of indirect participation. In the above case, if one takes the view that both Articles apply, then the increase in value of the OPCVM's shares would be taxed twice: once on the basis of the application of French tax rules to the subsidiary's result taxed in the hands of the parent pursuant to Article 209B, and once again on the parent, on a *pro rata* basis on its indirect share of the OPCVM by virtue of Article 209OA.

With respect to this potential double taxation, the French tax administration indicated in a Statement of Practice on Article 209OA that, in the above case, taxation of the increase in value of the OPCVM's shares may apply only once, i.e. upon computing the result of the subsidiaries in conformity with French tax law pursuant to the regime provided for by Article 209B, i.e. the deemed profit would not be separately assessed under Article 209OA.

The foregoing refers to a specific example. However, there may be other cases to consider, e.g. where a foreign entity located in a low-tax jurisdiction is regarded as an OPCVM under Article 209OA. We will not address these issues, contenting ourselves with indicating that arguments exist that may help to prevent this type of double taxation.

A special saving clause whereby the French member of a foreign OPCVM would have been allowed to credit its foreign taxes, if any, levied on the valeur liquidative of its participation in the OPCVM against the French corporation tax levied under Article 209OA, was rejected in parliament upon advice given by the Budget commission: "The risk of double taxation is almost nil. Normally, the applicable rules enable a French enterprise which has borne a final tax abroad on its investment proceeds to offset them against its French tax burden". The case examined looked at a situation where the tax was levied by a foreign jurisdiction and did not deal with the question of domestic double taxation.

Nevertheless, this perhaps indicates that neither the government nor the legislator wishes to tax the same profits twice, since the only reason the amendment was rejected was that a saving mechanism exists already in most cases.

(iii) Domestic tax consolidations. Under French domestic tax law, where a French entity (or French permanent establishment of a foreign company) subject to corporation tax owns at least 95 percent of the rights of a domestic company subject to corporation tax, both companies may elect under certain conditions to consolidate their results for tax purposes (so-called *intégration fiscale*). In their comments dated 9 May 1988 (§ 24 4H-9-88), the French tax authorities indicated that French domestic fiscal unity does not derogate from CFC legislation. The corporate members of a consolidated group are separately subject to Article 209B in respect of the profits derived by their foreign subsidiaries. As the income has not been realized by members of the group, it may not be taken into account when determining their overall taxable income.

B. Compatibility of Article 209B with income tax treaties[9]

It may be argued that Article 209B is not compatible with tax treaties. Under treaty rules, a foreign corporation is subject to French income tax if it owns a permanent establishment in France to which income is attributable. In contrast, Article 209B indirectly facilitates the taxing of a foreign entity in France, even though it has no permanent establishment in France.

The French tax authorities clearly indicated in their comments dated 6 March 1992 that Article 209B is compatible with tax treaties. However, two remarks must be made in this respect :

- the mere fact that the French tax authorities felt a need to comment indicates that the position is not without some doubt;
- the French tax authorities have succeeded in having a specific clause included in the protocol to the France–Mexico tax treaty dated 7 November 1991 (Article 13), in the protocol to the France–Venezuela income tax treaty dated 7 May 1992 (Article I) and in the new France–USA tax treaty of 31 August 1994 (not yet in force) stating that: "the provisions of the treaty cannot avoid the application of 209B". This may be interpreted as a recognition that Article 209B may not be compatible with most tax treaties.

The French tax authorities may argue that it is not the foreign entity which is taxable, but rather the French corporation, as the latter pays the tax. However, the reading of the legislation clearly shows that the profits of the foreign entity are being targeted. The mere fact that the tax is being levied on the French company appears simply to be a mechanism designed to tax a non resident tax payer on foreign profits.

Lastly, the administration may also argue that there is no double taxation as the mechanism of Article 209B provides a means of eliminating such double taxation.

C. Compatibility of Article 209B with EC law

Authors[10] have addressed the issue of whether Article 209B is compatible with EC regulations. The arguments against such compatibility are two-fold:

- Article 209B indirectly restrains the taxpayer's freedom of establishment; and
- it hinders the implementation of EC law.

Here again, the French tax authorities indicated in their ruling of 6 March 1992 that Article 209B is compatible with EC law by specifying that freedom of establishment cannot exclude the application of fiscal anti-evasion rules; they further specified that, on the contrary, the directives on mergers and

9. A. de Waal, "L'article 209 B du CGI: Mythe ou réalité" *Droit Fiscal*, 1991, No. 30; RDAI/IBLJ No. 51994 for the compatibility issue; E. Mouthon RDAI/IBLJ No. 1993.

10. For the issue of compatibility with EC rules, see P. Dibout, *Droit Fiscal*, 1990, No. 44, at 1485.

assimilated reorganizations and on distribution of dividends between parent companies and subsidiaries recognize that such rules, whether domestic or provided under a treaty, are compatible with EC law.

Although the French courts have not yet been involved, one remark may be made: where a tax holiday was set up with the prior approval of European authorities, the courts may be sensitive to the anti-compatibility argument (Dublin IFSC, Madeira International Centre).

D. The concept of privileged tax regime

The concept of the privileged regime as defined in Article 238A of the CGI has been outlined earlier. It should be noted that when making the comparison between tax rates, the taxes being compared must be similar in nature and must take into account the regimes applying to certain types of enterprise, activities or proceeds. Without going into detail, it appears that the recent case law is rather in favour of the taxpayer. Five remarks should be made. First, the favourable regime must be examined on a case by case basis, where it does not derive from a particular fiscal status. Second, in its Commentaries of 15 February 1983, the French administration indicated that temporary exemptions from corporation tax attaching to the setting up of a company carrying on its activity in the local market or to the acquisition of an investment in a foreign country shall not, as a general rule, be taken into account when determining whether the regime is privileged. Third, in a case heard by the Supreme Tax Court, P. Martin, an expert in administrative law, has indicated that what is relevant is the "fiscal profile of the foreign entity", i.e. the way it is run, the purpose of the business and the way the vehicle is subject to tax. This may be of assistance in determining whether Article 209B applies or not. Fourth, what characterizes a privileged regime is the benefit on a permanent basis of advantages which are considered to be definitive. Therefore, as discussed above, Article 209B may not apply to temporary tax breaks. Indeed it is also possible that Article 209 may not apply where the tax saving is merely potential, i.e. not guaranteed. Fifth, since the comparison must be with comparable French regimes, it should be noted that France does recognize a number of tax-exempt regimes: new companies (3-year exemption), so-called DOM-TOM investment companies (allowance on certain investments made in overseas departments), 10-year tax holidays for certain depressed zones (Dunkirk, La Ciotat ... even though this regime is ending).

E. The concept of local market

The local market is not defined in the legislation. A strict interpretation would be that local means the state or territory within which the foreign entity is established. However, this would in certain cases be too narrow a view. Although no case law exists in this respect, local market should also aim at a geographic area which shows an economic consistency.[11]

For instance:
- French trading companies are established in Hong Kong to carry on business in Hong Kong and its surrounding area; or
- a French company may establish its business in a TOM (French overseas territory) in the Caribbean Basin to deal locally with various islands.

Indeed, the tax authorities indicated in March 1992 that the local market includes, in principle, the state or the territory within which the entity is established. However, it further specified that this notion may be enlarged to zones in the close neighbourhood of the state or the territory when such zones, as regards economic and geographical features, are part of the same market. It is, however, thought likely that the tax authorities may reconsider their position and opt for a strict interpretation of the local market concept.

The question also arises as to whether the European Market may on the basis of the Single Act[12] be regarded as local.

F. Filing requirements provided by the Decree

The fact that the decree of 1994 provides that French corporations still have to file some documentation with the tax authorities, although they have no tax liability under Article 209B because they carry out their main commercial activity locally should be questioned. Although we do not propose to examine this issue in detail, it appears odd to provide for an obligation in connection with an income which is not subject to tax. In particular from a practical viewpoint, it places an unfair burden on a minority French shareholder who may not be able to obtain access to the required information.

G. Conclusion

In conclusion, it appears that French CFC legislation is a sensitive area. As the provision was enacted in 1980 and no court case whatever has yet been published, it is likely that it may be some time before the more significant issues are resolved. It will only be then that the precise scope of the provision will be determined.

The battle between the French tax authorities and the taxpayer is now likely to begin in earnest. This is because the French tax authorities consider that, with respect to entities established in treaty countries, the weapon, honed by the two amendments, is now effective. Fortunately, as outlined above, the taxpayer has arguments!

11. Pierre-Jean Douvier, *Bulletin Fiscal*, 1991, No. 10, at 626, paragraph 21.
12. See also P. Dibout, *Droit Fiscal*, 1994, No. 11, at 478.

WAIVERS AND SUBSIDIES BETWEEN COMPANIES FRENCH CORPORATE INCOME TAX AND VAT ISSUES

Philippe Juilhard and Anne Grousset

London - Bureau Francis Lefebvre - Paris

This article analyses the French tax treatment of waivers of debts in the light of recent important developments in the fields of both corporate income tax and VAT.

I. CORPORATE INCOME TAX

Under French law a waiver of debt is characterized by a combination of the following two elements:
- a material element, being (i) the existence of an asset recognized in the accounting records of the creditor company matched with a liability in the books of the debtor, and (ii) the subsequent crystallization of a loss by the creditor as a result of its waiver together with the realization of a matching profit in the books of the debtor;
- an intentional element being the creditor's intention in granting the waiver.

In contrast, subsidies, do not result in either the writing off of a debt by the grantor, or in the cancellation of a debt by the beneficiary. They have nevertheless the same economic effect as a waiver, since both waivers and subsidies amount to financial support offered by one company to another.

For French corporate income tax (CIT) purposes the loss resulting from a waiver or a subsidy is, as a general rule, a deductible expense for the company which grants it and a taxable profit in the hands of the beneficiary. Accordingly, the waiver granted by the creditor necessarily implies a reduction in the liabilities of the debtor and, as a corollary, an increase in its net assets and profits under Article 38-2 of the Code Général des Impôts (CGI)[1].

For a waiver to be tax deductible, it is necessary that the two conditions set out below are met:
- the waiver must be a normal business management decision, i.e. the companies must in principle be related;
- the waived debt must not increase the value of the shares of the beneficiary company in the hands of the grantor.

After having reviewed these limitations, i.e. normal and abnormal transactions (A.), commercial and financial waivers (B.), we will address the peculiarities of waivers and subsidies in an international context and the potential conflict with the French territorial principle of CIT.

Before addressing these issues it is important to mention a special type of waiver in France: the *abandon de créance avec clause de retour à meilleure fortune*. In granting the waiver the grantor may insert a condition whereby, although cancelled, the debt may under certain circumstances be reinstated at a later time if the beneficiary is in a better financial situation (*meilleure fortune*). In such a case the waiver will define the conditions under which the beneficiary may be considered in *meilleure fortune*. From both the accounting and the tax standpoint such *abandons de créance avec clause de retour à meilleure fortune* are treated as a straight waiver and, subject to the detailed analysis hereunder, the grantor recognizes a loss and the beneficiary a profit. The only modification in accounting treatment required is that the potential obligation be mentioned in the Appendix to the balance sheet. Such waivers are often used within groups of companies for tax planning of losses, since the waiver will utilize the losses of the beneficiary which could otherwise expire, but will leave the grantor with a conditional possibility of ultimately recovering its debt if the subsidiary eventually becomes financially sound (as defined in the waiver).

A. Normal and abnormal transactions

The tax treatment of subsidies or waivers first depends on whether or not the transaction constitutes a normal transaction. To obtain a tax deduction the creditor must be able to demonstrate that the transaction was normal.

The general principle is that a transaction is considered to be normal, when the waiver or the subsidy has been granted in the interest of the business of the creditor, who then receives a true and sufficient quid pro quo for what would otherwise appear to be a gift. In this regard, the mere fact that the creditor has a legal relationship with the beneficiary (e.g. a parent-subsidiary relationship) does not by itself establish that the transaction is "normal". The question as to whether a particular transaction is normal is, in essence, a question of fact. The following examples taken from case law illustrate this point.

1. Normal transactions

The following transactions have been held to be normal:
- subsidies granted by a parent company to its subsidiaries, where the parent company could hope that the subsidiaries would overcome their financial difficulties despite having a history of loss making;[2]
- subsidies granted by a company to its suppliers, where the granting company holds directly or indirectly the share capital of the said suppliers and imposes on them manufacturing standards and prices;[3]

1. Documentation Administrative 4A 243, No. 7, 1 March 1986; Conseil d'Etat (CE) 6 October 1941, No. 69561, Sec. 8; CE 29 January 1965, No. 62567, Sec. 9 Dupont 1965, at 230.
2. CE 12 July 1978, Nos. 2138 and 2769.
3. CE 16 February 1983, No. 37868.

– a partial waiver granted by a parent company to its subsidiary in order to allow the latter to remain in business, to maintain the reputation of the group and its position in the pharmaceutical field;[4]
– a waiver by a parent company to a subsidiary to enable it to stay in business, thus helping to maintain the good reputation of the group, notwithstanding the fact that the parent could have achieved the same end result by means of an additional capital contribution to the subsidiary;[5]
– waivers and subsidies granted by a company, to a subsidiary and to a sister company, when these transactions were designed to overcome the financial difficulties of the beneficiaries, thereby allowing the paying entity to keep its commercial networks.

2. Abnormal transactions

The following transactions have been held to be abnormal:
– regular waivers or subsidies which would result in reallocating, in the hands of the parent company, the losses incurred by certain foreign subsidiaries, thus optimizing the allocation of profits and losses among members of a group of companies. Here the implication would be particularly strong if the beneficiary was located in a country which had a privileged tax regime.
– the *ab initio* waiver of financial advances which were not granted during the course of the normal business management of the grantor company.[6]
– subsidies granted by one company to others when such subsidies could not be justified under the circumstances and the conditions under which they were implemented were not in accordance with commercial usage.[7]

From this list, it appears that the circumstances surrounding the transaction are of paramount importance and that no definite demarcation exists between what constitutes a normal waiver and what constitutes an abnormal one.

B. The distinction between commercial and financial waivers

The distinction between commercial and financial waivers is fundamental to the tax treatment of waivers in France.

The nature of a waiver may be ascertained by undertaking a comprehensive analysis of all the relevant factual or legal elements at the time the waiver is granted. Among the relevant factors are the nature and the amount of the waiver, and the relationship, past or present, between the debtor and the creditor.

The characterization of a waiver obviously does not raise too much difficulty when all relevant information leads to the same conclusion, as to whether the waiver is commercial or financial in nature.

A waiver may be classified as commercial where it is grounded in the commercial relationship of the two companies, for example when the objective of the waiver is to secure a point of sale for the products of the creditor, or when it is to secure a source of raw materials required by the creditor. By contrast, a waiver may be held to be financial where all the relevant features are financial. This would be the case for instance where the nature of the debt is financial (e.g. a loan), the companies involved do not have any commercial relationship and the motives for the forgiveness are strictly financial.

The characterization of the waiver may be difficult to determine when it embodies both commercial and financial features. This is particularly the case where the benefit granted is a general subsidy, and the relationship between the creditor and debtor is both commercial and financial (e.g. in a parent-subsidiary relationship). In such circumstances the nature of the waiver must be determined on the basis of the motives that lead to the waiver.

The motive test mentioned above is illustrated in the following examples.

Waivers held to be commercial:
– the waiver by a French company of all its claims against its German subsidiary even though the parent company owned 97.6 percent of the share capital of the German company. This was because the waiver was aimed at avoiding the winding up of the German company, which would have impaired the development of the activities of the French company in Germany;[8]
– successive subsidies granted by a Swiss company to its French subsidiary, to enable the latter to continue its commercial activity marketing the products of the Swiss parent in France;[9]
– the subsidies granted by members of an Economic Interest Grouping (GIE), where they bore no relation to their membership of the GIE being aimed at increasing the sales of the GIE.[10]

In contrast the following types of waiver have been considered to be essentially financial:
– the waiver by one company to another that was intended to effectively put an end to the commercial relationship they used to have;
– the waiver granted by a parent company to a subsidiary in the absence of a substantial commercial relationship between the entities. In this respect it should be noted that the fact that the parent company, or any other group company, performs general group services does not of itself amount to substantial commercial relations for the purpose of characterizing the waiver.

1. Commercial waivers

Provided the waiver is considered to be "normal" (see A. above), a commercial waiver is a deductible expense for the grantor. The expense must be recognized at the time the waiver is granted.

4. CE 13 July 1978, No. 3094.
5. CE 30 April 1980, No. 16253, also CE 27 November 1981, No. 16814.
6. CE 7 November 1979, No. 6188; CE 14 May 1980, No. 9259.
7. CE 12 July 1978, Nos. 2138 and 2769.
8. CE 27 November 1981, No. 16814.
9. CE 25 July 1980, Bulova No. 11169.
10. CE 9 January 1981, Total Gaz No. 10164.

For the beneficiary the waiver amounts to a taxable profit. Under Articles 38-2 and 209 I CGI corporate profits are determined by the difference between the net assets at the close of the financial year and those at the opening of that year. Since a waiver necessarily reduces the liabilities of the beneficiary, this automatically results in an increase in its net assets and profits.

In the case of waivers falling into the category of *abandon de créance avec clause de retour à meilleure fortune* the tax treatment is the same. Where *retour à meilleure fortune* occurs as defined in the waiver, the debt is reinstated and the beneficiary recognizes an expense which is fully deductible. Upon repayment the grantor must recognize a taxable profit. It should be noted that the repayment will only be allowed as tax deductible in the hands of the original beneficiary, if the waiver was granted under a subsequent condition of *retour à meilleure fortune*, i.e. normally the repayment of a debt which has been waived would not be deductible being a mismanagement decision.[11]

2. Financial waivers

(a) *For the creditor*

General principles

In the case of financial waivers, the extent of the deduction may not exceed:
- the negative net asset value of the beneficiary, and
- where the net asset value becomes positive as a result of the waiver, the proportion that represents the percentage of the share capital of the beneficiary company held by companies other than the shareholder granting the waiver. Above the break even point the waiver is, for the parent grantor, treated as an additional cost of the shares in the subsidiary.

Example:
Company A owns 90 percent of the share capital of company B. Company B has assets of 500 and liabilities of 600, i.e. a negative net asset value of 100. Of the 600 liabilities, B owes 200 to A. If A waives its 200 loan *vis-à-vis* B, A is not entitled to deduct the full sum waived, but only :

– the amount of the waiver up to the break even point:	100
– above the break even point, only to the extent of the shareholding of the other shareholders 100 x 10 percent	10
Total deduction:	110

The remainder of 90 is an additional cost of the participation of A in B. Accordingly, after the waiver B has a positive asset value of 100 and if B shares are sold at the net assets value, A will receive 90 and the other shareholders 10.

The grantor of the waiver is entitled to establish that the actual net asset value of the beneficiary is in fact lower than the book net asset value. It is for him to prove that there is a substantial discrepancy between the book and the true value.[12] By contrast, the tax authorities are authorized to establish that the book net asset value is substantially lower than the true net asset value of the beneficiary and to draw the necessary consequences as regards the deductibility of the waiver for the grantor. This may be the case for example where assets pregnant with capital gains would allow the negative book net asset value to be compensated for to the extent of the debt waived. The tax authorities are, however, instructed to use this possibility only in situations where the discrepancy is obvious and material.

For the purposes of this evaluation the net asset value should, in principle, be determined on the date the waiver is granted. However, when such information is not available the closest interim balance sheet or the closest yearly balance sheet are acceptable.

In the case of waivers with *clauses de retour à meilleure fortune* the same restrictions apply at the time the waiver is granted. In the event of subsequent repayment, the grantor is only taxable to the extent of the waiver which gave rise to the deduction in the first instance.

Waivers to foreign corporations

When the waiver is granted to a foreign company, the French company must take into account, when determining the extent of the deductibility, the net asset value of the foreign entity as it is defined under the relevant foreign legislation.

The French tax authorities may use the administrative assistance procedure when the beneficiary is located in a treaty country and the relevant treaty provides for such a procedure.

The French tax authorities take the position that a waiver granted by a French company in favour of a company located in a country with a privileged tax regime is not tax deductible.[13]

For these purposes a privileged tax regime is one under which a company is not taxed or is subject to CIT at a substantially lower rate than would apply in France. In practice, the tax authorities consider that a tax regime is privileged where the amount of tax levied in that jurisdiction is one third less than the rate of taxation that would otherwise be imposed in France.

This administrative position may be challenged since it is not grounded in French legislation and conflicts with Articles 57 and 238 A CGI. These Articles address the question of the transfer of profits abroad and specifically the restriction on deductibility for payment to countries which have a favourable tax regime. None of these provisions actually provides for a straight disallowance, even if the waiver is granted to a company located in a tax haven country. A reassessment under Articles 57 still requires that the tax authorities prove the transfer of profits and Article 238 A CGI only puts the burden of proof on the company. This will be further addressed in C. hereunder.

(b) *For the debtor*

From the beneficiary's viewpoint the waiver is, in principle, a taxable event, irrespective of its nature, subject to the relief

11. CAA Paris 6 July 1993, No. 91-997.
12. CE 30 April 1980, No. 16253, *RJF* 6/80 No. 467.
13. Inst. 22 August 1983, 4A 7 83.

contained in Article 216 A CGI. Financial waivers are therefore in principle taxable upon the beneficiary.

Article 216 A CGI stipulates that a financial waiver granted by a parent company (qualifying under Article 145 CGI) in favour of its subsidiary may in certain circumstances not be taxable on the subsidiary, to the extent that the parent company did not obtain a tax deduction. This relief is conditional upon the beneficiary undertaking to increase its share capital in favour of the parent company before the close of the second financial year following the waiver, in an amount at least equal to such a waiver. Failure to comply with any of the above conditions triggers the taxation of the waiver. The gain will crystallize at the date the waiver was granted, thus raising the spectre of interest charges becoming payable in respect of tax paid late.

It should also be noted that, before 1982, the year in which Article 216 A CGI was introduced into French tax law, the language of certain case law militated in favour of the non-taxation of financial waivers. The rationale behind this was the fact that, since they were to be treated as additional capital contributions by the creditor, they should not be taken into account as taxable income of the recipient.

In the event of repayment of an *abandon de créance avec clause de retour à meilleure fortune*, the repayment is deductible to the extent of the amount taxable in the hands of the debtor at the time of the waiver.

C. The territoriality principle

French corporate income tax is based on a strict territoriality principle, under which profits subject to CIT, are determined by taking into account only the profits realized by enterprises operating in France.[14] Under this principle French companies operating abroad are not subject to CIT on their foreign profits and, as a corollary, losses incurred abroad may not be offset against French profits.

When the waiver is granted by a French company to a foreign company, the deductibility of the transaction in France effectively results in the foreign losses being utilized in France.

Assume that the balance sheets of a French parent company and its foreign subsidiary are as follows:

FrCo				Sub			
Assets	100	Capital	50	Assets	20	Capital	60
Debt Sub	90	Profits	100	Debt	20	Loss	(100)
Cash	10	Liabilities	50	Cash	10	Debt Fr Co	90
	200		200		50		50

The decision by FrCo to waive its debt *vis-à-vis* Sub would lead to the reduction of FrCo's profits from 100 to 10 with a corresponding reduction in the losses of Sub from (100) to (10). The balance sheets of the two companies after the waiver would be as follows:

FrCo				Sub			
Assets	100	Capital	50	Assets	20	Capital	60
Cash	10	Profits	10	Debtor	20	Loss	(10)
		Liabilities	50	Cash	10		
	110		110		50		50

This example shows that the waiver of the 90 debt results in the utilization of Sub's losses by the FrCo. I.e. if FrCo is authorized to deduct the waiver, its profits will fall from 100 to 10.

The *Conseil d'Etat* (French Administrative Supreme Court) originally took the position that French companies could not deduct waivers granted to their foreign subsidiaries on the basis of the territoriality principle of CIT.[15] The Conseil d'Etat considered that French companies that have not been specifically authorized to consolidate their worldwide income (Article 209 quinquies CGI) should not be allowed to deduct, on a permanent basis, the losses of their foreign activities. It was, however, recognized that French companies could, in exceptional circumstances, grant support to their foreign branches or subsidiaries and deduct the expenditure incurred in France, when such support was a normal business decision and did not result in an increase in the value of the shareholding held in the foreign subsidiary.

The Conseil d'Etat gradually overruled the previous case law, first recognizing that waivers were deductible to the extent that they were granted for commercial reasons. The first leading decision dates back to 1987.[16] In this instance a French parent company met the cost of salaries of certain employees seconded to its Swiss subsidiary. The Conseil d'Etat considered that although this type of arrangement could be considered a transfer of profits from France to Switzerland under Article 57 CGI, the French company could nevertheless establish that the transfer was a normal business decision with sufficient quid pro quo. The Conseil d'Etat held that the French company met the necessary prerequisite in demonstrating that the waiver allowed it to achieve its commercial aims in Switzerland by maintaining the Swiss subsidiary in a reasonably sound financial condition. This was necessary to safeguard and develop its market share in Switzerland. Following this judgement, the tax authorities expressly recognized that such a waiver by a company would be deductible in France, provided it was a normal business decision and that the French company received sufficient quid pro quo.[17]

In February 1994, the Conseil d'Etat expressly extended this principle to financial waivers.[18] This development came as no surprise since it was already implicit in a 1991 decision.[19]

In 1991 the Conseil d'Etat was faced with a situation where a French company, SA Goupil, waived certain of its debts and gave non-interest-bearing advances to its German affiliate. This action was taken with a purely financial motive, to eliminate the losses of the subsidiary, the subsidiary having no material role in the marketing of the products manufactured

14. See Philippe Juilhard, "Corporate Income Tax: Recent developments in the French territorial approach", 49 *Bulletin for International Fiscal Documentation* 3 (1995), at 107.
15. CE 14 March 1984, No. 33188, Secs. 7 and 9; *RJF* 5/84 No. 590; CE 20 December 1985, No. 46390, Secs. 9 and 8, *RJF* 3/86 No. 266; CE 15 October 1986, Nos. 39415-40744, Secs. 7 and 8, *RJF* 12/86, No. 1066.
16. CE 30 March 1987, No. 52754 Plen *RJF* 5/87, No. 489.
17. Rép. Oudot *AN* 7 September 1987, at 5012, No. 25533.
18. CE 11 February 1994, No. 11 9726 Secs. 8 and 9 SA les Editions JC Lattes *RJF* 4/94, No. 396.
19. CE 9 October 1991, Nos 67642 – 69503, Secs. 7 and 9 SA Laboratoires Goupil *RJF* 11/91, No. 1355.

by Goupil. The Conseil d'Etat held that, since the company failed both to prove it had a direct interest in making good the losses of the subsidiary and to demand the repayment of the advances, Laboratoires Goupil had no right to deduct either the waiver or the bad debt provision made in respect of the advances.

By rejecting the deduction of the financial support on the basis of the lack of a direct interest on the part of the parent company, rather than on the basis of the territoriality principle, the Conseil d'Etat implied, in departing from prior case law, that financial waivers could also be deductible in France if such an interest was present.

This implicit conclusion was confirmed by the 1994 decision where the Conseil d'Etat held that the Court of Appeal could not refuse the deduction of a bad debt provision on advances granted by a French company to its foreign subsidiary, solely on the grounds that such actions had only a financial motive. The Conseil d'Etat further held that it was essential to determine whether the transaction was a normal business decision for the benefit of the French company. Finally, the Conseil d'Etat held that the Court of Appeal misapplied the territoriality principle as it resulted from Article 209 CGI.

Two conclusions may be drawn. Firstly, that financial support, whether made for commercial or financial reasons, or whether granted to a French or foreign subsidiary, is subject to the same tax treatment. It should, however, be noted that the deductibility of support granted to foreign subsidiaries may come under closer scrutiny, since the resulting taxable income for the subsidiary will be outside the scope of French CIT, as will the future profits of the subsidiary. In terms of a purely domestic transaction there is indeed a perfect match between the deductibility of the waiver and the taxation of the corresponding profit in the hands of the beneficiary, the only potential tax benefit being the timing of the deduction and the tax planning opportunities *vis-à-vis* the loss utilization rules in France. In an international context, however, the scope for tax avoidance may be even more pronounced, depending on the taxation position of the beneficiary (revenue v. capital).

Secondly, the same rules govern the deductibility of both commercial and financial waivers, namely that the transaction results from a normal business decision which furthers the interest of the grantor. The only distinction that remains between the two forms of support is the extent of the deduction. While commercial waivers are fully deductible provided the prerequisite conditions are met, financial waivers are only deductible to the extent of the negative net asset value of the subsidiary. Any excess above the break even point is considered to be an additional capital contribution, *pro rata* to its shareholdings, and is therefore not a deductible expense.

II. VAT

Traditionally, the Conseil d'Etat and the French tax authorities used to make the same distinction between commercial assistance and financial assistance, for both VAT and CIT purposes.

In 1988 the European Court of Justice in the Apple and Pear Development Council case[20] defined the scope of VAT and specified that economic operations performed by entrepreneurs fall within the scope of VAT if they are made in exchange for consideration. However, until 1990 the French Administrative Courts maintained their traditional interpretation and only from 1990 onward did the Conseil d'Etat abandon its traditional analysis of commercial and financial transactions, henceforth considering that a deal should only be subject to French VAT if it comes within the scope of VAT and is carried out in return for payment.

This change in case law has recently led to the French tax authorities commenting on these court decisions and to set out the consequences of non-taxation of such proceeds, with regard to the deductibility of input VAT and the payroll tax (*taxe sur les salaires*).

A. The pre-1990 approach

Under the traditional approach, the classification of subsidies or waivers was dependent upon an examination of all the legal elements and facts collected at the time the assistance was granted, e.g.:

- the nature and amount of the debt waived or of the subsidy granted;
- the relationship between the creditor and the debtor;
- the true motives behind the agreement to grant the assistance.

The principles of characterization of subsidies and waivers for VAT purposes were thus essentially the same as for CIT purposes and *mutatis mutandis* the comments and examples in B. above also applied in the VAT context.

If the assistance appeared to be normal and was granted on commercial grounds, it was said to have remunerated a "specific" service rendered to the creditor by the debtor, and was, in principle, subject to VAT. However, when the grantor was a foreign company which did not operate in France it could obtain a refund of the French VAT under Article 242-OM Ann. II CGI (8th Directive).

In the case of *abandon de créance avec clause de retour à meilleure fortune* the repayment allowed the beneficiary company to offset or claim back under Article 272-1 CGI the VAT paid at the time of the waiver and the grantor receiving repayment had in turn to repay the VAT. The reasoning behind this treatment was that as the service was cancelled, the tax position of the parties had to be returned to that which had existed prior to the waiver. It should, however, be noted that when the repayment was made in favour of a foreign entity the French company could not recoup the VAT originally paid.

If the type of assistance appeared to be financial or resulted from an abnormal management act (*acte anormal de gestion*)[21], it was exempt from VAT. However, the amounts

20. ECJ 8 March 1988, case No. 102/86.
21. As such not deductible for CIT purposes.

involved were not taken into account in the calculation of the *pro rata* deduction.

B. Apple and Pear Development Council and the French interpretation in the Comité pour le développement du Choletais case.

In the Apple and Pear Development Council case the European Court of Justice considered the meaning of the terms "operations made for consideration" defined in Article 2 of the 6th EC Directive. According to the Court, an operation falls within the scope of VAT if there is a direct link between the services rendered and the consideration received. Applying this principle, the Court held that a body established by statutory instrument, whose functions related essentially to advertising and the improvement of the quality of apples and pears and which was financed by an annual charge imposed on growers, did not carry out operations falling within the scope of VAT. This was because the charges imposed on the growers did not constitute consideration having a direct link with the related benefits accruing to individual growers.

Influenced by this European decision, the Conseil d'Etat has implemented these principles in the Comité pour le développement du Choletais case[22] heard in 1990.

Here, the Court had to determine whether a legal entity, having public interest functions in the agricultural field and financed by a tax imposed on growers, performed operations falling within the scope of VAT. The Court held that this entity did not perform taxable operations falling within the scope of VAT as the tax imposed on the growers did not give the growers a right to the services rendered to them. The Conseil d'Etat underlined the fact that there was no direct link between the amount of the tax paid to this entity and the benefits received by the growers as a result of the Committee's functions.

This principle contained in the first French court decision on the "direct link principle" questioned the traditional jurisprudence of the Conseil d'Etat. The principle has rapidly been extended to VAT matters relating to the scope of VAT. In particular it has been applied to waivers and subsidies between companies.

C. The CODIAC case

The Conseil d'Etat, in the CODIAC[23] case heard in 1990 reversed its previous case law and held that a subsidy received by an entity is subject to VAT, only if it constitutes the counterpart for a transaction.

The CODIAC was a Committee created by a City and a Chamber of Commerce. The aims and object of the CODIAC were to study and to promote the economic expansion of the area. For this purpose, the CODIAC assisted companies and towns, and undertook promotional activities, etc. As the CODIAC did not raise invoices for its services either to the companies or to the towns, those operations were financed through subsidies paid by the City and the Chamber of Commerce.

The Conseil d'Etat considered that the contributions paid in accordance with the general action plans of the Committee, did not relate to services rendered directly either to the City or to the Chamber of Commerce and that there was no link between their payment and the benefits received by the City and the Chamber of Commerce.[24]

By referring to a transaction made in consideration for payment, the Conseil d'Etat referred to the "direct link" concept, specifying that a transaction is only carried out in return for payment, if there is a close and direct link between the actual carrying out of a distinct transaction and the payment received.[25]

The application of the direct link principle is not restricted to subsidies received from public bodies. Indeed the administrative courts very quickly extended the scope to cover subsidies received by commercial or industrial enterprises from their parent or sister companies.

Henceforth, the administrative courts no longer examined the motives behind the waiver or the payment of a subsidy, when determining its taxability, looking instead for the existence of consideration given in return for the assistance, consisting of the direct or distinct provision of a service supplied to the entity granting the assistance.

Thus, it was decided that a subsidy paid by one company to a sister company in financial difficulty, was not within the scope of VAT, as it did not amount to consideration paid in respect of the provision of a service. This was so even though the company granting the subsidy had an inherent commercial interest in safeguarding its sister company's activities.[26]

The significance of this new case law led to the French tax authorities modifying their doctrine concerning the treatment applicable to assistance granted between enterprises. Thus, in a regulation dated 8 September, 1994[27], the tax authorities officially withdrew their previous interpretation and abandoned the distinction between commercial and financial subsidies. Now in order to determine the VAT regime applicable to subsidies granted, it is necessary to refer to the principle defined in Article 2 of the sixth EC Directive and to examine whether the subsidies are received in consideration for a service rendered to the grantor or not.

22. CE 9 May 1990, No. 82611.
23. CE 6 July 1990, No. 8824 CODIAC *RJF* 8-9/90 No. 989.
24. Interestingly, the Conseil d'Etat also referred to the absence of a direct link between the subsidies from the City and the Chambre de Commerce and the services rendered to such bodies to hold that CODIAC was not subject to corporate income tax, CE November 1990, No. 88226 Secs. 7 and 8 CODIAC; *RJF* 1/91 No. 36. In the same instance the court held that it was liable to CIT for the tax year where it prepared a report for a city and was remunerated for the work.
25. On the "direct link" see also CE 10 July 1991, No. 61575 Secs. 8 and 9 CCI de Perpignan et des Pyrénées orientales; *RJF* 10/91 No. 1215, CAA Paris 7 May 1992, No. 343, 3rd ch. SARL Informations juives/Le journal des Communautés *RJF* 8-9/92 inf. 147.
26. CAA PARIS 21 February 1991, No. 2606, SECIP *RJF* 4/91, No. 420.
27. Inst. 8 September 1994, CA-3-94.

D. The new rules defining the VAT treatment applicable to assistance granted between companies

In order to determine the VAT treatment applicable to assistance, it is now necessary to follow the analysis below.

Determine whether the company receiving the assistance is providing a specific service to the company granting the assistance. The provision of a service is qualified by the existence of obligations undertaken by the beneficiary. According to the French Revenue, the following examples do *not* constitute remuneration for the provision of a service:
- subsidies paid by a parent company to its subsidiary to enable the latter to finance a redundancy programme;
- subsidies paid by the members of a "partnership" responsible for commercializing wine production in order to balance the partnership's accounts, provided that the services rendered do not amount to the provision of specific services for the benefit of the individual partners, and that the payment has the sole purpose of balancing the partnership's accounts.

If a specific service is not being provided, it is necessary to establish whether the assistance constitutes the remainder of the price of the taxable transaction. It should be noted that the remainder of a price is not clearly defined by the tax authorities, who appear to consider that balancing subsidies (covering a deficit) constitutes the remainder of a price, provided that it is paid in accordance with a prior undertaking, either express or implied.

If the assistance is not remunerating a specific undertaking and does not constitute the remainder of the price of a taxable transaction, then it is exempt from tax.

It should be noted, however, that none of the case law decisions quoted by the tax authorities, has looked at whether the assistance received by the beneficiary companies constituted the remainder of a price. It is unlikely that a straightforward subsidy constitutes the remainder of a price. However, when the beneficiary company has agreed to certain pricing commitments which are compensated for by the subsidy, the position is far from clear. It remains to be seen whether the tax authorities intend to extend this principle to cases where a parent company is keeping its French subsidiary solvent with waivers of debts or the granting of subsidies.

E. Implications with regard to deduction rights and the payroll tax

The receipt of subsidies subject to French VAT does not alter the computation of the VAT right to deduction. This is in contrast to the adverse consequences that arise where the subsidies are not subject to French VAT. In addition to the direct VAT implications, subsidies also have an impact on the applicability of the payroll tax (see below).

1. Reduction in the deduction rights

Where the granting of assistance in the form of a waiver or subsidy is not subject to VAT, the beneficiary's deduction rights are reduced accordingly. The reduction is made on a *pro rata* basis. The application of this restriction can have very harsh consequences: for example, where a company in financial difficulty receives a subsidy from its parent company, its deduction rights may be reduced *pro rata* to the subsidy received, even if, given its business activity, it should, in principle, have a right to deduct input VAT in full.

To lessen the harmful impact of the *pro rata* restriction, the tax authorities accepted in their regulation of 8 September 1994, that "exceptional" subsidies do not need to be taken into account in computing the restriction.

The tax authorities insist on a strict interpretation of the term "exceptional subsidy". According to the tax regulation, the subsidy must not be recurring, it must be granted to finance a precise expense or support a specific undertaking, and the amount of the subsidy may only be accessory (i.e. of secondary financial importance) in relation to the normal receipts of the company.

The tax authorities have indicated that they consider exceptional:
- subsidies granted in the context of industrial restructuring;
- waivers made in exceptional cases to a company in difficulty by a company from the same group or by a financial institution.

This illustrates that the tax authorities are likely to place a narrow construction on the dispensation.

A further problem effecting the application of the dispensation is that the meaning of key phrases used in the dispensation has not been defined:
- what constitutes a "recurring" subsidy? Could it be that only subsidies given several times in a single year are caught or do subsidies paid for several consecutive years also fall within the meaning of this term? In this regard the interpretation of the Conseil d'Etat of the phrase "repetitive subsidies" although made in the context of direct taxation may be relevant. The Court had in the past considered that repetitive waivers granted by French parent companies to their foreign subsidiaries could not be regarded as deductible charges as far as they were not exceptional. The Conseil d'Etat held that in order to be exceptional, these payments had to be made only occasionally and for limited term. In another decision, the Conseil d'Etat considered that the financial assistance granted by a parent company to its subsidiary was not exceptional as it had been granted for six years[28]. It reached the same conclusion where financial assistance by a parent company to its subsidiary was made in the period from 1966 to 1972 through various means[29].
- what is meant by "accessory"? The tax authorities do not indicate what accessory means, although it seems to refer to the normal quantum of receipts of the company.

The tax authorities have not commented upon the meaning of these key concepts.

28. CE 15 October 1986, No. 39 415.
29. CE 20 December 1985, No. 46 390

Overall it is, however, questionable whether the *pro rata* should not only apply when the beneficiary, although within the scope of VAT, is subject to different VAT regimes for different types of activities. This question is likely to be raised before the courts.

A recent instruction[30] from the tax authorities confirms that the contribution by a member of an integrated group[31] to the parent company to compensate the latter for the tax borne on its behalf is not subject to VAT provided it is paid under a valid agreement between the parent and the subsidiary and is made solely in respect of the tax paid by the parent company on its behalf. All other subsidies must be taken into account when determining the denominator of the VAT *pro rata*.

2. The liability to payroll tax

(a) *Mechanism of the payroll tax*

In principle, employers who have a permanent establishment in France or who are domiciled in that country are liable to the payroll tax.

Most employers are nonetheless exempt from the payment of this tax, as a general exemption provides that employers subject to VAT in relation to at least 90 percent of their turnover are not liable.

Therefore employers subject to VAT on less than 90 percent of their turnover are taxable. The tax is calculated by reference to the total wages paid (gross income). The tax rate is set out below:
- 4.25 percent on wages up to FF 32,800
- 8.50 percent on wages between FF 32,800 and FF 65,600
- 13.60 percent on wages exceeding FF 65,600.

Employers subject to the payroll tax owe the tax proportionally to their non-vatable turnover. Before the SATAM case and the 1994 finance law[32], this proportion of taxation was the converse of the VAT *pro rata*, for example a company which had a deduction *pro rata* of 80 percent had a 20 percent (100-80) payroll tax liability. Companies which considered under the SATAM case that dividends had to be excluded from their VAT deduction *pro rata* calculation excluded those dividends from their payroll tax *pro rata*. The SATAM case therefore could have had a favourable effect both on the VAT *pro rata* and on the payroll tax liability.

(b) *Consequences of the SATAM case on the payroll tax*

As a result of the SATAM[33] case, under which it was held that the dividends received should be excluded from the computation of the *pro rata*, the tax authorities considered that the payroll tax *pro rata* should be disconnected from the VAT *pro rata*, and Article 231 CGI[34] was subsequently amended accordingly. Under the new version of this provision the turnover taken into account for the *pro rata* of payroll tax includes not only the turnover within the scope of VAT, but also all receipts and proceeds, which fall outside the scope of VAT (e.g. dividends, subsidies, etc.).

Following the rationale for the exclusion of exceptional subsidies from the VAT *pro rata*, the tax authorities have, however, excluded the same from the payroll tax *pro rata*. New regulations on Article 231 have been published incorporating the same restrictions as apply to VAT.

It must be emphasized that these changes apply retrospectively.

Thus, if a subsidy does not qualify as exceptional, the recipient will, in addition to the effect on the deductible VAT, have to bear the payroll tax on the remuneration paid to the employees in proportion to the turnover *pro rata*, taking into account the subsidy.

30. Inst. 29 June 95, 3D-7-95.
31. Under the French integration regime a corporation holding, whether directly or indirectly, not less than 95% of another entity subject to corporate income tax, may under certain circumstances elect to be liable for the corporate tax owed by reason of the income of the entire group.
32. See hereunder.
33. CE 18 March 1994, No. 61379.
34. Finance Law No. 93 1353 of 30 December 1993 (Article 18).

FRENCH HEADQUARTERS AND INVESTMENT INCENTIVES: A COMPARATIVE ANALYSIS

Jack Anderson

Partner, Ernst & Young, Paris

I. INTRODUCTION

The fact that the sales last year by foreign affiliates of multinational companies ("MNCs") of US$ 5.8 trillion exceeded world exports by US$ 1.1 trillion demonstrates the importance of foreign direct investment and of the headquarters choice made to manage these sales (and the trade) on an organizationally re-engineered and regional basis. Foreign direct investment continues to grow at an annual pace of over US$ 200 billion, with developing countries taking one-third of this total in 1994. A recent Ernst & Young study of *US Manufacturing Foreign Direct Investment* shows a majority of the investment continues to come to Europe with the number 1 and 2 targets in the world being the United Kingdom and France, respectively. Germany, Ireland and Italy are also in the top ten listing of targets for foreign direct investment.

With the stakes so high, it is not surprising to find Europeans trying to attract the maximum amount of their share of foreign direct investment and the jobs it brings. World Trade Organization and OECD recent efforts promise to further encourage foreign direct investment with a new investment agreement by 1997; but they may also try to limit the incentives governments grant, including tax advantages, to encourage foreign direct investment into their countries.

The purpose of this article is to look comparatively at some of the alternatives available to MNCs in choosing the location for their regional headquarters in Europe to manage their direct investments and to look more specifically at France as a country on the short list for evaluation. Our review here focuses on tax costs. However, the recent study, *Regions of the New Europe: A Comparative Assessment of Key Factors in Choosing Your Location*, written by Corporate Location and Ernst & Young, shows that the key location factors also include excellent international transport links; a well-educated labour force; attractive location for international executives; labour costs; and good telecommunications.

II. GROSS TO NET SALARY COMPARISON FOR EXECUTIVES

The most significant cost in most headquarters is the human capital it employs. Regional and global headquarters imply a mixture of local and expatriate executives. Executives are thought to triple their cost by becoming "an expatriate". Thus, the attempt to limit the expatriate by the creation of the "EuroExecutive". However, the substantial differences that remain in the European Union have limited the growth of the EuroExecutive who is treated as a local wherever he is in the European Union. A demonstration of the income tax and social tax differences that exist in nine European and three other major countries which are major foreign direct investors is shown at Table 1 (see Appendix).

This table shows that a local executive earning US$ 156,276 will net after income and social taxes a high of 68 percent to 65 percent in Switzerland and France versus as little as 44 percent to 48 percent in Belgium and Holland. It also shows that the total wage cost to the employer, after the corporate tax benefit for a profitable company, as a percentage of the US$ 156,276 ranges from a high of 94 percent to 85 percent in Sweden and France to a low of 55 percent to 63 percent in Germany and Holland. The United States, Japan and Korea fall in the middle of these ranges.

This table demonstrates that the EuroExecutive as well as the expatriate from the United States, Japan or Korea is subject to substantial differences in net compensation in Europe and that the employer's cost can vary significantly. In seeking to reduce the costs that are involved in equalizing these income and social tax differences (as well as the cost of living, housing, education, moving, etc. differences), for the headquarters we will review the principal alternatives that are available and then take a more detailed look at France.

III. SEVEN OTHER HEADQUARTERS REGIMES

Table 2 looks at the seven other headquarters regimes in Europe: Belgium, Denmark, Germany, Luxembourg, the Netherlands, Switzerland and the United Kingdom. The high marginal tax rates seen in Table 1 show why the headquarters regimes were developed in Table 2. The Belgium and Netherlands regimes are particularly interesting, but each system may be the "best" answer in varying specific factual patterns. They must be analysed from the point of view of reducing the headquarters' expatriate tax cost as well as the corporate tax burden in the cost-plus percentage and the amounts included in the base. Local taxes must also be considered.

Table 2

SEVEN OTHER HEADQUARTERS REGIMES

COUNTRY	EXPATRIATE TAXATION	CORPORATE TAXATION	COMMENTS
BELGIUM	*Tax-free allowances of £25,000 max for an expatriate in a qualifying Headquarters (Coordination Centre), research lab or only exercising control type activities. *£10,000 tax-free allowance for an expatriate only in a commercial or industrial entity (non-Headquarters). *School fees and certain one-time moving payments are tax-free without limit. *Net salary income earned for services outside Belgium is tax-free without limit. *Foreign-source passive income is tax exempt. *Automatic work permit. *Plus income and social security tax treaties and multilateral agreements including EU Directives (as is the case for all countries considered here except Switzerland for EU Directives).	*Headquarters/Coordination Centre is taxed on a cost-plus basis generally of 8% of operating expenses (excluding financing costs and payroll expenses) subject to a minimum base of certain non-deductible items and benefits received. *Non-qualifying Headquarters/Coordination Centre taxed on a cost-plus basis of generally 10% on all expenses.	*To qualify for Headquarters/Coordination Centre status the group's equity must be BEF 1 Billion-plus with BEF 500 million non-Belgian; turnover BEF 10 billion-plus with BEF 5 billion non-Belgian; subsidiaries in at least four different countries for at least two years; and not in the insurance, banking or financial services industries. *Qualified status for ten years, subject to extension. *Activities restricted to centralization and coordination of support activities of group, (including financial and treasury functions, research and development and distribution planning and management if a qualified Headquarters/Coordination Centre) *Physical distribution centres are subject to a special 5% cost-plus ruling.
DENMARK	*Special expatriate tax rate of 30% for the first three years.	*Special cross-border tax consolidation can reduce the effective tax rate to 20-25%, but this only applies if the Danish headquarters company is also the 100% group holding company. *5-15% cost-plus ruling available.	*Activities of the Headquarters are generally unlimited.
GERMANY	*There is no special tax treatment.	*Cost-plus basis of taxation at a 5-10% level.	*Activities of the Headquarters are limited to standard definition.
LUXEMBOURG	*Limited exemptions in special cases. *Reduced taxation on housing allowance.	*Qualifying Headquarters/Coordination Centre activities taxed at a 5% cost-plus basis.	*Activities of the Headquarters/Coordination Centre limited to the standard definition.
NETHERLANDS	*Special 35% tax-free allowance ruling permits qualifying expatriate to a tax-free allowance of up to 35% of the aggregate of total defined wages and the exempt allowance. Valid for five years. *Education allowance exempt for five years.	*Headquarters are taxed on a 5 to 15% cost-plus basis. 5% rate on standard Headquarters including R&D and financing activities. *Effective combination with a Dutch finance company on-lending and taxed on an agreed spread between 1/8 and 1/4%.	*No limit is placed on the activities of a Headquarters company (but activity may impact the cost-plus percentage).
SWITZERLAND	*No special treatment except certain cases *Certain Cantons may exempt education costs and allow a flat 10% deduction.	*Headquarters are taxed on a 10% cost-plus basis and withholding tax on a deemed dividend. *Cantonal regimes allow low tax or exemption on foreign-source income in Geneva, Fribourg and Zug, for example.	*No limit is placed on the activities of a Headquarters company.

UNITED KINGDOM	*No special provisions, but remittance base of taxation allows certain expatriates to exempt income not earned or received in the UK. *Housing allowance can be effectively structured.	*Arm's length pricing standard results in 5 to 15% cost-plus. However, financing function must be at market. *Surplus ACT trap now eliminated for "International Headquarters Company".	*No limit is placed on the activities of a Headquarters company.

The following gives a detailed description of the headquarters ruling in France and a specific case which reduces the headquarters expatriate tax cost by US$ 1 million.

IV. FRENCH HEADQUARTERS

A. Definition of headquarters

Headquarters for French ruling purposes can be defined as a fixed place of business belonging to an enterprise or to an international group of companies having its main office abroad and which exercises, within a given geographical area, specific activities for the sole benefit of the group (exclusive of any trading, commercial or industrial activity). The French tax authorities provide a special tax treatment for "qualifying" headquarters which is described below. In order to qualify, French headquarters must meet the following conditions:

- headquarters can be set up either as a branch or a subsidiary, or even as a separate department of an existing French entity;
- headquarters must act solely and exclusively for the benefit of companies of the group;
- headquarters must provide services like management, coordination, administration, control activities, etc;
- they are also permitted to include in their activities research and development (R&D); and
- headquarters' scope of activity should be limited to a specific geographical area and should not only concern the French entities of the group.

Examples of the activities of companies that have received headquarters rulings include the following:

- coordination of the policy of European subsidiaries that assemble, distribute and sell computers;
- provision of technical research and development studies for European and global subsidiaries;
- data processing of all commercial and financial information for the group;
- establishing budgets and controls;
- treasury management for European subsidiaries;
- management of the European and Middle Eastern branches of Japanese, Dutch and American banks;
- coordination of Middle Eastern and African operations for an American petroleum company; and
- product research and development European centre for a US computer software manufacturer and management of European operations.

This special tax regime is granted to French headquarters through a ruling to be negotiated on a case-by-case basis with the administration. However, the procedures have been simplified and the rulings are consistently obtained on a timely basis if the standard requests are made in the ruling request. The ruling has the advantage that if its terms are followed, it cannot be revoked without the payment of an indemnity equal to all future taxes to be paid as a result of the revocation; thus, as a practical matter, it is not revocable while legislative laws can change even retroactively without indemnification. Although the ruling is valid indefinitely, the advantages given to a particular expatriate are only valid for six years. It is possible to ask for a retroactive application of the tax regime to the beginning of the year of request.

B. Taxation of French qualifying headquarters

1. Corporate tax

The French authorities have devised a special tax regime for such qualifying headquarters. Indeed, they will not be taxed on their actual profits as is normally the case, but they will be subject to corporate income tax on a deemed profit basis (so-called "cost plus") at a rate ranging between 6 and 10 percent of their operating expenses.

The exact percentage is negotiated with the tax authorities at the time the application is made. It is usually determined in consideration of the quality and degree of "technicity" of the services provided by the headquarters (the more technical the services, the higher the deemed profit margin), as well as the size of the headquarters (the greater the headquarters, the smaller the mark-up).

This ruling, which has no set duration, may be reviewed at the request of either party, should changes occur in the operations of the headquarters.

2. Value added tax

It should be noted that the administration usually requires that services rendered to the other entities of the group are billed by the headquarters on a cost-plus basis, using the same rate of margin. The corresponding invoices will be subject to VAT. French VAT has now increased from 18.6 percent to 20.6 percent.

Services performed by headquarters are treated as "intangible services" and subject to Article 259B of the French Tax Code. Consequently, if the beneficiary of the services is established in France, French VAT is due; if not, no VAT is due in France, except if the beneficiary is established in another EU country and does not have the status of taxable person there.

The headquarters can theoretically recover all the input VAT incurred on expenses related to the purchase of goods or services, since its services are fully subject to VAT (even when invoiced to foreign entities since this income is treated as zero rated income for VAT purposes). However, in the case where the company would get the authorization of the administration not to invoice its total costs to the other entities of the group and where the headquarters would be financed through subsidies paid by the US holding company, the right to recover input VAT incurred by the headquarters could be limited to the ratio of actual fees invoiced compared to the total income including subsidies, in accordance with a recent regulation from the administration.

3. Miscellaneous taxes and duties

Headquarters are liable to other taxes and duties applicable in France (business tax, taxes assessed on salaries, registration taxes, etc).

C. Tax relief for employees of headquarters

The special tax regime is granted only to foreign expatriates (i.e. French nationality employees could not qualify for this regime) and for a period not exceeding six years computed individually for each expatriate from the beginning of his activity in France.

A distinction is made between the various types of benefits and allowances given to the headquarters' expatriates. The total gross salary and allowances would be divided into the three following categories of items which follow specific rules.

1. Expatriation expenses and allowances

Such items are not subject to personal income tax in France, but are subject to corporate tax ($33^1/_3$ percent). The temporary 10 percent corporate tax increase to 37 percent will normally apply to headquarters. Additionally, these items have to be included into the basis of the cost-plus computation.

The following items *exempt from individual taxation without a ceiling on the amount of this exemption* are included in this category:

- reimbursement of the tax equalization related to excess taxes and social charges which arise as a result of the expatriate's transfer to France;
- reimbursement of excess housing expenses as regards the French residence as well as expenses for maintaining his home country residence (caretaker's expenses, etc); and
- reimbursement of education expenses of the children;
- reimbursement of a yearly trip for the employee and his family to their home country; and
- reimbursement of a yearly trip for the employee's children studying abroad but considered as a dependent for French tax purposes.

The tax administration also stated that the above-mentioned items:

- must be included in the corporate tax basis in the year they are paid;
- should not be taken into consideration for the computation of the salary-related taxes as well as for the French legal profit-sharing plan, *participation*, if applicable.

2. Settling expenses

These personal expenses are *fully tax exempt at both individual and company level*, without a ceiling, but are included into the basis of the cost-plus computation:

- initial (preparation) visit by the expatriate and his spouse;
- storage expenses in the home country;
- moving expenses and round trip travel cost;
- expenses incurred to rent an accommodation (fees, etc.);
- car rental upon arrival;
- emergency travel cost to country of origin;
- hotel expenses at arrival and departure;
- double rent at arrival and departure;
- customs expenses;
- tax consultancy fees in connection with the expatriation; and
- French language courses for the expatriate.

3. Compensation remaining taxable

This category of compensation is *fully taxable under normal French rules*. It remains taxable at the individual level and is included in the basis of the cost-plus computation. However, other tax planning ideas remain available to reduce the tax burden.

The tax administration clearly stated that all the indemnities except those in categories 1 and 2 remain taxable at the individual level.

Examples:

- base salary;
- bonuses;
- cost of living allowance;
- furniture and fixture allowances; and
- car purchase allowance.

The French tax administration also stated that the above-mentioned items should be taken into consideration for the computation of the different salary-related taxes and French profit-sharing plan.

D. Comparative computations of tax with and without the headquarters

Table 3 shows several schedules showing the possible income tax savings of the implementation of a French headquarters for one highly compensated expatriate individual.

Table 3

SCHEDULE A

TAX COSTS WITHOUT THE HQ RULING

Taxable items - in US $	N	N + 1	N + 2
Gross assigned salary	400 000	400 000	400 000
Bonus	160 000	160 000	160 000
Housing allowance[1]	35 000	35 000	35 000
GTL insurance	10 000	10 000	10 000
Cost of living allowance (COLA)	50 000	50 000	50 000
School fees - Education	15 000	15 000	15 000
FICA	(5 123)	(5 123)	(5 123)
401 (k)	(8 000)	(8 000)	(8 000)
US hypothetical tax	(160 000)	(160 000)	(160 000)
French tax reimbursement :			
• CSG	0	5 192	16 815
• Income tax[4]	0	240 486	1 462 097
Net taxable income	496 877	742 555	1 975 789
US-source passive income[2]	21 250	21 250	21 250
French income tax	240 486	379 688	1 462 097
CSG[3]	5 192	7 760	20 647
Total income taxes	245 678	387 448	1 482 744

(1) Valuation is made on the basis of the value which has been given to us.
(2) After deduction of a 15% hypothetical tax.
(3) The difference on the CSG is included in the income tax.
(4) Income tax including the gross up on N+2.
Exchange rate : $1 = FF 5.6473

SCHEDULE B

TAX COSTS ON EMPLOYEE'S INCOME WITH THE HQ RULING

In US $	N	N + 1	N + 2
Category 1 (*1)			
French tax reimbursement	0	309 119	309 119
US hypothetical tax	0	(160 000)	(160 000)
Housing[1]	35 000	35 000	15 000
School fees	15 000	15 000	15 000
Total	50 000	199 119	199 199
Corporate tax cat 1 (34 %)	17 000	67 700	67 700
Category 2 (*2)			
Hotel expenses	0	0	0
Airfares	0	0	0
Shipment	0	0	0
Pre-assignment medical	0	0	0
Total exempted	0	0	0
Category 3 (*3)			
Gross assigned salary	400 000	400 000	400 000
Bonus	160 000	160 000	160 000
Cost of living allowance (COLA)	50 000	50 000	50 000
GTL insurance	10 000	10 000	10 000
FICA	(5 123)	(5 123)	(5 123)
401 (k)	(8 000)	(8 000)	(8 000)
Net taxable income	606 877	606 877	606 877
US-source passive income[2]	0	0	0
French income tax (roll-over)	302 777	302 777	302 777
CSG	6 342	6 342	6 342
Total taxes on category 3	309 119	309 119	309 119

(1) Valuation is made on the basis of the real value.
(2) After deduction of a 15 % hypothetical tax.

* 1: Items not subject to individual income tax but subject to corporate income tax.
* 2 : Personal expenses exempt of tax.
* 3 : Special allowances for expatriate's compensation which remain taxable at the individual level.

SCHEDULE C

CORPORATE TAX COSTS WITH THE HQ RULING

In US $	N	N + 1	N + 2
Cost-plus basis			
• Costs category 1	50 000	199 119	199 119
• Costs category 2	0	0	0
• Costs category 3	606 877	606 877	606 877
Total costs	656 877	805 996	805 996
Corporate tax basis (9 %)	59 119	72 540	72 540
Corporate tax (34 %)	20 100	24 663	24 663

SCHEDULE D

TAX COSTS COMPARISON

In US $	N	N + 1	N + 2	TOTAL
1. With the HQ ruling				
a) Tax on employee's income :				
– Individual's level	309 119	309 119	309 119	927 357
– Company's level	17 000	67 700	67 700	152 401
Total	376 819	376 819	376 819	1 079 758
b) Corporate tax on cost-plus	20 100	24 663	24 663	69 427
2. Without the HQ ruling				
Total income tax	245 678	387 448	1 482 744	2 115 870
3. TOTAL TAX SAVINGS HQ				**$966 685**

The tax computations were made on the following basis: a top executive expatriate is married and has two children; he arrives in France at the beginning of January of year N and leaves France on January 1 of year N + 3; the tax is computed with the current rates applicable to income for all years N to N + 2.

Symmetrically, the various items of income remain the same during these years. Moreover, the following comments have to be made on these schedules:

1. Schedule A: tax costs without the HQ ruling

In this schedule, the income tax reimbursed every year by the company to the employee is considered as taxable income of the following year ("roll-over system"). Consequently, a gross-up is computed for the year of the departure from France.

Housing allowance is computed on the basis of its real value. Nevertheless, it could be computed on the administrative value ("cadastral value"), which presupposes that the employee does not have the status of chairman of the board or chief executive officer; the employee has the disposal of the housing leased by his employer.

2. Schedules B and C: tax costs with the HQ ruling

Schedule B shows the tax costs on employee's income with the HQ ruling and the splits of the salary into the above-mentioned three categories of items. Payment of individual income taxes are actually made nine months after the year end, but are shown here as currently paid.

Schedule C shows the computation of corporate tax on the cost-plus basis. This computation is made with the $33^1/_3$ percent tax rate and the cost-plus is computed with a 9 percent margin which can often be reduced to 8 percent or exceptionally to 6 percent. The 10 percent temporary corporate surcharge (10 percent x 33.3 percent or 3.3 percent) has been ignored.

This cost-plus computation only takes into account direct salary costs and not other general costs such as fees or rental of premises, which are normally included in the cost-plus basis.

3. Schedule D: tax costs comparison

According to this schedule, the total cost is US$ 1,079,758 plus US$ 69,427 for a total of US$ 1,149,185 with the headquarters ruling and US$ 2,115,870 without this ruling, which results in an *income tax saving of US$ 966,685* on the total three-year period for just one expatriate. Obviously, this is a saving of US$ 10 million for ten expatriates at this level of remuneration over three years.

This comparison does not take into account the corporate tax on cost plus for the headquarters which is 2.9 percent (33.3 percent x 9 percent).

As a matter of fact, even in the case where no headquarters ruling is requested, the services rendered by the French entity to other entities of the group should be billed to these entities on an arm's length basis, i.e. on a cost-plus basis, which should in principle lead to the same tax costs, but the cost-plus basis would be increased by the gross-up effect.

Moreover, some elements may increase the cost of the gross-up calculation in the case where no headquarters are set up and consequently increase the tax savings generated by the headquarters ruling (family status of the employees, date of departure from France, etc.).

V. COMPARATIVE ANALYSIS FOR A PARIS, LONDON OR BRUSSELS HEADQUARTERS

Now that it has been shown what the headquarters ruling can do in France in comparison to the normal system the next question is how it compares to other European capitals with a more complicated mixture of expatriates, non-Europeans, local nationals and Europeans.

The following is a calculation of the tax and social security costs associated with four hypothetical mid-level (as opposed to the other French calculations for a top-level executive) expatriates and one local national working in Paris in a qualifying French headquarters versus London in an International Headquarters Company and Brussels in a Belgian coordination centre in order to determine, in this hypothesis, which location would result in the lowest total expatriate and local national employer cost.

Summarized below are the total recurring costs from Cases 1, 2, 3 and 4. Case 1 is two US expatriates, each at a different level of remuneration and allowances (based on remuneration tables of the home country in each case); Case 2 is non-US/EU expatriate from Africa; Case 3 is a local national; and Case 4 is an expatriate who is an EU national (a UK expatriate in Paris, a French expatriate in London and a UK expatriate in Brussels).

Employer Expatriate and Local National Tax and Social Security Costs

		PARIS	LONDON	BRUSSELS
Case 1	a)	$ 352,236	$ 413,680	$ 486,283
	b)	262,282	311,815	353,814
Case 2		177,736	234,215	219,456
Case 3		263,540	145,464	241,740
Case 4		279,462	501,149	305,721
Total Employer Tax and SS Costs		$ 1,335,256	$ 1,606,323	$ 1,607,014

It can be seen that recurring tax and social security costs are consistently lower in France than in London or Brussels except for the local national in Paris. This is due to a favourable progressive effective income tax rates (although a high marginal rate) and social security treaties and EU agreements that eliminate French social security for the expatriates. But the actual costs or saving will be determined by the mix of the above four cases in each location. Paris favours a headquarters with a wide mixture of nationalities, particularly US and UK, while the London headquarters favours one predominantly composed of local nationals. Note also that a

Belgian expatriate sent to the United Kingdom would be less expensive than a French expatriate shown in Case 4. In specific cases where the expatriates in the Belgium coordination centre travel more than one-third of their time, it will have an advantage over Paris and probably London.

The cost projections are based on the following assumptions:

- employees have been kept on home country social security systems where totalization agreements or EU regulations allow;
- each employee base salary is reduced by the home country stay-at-home hypothetical tax. Case 4 treats EU transfers as "expatriate transfers" although there is much discussion that the EuroExecutive should be treated as a local national. This is not yet the general case due to the continuing and substantial differences in income tax rates, social tax rates, equivalency of pension benefits, housing costs, cost of living, private education and wage and benefit packages and levels;
- headquarters status in France; related French corporate tax on benefits excluded from individual tax have been included in the cost summary. Belgian coordination centre status for Belgian calculations;
- special treatment is applicable to housing benefits in the United Kingdom to reduce the taxable amount in the United Kingdom by 80 percent;
- "individual tax" includes current year gross-up in the United Kingdom; under the headquarters ruling there is no gross-up in France. The same is true in Brussels, subject to limits in the Coordination Centre;
- tax planning for work performed outside France, the United Kingdom or Belgium has not been considered, but all countries have opportunities to realize additional savings. Since the marginal rate is higher in France and Belgium, applying this planning would have a more significant impact on the Paris numbers and even more on the Brussels numbers if the travel was more than one-third of the total working days;
- the United Kingdom does not have a special headquarters regime. However, more non-statutory and creative planning ideas could be considered in a more detailed analysis to reduce the UK tax. However, this is true of the other two locations as well;
- of course, each headquarters analysis is unique with respect to its facts. The hypothetical factual situation here is representative for the multinational headquarters executive staff. Compensation levels between countries and benefits and allowances (for expatriates as well as locals) will be unique to each multinational. The top executive (shown in the separate French headquarters calculation) of the headquarters will often have much higher compensation than shown here and will have unique facts that will lead to customized planning and disproportionate savings.

CASE 1
(AMERICAN Expatriates)

	FRANCE		UK	BG
A)	$ 188,000	Salary	188,000	188,000
	30,000	COLA	17,000	30,000
	46,000	Housing	63,000	46,000
	27,000	School Fees	28,000	27,000
	46,824	Individual Tax	149,503	228,667
	47,796	Corporate Tax (HQS)	–	–
	(41,439)	Employee Hypo Tax	(41,439)	(41,439)
	8,055	Employer's SS Costs	9,616	8,055
	$ 352,236	TOTAL COST	$ 413,680	$ 486,283
B)	$ 125,000	Base	125,000	125,000
	28,000	COLA	16,000	28,000
	39,000	Housing	52,000	39,000
	27,000	School Fees	28,000	27,000
	23,422	Individual Tax	105,369	150,585
	35,631	Corporate Tax (HQS)	–	–
	(22,714)	Employee Hypo Tax	(22,714)	(22,714)
	6,943	Employer's SS Costs	8,160	6,943
	$ 262,282	TOTAL COST	$ 311,815	$ 353,814

CASE 2
(Non US/EU Expat from AFRICA)

FRANCE		UK	BG
$ 75,000	Salary	$ 75,000	$ 75,000
26,000	COLA	15,000	26,000
34,000	Housing	47,000	34,000
14,000	School Fees	28,000	14,000
23,240	Individual tax	70,704	50,312
27,694	Corporate Tax (HQS)	–	–
(23,168)	Employee Hypo Tax	(23,168)	(23,168)
970	Employer's SS Costs	21,679	43,312
$ 177,736	TOTAL COST	$ 234,215	$ 219,456

CASE 3
(Local Nationals)

FRANCE		UK	BG
$ 180,000	Salary	$ 132,000	180,000
–	COLA	–	–
–	Housing	–	–
–	School Fees	–	–
38,250*	Individual Tax	44,262*	78,130*
–	Corporate Tax (HQS)	–	–
(38,250)*	Employee Hypo Tax	(44,262)*	(78,130)*
83,540	Employer's SS Costs	13,464	61,740
$ 263,540	TOTAL COST	$ 145,464	$ 241,740

* Taxes not reimbursed; no cost to company.

CASE 4
(UK Expat in France; French Expat in UK; and UK Expat in Belgium)

FRANCE		UK	BG
$ 132,000	Base	$ 180,000	$ 132,000
12,000	COLA	12,000	12,000
42,000	Housing	58,000	42,000
27,000	School Fees	6,000	27,000
45,173	Individual Tax	125,503	115,164
43,732	Corporate Tax (HQS)	–	–
(44,262)	Employee Hypo Tax	(38,250)	(44,262)
21,819	Employer's SS Costs	157,896	21,819
$ 279,462	TOTAL COST	$ 501,149	$ 305,721

In order to attract more foreign direct investment the analysis does not stop at analysing only the headquarters regimes. The foreign direct investor must also consider the various investment incentives that are offered, if not directly for the headquarters, for their group's accompanying industrial, manufacturing, commercial, trading, financing or sales activities. The following provides a detailed look at the French investment incentives. An overall comparative European review of investment incentives is provided in Table 4 (see Appendix).

VI. INVESTMENT INCENTIVES

The French government offers assistance to firms establishing themselves in France in four principal areas: investment assistance, tax concessions, accelerated depreciation of capital assets and low-interest and/or long-term loans.

The French seek both modernization and innovation of their enterprises, including improvements in the efficiency standards of production facilities, design and development of automated machines, increases in productivity standards, work force training and development of new and improved products. Grants are based on location, number of jobs created, amount of new R&D that is transferred and type of investment (the more capital intensive, the fewer subsidies offered). The maximum subsidy allowed amounts to approximately 25 percent of the total investment. There are exceptions, for instance the European Development Pole, where the European Union contributes an additional 12.5 percent subsidy, bringing the total to 37.5 percent. The following is a general summary of the groups that offer incentives and the various packages available.

A. Government programmes

1. DATAR

The *Délégation à l'Aménagement du Territoire et à l'Action Régionale* (DATAR) is the French government agency that oversees foreign investment in France. It actively courts firms that provide capital, create or preserve jobs, increase French exports and provide high technology.

DATAR provides grants to finance up to 25 percent of an investment during the first three years of operation. Eligibility for such grants depends on site selection, number of jobs created, type of activity and profile of the foreign investor. One-third of the grant is paid at the beginning of the investment programme, and the rest is paid in instalments as the project moves toward completion. For example, eligible companies with greenfield industrial projects must be prepared to invest a minimum of 20 million francs and create a minimum of 20 jobs within the first three years.

2. Regional and local incentives

Investment assistance at the regional level includes grants paid to businesses which either establish operations or take over ailing companies in an underdeveloped region. The *Prime d'Aménagement du Territoire* (PAT) and the *Prime Régionale à l'Emploi* are two such subsidies.

A PAT is available to firms which create a new enterprise, provided that the amount of investment exceeds US$ 3.6 million or that the company's annual sales exceed US$ 54.5 million. The new enterprise must also create a minimum number of jobs. A PAT grant is usually between US$ 6,350 and US$ 9,000 for each job created. In the case of a service industry project, a minimum of 30 new jobs must be created within three years in order to qualify for the subsidy. The PAT is allocated by a government level committee headed by the DATAR Chairman and is paid in three instalments. Other incentives, such as low-interest loans offered by the Rhône-Alpes region are available.

Job training subsidies are also available, along with special government incentives designed to alleviate unemployment. For example, by hiring special case labour (i.e. unemployed under age 25, unemployed for more than one year, ex-convicts or the handicapped) a company can receive up to FF 70,000 in subsidies.

3. Government loans

Both low-interest and long-term loans are available from government agencies and banks. Interest rates depend on the level of capitalization of the enterprise, its annual sales, the risk as perceived by banks, the length of time for repayment and/or market rates.

Companies are also eligible for exemption from the business licence tax, a local tax levied on all legal entities and individuals carrying out business activities. For industrial corporations it ranges from 1 percent to 1.5 percent of total annual sales, but exemptions are granted for five years if certain qualifications are met. These qualifications differ from area to area but generally include the creation of at least 30 jobs with an investment of at least US$ 145,000.

4. ANVAR Grants for Research & Development

The *Agence Nationale de Valorisation de Recherche* (ANVAR) is a French government agency dedicated to technology innovation and transfer. It finances R&D projects in the electronics, biotechnology, metallurgy, energy, pollution control, measurement control and medical industries with foreign financial participation as well as domestic capital. These grants are usually reimbursable only if the project is successful.

Subsidies available from ANVAR are offered for the setting up of new R&D centres, engineering and software development operations. They can be used to pay the labour and transportation costs of outside consultants and research specialists, costs incurred during a project's actual research and the training costs of project personnel.

Monetary assistance ranges from interest-free advances to subsidies of 50 percent to 75 percent of a project's costs, with maximum financial assistance limited to US$ 41,000 per project. Included in these costs are consultants' services, product conception, market and feasibility studies, opportunities for technology, investigation of export insurance and the search for foreign partners.

ANVAR has lately placed an emphasis on financing "high-risk" technological research and has become more selective in the financing of R&D projects. ANVAR is also coordinating pan-European projects with similar institutions from other EU Member States.

B. Technopoles

Technopoles are best described as centres designed to combine education, research and development, and high-tech production in newly developed communities expressly designed for this purpose. Technopoles are not just business parks; they are meant to be a catalyst, promoting synergy between private companies, universities and technical schools, and local, regional and national authorities. Each of France's regions features at least one "technopole".

Just one example of this concept is the European Development Pole, bounded by the towns of Longwy (France), Athus (Belgium) and Rodange (Luxembourg). The special status of this area includes customs advantages and eligibility for direct investment aid from the individual countries and the European Union. The French government and EU authorities set up a joint programme to promote development in north-eastern France with grants up to 37.5 percent of total investment (25 percent regional plus the additional 12.5 percent from the European Union).

1. SOFIREM

The *Société Financière pour favoriser l'Industrialisation des Régions Minières* (SOFIREM) promotes redevelopment of mining regions and provides financial incentives for investment. A subsidiary of the French group Charbonnages de France, it is one of ten industrial groups formed to promote the development of new industries and the creation of long-term jobs in depressed areas (St. Gobain Development is another example). SOFIREM, founded in 1967, is the oldest of this group.

SOFIREM provides two types of financial aid: medium-term loans and direct investment in companies. Preferential-rate loans, unsecured for eight years, are offered at about 3 percent less than the French market rate. Today the loans would be issued at 7.5 percent net (including insurance). SOFIREM takes a temporary equity position in the company and sells its share after two to seven years. This position is always less than 33 percent as SOFIREM prefers to be a silent partner.

Small and medium-sized enterprises are the primary beneficiaries of aid provided by SOFIREM. The company specializes in greenfield projects (built from the ground up). Aid is to be considered as part of a group of grants, loans, and tax exemptions provided by governmental authorities.

SOFIREM is active in the French regions of Auvergne, Burgundy, Languedoc-Roussillon, Lorraine, Midi-Pyrénées, Nord-Pas de Calais, Provence-Alpes-Côte-d'Azur, and Rhône-Alpes. Aid is offered to numerous manufacturing sectors including agrofoods, engineering, chemicals, plastic processing, automobiles and electronic equipment. A few of the 300 foreign investments that have received SOFIREM assistance include subsidiaries of Samsonite, Corning Glass, and Delco.

Assistance from the European Commission is also available in the following areas:
- infrastructure;
- agriculture and fisheries support;
- education and training;
- research and development; and
- special initiatives.

Infrastructure and economic development support is in the form of structural funds. These are major sums of money allocated to regions (the budget provisions for 1994-1999 amount to ECU 13.5 billion). The Commission also makes loans available at relatively low interest rates to the private sector; in those areas suffering significant decline in the coal or steel sectors. For investment projects that create at least two jobs in the designated areas, loans meeting 50 percent of project costs are offered at a rate of interest that can be lower than normal commercial rates. Interest rates can be fixed or variable for the loan period, with a capital repayment exemption for the first four years. An interest rebate of 3 percent is awarded during the first five years for a proportion of the loan, depending on the number of jobs created by the project. Loans are administered on behalf of the ECSC (European Coal and Steel Community) by major banks and other financial institutions.

In France, approximately 39 percent of the population live in areas qualifying for EU assistance. The EU aid ceiling is set at 25 percent for these areas, i.e. the amount of the grant allowed can be no more than 25 percent of total capital expenditure for the project.

VII. CONCLUSION

This article has demonstrated the continuing and expanding importance of foreign direct investment to the economies of the world and Europe. The key to the effective management of this investment from a European point of view is the creation of a cost-effective regional headquarters with its expensive expatriate and local human capital. The income and social tax rates in Europe require that creative tax planners use all the tools available to them including headquarters regimes, income and social tax bilateral treaties, multilateral and EC directives and agreements, local law and entity structuring. When the tax analysis is near the goal, investment incentives may then allow the mission to be completed: cost-effective, value-added and most importantly allowing the client to accomplish his business goals in maximizing the long-term return on his foreign direct investment (on an after-tax basis, of course).

Appendix

Table 1a

GROSS TO NET SALARY COMPARISON FOR EXECUTIVES (w/o planning) AND TOTAL COST TO EMPLOYER COMPARISON FOR SELECTED COUNTRIES (Ranking by Net Percentage to Employee)

Country	Gross Salary US $	Employee Social Security[1] US $	Income Tax[2] US $	Net to Employee US $	Ranking by Net % to Employee after Social and Income Tax	Top Marginal Individual Income Tax Bracket Percentage	Employer Social Security[1] US $	Total Cost to Employer as a % of Gross (before corp. tax benefit)	Top Marginal Corporate Income Tax Bracket Percentage	Total Cost to Employer as a % of Gross (after corp. tax benefit)
Switzerland[5]	156,276	7,426	41,882	106,968	68%	47%	7,426	105%	37%[f]	66%
France	156,276	23,798	30,133	102,345	65%	59%	55,612	136%	37%[b]	85%
United Kingdom	156,276	2,754	53,531	99,992	64%	40%	16,253	135%	33%	74%
Germany	156,276	8,944	49,144	98,188	63%	53%	8,944	106%	48%[c]	55%
Spain	156,276	1,843	67,453	86,980	56%	56%	9,542	106%	35%	69%
Italy	156,276	18,180	52,760	85,336	55%	51%	60,501	139%	52%[e]	66%
Sweden	156,276	0	72,640	83,636	54%	56%	48,446	131%	28%	94%
Holland[4]	156,276	(516)	82,051	74,741	48%	60%	7,507	105%	40%[d]	63%
Belgium[3]	156,276	20,355	66,908	69,013	44%	62%	54,056	135%	40%[a]	81%
Korea[8]	156,276	0	35,578	120,698	77%	48%	0	100%	32%[h]	68%
Japan[7]	156,276	9,649	39,275	107,352	69%	65%	11,305	107%	38%	67%
United States[6]	156,276	5,174	51,052	100,050	64%	52%	5,174	103%	35%[g]	67%

Table 1b

GROSS TO NET SALARY COMPARISON FOR EXECUTIVES (w/o planning) AND TOTAL COST TO EMPLOYER COMPARISON FOR SELECTED COUNTRIES (Ranking by Total Cost to Employer)

Country	Gross Salary US $	Employee Social Security[1] US $	Income Tax[2] US $	Net to Employee US $	Net % to Employee after Social and Income	Top Marginal Individual Income Tax Bracket Tax	Employer Social Security[1] US $ Percentage	Total Cost to Employer as a % of Gross (before corp. tax benefit)	Top Marginal Corporate Income Tax Bracket Percentage	Ranking by Total Cost to Employer as a % of Gross (after corp. tax benefit)
Sweden	156,276	0	72,640	83,636	54%	56%	48,446	131%	28%	94%
France	156,276	23,798	30,133	102,345	65%	59%	55,612	136%	37%[b]	85%
Belgium[3]	156,276	20,355	66,908	69,013	44%	62%	54,056	135%	40%[a]	81%
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Switzerland[5]	156,276	7,426	41,882	106,968	68%	47%	7,426	105%	37%[f]	66%
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(1) Before application to expatriates of Totalization Agreements and EC Directives on social security
(2) Before application of special expatriate tax rulings, e.g. HQ ruling in France, and treaty provisions, for married plus two children
(3) Including communal tax of 10% and crisis tax of 3%
(4) Net of allowance paid by employer
(5) Including cantonal and city taxes of Geneva
(6) Including New York state and city tax
(7) Including Tokyo local inhabitants tax
(8) Including 7.5% resident tax

(a) Corporate rate includes a 3% surtax – crisis contribution
(b) Corporate rate of 33.3% plus proposed 10% surtax
(c) Corporate rate includes a 7.5% surtax assessed for 1995 and subsequent years
(d) Corporate rate drops to 35% above Dfl. 100,000
(e) Corporate rate includes 16.2% local tax
(f) Corporate rate includes federal and cantonal top rates
(g) Corporate rate does not include state corporate income tax rates
(h) Corporate rate includes 7.5% surtax

Table 1c

GROSS TO NET SALARY COMPARISON FOR EXECUTIVES (w/o planning) AND TOTAL COST TO EMPLOYER COMPARISON FOR SELECTED COUNTRIES

Country	Gross Salary US $	Employee Social Security[1] US $	Income Tax[2] US $	Net to Employee US $	Net % to Employee after Social and Income Tax	Top Marginal Individual Income Tax Bracket Percentage	Employer Social Security[1] US $	Total Cost to Employer as a % of Gross (before corp. tax benefit)	Top Marginal Corporate Income Tax Bracket Percentage	Total Cost to Employer as a % of Gross (after corp. tax benefit)
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(2) Before application of special expatriate tax rulings, e.g. HQ ruling in France, and treaty provisions, for married plus two children
(3) Including communal tax of 10% and crisis tax of 3%
(4) Net of allowance paid by employer
(5) Including cantonal and city taxes of Geneva
(6) Including New York state and city tax
(7) Including Tokyo local inhabitants tax
(8) Including 7.5% resident tax

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(e) Corporate rate includes 16.2% local tax
(f) Corporate rate includes federal and cantonal top rates
(g) Corporate rate does not include state corporate income tax rates
(h) Corporate rate includes 7.5% surtax

Table 4

Country	Main scheme	Maximum grant % of capital investment	Comments
Austria	Loan scheme	N/A	Loans up to 50% of capital expenditure. General tax allowances including 20% for capital expenditure
Belarus	N/A	N/A	No incentives
Belgium	Capital grant	21	Covers 36.3% of population, mainly in the south of Belgium
Bulgaria	N/A	N/A	No incentives, however joint-venture income is tax-exempt for 5 years in free-trade zones and subsequently is subject to 20% tax
Croatia	Tax allowances	N/A	Exemption of tax on profits during the first year of operation; 50% reduction of tax liability during the second year and 25% for the third year. Foreign investments in special under-developed areas have a 2-year tax holiday
Czech Republic	N/A	N/A	No incentives
Denmark	N/A	N/A	No scheme in operation at the moment. Legal powers are still available to award grant in exceptional cases
Estonia	Tax allowances	N/A	3-year tax holiday and 50 % tax reduction for the subsequent 5 years if foreign investment (FI) is 50% or more of statutory capital and exceeds US$1 million; if FI is more than 30% of capital and exceeds US$ 50,000, a 2-year holiday and 50% tax reduction of subsequent 2 years are applicable; if FI constitutes more than 30% of firms statutory capital and the latter operates in a designated sector, it enjoys a 3-year tax holiday and 50% tax reduction for subsequent 2 years
Finland	Discretionary capital grants	N/A	Up to 75% of training costs related to a new investment. Other discretionary grants depending on location. Additionally, contributions can be made to training costs (up to 75%) and various tax allowances are also available
France	Regional Policy Grant	25	Covers 42% of population for manufacturing projects but much wider coverage for R&D or headquarters projects
Germany	Investment grant	23	Grants more generous in former GDR. Covers all of former GDR and 22% of former FRG
Greece	Investment grant	55	Scheme due to be overhauled. Currently covers 58% of population and excludes Athens
Hungary	N/A	N/A	No incentives
Ireland	New ind. programme	60	A combination of similar programmes available all over Ireland
Italy	Assistance for Regional Development Areas	50	Scheme not yet operational due to delays in legislation. Will be targeted at SMEs in northern areas and all firms in the south
Latvia	Tax allowances	N/A	Automatic tax allowances with discretionary top-up. 2-year tax holiday starting in the first year of tax generation. 50% reduction in profit in subsequent 2 years. If investment exceeds US$ 1 million, the tax holiday is extended to 3 years and 50% reduction over the subsequent 5 years

Lithuania	Tax allowances	N/A	If FTE is registered before 31 December 1993, foreign share of profits enjoys a 70% tax reduction for the first 5 years after the first income is declared and a 50% tax reduction for the subsequent 3 years; if FTE is registered between 1 January 1994 and 31 December 1995, foreign share of profits enjoys a 50% tax reduction for 6 years.
Luxembourg	Regional assistance for investment	25	Discretionary capital grant
Netherlands	Investment premium	20	Grant is automatic up to US$ 2 million expenditure. Discretion to award higher grants for larger projects
Norway	Industrial and Regional Development Fund	N/A	Loans available but usually only on normal business terms
Poland	Tax allowances	N/A	3-year tax-free period for foreign investment was automatic, but is now discretionary, targeted at major investments in priority sectors and high unemployment areas
Portugal	Regional aid system	70% combination of grant + loan	The scheme has very recently been introduced. It is directed at mainland Portugal excluding the coastal areas between Braga and Setubal and between Lagos and Faro
Romania	Tax allowances	N/A	Various tax incentives
Russian Federation	Tax allowances	N/A	General tax holiday for investments now at an end. 1-year tax reductions for firms investing in priority and designated sectors are possible; JVs registered after 1 January 1994, engaged in production activities and having at least 30% paid-in foreign share in capitalization (worth at least US$ 10 million) enjoy a 2-year tax holiday; during the subsequent 2 years, profit tax rates do not exceed 1/4 or 1/2 of the average tax rate
Slovakia	N/A	N/A	No major incentives
Spain	Regional investment grant	75	Covers 55% of country excluding Madrid and north west areas
Sweden	Location grant, development grant and employment grant	70	Assisted areas cover 60% of country but only 8% of population
Switzerland	Federal schemes	N/A	Vary enormously between cantons. Can include up to 10 years' tax-free period or cheap land/buildings
Great Britain (excl. Northern Ireland)	Regional Selective Assistance	30 50	Vital to demonstrate the need for assistance. Covers 35% of population
Northern Ireland	Industrial Development Grant	N/A	Maximum grant is 30% but an additional 20% is available for inward investment projects. Scheme is similar to Great Britain's RSA
Ukraine	Tax allowances		5-year tax holiday for companies with foreign equity share exceeding 20% and worth at least US$ 50,000; if foreign equity share is 30% more, the firm enjoys a 5-year tax holiday and 30% tax reduction subsequently

THE CROSS-BORDER ACQUISITION AND LEASING OF AIRCRAFT BY FRENCH DOMICILED TAXPAYERS

Patrick Donsimoni

Avocat à la Cour, Stibbe Simont Monahan Duhot, Paris.

I. ACQUISITION OF NEW AIRCRAFT FROM ANOTHER MEMBER STATE OF THE EUROPEAN UNION BY TAXPAYERS DOMICILED IN FRANCE

A. Principles

1. Introduction

As from 1 January 1993, the supply of goods between France and the other Member States of the European Union (EU) takes place within the internal market without border formalities. In order to achieve this objective the concepts of importation and exportation have been replaced, for VAT purposes, with the concepts of an intra-Community acquisition and an intra-Community supply, respectively. The terms "exportation" and "importation" now concern only transfers of goods with economic agents located in countries outside the EU. (Provisions related to intra-Community supplies are not applicable between the French overseas departments and metropolitan France or the other EU Member States.)

2. EU Regulation

The intra-Community acquisition rules result from the provisions of Directive 91/680/EEC dated 16 December 1991[1], which were introduced into French law by Law No. 92-677 dated 17 July 1992[2]. Directive 91/680 amended the Sixth VAT Directive 77/388/EEC dated 17 May 1977, on the harmonization of the laws of Member States relating to turnover taxes – common system of value added tax: uniform basis of assessment. The rules on intra-Community transactions were modified by Directive 92/111/EEC dated 14 December 1992[3], the so-called simplification Directive introduced into French internal legislation by the Finance Law of 1994, but already applied in France by the French Tax Administration before this law was enacted.

The French tax authorities have made comments on these Directives, more particularly in instructions 3 CA-92 dated 31 July 1992, published in a special issue of the Official Tax Bulletin (*Bulletin Officiel des Impôts*) and 3A-7-93 dated 6 August 1993.

According to Article 256 bis I 1 of the French General Tax Code (CGI), the intra-Community acquisition of tangible movable goods by a taxpayer domiciled in France and acting as a taxable person, from another taxable person located in another EU Member State, is subject to French VAT.

Article 256 bis I 3 of the CGI defines an intra-Community acquisition as obtaining the power to dispose, as an owner, of tangible movable goods sent or transported to France by the seller, the buyer or on their account, to the buyer, from another EU Member State.

Article 258 C of the CGI provides that the place of an intra-Community acquisition of tangible movable goods is considered to be situated in France when the goods are located in France at the moment of the arrival of the dispatch or at the moment of the consignment of the goods to the buyer. The buyer is the person subject to French VAT which is due by reason of the intra-Community acquisition[4].

The purchase of a new means of transport in another EU Member State to be delivered in France, by a firm subject to French VAT, is subject to the general tax rules on intra-Community acquisitions.

A particular tax regime established by Article 298 sexies I of the CGI allows, in principle, any person resident or domiciled in France (regardless of whether the person is a taxable person for VAT purposes), to be subject to French VAT when buying a new means of transport in another EU Member State. But Article 262 ter II of the CGI exempts from French VAT the intra-Community acquisitions of goods, whose importation would be exempt, pursuant to the provisions of Article 291 II of the said Tax Code. It concerns, in particular, aircraft acquired by airline companies whose services from France to abroad or from abroad to France or from the French overseas departments represent at least 80 percent of the services that they exploit[5]. Therefore, the intra-Community acquisition of a new aircraft, such acquisition being deemed to occur in France, is subject to VAT in France, provided that the provisions of the above mentioned Article 262 II 4e do not apply.

B. Application

1. Definition

Aircraft used for the carriage of goods or passengers are considered to be means of transport coming under the provisions of the French law discussed in this article if their total weight at take-off exceeds 1,550 Kg. (Article 298 sexies III 1). An

1. J.O.C.E. No. L.376 of 31 December 1992.
2. J.O. of 19 July 1992, at 9700s.
3. J.O.C.E. No. L.384 of 30 December 1992, at 47.
4. Article 283 2 bis of the CGI.
5. Article 262 II 4e of the CGI.

aircraft which fulfils this condition is considered to be new when one of the two following conditions is met:
- the aircraft is delivered to the buyer within three months after it is first placed in service, i.e., after the date it was authorized to fly; or
- the aircraft has flown less than 40 hours.

As stated above, these provisions are not applicable to the aircraft of airline companies exempt from French VAT under the provisions of Article 262 II 4e of the CGI mentioned above.

When an aircraft cannot be considered to be a new means of transport, the intra-Community acquisition comes under the provisions applicable to sales of second-hand goods.

2. Taxation procedure

The intra-Community acquisition of a new aircraft sent or transported from another EU Member State to France is, according to the conditions described above, subject to VAT in France. Tax is determined and paid directly by the buyer according to a reverse charge mechanism. The buyer mentions the intra-Community tax due with respect to the acquisition of the aircraft on the VAT return which it normally files for its own commercial activity. Therefore, tax is no longer payable to the Customs Authorities at the frontier, as was the case before 1 January 1993.

Tax is levied on the sale price mentioned on the invoice converted into French Francs, as provided by Article 266 I bis of the CGI. The French VAT is calculated at the standard rate of 18.6 percent rate.

The VAT due by the buyer under the above-mentioned reverse charge mechanism can be deducted on the buyer's VAT return form, assuming the buyer is a taxable person entitled to an input tax credit. Therefore, no VAT has to be paid in this case.

This rule applies to aircraft specially designed for freight transport, aircraft acquired by a public passenger transport firm and exclusively used for such transport[6] or for an aircraft solely used to teach flying[7].

In order to encourage taxpayers to properly fulfil their obligations and, if necessary, to pay any tax due, the French Civil Aviation Authority (*Direction Générale de l'Aviation Civile*, "DGAC") authorizes the registration of an aircraft in France only if the buyer has previously declared its acquisition to the appropriate French Tax Authorities (*Recette des Impôts*) within whose jurisdiction it is located[8]. This procedure of prior declaration of the intra-Community acquisition to the French Tax Authorities is also applicable to the registration of aircraft whose acquisition is exempt from French VAT, for example, pursuant to the above mentioned provisions of Article 262 II 4e of the CGI.

The buyer must file an acquisition certificate of a new means of transport, in duplicate, with the French Tax Authorities designating origin in the EU by a taxable person with a VAT identification number (*Certificat d'acquisition d'un moyen de transport neuf en provenance de l'Union Européenne par un assujetti identifié*). A copy of the acquisition invoice is to be enclosed with this certificate[9]. The certificate contains the buyer's commitment to make reference to the intra-Community acquisition (or, if appropriate, the buyer's declaration that the transaction is exempt from French VAT) on its VAT form (form CA 3). After the certificate has been signed by the French Tax Authorities, the buyer must send it to the DGAC in order to obtain registration of the aircraft prior to its entry into service.

(a) *Acquisition certificate for a means of transport from the EU by a taxable person*

This certificate contains three parts which must be filled in by the buyer, the French Tax Authorities and the DGAC, respectively.

The first part of this certificate, filled in by the buyer, indicates:
- the surname and first names, or legal name, of the buyer (the surname and first names of the legal representative are to be added for a legal entity);
- the individual French VAT identification number of the buyer beginning with "FR";
- the profession or activity of the buyer;
- the taxpayer's address (address where VAT forms are filed);
- the legal name of the seller;
- the individual VAT identification number and the address of the seller;
- the nature (aircraft) and the specifications of the acquired good (serial number, registration number, take-off weight);
- the date on which the aircraft was first placed into service;
- the indication of the number of hours the aircraft flew up to the date of delivery;
- the sale price, excluding VAT, in the currency of the country of origin and its amount converted into French Francs[10];
- the applicable French VAT rate (presently 18.6 percent for aircraft);
- the period (month or quarter) during which the taxpayer will declare the transaction on its French VAT return (form CA 3).

The second part of this certificate is reserved for the signature of the French tax authorities to certify that the buyer has carried out the formalities regarding payment of French VAT.

The third part of the certificate is reserved for the registration department of the DGAC.

Once the DGAC has verified that the document has been signed by the French tax authorities, the DGAC also signs it which then allows the registration of the aircraft in the name

6. Article 237 of annexe II of the CGI.
7. Article 273 septies A of the CGI.
8. Article 3 of the Order No. 93-878 of 25 June 1993, J.O. of 3 July 1993, at 9460.
9. Order No. 93-878 of 25 June 1993, J.O. of 3 July 1993, at 9460.
10. Article 266-1 bis of the CGI and Inst. 3 CA-92, No. 416.

of the buyer. The buyer must make a specific request to have the aircraft registered.

(b) *Invoice*

The invoice, or documents replacing the acquisition invoice, must include, apart from the information necessary to deduct the French VAT incurred, the following specific information:
- name and address of the taxpayer carrying out the delivery;
- name and address of the buyer as well as the indication of the name of the Member State to which the new means of transport is sent or carried;
- the exhaustive identification of the means of transport:
- nature;
- purpose;
- trademark;
- type;
- serial number;
- total weight on the take-off for the aircraft;
- date of issuance of the first air worthiness certificate or export air worthiness certificate;
- number or registration mark;
- date of delivery,
- number of flying hours by the aircraft between the date it is first put into service and the date of delivery or, when the means of transport has not already been put into service, a reference specifying that the aircraft has never been used;
- the selling price exclusive of VAT; and
- the reference: "Exemption from VAT, Article 298 sexies of the CGI".

C. Conclusion

The new Community provisions introduced into France on 1 January 1993 simplify the VAT procedure for the acquisition of new aircraft by taxable persons entitled to an input tax deduction. Indeed, in this case, the buyer collects the French output VAT due on the intra-Community acquisition and has the right to deduct input tax for the intra-Community acquisition on the same CA 3 VAT return, i.e. it has the right to immediately deduct the VAT. The buyer derives a certain financial advantage, i.e., a cash-flow benefit, from this because the French VAT due on the intra-Community acquisition of the aircraft is not actually paid. Moreover, by not paying the French VAT, the taxpayer avoids the risk of not being able to charge it against the French VAT collected as part of its usual activity and of finding itself, at least temporarily, with a credit of deductible tax to be funded.

It should be noted that, under Article 298 sexies of the CGI, the particular taxation rules for acquisitions relating to new aircraft are applicable to other new means of transport (boats, land vehicles) with regard to the references which must be noted on the invoice delivered to the buyer and the taxpayer's obligation to pay VAT.

II. INTRA-COMMUNITY LEASING OF AIRCRAFT BY TAXABLE PERSONS DOMICILED IN FRANCE

The leasing of an aircraft by a lessor who is a taxable person domiciled in an EU Member State to a lessee who is a taxable person domiciled in France, raises the double problem of being subject to French VAT (i) with respect to the rent paid and (ii) with respect to the physical transfer of the aircraft to France for use during the terms of the lease.

A. Taxability of rental income

1. Airline companies

According to Article 262 II 4e of the CGI, the provision of services in connection with aircraft used by airline companies whose services to or from foreign countries or the French overseas departments, apart from metropolitan France represents at least 80 percent of the services that they offer, are exempt from French VAT. The leasing of an aircraft used by an airline company fulfilling the conditions of international traffic laid down by Article 262 II 4e of the CGI is therefore completely exempt from VAT in France.

2. Other users

According to the provisions of Article 259 A 1b of the CGI, the leasing of a means of transport is subject to VAT in France when:
- the provider (lessor) is domiciled in France and the good is used in France or in another EU Member State,
- the provider (lessor) is domiciled outside the EU and the good is used in France.

Therefore, when the lessor of an aircraft is domiciled in another EU Member State and, regardless of the place of utilization of the leased aircraft (France, EU, outside the EU), rents paid are not subject to French VAT. VAT due outside of France for the leasing of an aircraft is, in fact, invoiced to the lessee and paid by the lessor in the EU Member State in which it is domiciled at the rate in force in this State[11]. The taxpaying lessee domiciled in France will generally be able to ask for a refund of the tax paid abroad, in application of the combined provisions of Article 17 of the Sixth VAT Directive[12] and Article 2 of the Eighth VAT Directive[13].

The French tax administration noticed that when a lease granted with an option to purchase was considered to be a deemed sale of assets in the State where the lessor was located, no VAT was charged by the lessor on the deemed sale, according to VAT rules on intra-Community supplies of goods. The rents paid by a French lessee to an EU lessor could thus be totally exempt from VAT (both in France and abroad).

11. D. Adm. 3A-2132 of 1 May 1992, No 6.
12. 77/388/EEC of 17 May 1977.
13. 79/1072/EEC of 6 December 1979.

In order to avoid the result of non-taxation by the combined application of the domestic VAT rules of two different Member States (leading to VAT exemption) the provisions of Article 22 of the French correction finance law for 1994[14] state that as from 1 January 1995, French VAT is due presently at the rate of 18.6 percent on the rent paid by a French party which leases a means of transport used either in France or within the EU (i.e. in cases where, previously, French VAT was not payable) if the State where the lessor is located considers a lease with a purchase option to be a deemed sale exempt from local VAT. The EU lessor who must henceforth collect French VAT on the lease, must name a French tax representative to file any tax return on his behalf and pay the VAT collected[15].

B. Transfer of the aircraft in France

1. Former regime

Before the entry into force of the new VAT rules on 1 January 1993, the importation of an aircraft into France by a taxpayer subject to French VAT domiciled in an EU Member State, even without a transfer of the property, was subject to French VAT[16], subject to the exemption applicable to airline companies fulfilling the conditions stipulated by Article 262 II 4e of the CGI (see above). The importer (in principle, the EU lessor/owner of the rented aircraft) was supposed to pay the tax, when it was due, to Customs agents at the French frontier. It could then request a refund of such French VAT paid on this importation according to the procedure described in Articles 242 OM to 242 OT of the annexe II of the CGI (see below).

Since 1 January 1993, within the EU, the concepts of an intra-Community supply and an intra-Community acquisition have replaced the concepts of exportation and importation for intra-Community transactions. The aircraft's physical transfer to France from another EU Member State is considered to be an intra-Community acquisition normally subject to VAT in France but it is in fact exempt as the following discussion shows.

2. Principles

(a) *Taxation*

New Article 256 bis II 2 of the CGI stipulates that the transfer to France by a taxable person, for its own needs, of a good under its control sent or transported from another Member State to be used in France for services rendered in France is considered to be an intra-Community acquisition. The physical transfer of the aircraft to France, with a view to leasing the aircraft or for its own use, by a taxable person established in another EU Member State, is therefore considered to be an intra-Community acquisition.

According to Article 256 bis I 1 of the CGI, the intra-Community acquisition of tangible movable property is, in principle, subject to French VAT. Article 258 C of the CGI stipulates that the place of the intra-Community acquisition of tangible movable property is France when the goods are to be found in France at the moment of their arrival, their consignment or their transport to the buyer. The transfer of an aircraft to France by a lessor subject to VAT domiciled in another EU Member State for its own needs is therefore, in principle, presently subject to VAT in France at the rate of 18.6 percent. The tax basis, in such a situation, is defined by Article 266 1c of the CGI in the same way the basis for a self supply is determined. In principle, the tax base is the purchase price of similar goods or the cost price of goods transferred to France.

(b) *Tax representative*

According to the provisions of Article 289 A 1 of the CGI, a foreign firm domiciled outside of France subject to VAT in France, or which must comply with certain declaration formalities in France, is obliged to appoint a VAT representative domiciled in France who is registered with the appropriate services of the French tax authorities. Such representative fulfils the formalities which are incumbent on this foreign firm to pay French VAT on its behalf. The aircraft lessor, in principle subject to VAT in France, must therefore name such a tax representative. The latter is freely chosen and can be, for example, the lessee.

3. Exemption from French VAT

(a) *Article 262 ter II of the CGI*

Article 262 ter II of the CGI exempts intra-Community acquisitions of goods (or similar operations) from VAT:

- whose delivery in France would be exempt. This is the case, for example, of aircraft deliveries to airline companies which benefit from the above mentioned provisions of Article 262 II 4e of the CGI;
- whose importation would be exempt in application of the provisions of Article 291 II of the CGI (more particularly, goods which can benefit from the French tax regime of temporary admission);
- for which the buyer, not domiciled in France and which does not carry out supplies of goods or services subject to VAT in France (case at hand, see above), would benefit from the right of the total refund of the French VAT which, in principle, would be due for the acquisition (or for an assimilated operation), according to Article 271 4 d of the CGI, recodified as Article 271 V d by Law 93-859 dated 22 June 1993.

Provisions of V d (previously 4d) of Article 271 of the CGI refer to an Order codified under Articles 242 OM to 242 OT of annexe II of the CGI. Article 242 ON of said annexe II more particularly provides that taxpayers domiciled in an EU Member State can obtain, upon request, reimbursement of French VAT paid on services provided to them, and on tangible movable property which they acquired or imported into France, when these goods and services are used for the realization or for the needs of operations which are taxable

14. Codified under new Article 259 A 1 bis.
15. Article 289 A 1 of the CGI.
16. Articles 291 to 293 A of the CGI.

abroad but which would entitle the taxpayer to a deduction if the place of taxation was in France.

In the situation under consideration, since, on the one hand, the place of taxation would be France if the lessor of the aircraft had been domiciled in France[17] and since, on the other hand, the French VAT due on the occasion of the aircraft's transfer could have been deducted from the VAT collected on the leasing of the aircraft (or refunded as the case may be), the aircraft's transfer to France by the EU lessor is exempt from French VAT, in application of the above mentioned Article 262 ter II of the CGI.

(b) *Tax representative*

The EU lessor must name a representative who is a taxable person domiciled in France, notably, in order that it be registered with the French tax authorities[18]. Indeed, Article 286 ter 3 of the CGI provides that any taxable person which carries out intra-Community acquisitions of goods in France for the needs of its operations which come within the scope of the economic activities mentioned in the fifth paragraph of Article 256 A of the CGI and carried out outside France must be identified by an individual registration number. The economic activities mentioned in the fifth paragraph of Article 256 A of the CGI are all activities of producers, trades people or providers of services, including mining and quarrying activities and those of the liberal or similar professions. Operations including the exploitation of tangible (or intangible) movable property in order to obtain a return with a permanent character from its use are also considered to be economic activities in the sense of this Article. In the author's opinion, the leasing of an aircraft really comes under this last case.

Thus, foreign taxable persons which carry out intra-Community acquisitions in France (or similar operations) must identify themselves to the French tax authorities. The tax representative carries out the formalities relating to the preparation of the certificate which must be signed by the French tax authorities and which will be presented to the DGAC if a registration number must be assigned to the aircraft leased in France. This certificate will mention that the transfer operation to France of the aircraft assimilated to an intra-Community acquisition is exempt from French VAT under the provisions of Article 262 ter 3e of the CGI.

C. Conclusion

The above mentioned provisions of the CGI now allow the EU lessor, in principle subject to French VAT, not to pay this tax until the date on which it obtains its reimbursement from the French Treasury. Nevertheless, the EU lessor is always obliged, for administrative reasons, to carry out the formalities inherent in any intra-Community aircraft acquisition, i.e. nomination of a tax representative and obtaining and presenting, if necessary, the certificate to the DGAC.

17. Article 259 A 1b of the CGI.
18. Article 289 A 1 of the CGI.

OVERVIEW OF THE FRENCH TAX SYSTEM

Olivier Delattre and Camille Villette

Avocats à la Cour, Stibbe Simont Monahan Duhot, Paris.

I. INTRODUCTION

The income of the French state from taxes and custom duties in 1994 was about FF 1,500 billion. Direct taxes represent about 39 percent of this amount, VAT and indirect taxes represent 47 percent, registration and stamp duties represent 8 percent and customs duties about 7 percent.

Compared to the other members of the G7, France has a high level of taxation (including social security contributions) since these charges represented, in 1994, 44.5 percent of the gross national product. The proportion of the individual income tax to the total tax receipts of the French State is quite low since the individual income tax system offers a number of allowances and exemptions and thus applies only to half of the potential taxpayers. Individual income tax represented, in 1994, less than FF 300 billion. On the other hand, social security contributions represented a much bigger amount. In France, in 1993, social security charges amounted to 45 percent of the overall tax receipts compared to 30 percent in the United States and 18 percent in the United Kingdom. The corporate income tax burden for companies in France is similar to that in Germany but is lower than in Japan.

In France, during the last years, the tax burden at the national level has generally decreased whereas the social security charges and the local taxes have increased. The local taxes now represent FF 390 billion; in 1982, they represented only FF 116 billion. The reason for this is that France is decentralizing its tax system.

The French tax system is, moreover, evolving because of France's membership in the European Union (EU). Tax harmonization between the EU Member States is a priority. For example, a coordinated VAT system has been implemented throughout the European Union. In addition, EC directives regulate within the European Union the relationship between subsidiaries and parent companies and operations such as mergers.

Taxes to be paid by French taxpayers may be categorized as follows:
- direct taxes which are levied annually on the income of the taxpayer;
- French VAT (*Taxe sur la valeur ajoutée*) and other turnover taxes as well as indirect taxes which are generally collected directly by the taxpayers; and
- registration and stamp duties including inheritance and gift tax, wealth tax and transfer taxes.

II. DIRECT TAXES

Direct taxes can be divided into two categories:
- direct taxes paid to the state; and
- direct taxes paid to the local authorities.

A. Direct taxes paid to the state

1. Corporate income tax

The corporate income tax rate is currently 33.33 percent. It can be characterized as a comprehensive tax since it is applied to the net income of taxpayers.

(a) *Definition of taxpayer*

Corporate income tax is, notably, levied on corporations, i.e. stock companies (*sociétés anonymes* (SA), and *sociétés par actions simplifiées* (SAS)), limited liability companies (*sociétés à responsabilité limitée* (SARL))[1] and partnerships limited by shares (*sociétés en commandite par actions*).

Partnerships, i.e. mainly general partnerships (*sociétés en nom collectif*), are generally not subject to corporate income tax; their profits are taxed in the hands of the partners, such tax being calculated according to the tax status of each partner and paid by each partner in proportion to the percentage of the entity owned by said partners. Partnerships may, however, elect to be subject to corporate income tax.

In addition, the corporate income tax is also levied on:
- so-called civil law companies (*sociétés civiles*) involved in industrial or commercial activities;
- the portion of partners' profits in limited partnerships (*sociétés en commandite simple*) and joint ventures (*sociétés en participation*) when such partners are not jointly and severally liable for the companies' debts or their names have not been disclosed to the French tax authorities; and
- French branch profits of foreign corporations.

Groupements d'intérêts économiques (GIE) are never subject to corporate income tax.

(b) *Territoriality rules*

Under Article 209 I of the CGI, French corporate income tax is assessed on income derived from enterprises engaged in business operations in France and on income taxable in France by application of a tax treaty.

1. When a SARL is organized by a single shareholder, it is also called an "Entreprise Unipersonnelle à Responsabilité Limitée" or "EURL".

Profits realized by enterprises operating outside France are thus exempt from French corporate income tax even though their accounts are maintained in France. Similarly, a French corporation cannot normally deduct from its taxable profit losses realized in a foreign activity.

French tax law does not define what constitutes an enterprise operating in France. According to the case law of French tax courts and to administrative regulations, the notion of " an enterprise operating in France" may be understood to mean the performance, in a usual manner, of an activity which may:
- be performed through an establishment both permanent and autonomous (such as a branch, shop, factory, mine, or building site) where decisions are duly made; or
- be performed, when there is no permanent establishment, through a dependent agent; or
- result from the performance of operations deemed to involve a complete commercial cycle (purchase and resale of goods, rendering of services distinct from the head office's business).

These criteria apply unless a tax treaty provides otherwise. When no tax treaty applies, foreign enterprises are subject to corporate income tax in France if:
- in the absence of a French permanent establishment they conduct their activities through a dependent agent who has the authority to conclude contracts on behalf of the foreign undertaking; or
- in the absence of a permanent establishment in France or of a dependent agent acting on their behalf, they carry out business operations deemed to constitute a complete commercial cycle.

Conversely, French enterprises are normally not subject to corporate income taxation in France on profits deriving from a foreign permanent establishment, when they act through a dependent agent located abroad or when they are involved in business operations which can be deemed to constitute a complete commercial cycle distinct from the other activities carried on in France.

However, the following exceptions to the above territoriality rules should be noted:
- French companies which create permanent establishments or subsidiaries abroad may deduct some expenses from their French income subject to corporate income tax;
- French companies authorized by the French Minister of Economy and Finance may opt to determine their taxable base by consolidating all income of their French and foreign subsidiaries of which they own 50 percent or more of the registered capital (*bénéfices consolidés*) or they may elect taxation on the income of all their enterprises both in France and abroad (*bénéfice mondial*);
- French corporations are subject to French corporate income tax on their share of profits realized in foreign subsidiaries or through foreign branches which are subject, locally, to a favourable tax regime, unless it can be established that the foreign subsidiaries or the foreign branches have a real industrial or commercial activity on the domestic market.

(c) *Determination of corporate income tax*

Corporate income tax is calculated on the net profits of the corporate taxpayer. The CGI provides that tax is due on "net profits arising from all operations including disposal of assets" and defines net profits as "the difference between the net asset value of the company at the beginning and at the end of the tax year, reduced by the amount of additional capital contributions and increased by income distribution".

The net asset value is defined as the excess of total net assets over total liabilities of the company, depreciation deductions and deductible tax reserves. A company will therefore be taxed not only on industrial and commercial profits but also on earnings from stock exchange transactions, dividends, partnership income received, etc.

The taxable income is subject to corporate income tax at a 33.33 percent rate. However, capital gains deriving from the sale of capital assets purchased or created two years or more before the sale may be subject to a reduced corporate income tax rate of 19 percent, provided that the net gains are booked in a special reserve account. As regards securities, the reduced 19 percent rate may be applied only to gains derived from the sale of interests in subsidiaries or from the sale of shares of *fonds commun de placement à risque* and/or *sociétés de capital risque*.

Dividend tax credits (*avoirs fiscaux*) and tax credits attached to dividends and interest received by the company are deductible from corporate income tax.

Tax losses incurred during a financial year are in principle deductible from the taxable income of the five following financial years. Upon election, they may also be carried back and offset against the taxable income of the three financial years preceding the one during which losses were incurred.

(d) *Computation of taxable income*

Entities subject to corporate income tax are required to keep regular accounts according to rules set forth in the National Accounting Plan and by professional associations. The financial results of a company, calculated under such rules, are merely the starting point for the calculation of the taxable income of a French corporate taxpayer. Adjustments are made to a company's book income to arrive at taxable income.

The tax authorities and the courts rigorously enforce the rule that corporate tax is assessed on an annual basis. At the end of its financial year a company is required to take into account all accrued income and all incurred expenses. In addition, during a given financial year the company will be deemed to realize any profits or capital gains to which it is entitled. Each financial year is deemed to be absolutely independent of the preceding and subsequent financial years. A company is free to choose the financial year over which it will calculate income.

Sales and purchases are accounted for on an accrual basis. A sale is deemed to be realized during the tax year in which it is concluded (and the property transferred), meaning normally when the merchandise is delivered. The payment for services usually accrues when the corresponding work is completed. Correspondingly, under the same principles, the expenses of purchases and services are taken into account when they are incurred.

Credit and debts are stated in French francs and appear at face value both for accounting and tax purposes. When they are stated in a foreign currency, hidden gains and losses are taken into account for tax purposes. Book accounting rules are different: they proscribe the booking of hidden gains but require that an expense reserve be credited.

A taxpayer must value its inventory at the end of the tax year at cost, or at market value if the latter is less than cost. When market value is lower, a tax-deductible reserve account can be credited for depreciation.

Cost is defined as the initial purchase price increased by inventory expenses, such as transportation, maintenance, insurance, customs charges, etc. The cost of products manufactured by the enterprise will be the cost for raw materials and all direct and indirect manufacturing costs except financing charges. Value-added tax is excluded from inventory cost.

If the goods are traded on a regular market, the company may determine the cost price of inventory using either a weighted average cost method, or a first-in, first-out (FIFO) method. The last-in, first-out (LIFO) method may not be used unless it corresponds to actual inventory maintenance practices. When there is no regular market for the goods, market value will be the probable value.

(e) *Dividends paid by French companies*

Dividends paid by a French company are distributed from taxable income which, in principle, has been subject to corporate income tax before the distribution by the French company.

At the date of the distribution, dividends paid to French residents benefit from a dividend tax credit (avoir fiscal) equal to 50 percent of the dividend. The purpose of the avoir fiscal is to avoid double taxation of dividends, as follows: the amount of the dividend increased by the dividend tax credit is subject to corporate income tax (or to individual income tax depending on the recipient of the dividend); the dividend tax credit is then deducted from the income tax due by the taxpayer. Since corporate income tax is levied at a 33.33 percent rate the dividend tax credit completely offsets the corporate income tax due in respect of these dividends.

When the shareholder receiving the dividend is subject to corporate income tax and holds a participation in the distributing company representing 10 percent or more of the registered capital of the distributing entity, or holds an equity interest representing an investment of at least FF 150,000,000, this shareholder may elect to be subject to the parent-subsidiary tax regime. Under this regime, the shareholder is not subject to corporate income tax on the dividend received from its subsidiary and cannot offset the dividend tax credit attached to the dividend received against its corporate income tax liability. The shareholder will, however, be allowed to offset the dividend tax credit against the equalization tax (*précompte mobilier*) which may be due if the dividend received is redistributed.

It is worth noting that the ordinary tax regime is less favourable than the parent-subsidiary regime when the parent company realizes losses (since, in that situation, dividends received reduce losses) or when the subsidiary is located abroad (since, in that situation, the tax credit corresponding to the foreign withholding tax is not sufficient to offset the corporate income tax).

When dividends are paid to non-residents, the dividend tax credit is not granted to the foreign recipient unless otherwise provided by the applicable tax treaty. These dividends are subject to a 25 percent French withholding tax which may be reduced by or avoided under double treaties.

Dividends which have not been subject to the normal rate of corporate income tax (presently 33.33 percent) will carry the dividend tax credit but the distributing company will have to pay an equalization tax (précompte mobilier).

French holding companies owning mainly foreign subsidiaries may, under specific conditions, be exempted from the equalization tax. In such a case, no dividend tax credit will be attached to the dividends paid.

(f) *Foreign dividends*

When receiving dividends from a foreign corporation, a French tax resident, whether a company or an individual, must include the net dividend received into its taxable base and is allowed, if a tax treaty so provides, to offset the amount of the withholding tax paid abroad against the French income tax due in France on the foreign-source dividend. The French corporation is not entitled to an indirect foreign tax credit. However, as seen above, such dividends are exempt from corporate income tax under the special parent-subsidiary tax regime.

(g) *Tax consolidation*

A French corporation may elect to be taxed on a consolidated basis along with its 95 percent, directly or indirectly, owned French subsidiaries. The election is made for a five-year period.

2. Individual income tax

(a) *Description*

All individuals whose tax domicile is located in France as well as individuals whose tax residence is not located in France but who have realized French-source income are subject to individual income tax. Under French law, an individual will be considered a resident of France if he has his home in France, or if his principal place of abode is in France, or if he is engaged in a business activity in France, or if the centre of his economic interests in France.

Individual residents of France are subject to income tax on their worldwide income. Non-residents are subject to income tax only on their French-source income.

The individual income tax base is the net income of various categories of income. The net income of each of these categories is determined with reference to specific rules. The categories of income are: real estate income, industrial and commercial income, income received by corporate executives, agricultural income, employment income, income from independent personal services, investment income and capital gains.

The total amount of the net income from each category constitutes the gross taxable base for individual income tax purposes (which under specified conditions may be decreased by certain tax-deductible losses). The net taxable base is obtained by deducting from the gross taxable base certain expenses such as social security contributions, interest paid on certain kinds of loans, alimonies, etc. and certain deductions.

Individual income tax is levied on the net taxable base determined on the above basis at progressive rates. The rates vary from 0 percent up to 56.8 percent.

It should be noted that the family status of the taxpayer limits the progressiveness of individual income tax. This system consists in dividing the taxable base of a taxpayer into a number of "shares" based on the number of members of a family residing at the taxpayer's place of abode and based on whether the taxpayer is either single, married, widowed or divorced. Once the net income has been divided into such shares, individual income tax rates apply according to the income bracket for the income determined for one such share. The tax resulting from this operation is then multiplied by the number of shares so allocated to the taxpayer. These computations provide a gross amount of individual income tax due. The gross individual income tax due is then corrected by deductions for certain investments, donations to charities, political contributions, etc. The result of these operations is the amount of individual income tax to be paid.

Individual income tax is determined by the French tax authorities on the basis of information provided on a special tax return normally filed by taxpayers by 28 February of each year. Payment of the tax due by the taxpayer is made in instalments in the year which follows the year of realization of the income.

(b) *Capital gains and interest income*

Taxpayers may elect to subject interest income to a withholding tax of, generally, 19.4 percent instead of the normal income tax rate of up to 56.8 percent. Capital gains realized on the sale of securities are subject to taxation at the same rate of 19.4 percent. The 19.4 percent rate includes the special social contribution of 2.4 percent and 1 percent of other social security contributions.

(c) *Taxation of non-resident taxpayers*

Individuals who are non-residents for tax purposes are subject to French individual income tax only with respect to French-source income as defined by French tax law or in the tax treaties concluded by France.

However, the taxable base of non-resident taxpayers who are domiciled in a country which has not signed a tax treaty with France but who have the use of one or more dwelling houses in France may not be lower than three times the rental value of these houses. (Article 164 C of the CGI)

Unless provided otherwise by tax treaties, income received or realized in France by non-residents is subject to a French withholding tax on:

- amounts paid as consideration for independent personal services performed in France when the recipient of such income has no permanent professional establishment in France;
- amounts paid to inventors or with respect to copyrights;
- amounts paid with respect to rights on commercial and industrial property or similar rights; and
- amounts paid as consideration for services of any kind performed or used in France.

The withholding tax rate is presently 33.33 percent, reduced to 15 percent for payments for services of an artistic or sporting nature. In addition, non-residents are liable to withholding tax on wages, salaries, pensions and annuities, the rates of which depend on the amount of the relevant income. Presently these rates are 0 percent, 15 percent and 25 percent. These withholding taxes are not always final, which means that the foreign taxpayer may have to file a tax return in France (for example in the case of employment income).

3. Other taxes

(a) *Payroll tax (taxe sur les salaires)*

Tax on salaries is due by any individual, company, association or other private or public entity located in France which employs salaried persons. However, employers liable to VAT on at least 90 percent of their turnover are exempt from the payment of the payroll tax. Local authorities, farmers and individuals having only one employee are also exempt.

This tax is calculated on the basis of salaries paid by the employer increased by any bonus and fringe benefits paid in cash or in kind to or enjoyed by the employee net of social charges. The rates vary between 4.25 percent and 13.60 percent.

(b) *Apprenticeship tax*

An apprenticeship tax is paid yearly by all industrial and commercial enterprises. The tax rate is 0.5 percent of all salaries paid by the enterprise during the preceding year. The taxable base is the same as that of the payroll tax. It should be noted that taxpayers may deduct from the tax due any payments paid with respect to apprenticeships, such as the costs of operating a corporate training school, contributions to recognized schools including certain graduate schools (such as MBA or engineering schools).

(c) *Continuing professional training tax*

All employers located in France whatever their activities, legal form or tax regime are subject to the professional training tax. The tax rate is 1.5 percent, or 0.25 percent of the salaries paid during the current financial year if more than ten salaried persons are employed. Like the apprenticeship tax, payments for professional training are deductible.

(d) *Participation in housing construction*

All employers in the private sector who employ ten salaried employees or more must pay before 31 December of each year a tax equal to 0.45 percent of the total amount of salaries paid during the preceding year. The revenue from this tax is to assist in the construction of residential housing. Any late payment or failure to pay increases the tax rate to 2 percent.

(e) *Solidarity social contribution for companies*

The solidarity social contribution due by companies is used to finance the social security regime of non-salaried individuals. It is levied on enterprises whose turnover equals at least FF 3 million which have been set up as a stock company (SA), limited liability company (SARL), one-owner limited liability company (EURL), limited partnership (SCA), or state or other public enterprises.

The rate of the tax is 0.1 percent and it is based on the entity's turnover, subject to various corrections.

(f) *Special social contribution for individuals (contribution sociale generalisée)*

The special social contribution for individuals was created by a law of 29 December 1990 and is levied on all individuals who reside in France for tax purposes. From 1 July 1993 the rate is raised to 2.4 percent. This social contribution applies to two categories of income:
- income deriving from the taxpayer's activities (for employees, the taxable base is 95 percent of the gross income and for non-employees such as professionals, the taxable base is the same as the base used to compute the family's social security contribution); and
- income deriving from a taxpayer's investments (e.g. in real estate or securities).

B. Local taxes

Local taxes are those taxes which are paid not to the state but to local authorities and to some public agencies.

1. Real property tax on developed property

A real property tax is assessed on the value of real property that has been significantly developed or improved. It applies to buildings, houses, workshops, storage sheds and other industrial improvements with a permanent character, roads other than public roads, land that is part of buildings and their outbuildings, etc.

Buildings used for agriculture, government property, churches and other buildings used for religious purposes, diplomatic residences and offices are exempt. New construction is exempt from the tax for the first two years and longer exemptions may be granted to specific public or subsidized housing.

The real property tax rate is determined each year by the local authorities. This tax is based on an administrative rental value which may be quite low when compared to market rates.

2. Real property tax on undeveloped land

This tax is levied mainly on land located in rural areas, outside cities or townships. The applicable tax rates are determined each year by the local authorities.

3. Occupancy tax

The occupancy tax is levied on any person who has the use of a furnished residence. The tax rate is determined by the local authorities and the tax is assessed on the administrative rental value of the premises (see II.B.1.).

4. Business tax

The business tax (*taxe professionnelle*) is assessed on individuals or corporate entities involved in business or professional activities, with the exception of individuals who are salaried employees. The taxable base is composed of two elements:
- the rental value of the assets used by the enterprise for its activities; and
- 18 percent of the annual salaries paid by the enterprise.

The owner of an enterprise is liable for the business licence tax in the city or town where it has business property as of January 1 of each year. The tax is calculated by applying to the tax base that year's annual rate as voted by the local governmental authorities having jurisdiction over the area (i.e. *régions*, *départements* and *communes*).

Before 1 May of each year, an enterprise must file a return listing the assets constituting the business tax base in each commune where such an enterprise has an establishment (i.e. one return has to be filed for each locality).

Enterprises that qualify for a company-tax holiday for new companies or following the acquisition of a failed or bankrupt business are granted a temporary business tax exemption covering the new or failed establishments.

5. Three percent real estate tax

French and foreign entities owning French real estate must – subject to the exemptions below – pay an annual tax equal to 3 percent of the market value of the real estate.

French entities are exempted from the annual three percent tax if:
- the real estate they own represents less than 50 percent of their assets; or
- the real estate assets they own represent more than 50 percent of their total assets, provided they file, each year, a special form describing the real estate owned and disclosing the identity of each shareholder.

Foreign companies located in a state which has signed a mutual assistance treaty with France or a treaty providing that a Contracting State shall apply to the nationals of the other state the same tax treatment as it does to its own nationals may be exempted from the three percent tax if:

- they file a special form containing information on the real estate owned and disclosing the identity of each shareholder before 15 May of each year; or
- they make a written commitment, within two months following the acquisition of real estate, to provide the French Tax Authorities with this information at the first request.

III. INDIRECT TAXES

Turnover taxes (mainly the French value added tax and other miscellaneous taxes) as indirect taxes share the common characteristic of being passed on to the consumer who bears the actual burden of the tax.

A. French value added tax

French value added tax is assessed on all economic activities, i.e. on the supply of goods and services for consideration, farming, legal, accounting and other professional activities (the liberal professions). French VAT is based on the deduction system where VAT paid is deductible from VAT collected from the ultimate consumer.

VAT is levied at a reduced rate of 5.5 percent (applicable mainly to food, water, books and to specific services such as the transportation of passengers) and at a normal rate of 18.6 percent (applicable to all operations which are not subject to the reduced rate).

1. Taxable transactions

Transactions falling within the scope of application of VAT are defined by Article 256-1 of the CGI. VAT is assessed on the supply of goods and services rendered for consideration by a person subject to VAT. Article 256 A of the above Code states that anyone engaged for his own account in one of the economic activities listed in Article 4(2) of the Sixth European Directive on VAT is liable to French VAT.

Economic activities include the production of goods and the supply of services of any kind: for example, the extraction of natural resources, farming, liberal professions, etc.

In addition, the CGI expressly subjects to French VAT imports, some purchases from non-VAT liable persons (the sale of pearls, precious stones, purchase of spirits or wine), real estate construction and the self-supply of property. Conversely, exports, the supply of goods within the European Union (EU), some international transport, some financial operations, some sales of second-hand goods, some so-called "liberal activities" such as insurance and reinsurance, offshore fishing, etc. are exempt from French VAT.

Articles 260 – 260 B of the CGI allow the taxpayer to elect to be subject to French VAT when performing certain activities. These taxpayers are, among others:

- anyone renting unfurnished real property used for business purposes;
- banks and financial institutions, for certain transactions; other transactions are subject to a special turnover tax which applies to financial transactions and which is called the *taxe sur les activités financières*;
- local authorities, for some transactions; and
- farmers, under certain conditions.

2. Territoriality rules

For goods delivered in their original condition, three scenarios need to be examined:

- if the place of departure of the goods is located within France, French VAT liability is incurred unless the goods are exported or delivered within the EU;
- if the place of departure of the goods is located outside France, the goods do not attract VAT unless taxed as an import or as an intra-EU acquisition; and
- if the goods are not transported, French VAT applies if the goods are located in France when they are delivered to the customer.

When the goods are installed or assembled after delivery in France, they are always taxed in France.

The supply of services is normally subject to French VAT when the supplier is established in France. However, two exceptions apply to this rule with respect to services which are materially performed in France and services that are considered immaterial ones. Materially performed services are subject to VAT in France when rendered in France. These are: rental of transportation, services on real property, certain transportation services, services rendered in connection with cultural and artistic events, works and services of experts on movable property located in France, supply of lodging and meals.

Immaterial services involve, among others: the sale or licensing of copyrights, patents, trademarks, and similar rights, advertising services, counselling services, the supply of information, banking, financial and insurance services, and services of intermediaries and brokers related to the supply of the above categories.

French VAT is due with respect to intangible services as follows:

- if the above services are supplied by a person established in France, the services are only taxable in France:
  (i) if the customer is established in France; or
  (ii) if the customer is established in another EU Member State and is not liable to VAT there;
- if the services are supplied by a person not established in France (whether in or outside the European Union), the services are only taxable in France:
  (i) if the customer is liable to VAT in France; or
  (ii) if the supplier is not established in the European Union and the customer is established in France, while a person not liable to VAT actually used the services in France.

In all other cases, immaterial services are not taxable in France.

3. Taxable base

Under Article 266-1 (a) of the CGI, the taxable base of French VAT for the supply of goods, services and intra-EU acquisitions is the price charged. The price is made up of all sums, values, goods or services received or to be received by the supplier of the goods or by the persons rendering the services. As a result, taxes of any kind, except French VAT itself, must be included in the VAT taxable base. Similarly, transportation expenses that the supplier invoices to his client must be included in the VAT taxable base.

4. Taxable event and liability to tax

The chargeable event for VAT purposes, in so far as the supply of goods is concerned, arises on the date of delivery. It should be noted that liability to tax also arises at this date.

As regards the supply of services, the taxable event is the date of performance of the services. Liability to tax occurs, however, only when the corresponding price is paid in whole or in part.

Taxpayers may be authorized to collect VAT on a debit basis, i.e. when the invoice is issued and not when the price is paid.

5. Reporting requirements

Taxpayers must meet the following reporting requirements:
- VAT returns must be filed where the VAT taxable base is declared;
- invoices must be issued containing all the required information;
- a special tax return relating to the exchange of goods in case of intra-EU supply or acquisition must be filed; and
- accounts must be kept.

6. Deductions

Taxpayers may deduct VAT incurred from VAT collected or, in case of a VAT credit, under certain conditions claim a VAT refund from the French Treasury.

VAT is deductible subject to the following conditions:
- VAT paid by the enterprise on goods or services must be used by the enterprise for transactions that are actually subject to VAT;
- input elements or taxable expenses must be incurred for the normal and necessary operation of the business;
- input items must not be of a type that is not deductible under an express provision of the CGI; and
- input VAT that is deducted must be indicated on an invoice or other acceptable document.

VAT paid on most taxable goods and services is deductible. However, VAT incurred on the acquisition of the following goods and services is not deductible:
- expenses incurred for food, lodging and entertainment;
- the cost price of passenger vehicles;
- expenses incurred in transactions involving the transportation of persons;
- the acquisition price of gifts or items sold for a small fraction of the initial cost;
- certain services related to VAT-exempt goods; and
- certain petroleum products.

Finally, enterprises engaged in taxable and non-taxable transactions must determine their "VAT *pro rata* percentage" which is equal to the percentage of their turnover which is subject to VAT and is then used to allow a proportional deduction of incurred VAT. However, when an enterprise is engaged in different sectors of activity, each subject to a different VAT treatment, the CGI provides that the enterprise must determine a specific VAT *pro rata* percentage for each sector.

B. Other turnover taxes

There are two types of turnover tax other than VAT:
- taxes for which the rate is determined as a percentage of the turnover of the taxpayer: the tax on forestry products, on publishing, etc.; and
- specific taxes for which the rate is not equal to a percentage of the taxpayer's turnover: the tax on cooking oil, on meat, beetroots and on television advertisements.

C. Indirect contributions

Indirect contributions include the following taxes:
- licence rights on bars;
- beverage taxes;
- entertainment taxes; and
- taxes on precious metals.

IV. REGISTRATION DUTIES, STAMP DUTIES AND WEALTH TAX

A. Registration duties

Registration duties are levied when specific transactions are entered into (sales of certain assets, contribution of assets to a corporation, mergers and similar restructuring, etc.) and also in case of gift or death.

Once a very important source of income for the French state, registration duties now represent less than 6 percent of total revenues. However, registration duties must still be taken into account for some corporate transactions since the rates may be quite high.

1. Registration duties to be paid by companies

Some registration duties must be paid by companies or by their shareholders with respect to certain deeds which must be registered within a compulsory time period (frequently one month) following the date of execution. Among those deeds are the following:
- the by-laws of a new corporate entity and amendments thereto. Contributions to capital will, in general, be subject to a flat tax of FF 500. However, contributions from an individual or a partnership to a corporation of real estate assets and/or goodwill gives rise to a transfer tax of

13 percent or 11 percent which can be limited in some circumstances;
- during the life of the company, deeds relating to an increase of capital give rise to the same taxes as those applying to the initial contribution; merger agreements enjoy a special flat rate tax of FF 1,220; transformation of a company is usually subject to a flat rate tax of FF 500. Sale of shares of a corporation (SA, SCA or SAS) will be subject to a transfer tax of 1 percent limited to FF 20,000 per transfer if such a transfer is evidenced by a share purchase agreement. Sale of an interest in a partnership (SCS, SNC) or in a SARL/EURL gives rise to a transfer tax equal to 4.80 percent of the sale price or market value, whichever is higher;
- the deed relating to the dissolution of a company is subject to a flat rate tax of FF 500 and the distribution of the assets among the shareholders is subject, in principle, to a tax of 1 percent.

2. Sale of real estate, goodwill, trademarks used in France

Deeds on agreements for the transfer of real estate, goodwill and/or actively used trademarks are subject to transfer taxes at rates varying from 6.40 percent to 18.20 percent, assessed on the stated price of sale or on the market value of the good, whichever is higher.

3. Gift and death taxes

Death taxes are levied on the worldwide assets of decedents having their residence in France at the time of death. The definition of residence for death tax purposes is the same as for income tax purposes.

Taxes are paid by the beneficiary and rates depend on the relationship between such beneficiary and the deceased person. In a direct line and between spouses, the rates vary between 5 percent and 40 percent (with the 40 percent rate applying on the share of the assets received by a given person for a value in excess of FF 11,200,000). Between unrelated persons, the tax rate is 60 percent.

For decedents who are not residents of France at the time of death, only French assets are subject to death taxes.

Gift taxes are subject to the same rules and rates.

B. Stamp duties and other miscellaneous taxes

Stamp duties are paid in connection with the recording of certain deeds, such as the registration of a transfer deed, or other legal proceedings such as the issuance of a bill of exchange or service of process. The rate of the applicable stamp duty depends on the situation involved as well as on the type of deed involved.

The main miscellaneous taxes are the following: tax on vehicles, local tax on advertisement, tax on insurance contracts, etc.

C. Wealth tax

Article 26 of the 1989 Finance Law enacted an annual wealth tax. This tax is to be paid by individuals whose net wealth exceeds a threshold level which is adjusted each year for inflation (FF 4,530,000 for 1995). This threshold is determined on the basis of the net wealth of all members of the taxpayer's household.

Taxpayers are subject to the wealth tax on a worldwide basis if they are residents of France for tax purposes. Otherwise, they are subject to wealth tax only with respect to their assets located in France, apart from financial investments which are expressly exempt from wealth tax.

These provisions apply unless provided otherwise by international tax treaties concluded by France.

Wealth tax is assessed on all the property owned by the taxpayer, his spouse and his children and members of his household as of 1 January of each year. Some property is exempt from tax such as assets used by professionals in the exercise of their business, works of art, etc.

Wealth tax rates are progressive and range from 0 percent to 1.5 percent depending on the net taxable wealth.

V. STATUTE OF LIMITATION AND PENALTIES

As a general rule, the statute of limitations for the individual and corporate income tax expires at the end of the third year following that for which tax is due. For example, for a corporate income tax return timely filed for the financial year ending 31 December 1994, the tax authorities's audit period will expire on 31 December 1997. A longer statute of limitations is allowed under special circumstances. Indeed, when a criminal charge alleging a fraudulent tax transaction is made, the normal statute of limitations is extended by two years. Furthermore, the 1990 Finance Law extended the special open audit period that follows the revelation of tax evasion during a criminal proceeding. Thus, any type of judicial proceeding (civil or commercial) could trigger a new open period which would expire at the end of the year following the decision which closes the proceeding, and at the latest at the end of the tenth year which follows the year during which tax was due.

The statute of limitations for VAT begins to run at the beginning of the taxpayer's financial year and expires on 31 December of the third year following that during which a particular transaction whose tax is contested was concluded. For a calendar-year taxpayer, the tax authorities will have until 31 December 1995 to review transactions concluded since 1 January 1992 for calendar-year taxpayers.

For registration duties and related taxes, the statute of limitations ends on 31 December of the third year following that during which the tax authorities became aware that registration duties or other taxes were due and payable, e.g., following the registration of a deed or the filing of a declaration. If insufficient facts were indicated on a return to allow the tax authorities to become aware of the transaction and the corresponding tax liability, the statute of limitations expires at the end of the tenth year following the year during the course of which the transaction took place.

Once the tax authorities interrupt the statute of limitations by sending a final adjustment notice (*notification de redressement*), a new period of three years begins in which the tax can be assessed, up to the amounts set out in the adjustment notices, e.g. a taxpayer who received an adjustment notice in November 1992 on corporate income taxes paid for the 1989 calendar year will have to receive the final tax assessment before 31 December 1995, provided that the amount of the assessment does not exceed the amount indicated on the adjustment notice. Therefore, many adjustment notices grossly exceed the amount finally determined as due by the tax authorities in their final assessments.

Sanctions are applied in the case of a failure to correctly file declarations and pay taxes. These sanctions can be split in two categories: on the one hand, the tax fines which are applied by the tax authorities and are subject to appeal before administrative courts; on the other hand, criminal penalties which are decided by criminal courts in the case of important tax offences.

Late payments of income tax and local direct taxes will lead to an automatic penalty of 10 percent, which is triggered after the last day of the month following the month during which the tax was due and payable. In addition, interest at a rate of 0.75 percent per month computed on the unpaid taxes has to be paid.

For other taxes, interest for late payments is imposed at a rate of 0.75 percent per month on all taxes due but not yet paid by the taxpayer. In addition, the taxpayer is liable for a 5 percent penalty. This penalty is automatically assessed when the taxpayer's good faith is not questioned.

Tax penalties increase progressively depending upon how onerous the taxpayer's behaviour is or how insufficient the information is. For example, a 40 percent penalty is assessed when the taxpayer only files a required declaration after having been notified to do so by the tax authorities and fails to do so within the time period set by the authorities. The penalty is raised to 80 percent if the taxpayer fails to file a return after repeated demands.

Taxpayers who fail to pay sufficient amount of tax without having a bona fide reason are liable for a tax penalty equal to 40 percent of the unpaid tax (only applicable above a statutory threshold of 5 percent). This penalty is doubled, i.e. increased to 80 percent, when the taxpayer engages in fraudulent behaviour or commits an abuse of law (see above).

Moreover, individuals who commit serious tax fraud can be brought before the criminal courts. Under Article 1741 of the CGI, a taxpayer convicted of tax fraud for a first offence risks a fine from FF 5,000 to 250,000 and one to five years in prison. In case of false invoices or recidivism, these penalties are increased.

VI. FUTURE PROSPECTS

Over the past years, the French tax rules applicable to business activities have been subject to important modifications in order to create a more competitive tax environment and in order to implement the various EC Directives.

The rates of corporate income tax have been reduced from 50 percent to 33.33 percent for the tax years beginning on or after 1 January 1993. The avoir fiscal which is attached to dividends remains equal to 50 percent of the amount of the dividend. This compensates totally the amount of the French corporate income tax paid on the distributed dividends.

French groups companies may now file consolidated tax returns including the profits and losses of all 95 percent-owned subsidiaries.

The tax regime applicable to mergers and similar transactions has been modified to make it applicable to European reorganizations in conformity with EC Directive 90/434 of 23 July 1990. Similarly, the provisions of EC Directive 90/435 of 23 July 1990, which regulate the tax regime applicable to parent companies and subsidiaries, have been implemented in French tax law.

The system is now considered adequate by the French tax authorities and no major changes are expected in the near future. The tax programme of the newly elected President is limited, for business activities, to measures intended to improve capitalization of companies, a constant problem in France.

However, the newly elected President's tax programme concerning individuals is much more important. It is true that only individuals can vote, but French income tax rules and French estate tax rules have not been modified for a very long time and many prior governments had announced an important reform, but with no effect. The new government has promised that a major tax reform will receive priority and that various measures will be adopted such as:

- reduction of the top tax rate from 56.8 percent to 50 percent;
- limitation of the number of exemptions and deductions which had been granted to various categories of taxpayers over the years;
- taxation of passive investment income (which in practice is often taxed at the reduced 19.4 percent rate) and a more equitable taxation of active income;
- special rules to facilitate the transfer of enterprises; and
- the reduction of local taxes and transfer taxes.

It will be interesting to see if this reform is implemented. For the time being, the only certainty is an increase on 1 August 1995 of the VAT rate from 18.6 percent up to about 20.6 percent in order to finance part of the social programme and the temporary increase of the corporate income tax by 10 percent. Rates of the corporate income tax will be raised up to 36.6 percent for the normal rate and up to 20.9 percent for the reduced corporate income tax applicable to long term capital gains.

Tax Reform in the Maghreb Countries

Jean-Pierre Andrieux

Partner, Bureau Francis Lefebvre, Paris.

The objective of the tax reforms recently implemented in the Maghreb countries (Algeria: 1992, Morocco: 1986, Tunisia: 1988 and 1990) was to modernize their respective tax systems. The reforms were long overdue as the tax systems had been relatively unchanged over the previous 20 years. This lack of adaptation to modern commercial conditions had resulted in slow economic progress.

In each of these countries, the reform of the tax system was effected by replacing a complex structure of turnover taxes by VAT, corporation tax and income tax. In addition to these tax reforms, Tunisia and Algeria have also implemented new rules in order to encourage investments. Morocco is expected to introduce similar changes in the near future. Another notable development has been Tunisia's reform of its oil codes in 1985, followed by Algeria in 1986 and 1991. This article will, however, limit itself to analysing the implementation of the three new taxes.

The general principles followed by the three countries in the implementation of their tax reforms are similar. There are, of course, differences in the actual application of the new measures. These differences stem both from the remnants of the old system which remain embedded in the countries fiscal structures, and the countries diverging economic and political orientations.

This article does not intend to provide an exhaustive analysis of the reforms, but rather to outline the principles followed, and to highlight the more interesting features of the reforms. Issues affecting taxpayers' rights and tax compliance have not been examined, although it should be noted that these have constituted an important part of the reforms.

I. WHY WAS TAX REFORM NECESSARY?

To understand why reform was needed, it is necessary in the first instance to describe the old tax regimes that existed in these countries, and also to set out the objectives of the legislators in introducing reform.

A. The old regime

State revenues

Ignoring the oil taxes in Algeria and Tunisia, the *droits de porte*, indirect taxes and turnover taxes represented the major part of state revenues. Income tax represented only a small percentage of revenues despite the high tax rates. In addition, it should be noted that a significant part of income tax was levied, through a PAYE system on employment income.

Turnover taxes

All three countries levied a tax on the production of industrial companies, as well as a tax on services. The tax on services was multi-stage and cumulative. In contrast, when calculating the tax due on production, credit could be obtained for input tax, whether paid to suppliers, or paid on importation.

Income tax

The tax system combined a schedular tax system (*Impôts Cédulaires*) with a surtax (*Impôt de Superposition*). The tax rates were high (except on employment income in Algeria as from 1979), but the income tax revenues remained low except for those taxes which were withheld at source (tax due by employees and, in Algeria, by foreign companies).

In addition to the above, local taxes were levied in the form of a business tax (*patente*) and a real estate tax (*impôt foncier*). A wage tax due by the employer, consumer taxes, registration duties and stamp duties were also payable.

Since their independence, Algeria and Tunisia had adopted numerous reactive measures which had rendered the tax systems of those countries cumbersome, while increases in the tax rates had not generated more state revenue. In Morocco, where the burden of tax had been rather low up until the 1950s, a tax system modelled on the Algerian and Tunisian systems had been implemented between 1959 and 1972, with the same imperfections. It can be said therefore, that the tax reforms were dictated by economic considerations and had to be, at least in the initial phase, revenue neutral.

The legislator's main objective was to encourage the development of a modern, private sector by creating a fiscal environment in which both big and small companies could thrive. Consequently, the existing tax systems needed to undergo fundamental structural changes.

The legislators had realized that the development of an "informal sector" was having a serious negative effect, both on the national economy, and on state revenues. The modernization of the tax system, coupled with an increase in the tax authorities' enforcement powers, promised to be a way of eliminating the "informal sector".

II. INTRODUCTION OF VAT

The laws implementing VAT are:
- in Morocco: Dahir No. 1-85-347 of 20 December 1985 for the application of the Law No. 30-85 relating to VAT;
- in Tunisia: Law No. 88-61 of 2 June 1988 implementing the VAT code;

- in Algeria: 1991 Finance Law No. 90-36 of 31 December 1990 and 1992 Finance Law No. 91-25 of 18 December 1991.

In each country, VAT replaced a system of tax on production and tax on services which, due to numerous piecemeal reforms, had become increasingly complex.

The introduction of the VAT system in the industrial sector was relatively straightforward, as the tax on production also incorporated an imputation mechanism similar to the VAT system.

The changes were more difficult to implement for the services sector, which was generally subject to a multi-stage cumulative tax, and for the commercial sector, which had been largely exempt from the turnover taxes regime. Not surprisingly, problems linked to the introduction of VAT occurred mainly in these two sectors.

Each country's approach to the implementation of VAT varied slightly.

A. Taxable transactions

In each country, VAT is due on all operations of an industrial, commercial or craft nature and on operations relating to the exercise of liberal professions. However, when implementing the new VAT regime in Tunisia, purchase/resale transactions were only in certain instances subject to VAT (industrial equipment or building materials). Transactions between wholesalers, and between wholesalers and retailers, became subject to VAT at a later date. Retailing remains the only sector of activity completely outside the scope of VAT.

In Morocco as in Algeria, sales (*ventes en l'état*) by wholesalers have been subject to VAT as from the introduction of the new rules. Later, sales by any entrepreneur with a turnover higher than a specific amount (DH 3 million) became subject to VAT in Morocco.

In each country, supplies of services as well as imports and self-supplies are generally subject to VAT.[1]

B. Territoriality

The principles which applied in France before the Sixth Directive, were also applied in the tax on production and the tax on services. As a result, the following transactions are covered by the principle of territoriality:

- sales with supplies in the relevant country; and
- all other operations, when the service rendered, the rights transferred or the assets leased are used or exploited in the relevant country.

The criterion used for sale transactions is relatively easy to apply. Unfortunately, this is not the case for the criteria used for services.

The tax authorities normally considered that the place where the service was used was the place where the service had been rendered. Therefore, in some cases, VAT was due on services rendered locally to foreign clients, even though the client used the service abroad. Such a rule, of course, discourages exportation of services; therefore (without modifying the rules of territoriality), the Moroccan Finance Law for 1995 exempted from VAT, the exportation of the following:

- services rendered in connection with the exportation of goods;
- services to be rendered or used outside Moroccan territory.

C. Exemptions

Despite the efforts made by the tax authorities, there are numerous exemptions. It is important to note that the agricultural sector remains generally outside the scope of VAT. In Algeria and in Tunisia, the exploration and exploitation of hydrocarbons are also not subject to VAT. Naturally, exports are exempt too.

D. Taxable event

Morocco considers that payment of the price constitutes the taxable event, both for the supply of goods and the supply of services, unless the taxpayer opts for a prepayments regime.

In Algeria, for goods the taxable event is the delivery. For construction and the supply of services, the taxable event is the partial or complete payment of the price. In Tunisia, the delivery of goods constitutes the taxable event. As far as construction works and the supply of services are concerned, the determining factor is the full or partial completion of the operation, or the full or partial payment of the price.

E. Tax rates

The standard rate of VAT is 17 percent in Tunisia, 19 percent in Morocco and 21 percent in Algeria.

Reduced or higher rates also apply. In Algeria, a reduced rate of 13 percent applies to certain operations, (e.g. building material, construction work or certain services), a special reduced tax rate of 7 percent applies to agricultural products or "essential items", and a higher rate of 40 percent also applies in some cases. The reduced rate of 13 percent demonstrates the commitment to the construction sector and certain elements of the service industry which were previously liable to a turnover tax on services at a rate of 8 percent.

In Tunisia, a reduced rate of 6 percent applies to certain categories of services (e.g. transport services) and to "essential items". Another reduced rate of 10 percent was introduced by the 1995 Finance Law, which applies, for example, to transportation operations, computers, televisions and certain cars. A higher rate of 29 percent also applies in some cases.

In Morocco, the higher rate of 30 percent was abolished by the 1993 Finance Law. A reduced rate of 7 percent applies to

1. Note, however, that financial services in Algeria are subject to a specific tax on banking and insurance activities.

essential products, and a rate of 14 percent applies to building constructions and to transport operations.

A rate of 12 percent had originally applied to the liberal professions, even when exercised within the framework of a legal entity. The tax paid was not deductible: despite its name, it was in reality the old tax on services![2] Later on, the VAT rate on the supply of legal and medical services was reduced from 12 percent to 7 percent, (although the supplier has no right to deduct input tax,) while other activities are now covered by the VAT regime at the standard rate of 19 percent.

F. Deduction

Principle

In the three countries, (input) VAT paid on the purchase of raw materials and services used in the manufacture of a product is deductible from the (output) VAT due on its sale. In Tunisia, some restrictions apply, hence VAT on cars and car rentals is not creditable. Exceptions to the deductibility of input VAT are slightly more significant in Algeria and Morocco.

Deductibility procedure

The one-month stagger rule, applicable in France until 1993, has not been adopted in Tunisia. However, it applies for non-depreciable assets in both Algeria and Morocco.

Refund of VAT overpayment

Generally speaking, a VAT overpayment is not refunded either in Algeria or in Morocco, except for exportations and tax-free sales.

In Tunisia, an overpayment of VAT is refunded when the taxpayer has been in a credit situation for 12 consecutive months. Only 20 percent of the overpayment of VAT calculated on a calendar-year basis is refunded, except when the taxpayer is ceasing activities. These conditions do not apply to exportations, or to VAT-exempt operations.

Turnkey operations

Turnkey contracts normally provide that customs clearance on imported equipment to be used on a project undertaken by a foreign entrepreneur will be in the hands of the local building contractor. This results in a very complex situation with regard to VAT, as, if the law is strictly interpreted, VAT is due by the entrepreneur on the total price of the work, including the VAT due on the importation of the equipment, without any entitlement to a deduction for the VAT paid on the importation of the equipment by the contractor.

This is the reason why the three countries have taken the position that, for turnkey contracts, the entrepreneur is entitled to deduct from the total output VAT due, the VAT paid on the equipment used in the project regardless of who actually purchased it.

G. VAT Waivers

The three countries have become aware of the cash-flow problems affecting investors who are required to pay VAT on the acquisition of an asset. The VAT due in respect of the purchase is, of course, deductible from the liability to output VAT, but the long delay occurring before all the input VAT is utilized may seriously affect the cash-flow position of the investor.

Consequently, all three countries have taken measures in the framework of their investment codes allowing the VAT free acquisition of fixed assets. In Morocco, under ordinary tax law, it is possible for the supplier to benefit from this favourable regime, i.e. subject to the authorization of the tax authorities, any fixed asset the purchase of which would result in the obtaining of a deduction for the input VAT, can be acquired tax-free. The supplier of the asset can acquire all the necessary goods for the manufacturing or production of the asset, free of VAT, subject to very strict conditions.

Algeria applies a similar, but considerably more limited system, i.e. only newly created enterprises or activities in "priority industries" can benefit. In addition to this, exporters and suppliers of certain exempt companies in Tunisia and Algeria (e.g. oil companies) may operate without applying VAT, subject to strict conditions.

III. CORPORATE INCOME TAX

In Algeria, corporate income tax is referred to as *Impôt sur les Bénéfices des Sociétés* (IBS). It will be referred to in this article as *Impôt sur les Sociétés* (IS) as for Tunisia and Morocco.

The laws creating corporate income tax are as follows:
- in Morocco, Dahir No. 1-86-239 of 31 December 1986 for the application of Law No. 24-86 relating to corporate income tax;
- in Tunisia, Law No. 89-114 of 30 December 1989 for the application of the Personal and Corporate Income Tax Code;
- In Algeria, Law No. 90-36 of 31 December 1990 for the application of the 1991 Finance Law and Law No. 91-25 of 18 December 1991 for the application of the 1992 Finance Law.

Prior to the tax reforms, companies and similar entities were subject to a schedular tax on their industrial and commercial profits, (*Impôt sur les bénéfices professionels* in Morocco and *Impôt de Patente* in Tunisia), at a rate of 44 percent in Tunisia, 48 percent in Morocco and 50 percent in Algeria.

The introduction of corporate income tax has only slightly modified the method of determining taxable income, although considerable modifications have been made to the tax rates that apply.

2. Note that in Algeria, foreign companies rendering taxable services without having a PIE in Algeria are subject to VAT at the rate of 7% without any input credit.

The more significant changes brought about by the reforms are discussed below.

A. Companies and entities subject to corporate income tax

In the three countries, limited liability companies are statutorily subject to corporate income tax (with the exception, in Morocco, of certain real estate companies).

Partnerships are not subject to corporate income tax in Tunisia (except for partnerships with a civil object, which have characteristics comparable to those of a corporation). The same rule applies in Algeria, where partnerships are permitted to opt for the corporate income tax regime. In Morocco, partnerships are subject to corporate income tax (except for certain real estate partnerships), unless all the shareholders are individuals (however in this situation, it is still possible for the partnership to elect for the corporate income tax regime).

It should also be mentioned that public bodies and other public undertakings, carrying on industrial or commercial activities, are subject to corporate tax.

B. Territoriality

It seems that each country has followed the jurisprudence established in France on this matter, i.e. a company is subject to tax in the country in which it is resident. Foreign companies are only liable to tax in the countries concerned, where they realize profits in that country through a permanent establishment or permanent representative.

In addition, foreign companies are liable to corporate income tax where they receive income from a source situated in one of the countries concerned, even if no activity is performed therein. This will be examined below when dealing with the taxation of foreign companies.

None of the countries concerned allows a company to opt for consolidated accounts or to be liable to tax on its worldwide income.

C. Tax rates

In Tunisia, the corporate income tax rate is 35 percent, which is also the top marginal tax rate for personal income tax. In addition, dividend income is exempt from tax, as described below. Therefore, the choice between a partnership or a corporation is tax neutral.

The use of the same rate of 35 percent for both corporate and personal income tax (in the latter case, the top tax rate) gives a remarkable coherence to the new Tunisian tax system; it should be noted that the rate of 35 percent is in line with the tax rate generally adopted by European countries, and now also by the most dynamic newly industrialized Asian countries.[3]

Algeria and Morocco have adopted a cautious approach. The rate of corporate income tax in Algeria was initially fixed at 42 percent, (which represented an improvement compared to the rate of 50 percent previously used,) and was further reduced to 38 percent in 1994. However, profits which are reinvested within the company are subject to a reduced tax rate which was originally fixed at 5 percent but was recently increased to 33 percent. The difference between the two rates is not very significant any more, and it is expected that this twin-rate system will be replaced by a single rate system. Morocco initially fixed the corporate income tax rate at 45 percent before reducing it to 40 percent, 38 percent and finally 36 percent. The effective tax rate is, in reality, higher, as a surcharge tax of 10 percent of the corporate income tax is due in respect of the *Prélèvement de Solidarité Nationale* (surcharge tax for national solidarity). In other words, the effective corporate income tax rate is equal to 39.60 percent.

In Morocco, a minimum tax not exceeding DH 100,000, was also due.[4] This ceiling has been subsequently abolished and the minimum tax now amounts to 0.50 percent of turnover, and may be offset against the corporate income tax due in respect of the same, or the subsequent three accounting periods. The abolition of the DH 100,000 ceiling may indicate that the reforms have had the expected impact on taxpayer behaviour although the tax authorities may still have some difficulty in checking the information reported in their tax returns.

D. Deductions from taxable income

The rules that apply are not very innovative, most of the old rules having been retained.

Financial charges relating to loans taken out outside Algeria, payment of royalties, remunerations paid in respect of technical assistance, fees and other similar remunerations, are not deductible if paid in currencies other than the Algerian Dinar, unless the competent financial authorities authorized payment in a foreign currency.

In Tunisia, depreciation is made in accordance with the straight-line method, (except in some very limited cases) whereas since 1994 Morocco allows the use of the declining-balance method.

In Tunisia, provisions and reserves are not deductible, unless made in respect of doubtful debts. Here it is a condition that legal action has been taken to recover the debt, and the deduction may not, in any event, exceed 10 percent of turnover (special rules apply to banks). Furthermore, interest payments to shareholders are deductible provided (i) the interest rate does not exceed 12 percent; (ii) the amounts borrowed do not exceed on average half of the capital of the company; and (iii) the capital is entirely paid-up.

3. Note that a number of other African countries, such as Egypt, Nigeria and Ivory Coast, have followed the Tunisian example and lowered their corporate tax rate to 35%.
4. A minimum tax is also due in Tunisia but it may not exceed DT 1,000 (± FF 6,000).

In Morocco, the total amount of debt cannot exceed the amount of the capital of the company, which should also have been entirely paid-up, and the interest rate used should not exceed the basic discount rate used by the Bank of Morocco for short-term private securities plus two percentage points. Finally, in Algeria, no special rules have been enacted in this respect.

E. Capital gains

Generally speaking, capital gains must be added back to the taxable profits of the accounting period in which they were realized, although in practice part of the gain is usually non-taxable.

In Tunisia, the only case where a capital gain does not have to be added back to the taxable income, is in the framework of a transfer of all assets, or upon a merger, subject to the condition in both cases that the assets transferred remain part of a business or trade.

It should also be noted, that Tunisia applies a system whereby assets can be revalued without the need to recognize a capital gain on the revaluation.

In Algeria and in Morocco, capital gains are only partially added back to the taxable income. The fraction to be added back in Algeria is 70 percent for short term capital gains (capital gains realized on assets owned for a period of up to three years) and 35 percent for long-term capital gains. In Morocco, the fraction of the gains added back amounts to 75 percent for assets owned for at least four years but less than eight years, and 50 percent for assets owned for more than eight years. The taxable fraction of the gain is reduced where there has been a total or partial cessation of activity. Both countries have maintained measures which originated in the pre-1965 French tax system, which defer or exempt a capital gains tax liability where that gain is reinvested.

In Algeria, where the regime is the closest to the old French system, the gain is deferred where the taxpayer commits itself to acquiring fixed assets to the value of the gains plus the acquisition cost of the assets sold. The reinvestment must be made within a three-year period, commencing from the end of the accounting period during which the asset was disposed of. The capital gain on the asset disposed of is booked as a depreciation allowance on the replacement asset, whether the latter is depreciable or not.

In Morocco to obtain an exemption, the taxpayer must commit itself to reinvest the gain within the same period of three years, and can buy either fixed assets or securities of companies subject to corporate income tax. The taxpayer must also commit itself to keep the assets or the securities acquired for a period of at least five years.

In both cases, the objective is to encourage the reinvestment of the capital gains realized by companies.

F. Taxation of dividends received

In Tunisia, dividends do not constitute taxable income whether received by individuals or by companies: consequently, dividends received by a Tunisian company are not subject to corporate income tax. In Morocco, the principle that originally applied was that dividends had to be included in the taxable profits of a company net of a 85 percent deduction. Since 1994 the deduction has been equal to 100 percent. Finally, in 1993/94, a system was implemented in Algeria which has been largely inspired by the French parent-subsidiary regime aimed at avoiding the double taxation of dividends.

G. Carry-forward of losses

Losses may be carried forward for a period of up to five years in Algeria, four years in Morocco and three years in Tunisia. Tunisia and Morocco both now apply the principle of deferral of depreciation in loss years. Depreciation thus deferred can be carried forward indefinitely. This deferral is not possible in Algeria.

None of the three tax regimes facilitates the carrying back of losses.

H. Foreign companies

Foreign companies having a permanent establishment in any of the three countries are, in principle, subject to corporate income tax in that country as if they were a local company. However, in Algeria, foreign companies performing construction work in Algeria are subject to corporate income tax at a reduced rate of 8 percent on their turnover. The tax is withheld by the payer. These companies can opt for the general regime to apply. In Morocco, foreign companies are subject to the general corporate tax regime, unless they opt for a regime similar to the Algerian regime described above. The rate of tax is, however, 12 percent and the amount of tax withheld corresponds not only to the corporate tax but also to the tax on income from capital (*Taxe sur le produit des actions*, TPA).[5]

Foreign companies receiving income without having a permanent establishment in the source country, are subject to withholding tax in respect of the corporate tax due at a rate of 10 percent in Morocco, 15 percent in Tunisia and 18 percent in Algeria.

In the three countries, patent royalties and payments in respect of know-how are subject to the withholding tax regime. The following payments are also caught; rent paid for the use of industrial or commercial equipment, remuneration paid for technical and/or economic assistance, fees, etc.

5. While the special Algerian regime is widely used, the special Moroccan regime has hardly been used.

I. Payment of tax

The rules previously applicable in Algeria were largely inspired by the French regime, tax being due in four advance instalments throughout the tax year, calculated on the basis of the profits realized during the previous accounting period. A final payment was due at the time the company filed its tax return. These rules have remained unchanged with the introduction of corporate income tax.

In Tunisia, corporate income tax is paid in the form of three advance payments due in the first 25 days of the sixth, ninth and twelfth month following the end of the previous accounting period. Each advance payment is equal to 30 percent of the tax due on the basis of the taxable profits of the previous accounting period. The final payment must be made at the time the company is filing its tax return for the current accounting period, (within the first 25 days of the third month following the end of the accounting period). It should be noted that the law does not allow the taxpayer to reduce the amount of advance payments due although such a reduction is possible, in both Morocco and Algeria.

In 1990 Morocco adopted a system similar to that used in Algeria: four advance payments need to be made, each equal to 25 percent of the tax due on the basis of the profits of the previous accounting period, and payable at the end of the third, sixth, ninth and twelfth month during the accounting period. The final payment is due within three months from the end of the accounting period.

In Tunisia, in addition to the regime of advance payments, withholding taxes may be imposed on certain categories of income, even when received by legal entities subject to corporate tax.

Commissions, and rents are subject to a withholding tax of 5 percent. The rate is reduced to 2.5 percent for fees and increased to 15 percent on income from movable capital. The tax withheld is deductible from the amount of corporate tax due for the same accounting period and any excess is refunded.

IV. PERSONAL INCOME TAX

Personal income tax is known as *Impôt sur le revenu global* (IRG) in Algeria and as *Impôt général sur le revenu* (IGR) in Morocco. The relevant laws in this respect are:

- in Morocco, Dahir No. 1-89-116 of 21 November 1989 for the application of Law No. 17-89 relating to personal income tax;
- in Tunisia, Law No. 89-114 of 30 December 1989 for the application of the Personal and Corporate Income Tax Code;
- in Algeria, Law No. 90-36 of 31 December 1990 for the application of the 1991 Finance Law and Law No. 91-25 of 18 December 1991 for the application of the 1992 Finance Law.

Personal income tax has replaced the schedular system and the surtax. It should be noted that remnants of the old systems are still to be found, notably in Morocco where the taxation of dividends and interest is largely governed by the old rules.

A. Residence

In each country, a distinction is made between individuals resident in the country concerned and therefore subject to tax on their worldwide income in that country, and non-resident individuals who are subject to tax in that country only on income derived therein. The principle is common to all three countries, but the definition of fiscal residence differs from one country to another.

In Tunisia, an individual is deemed to be resident where either he has a permanent abode there, or lives there for more than six months during the calendar year. In Morocco, an individual is regarded as resident for tax purposes if he has his habitual place of abode, his principal private residence or the centre of his economic interest there (when the periods spent in Morocco exceed 6 months on a 12-month basis).

Algeria combines the criteria applied in Tunisia and in Morocco and also takes into consideration the exercise of professional activities in Algeria.

B. Taxable base

The taxable income is determined for each category of income and the following rules apply.

Self-employment income (BIC)

The main issue here is the determination of the taxable profits of the taxpayers' small business. A special regime (forfait) applies in Algeria to businesses with a turnover lower than DA 1,500,000 (sales activities) and DA 800,000 in any other cases. The profit is evaluated over a two-year period by the tax authorities (profits actually realized may be different for the two accounting periods concerned). It should be noted that it is possible to extend the taxable period for a further year.

In Tunisia, a distinction is made between the legal "forfait", subject to conditions of turnover, and the simplified "forfait" which applies to certain categories of professions. In both cases, tax is calculated in accordance with a tax table specified by law and constitutes a final tax for VAT and personal income tax purposes for those taxpayers with no other source of income.

In Morocco, in addition to the standard regime there exists a "forfait" and a simplified "forfait" regime both subject to conditions relating to turnover slightly higher than in Algeria and Tunisia. It should be noted that the *bénéfice forfaitaire* is determined by applying to the turnover of each calendar year a legal coefficient published for each profession.

Self-employment income for non-professional activities (BNC)

In Morocco, the rules mentioned above also apply to this type of income. In Algeria, the taxable income is determined by applying the regime of the declaration controlee or, where the turnover is less than DA 200,000 following the rules of the administrative evaluation, similar to the rules of the *forfait.*

Tunisian taxpayers may choose to be liable to tax on income determined in application of the rules outlined in the previous paragraph as long as they use a proper system of bookkeeping, alternatively they are liable on the basis of 70 percent of their gross receipts.

Agricultural income

Despite the fact that Moroccan law has enacted special rules applicable to agricultural income, they are still ineffective in practice as Dahir No. 1-84-46 of 21 March 1984 states that such income is exempt from tax until 21 December 2000. In Algeria, profits derived from cereal production are exempt. Other income is subject to tax on a fixed basis using a tax table published by the Ministry of Finance. In Tunisia, tax is calculated by application of the same rules as outlined under self employment income above.

Rental income

Gross rental income from properties is taxable in Morocco after a deduction of 40 percent. In Algeria, the deduction is equal to 10 percent but is increased to 50 percent without exceeding DA 50,000 when the property is rented for residential use. In Tunisia, the deduction is equal to 30 percent but repairs and maintenance expenses and the tax on the rental value of the property are deductible.

Capital gains on real estate

Gains, other than business gains and those realized on real estate are subject to income tax.

Capital gains on real estate are subject to personal income tax in Tunisia, except in certain cases (e.g. on the sale of a principal residence, or if the sale is made between ascendants and descendants). The gain is taxed at a flat rate which generally amounts to 15 percent. The gain is determined by increasing the acquisition price by 10 percent for each year of ownership. However, the taxable gain may not be lower than 2.5 percent of the sale price.

In Algeria, gains on real estate are also subject to personal income tax, after applying a deduction. The amount of the deduction has been progressively increased (it currently amounts to 100 percent if the property has been held for more than 15 years). The gain is assessed at a flat rate of 15 percent.

In Morocco, capital gains on real estate are still subject to a special tax, namely the tax on real estate profits (*Taxe sur les profits immobiliers*), established by the Dahir No. 177-372 of 29 December 1977, as amended. Tax is due at a rate of 15 percent and the taxable amount is determined after revising the acquisition cost using a special table published by the Decree.

Dividends and interest

The most innovative solution has been adopted in Tunisia where dividends are exempt from personal income tax. Interest, however, remains subject to personal income tax at a rate of 15 percent, the tax being deducted by the payer. In Morocco, dividends and interest are in principle subject to personal income tax. However, it should be noted that the withholding tax on securities (*Taxe sur le produit des actions*, TPA) as created by Dahir No. 172.532 of 8 January 1973 and amended by the Dahir No. 1-89-145 of 23 October 1989 is a final tax for personal income tax purposes. It is currently withheld at the rate of 10 percent (15 percent prior to 1 January 1995) on the gross dividend. The tax on fixed income securities (*Taxe sur les produits de placement à revenu fixe*, TPP) created by Dahir No. 1-77-372 of 30 December 1977 as amended by Dahir No. 1-91-231 of 30 December 1991 is also in some situations a final tax for personal income tax purposes. It is withheld at a rate of 30 percent where the shareholder does not disclose his identity. Where the identity of the shareholder is known, tax is withheld at a reduced rate of 20 percent, although further tax may become payable depending on the financial circumstance of the taxpayer.

In Algeria, dividends and interest are subject to personal income tax. A withholding tax is imposed at a rate of 20 percent on dividends and 15 percent on interest (20 percent on bearer bonds). The tax withheld is deductible from the total personal income tax due.

Salaries, wages and pensions

With regard to salaries, the taxable income in all three countries consists of the total salary and benefits in kind received by the taxpayer, less compulsory social security and pension contributions paid by the employer. In Algeria, however, indemnity payments for working in certain parts of the country (for example, the south of Algeria) are exempt from tax. In addition, the supply of food and accommodation to such employees is exempt from the benefits in kind provisions.

Employees in Tunisia are entitled to a special deduction of 10 percent for business expenses. The same deduction exists in Morocco but at a rate of 17 percent with a maximum of DH 24,000 per year (approximately FF 14,000). The maximum amount of deduction is even lower in Algeria.

After their independence, the three countries have implemented a PAYE system on employment income. This system has proved to be successful in practice and the tax withheld constitutes in some cases a final tax as it is not necessary for the taxpayer to file an income tax return if he has no other sources of income.

C. Calculation of tax

This paragraph sets out the rates of tax applying as well as the manner in which family circumstances are taken into account.

Tax rates

In Tunisia, the system is simple. The annual tax table, unchanged since 1990, is as follows:

– up to DT 1,500	0%
– from DT 1,500 to DT 5,000	15%
– from DT 5,000 to DT 10,000	20%
– from DT 10,000 to DT 20,000	25%
– from DT 20.000 to DT 50.000	30%
– exceeding DT 50,000	35%

The top tax bracket amounts to DT 50,000 and the highest marginal rate is 35 percent.

These tax rates have not been modified since the publication of the law establishing personal income tax in 1990, this has increased the tax burden on taxpayers because of the effects of inflation. It should be noted that under the old regime, the surtax (State personal contribution or *Contribution Personnelle d'Etat*) was calculated at a rate of 68 percent to which was added the schedular tax.

For example, an employee with a taxable income of DT 50,000 was liable to pay around DT 27,000 tax, before the reform (an average rate of tax of 54 percent). Since the reform, the amount of tax due would be DT 13,000 (average rate of tax of 26 percent).

Under the old regime, Tunisian employers were in practice paying many different types of exempt bonuses and allowances to their employees. The non-taxable character of these payments was often challenged but the tax authorities proved to be reluctant to adopt a strict position in this respect. One of the consequences of the introduction of the tax reforms was that these bonuses and allowances became taxable.

In Morocco, there are eight tax brackets, the highest marginal rate being 52 percent where annual taxable income exceeds DH 200,000 (around FF 120,000). Recent amendments have eliminated the two highest tax brackets. Today the top tax rate is equal to 46 percent and applies to income in excess of DH 90,000 (around FF 50,000). The highest marginal rate applies to a relatively low level of income and may in this respect appear severe.

In Algeria, the tax tables were introduced by the 1992 Finance Law and have been subsequently modified twice. The original tax rate of 70 percent proved to be too high and has been reduced to 50 percent. The high inflationary pressures since 1992 resulted in further amendments. For example, a new rule was introduced under which foreign employees exercising their professional activity in certain economic sectors such as the oil industry, are liable to tax at a fixed rate of 20 percent.[6]

Family circumstances

None of the three countries has adopted the system of the family coefficient implemented in France. Deductions in respect of family circumstances are allowed in Morocco as well as in Tunisia where deductions can be made from the aggregate income. In Algeria, the deduction is only available to employees. The amount of deduction allowed remains low (for example, DH 180 per person in Morocco without exceeding DH 1,080, around FF 600).

D. Payment of tax: development of a withholding tax system

In the three countries, salaries, wages, dividends, interest and income paid to non-residents are subject to withholding tax. In Algeria, tax is withheld at a rate of 20 percent on remuneration paid to the liberal professions. In Tunisia, commissions, and rents are subject to a withholding tax of 5 percent as is the remuneration of non-commercial activities. It should be noted, however, that where fees are either payable to an entity subject to corporate income tax or to entities or individuals subject to income tax under the ordinary rules, the withholding tax rate is reduced to 2.5 percent. A 2.5 percent withholding tax also applies to the sale price of real estate. It is creditable against income tax on the gain.

V. CONCLUSION

In summary, it can be said that the tax reforms outlined in this article have resulted in the implementation of modern and simplified tax regimes, adapted to the economic circumstances of each of the three countries concerned. It is hoped that the similarities of the three regimes should help foster the development of close economic ties, not only between these countries, but also between them and other European countries with comparable tax regimes.

6. A similar regime applies in Tunisia to foreign employees in the oil exploration sector or in exclusively exporting activities.

CUMULATIVE INDEX -1995

I. ARTICLES

Conference diary

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

SEPTEMBER 1995

Transfer of business or private assets in order to create usufruct and annuities or other permanent encumbrances, Mainz, 1 September 1995 and München, 7 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

Seminar on corporate income tax, Frankfurt/Main, 2, 9, 23 and 30 September 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

Practical cases regarding the change of a legal form, Frankfurt/Main, 8 September 1995 and München, 6 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

49th Congress of the International Fiscal Association, Cannes, 17-22 September 1995 (simultaneous translations into French, English, German and Spanish):

Novatours Congres IFA – Official Congress Agent, rue de Lille, F-06400 Cannes, Tel.: 33-93-694 747, Fax: 33-93-464 483.

Taxation of non-profit clubs, Köln, 25 September 1995 and München, 9 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

International Tax Avoidance/Anti-Avoidance, Amsterdam, 28-29 September 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1995

Meeting of the International Tax Planning Association, Monte-Carlo, 19-20 October 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-173-276 2910, Fax: 44-173-276 3762.

NOVEMBER 1995

Double Taxation Relief, Amsterdam, 2-3 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Asia-Pacific Tax Conference, Singapore, 13-14 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

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The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.

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(B. 114.511)

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(B. 114.516)

Författningar om uppbörd 1995.
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International Tax and Business Guide: United Kingdom.
New York, Deloitte Touche Tohmatsu International. 1995, pp. 169.
Guide designed to provide potential foreign investors with fundamental information about the UK environment, including factors a foreign investor should consider in deciding whether to acquire an existing UK company or to start a new operation in the country. These factors include tax planning, employment and labour, financing, importing, exporting and accounting.
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The author compares the legal situation of corporations in France, Germany, the Netherlands and the United Kingdom with the plans for creating a European corporation.
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Transactions: taxation of joint ventures. General editor Patrick Way.

London, Longman Group UK Ltd. 1994,
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This book on joint ventures is intended to be both practical and accessible. Chapters written by a team of specialists include: "Joint venture structures and factors affecting the selection of structure" by D. Taylor; "Taxation and joint ventures" by P. Way; "Tax aspects of international joint ventures" by D. Mullarkey; "Transfer pricing issues for joint ventures" by R.B. Peake; "Relevant UK tax issues when advising on a US/UK corporate joint venture in the UK" by R. Schon; "Joint ventures – a case study" by A. Dicker.
(B. 114.622)

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Acamedia Research Monograph, No. 11, pp. 216. ISBN: 0 86196 390 3.
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Herausgegeben von Harald Schaumburg.
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(B. 114.339)

Ogley, Adrian.
The principles of international tax. A multinational perspective.
London, Interfisc Publishing, 7 Chelverton Road, High Street, Putney, London SW15 1RN, United Kingdom. 1994, pp. 186. £ 62.95. ISBN: 0 9520442 0 X.
The author looks at all the principal kinds of tax system around the world, outlining their interaction, and presents the fundamental principles of international tax planning.
(B. 114.571)

Picciotto, Sol.
International business taxation. A study in the internationalization of business regulation.
New York, Quorum Books, One Madison Avenue, New York, NY 10010, USA. 1992, pp. 400. ISBN: 0 89930 777 9.
The book describes the most important topics in international business taxation. It is a well researched study on the historical development and current status of international tax law in several of the world's most important trading economies. The book emphasizes the laws and policies of the United States, Western Europe, the United Nations and the OECD. Chapter eight contains a discussion of transfer pricing. Chapter ten addresses the internationalization of tax administrations, contains information relating to tax havens, anti-tax haven legislation, transfer pricing, and tax treaties. Other chapters cover the history, principles and policies of international tax laws; the past and present status of the international tax treaty system; international tax avoidance; the problems created by tax deferrals; worldwide unitary tax issues; and global business and international fiscal laws.
(B. 114.602)

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New York, Deloitte Touche Tohmatsu International. 1995, pp. 109.
(B. 114.538)

Land and taxation. Editor Nicolaus Tideman.
London, Shepheard-Walwyn Publishers Ltd., 26 Charing Cross Road (suite 34), London WC2H 0DH, England. 1994. Georgist Paradigm Series, pp. 181.
ISBN: 0 85683 162 X.
Theoretical contributions by various authors concerning principles of land rights and public finance, integrating economic efficiency and social justice.
(B. 114.509)

The Tax Thesaurus and Geographic Identifiers.
Arlington, Tax Analysts. 1995, pp. 163.
This tax thesaurus is the source for index or description terms used in Tax Analysts' printed indexes to all magazines and in the electronic files from January 1991. The index terms are published in alphabetic and Code Section order.
(B. 114.554)

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Taxation and the environment. Complementary policies.
Paris, OECD – Organisation for Economic Co-operation and Development. 1993, pp. 116.
ISBN: 92 64 13839 0.
This report examines how environmental taxes and charges can be integrated into fiscal policies and structures of OECD Member countries and assesses how existing taxes and charges can be made compatible with environmental objectives.
(B. 114.603)

OECD Economic Studies: The effects of trade and foreign direct investment; The EC's internal market: implementation and economic effects; Costs and benefits of moving from low inflation to price stability; Estimating pension liabilities: a methodological framework; A survey of the trade and environment nexus: global dimensions.
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OECD Economic Studies, No. 23, Winter 1994, pp. 192.
(B. 114.534)

LATIN AMERICA

Commercial & Investment Law: Latin America. Volume 1. Editor Andrea Bonime-Blanc.
New York, Transnational Juris Publications, Inc., one Bridge Street, Irvington-on-Hudson, New York 10533, USA. 1995.
Loose-leaf publication providing overview and analysis of relevant laws. Individual country chapters written by leading national law firms discuss the principal laws affecting foreign investors. The service also includes copies of some of the most important laws affecting foreign investors in English or Spanish/Portuguese. Periodic updates will keep the service up-to-date. Countries covered: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Panama, Paraguay, Peru, Portugal, Puerto Rico, Spain, Uruguay and Venezuela.
(B. 18.872)

Argentina

Doing business in Argentina.
Amsterdam, Price Waterhouse. 1995, pp. 140.
Information guide on doing business in Argentina including tax aspects based on material assembled at 30 September 1994.
(B. 18.871)

Brazil

Mercosul. A estratégia legal dos negócios.
Coordinated by Luiz Olavo Baptista.
São Paulo, Editora Maltese, Alameda Itu, 1063 Jardins, São Paulo. 1994, pp. 140.
Booklet containing contributions by various authors, analysing the most important rules governing the Mercosur market. Some of the issues analysed include: economic

perspectives, different forms of doing business, especially corporate tax law, taxation, industrial property and solutions of conflicts in Mercosur.
(B. 18.878)

Mexico

Plascencia Rodriguez, José Francisco.
La aplicación del IVA en la prestación de servicios.
Guadalajara, Indetec. 1994, pp. 196.
ISBN: 968 6627 73 1.
The application of VAT on supply of services. The book analyses in-depth different issues concerning the application of VAT on supply of services in Mexico such as: the concept of services, the element comprising VAT on supply of services, the territoriality principle, tax aspects, services subject to the tax and exempt services.
(B. 18.866)

Navarro Bañuelos, Ramón.
El Código Fiscal de la Federación y la Fiscalización Coordinada. (Guía básica del curso).
Guadalajara, Indetec. 1994, pp. 215.
ISBN: 968 6627 70 7.
The book analyses the Federal Tax Code of Mexico and the different issues that are included in that law. The different items include: different sources in Mexican tax law, to which tax laws does the Tax Code applies; the legal nature of tax credits; interpretation of tax laws; rights and obligations of taxpayers; tax audits; criminal tax law and tax procedure law.
(B. 18.868)

El registro contable del impuesto al valor agregado.
Guadalajara, Indetec. 1994, pp. 235.
ISBN: 968 6627 72 3.
The book analyses the rules governing the recording of transactions concerning Mexican VAT. Accordingly, after making a description of the different laws that set forth obligations concerning the registration of transactions it analyses in-depth the way of registering VAT, specially in the different VAT accounts.
(B. 18.867)

International Tax and Business Guide: Taxation in North America: the North American Free Trade Agreement.
New York, Deloitte Touche Tohmatsu International. 1995, pp. 113.
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(B. 114.539)

Paraguay

Plano de Egea, José M.
Sistema tributario de la República del Paraguay. La reforma tributaria. Actualizada y reglamentada.
Asunción del Paraguay, Editorial Latindata, Chile 1229 Piso 1º Of. 4., Asunción del Paraguay, Paraguay. 1994, pp. 310.
Compilation of tax laws and regulations in effect in Paraguay up to July 1994, comprising: income tax, capital tax, VAT, consumption tax, tax on cattle commercialization, stamp duties, tax obligations and tax procedures.
(B. 18.879)

MIDDLE EAST

Israel

Doing business in Israel.
Tel-Aviv, Somekh Chaikin/Price Waterhouse, 33 Yavetz Street, Tel Aviv 65258, Israel. 1995, pp. 257.
1995 Edition of information guide on doing business in Israel including tax aspects based on material assembled on 1 January 1995. Chapters include: foreign investment and trade opportunities, banking and finance, exporting to Israel, labour relations and social security, audit and accounting, the tax system, taxation of corporations and individuals, foreign company, VAT and other indirect taxes.
(B. 58.091)

NORTH AMERICA

Canada

Tax planning for individuals 1995. Prepared by
Arthur Andersen & Co.
North York, CCH Canadian Limited, 6 Garamond Court, North York, Ontario M3C 1Z5. 1995, pp. 90. ISBN: 1 55141 779 0.
Booklet providing a number of tax planning ideas which should provide a useful reference for taxpayers seeking opportunities for tax saving. Information based on the federal budget of 27 February 1995.
(B. 114.627)

International Tax and Business Guide: Taxation in North America: the North American Free Trade Agreement.
New York, Deloitte Touche Tohmatsu International. 1995, pp. 113.
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(B. 114.539)

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OVER THERE, BUT UNDECLARED – OFFSHORE INFORMATION

Michael Dirkis

Michael Dirkis LL M (Comm)(Adel.), GDLP (SAIT), BEc (ANU), FTIA, is Senior Lecturer in Law at the University of Canberra, Canberra, Australia. He is admitted as a Barrister and Solicitor, is a member of the Law Society of the Australian Capital Territory's Revenue Law Committee, an associate of the National Centre for Corporate Law and Policy Research and is one of the correspondents for the *Bulletin for International Fiscal Documentation*. He has also written a number of articles in leading journals. His major interests include revenue law, corporation law and corporate crime.

I. INTRODUCTION

With the internationalization of trade and business in the 1980s, the Australian revenue authorities were increasingly faced with the problem of documents being held in offshore jurisdictions. The Commissioner of Taxation's ability to obtain such information was believed to be limited as the Commissioner's general information gathering powers under Sections 263 and 264 of the Income Tax Assessment Act 1936 ("ITAA") were ineffective where information was located offshore.[1]

The first problem was that the general access power under Section 263 relies on the document or person being located in Australia, as does the Commissioner's power under Section 264 to compel a person to submit to an oral examination. Therefore, they are inapplicable where the materials or persons are located offshore. Problems also arose with the Commissioner's powers to compel production of documents under Section 264. These powers are based on the presumption that the person served with a Section 264 notice has control of the documents. Control of documents is often difficult to establish in situations where tiering and other complex structures are adopted.

In recognition of the possible problems with the use of Sections 263 and 264 to access information held offshore,[2] the Government introduced Section 264A.[3] Section 264A was modelled on provisions enacted in the United States and Canada. In general, Section 264A empowers the Commissioner to issue an "offshore information notice" to a taxpayer, requiring the taxpayer to produce information within a specified period. Failure to comply will trigger evidentiary exclusionary sanctions that deny the admission of information that was the subject of the notice, or secondary evidence of that information, in proceedings where the taxpayer's assessment is challenged.

Despite civil libertarian[4] concerns with the potential intrusiveness of Section 264A, it has taken almost four years before the Federal Court has had the opportunity to rule on the validity of an offshore information notice and to provide guidance on the scope of Section 264A. This paper reviews the offshore information notice procedures in light of recent judicial decisions.[5]

As well as the offshore information procedures, the Commissioner has resort to the exchange of information articles contained in Australia's bilateral tax treaties.[6] A brief examination of the restrictions on the Commissioner's use of these exchange of information articles will also be undertaken.

II. OFFSHORE INFORMATION NOTICES

Where the Commissioner has reason to believe that information relevant to the assessment of a taxpayer is either within the knowledge of a person, recorded in a document or kept by mechanical, electronic or other device outside of Australia, Section 264A(1) empowers the Commissioner to issue an "offshore information notice" to a taxpayer. Under Section 8(1) of the Taxation Administration Act 1953 ("TAA") the Commissioner may delegate this power, via an instrument of delegation, to a Deputy Commissioner or any other person. As the delegates are estopped from sub-delegating,[7] and it is not practical for the Commissioner to delegate to every officer, a system has been established where the delegate authorizes certain officers to exercise the powers on his behalf. This system was approved by the High Court in *O'Reilly v. The State Bank of Victoria*.[8]

In *FH Faulding and Co Ltd v. FCT*[9] the issue arose as to whether the delegatee and the authorized officer must both hold "a belief" that, information relevant to the assessment is held outside Australia. Cooper J found, relying on *O'Reilly*, that the Section is satisfied by the properly authorized officer holding the requisite belief.[10] It is not necessary that the per-

1. Australia, Taxation of Foreign Source Income, *Information Paper* (1989)
2. *Ibid.*
3. Taxation Laws Amendment (Foreign Income) Act 1991 (No. 5 of 1991).
4. See statements by Senator Watson in Senate Standing Committee on Finance and Public Administration in *Hansard*, 14 December 1990 at 41 and subsequent Senate debate in *Hansard*, 19 December 1990 at 5976.
5. See "Foreign Income: Out of sight: not out of mind" (1992) 1 *Taxation in Australia Red Edition*, at 26 for earlier research on this topic.
6. Under the Income Tax (International Agreements) Act 1953 Australia has 39 bilateral tax treaties – 35 comprehensive agreements and 4 airline profits agreements.
7. *Delegatus non potest delegare* – he who himself is a delegate of a certain power cannot further delegate the exercise of that power to a sub-delegate.
8. (1983) 153 CLR 1
9. (1994) ATC 4867
10. *Ibid.* at 4917.

son delegated also personally holds the requisite belief. However, it is clear that a notice issued by an unauthorized person would be invalid and subject to challenge.

A. Width of the power

The scope of the Commissioner's power to seek information and documents is prima facie quite wide. The Commissioner can require a taxpayer:

- to give the information within the period and in the manner specified (this is usually done by interview, but affidavits could be used);[11] or
- to deliver documents within the period and in the manner specified;[12] or
- to make copies of any such documents and to produce them within the period and in the manner specified.[13]

The phrase "in the manner specified", used in respect of information documents or copies, qualifies the giving of the information. That is, the word "manner" in this context means the procedure or way the information is to be communicated to the Commissioner by the taxpayer.[14] A notice will be invalid if the notice seeks to "... specify that a third party record in a statement the third party's version of the fact or answer the questions asked of the taxpayer".[15]

Given the width of the Commissioner's powers, it would have been thought that it would be almost impossible to challenge the issue of the offshore notice on the basis that the scope of the information or documents requested was unreasonable. However, Cooper J in *Faulding*[16] held that

> "The power given by Section 264A(1), like any other administrative power, must be exercised ... within any statutory limitations attaching to the extent of the power and the means by which the power is exercised. The statutory limitation contained in Section 264A is that the information or documents are "relevant to the assessment of a taxpayer" (Section 264A(1)(a) and (b)) and as the power is given to enable the Commissioner to perform his or her functions under the Act it must be used for that purpose. Therefore the power is only available for the purpose of obtaining information or documents relevant to the assessment of the applicant as a taxpayer". Thus, Cooper J in Faulding, relying upon *FCT v. Australia, New Zealand Banking Group*; *Smorgon v. FCT*[17] and *Perron Investments v. DCT(WA)*,[18] accepted that Section 264A(1) requires that for the notice to be valid, it must be apparent on its face that the information and documents which it seeks, in fact relate to the taxpayer's assessment.[19] Thus, where the notice:

- is uncertain;
- does not relate or is not limited to the transactions identified;
- is not relevant to the operative sections cited in the notice;
- makes an incorrect assumption of fact; or
- there is no basis for assuming information exits;

then the paragraph is beyond the power of the respondent under Section 264A(1).[20]

B. The form of the notice and the process of service

Section 264A does not prescribe the form the notice shall take. In practice, the form of a Section 264A notice is similar to the form of a Section 264 notice, although it is obviously phrased in accordance with the wording of Section 264A. The period for compliance specified in the notice cannot exceed 90 days after the service of the notice.[21] The Commissioner may, by notice in writing, vary an offshore information notice by reducing its scope or correcting a clerical error or obvious mistake.[22] Such variations will not effect the time limit for compliance.

Where major changes to the notice are required, the Commissioner can either:

- withdraw the notice;[23]
- replace the withdrawn notice with a new notice;[24] or
- vary the original by issuing a subsequent notice to the taxpayer.[25]

The additional information requested in the subsequent notice is deemed to form part of the original notice for the purposes of the evidentiary exclusionary provisions.[26] The time for compliance will be the period specified in the original notice, but will be extended where the subsequent notice provides for a period which exceeds that specified.[27]

The notice must be served in accordance with the three modes of service prescribed under Reg. 170(1) of the Income Tax Regulations. It must be served upon a person (including an attributable taxpayer) by personal service, or by leaving it at an address for service, or by posting it to an address for service. In order to ensure that a taxpayer receives a request, in light of the penalties for failure to respond, the Courts have adopted a strict view that service must strictly comply with the wording of the regulation.[28] For example, service to the office of an accountant rather than the address for service of notices, his post office box, was deemed to be invalid service.[29] Thus, where service is not strictly within the terms of Reg. 170(1), there is a risk that the service of the notice will be set aside.[30]

11. Sec. 264A(1)(c).
12. Sec. 264A(1)(d).
13. Sec. 264A(1)(e).
14. See *supra* note 9 at 4917.
15. *Ibid.*
16. *Ibid.* at 4903
17. (1979) 143 CLR 499, 544.
18. (1989) 90 ALR 1; (1989) 20 ATR 1299.
19. See *supra* note 9 at 4911.
20. *Ibid.* at 4912-16.
21. Sec. 264A(20).
22. Sec. 264A(7).
23. Sec. 264A(8).
24. Sec. 264A(9).
25. Sec. 264A(6).
26. Sec. 264A(6)(d).
27. Sec. 264A(6)(e).
28. "An Orwellian Spectre – A review of the Commissioner of Taxation's powers to seek information and evidence under Section 264 of the Income Tax Assessment Act 1936 and under Section 10 of the Crimes Act 1914 (Cth)" (1989) 12 *Adelaide Law Review* 63 at 72-3.
29. *DCT(Tas) v. Naidoo* (1981) 12 ATR 348
30. For further discussion on the requirements for proper service under Reg. 170(1), see discussion on Reg. 59 *supra* note 28 at 72-4.

C. Extension of the period for compliance

The taxpayer can, in writing, seek an extension of time for compliance with the notice.[31] This request must be made before the end of the 90 days[32] (or the period as previously extended[33]) as the Commissioner has no express power to grant an extension of time, if the application is lodged after the time specified in the notice (or as extended) has elapsed. Upon receipt of the application for extension of time the Commissioner may, by notice in writing, extend the period specified.[34] If the taxpayer has not been notified of the Commissioner's decision by the time the period specified in the notice has elapsed, the period is deemed to have been extended to the date at which the decision is notified to the taxpayer.[35] That date is also the date from which any extension of time will operate.[36] A failure to grant an extension of time could be challenged under the Administrative Decisions (Judicial Review) Act 1977 ("AD(JR) Act").[37]

D. Results of a failure to comply

A failure to comply is not defined. It includes a refusal to comply as well as a failure due to the inability to find the information.[38] Thus, the non-disclosure of privileged information would be prima facie a failure to comply.[39]

The failure to comply with a notice is not an offence, nor is the notice a request for the purposes of the Act or any provision of the TAA. However, if there is a failure to supply the information or documents requested under the notice, the information or documents (or even secondary evidence of those documents) is inadmissible in proceedings before a court or the Administrative Appeals Tribunal in which the taxpayer disputes the assessment, unless the Commissioner gives consent to their admission.[40]

Where the notice covers a number of issues, and information has been supplied in respect of all but one of those issues, only information, documents (or parts thereof), or secondary evidence of those documents in respect of that specific issue will be excluded.

Where there has been partial compliance with the notice, the Commissioner, in exercising his power under Section 264A(10), must have regard to the fact as to whether the information or documents supplied are, or are likely to be, misleading.[41] Prima facie, non-compliance being due to a legal protection (public interest immunity or legal professional privilege) could also result in the exclusion of that other evidence, if it was misleading.

Where the Commissioner forms the view before the commencement of proceedings that the notice has not been complied with, and that the Commissioner is unlikely to give consent to admit documents covered by the notice, then the Commissioner is required to advise the taxpayer of that view.[42] However, the failure to advise will not affect the validity of the decision.

The documents will not be admissible if misleading. Subject to this restriction, the grounds for admitting information or documents supplied, are that it would be unreasonable not to consent or that the refusal would have the effect under the Constitution of making any tax or penalty incontestable.[43] The fact that supply of the information requested would lead to a breach of a foreign secrecy law is not a ground for admitting the information.[44]

A further ground may be where the information not supplied is subject to legal professional privilege. However, questions of equity and fairness appear to take precedence, particularly where the non-privileged information sought to be admitted is misleading.

E. Avenues to challenge the issue of the notice

There are a number of possible challenges to a notice. The three major areas of challenge are administrative review, constitutional challenge or via common law limitations.

1. Constitutional challenge

Concerns about the validity of Section 264A, had lead the Government to insert Section 264A(13), which requires the courts to read down, rather than extinguish the Section if constitutionally invalid.[45] In *Faulding* Cooper J considered six grounds for constitutional challenges to the operation of Section 264A. The taxpayer contended[46] that the constitution had been breached as:

- Subsections (1) to (9) of Section 264A purport to vest the judicial power of the Commonwealth in a non-judicial body (the Commissioner) or otherwise to interfere with the judicial power of the Commonwealth, by permitting the issue of admissibility of evidence in judicial proceedings contesting any assessment of tax, to depend upon the consent of the Commissioner;
- that the evidentiary exclusion in Subsections (10) to (16) amounts to the imposition of an 'incontestable tax';
- that Subsections (10) to (20) are not reasonably and appropriately related to the process of assessment, the imposition of taxation, and interfere disproportionately with the taxpayer's right to challenge any assessment;
- that the issue of a notice under the Section has the effect that the law applicable to the applicant's tax liability is unilaterally varied by the Commissioner from the gener-

31. Sec. 264A(3).
32. Sec. 264A(4)(a).
33. Sec. 264A(5).
34. Sec. 264A(3).
35. Sec. 264A(4)(c).
36. Sec. 264A(4)(d).
37. *Ganke v. DCT(NSW)* (No. 2) (1982) 13 ATR 440.
38. Sec. 264A(16).
39. Sec. 264A(10) and (16).
40. Sec. 264A(10).
41. Sec. 264A(11).
42. Sec. 264A(14).
43. Sec. 264A(13).
44. Sec. 264A(12).
45. Le Huray, P., "Taxation of Foreign Income: Road Map Review of the Taxation Laws Amendment (Foreign Income) Act 1990" (1991) 3(2) *CCH Journal of Australian Taxation* 36, at 42.
46. See *supra* note 7 at 4868-9

al law applicable to other taxpayers. In consequence, the Section operates as a discriminatory and disproportionate intrusion upon the right of equality before the law protected by Chapter III of the Constitution and the separation of powers;
- the power to exclude evidence makes the assessment an arbitrary one and not a tax within Section 51(xi) of the Constitution; and
- that the Section purports to authorize the Commissioner to compel the applicant to create information and documents to provide to the Commissioner without compensation; as possibly amounting to an acquisition of property requiring payment on just terms under Section 51(xxxi) of the Constitution.

Cooper J dismissed all the arguments and held that Section 264A was constitutionally valid.[47] Thus, *Faulding* confirms the view that Section 264A(13) was merely an example of drafting "overkill" aimed at preserving the Section in extreme circumstances.[48]

2. Administrative review

The exercise of the Commissioner's discretion to issue the notice under Section 264A, is subject to judicial review under the AD(JR) Act. The decision to issue the notice could be challenged on a number of grounds.

First, the issue of the offshore notice could be challenged on the basis that it was not issued in accordance with the principles of natural justice. However, it is unlikely that this administrative argument could succeed because as the principles of natural justice do not apply to Sections 263[49] and 264,[50] it is unlikely that the principles will apply to Section 264A.

The issue of the offshore notice could also be challenged on the basis that the Commissioner had no reasonable grounds for believing that the relevant information or documents were held outside Australia. In *Faulding* Cooper J found that such grounds may invalidate the request.[51] The Commissioner does not need actual knowledge of information or documents, he need merely have a reason to believe that the information or documents are held offshore. The existence of a single overseas transaction may be sufficient reason.

Finally, the issue of the offshore notice could be challenged on the basis that the decision to issue the offshore information notice was made in bad faith. The power given by Section 264A(1), like any other administrative power, must be exercised bona fide for the purposes for which it is given. Thus, the power is only available for the purpose of obtaining information or documents relevant to the assessment of the applicant as a taxpayer. Cooper J in *Faulding*[52] held that

> "Having regard to the purpose of the Section and the manner in which it is intended to operate, it cannot be said that the power is only available for use as a matter of last resort or that the power may not be used if there is a real risk that the taxpayer may be incapable of complying with the request. Provided that the preconditions for the use of the power are satisfied and that the power is used to seek to obtain information or documents to allow the Commissioner to discharge the statutory duty to assess, no other limitations beyond those required by the Act or the general body of administrative law ought to be applied to the exercise of the power. The fact that compliance with the notice will be onerous or in the end result may be impossible and thereby expose the taxpayer to a sanction, will not of itself impose any limitation on the use of the power. In this respect I see no relevant difference between Section 264 and Section 264A. (See *Federal Commissioner of Taxation v. Australia and New Zealand Banking Group Ltd* 79 ATC 4039 at 4053; (1977-1979) 143 CLR 499 at 537)...
>
> There is in the circumstances outlined above no lack of bona fides or use of the power contained in Section 264A for an improper purpose".

Given the heavy burden on the taxpayer to prove that the Commissioner acted in bad faith or for an improper purpose, it will be difficult to establish in all but an extreme case, that the power was exercised wrongly.[53] Thus, the administrative remedies are notional rather than being practical limitations on the Commissioner's power under Section 264A.[54]

3. Common law limitations

There are a number of substantive common law rules which can impose limitations upon the issue of, or content of, an offshore information notice. The first of these is legal professional privilege. Legal professional privilege protects a person from disclosing:

> "... oral or written confidential communications, between himself and his solicitor or barrister, made or brought into existence for the sole purpose of seeking or giving advice or for the sole purpose of use in existing or anticipated litigation ... It is privilege of the client and protects him from being compelled to make such disclosure of such communications either in testimony or by the production of documents ..."[55]

Although the issue of whether the privilege applies to Section 264A has not been considered, it is clear following a number of Federal Court decisions in the late 1980s ending with *Perron Investments v. DCT*[56] that legal professional privilege does apply to limit the scope of documents that can be requested under administrative access provisions like Section 264A. Therefore, it is generally believed that a taxpayer is protected from disclosing the class of information or documents (including copies) covered by legal professional privilege. The privilege is not available to a company.[57]

It has also been argued that the privilege against self-incrimination could limit the scope of Section 264A. The privilege prevents the involuntary divulging of information which has "... a tendency to expose the deponent to any criminal charge or forfeiture".[58] It protects a person from being compelled to

47. *Ibid.* at 4903.
48. This view was expressed by Senator McMullin – see *Hansard*, 19 December 1990 at 5992.
49. *Allen, Allen and Hemsley v. FCT* (1988) 19 ATR 1462.
50. *Sixth Ravini Pty Ltd v. DCT* (Vic) (1985) 16 ATR 499.
51. See *supra* note 7 at 4917.
52. *Ibid.* at 4905.
53. Keane, P.A., "Investigations and Rights of Access" (1983) 18 *Taxation in Australia* 405, at 417.
54. See *supra* note 28 at 75.
55. *Baker v. Campbell* (1983) 153 CLR 52, 112 per Deane J relying on *Grant v. Downs* (1976) 135 CLR 674.
56. (1989) 90 ALR 1; (1989) 20 ATR 1299.
57. *Environment Protection Authority v. Caltex Refining Co Pty Ltd* (1993) 178 CLR 477.
58. *Blunt v. Park Lane Hotel Ltd.* [1942] 2 KB 25.

testify and confers immunity from prosecution if a person has been compelled to testify. It includes oral answers, requests to produce documents and information about their location.[59]

Despite this argument, it appears that the privilege against self-incrimination would not apply to Section 264A, as the failure to comply with a notice is not an offence[60] nor is the notice a request for the purposes of the Act or any provision of the TAA.[61] It would depend upon whether the evidentiary exclusionary provision could be defined to be forfeiture. It is submitted, however, that an argument that a penalty exists because the exclusion of evidence in some future possible litigation may lead to an increase in tax, is at best tenuous and too remote to be considered to be a penalty.

However, if the offshore information notice was issued with a Section 264 notice, the failure to supply the documents covered by that notice would be an offence under Sections 8C and 8D of the TAA. The privilege against self-incrimination would still not excuse the taxpayer as it has been abrogated.[62]

A further potential bar to the operation of Section 264A is public interest immunity (formerly crown privilege). Public interest immunity is a rule of evidence which requires the Court

> "... to weigh on the one hand the considerations which suggest that it is in the public interest that the document in question should be disclosed and on the other hand those which suggest that it is in the public interest that they should not be disclosed ..."[63]

Thus, a court will not order the production of a document, although relevant and otherwise admissible, if it would be injurious to the public interest to disclose the document.[64]

Until recently it was not clear whether the immunity applied outside court proceedings.[65] *In Beneficial Finance Corporation Limited v. Commissioner of the Australian Federal Police and Ors*[66] it was held before both Wilcox J and the full Federal Court that the immunity applied to search warrants issued under Section 10 of the Crimes Act (Cth) 1914. Subsequently, the Victoria Supreme Court in *Middendorp Electric v. Law Institute of Victoria & DCT*[67] held that it also applied to Section 263. Given the many judicial statements which stress the need for the Court to "... safeguard the extremely important social value of privacy which must be balanced against the necessities of administration of the revenue laws"[68] and the judicial trend to apply restrictions on the Commissioner's other information gathering powers, it is highly likely that public interest immunity would apply to limit the scope of an offshore information notice.

Finally, although contractual arrangements can purport to restrict parties from disclosing information or releasing documents, they are unlikely to override Section 264A given judicial decisions in respect of Section 264.[69] Similarly, foreign secrecy laws cannot override Section 264A.[70]

III. USE OF TREATIES

As well as the offshore information procedures, the Commissioner has resort to the exchange of information articles contained in Australia's bilateral tax treaties.[71] The use of treaties has been quite successful according to an Australian Taxation Office Media Release,[72] in particular, successes have occurred with the United States Internal Revenue Service in respect of transfer pricing. However, although they are in theory a good mechanism for obtaining information, they are not a practical mechanism in all situations as their scope is restricted by express and practical limitations.[73]

The express limitations include the fact that the information requested can only relate to taxes to which the agreement applies. For example, a request for sales tax information need not be complied with by the foreign state, as sales tax lies outside the agreement.[74] Another limitation is that a Contracting State is not obliged to supply information that 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. Also, following the acceptance by the High Court in *Thiel v. Federal Commissioner of Taxation*[75] that the Vienna Convention on the Law of Treaties could be used in interpreting Australian treaties, the exchange of information articles may be limited by the Convention and by any other "... subsequent agreement or practice of the parties or relevant rules of international law".[76] However, the extent to which the treaties limit the operation of such articles, will depend upon their incorporation into Australian law.[77]

There are three fundamental principles which underlie the use of these articles, secrecy, necessity and reciprocity.[78]

However, due to the undermining of these principles by governments, practical limitations arise. In many jurisdictions revenue authorities' access powers can be extremely limited. They may be subject to direct judicial restraint, or have limited scope (i.e. specific categories of information are protect-

59. *Controlled Consultants Pty Ltd v. Commissioner for Corporate Affairs* (Vic) (1985) 59 ALR 254.
60. Sec. 264A(22).
61. Sec. 264A(21).
62. *Stergis v. Boucher and Anor* (1989) 20 ATR 591.
63. *Alfred Crompton Amusement Machines Ltd v. Customs and Excise Commissioners* [1974] AC 405.
64. Per Gibbs ACJ in *Sankey v. Whitlam* (1978) 142 CLR 1, 38.
65. *Aboriginal Scared Sites Protection Authority v. Maurice* (1986) 65 ALR 247.
66. Before Wilcox J (1991) 21 ATR 1584; Full Court (1991) 22 ATR 636.
67. (1993) 27 ATR 64.
68. See *supra* note 17 at 544.
69. *Ibid.* at 522.
70. Sec. 264A(12).
71. The exchange of information article adopted in Australia's most recent agreements is a modified Article 26 of the 1977 OECD Model Convention. It varies from the OECD Model only in that it does not include the express power that the competent authority may disclose the information received in public court proceedings or judicial proceedings.
72. Australian Taxation Office Media Release 10/1991.
73. For a comprehensive analysis of these problems see Burns, L. and Woellner, R.H., "Bilateral and Multilateral Exchanges of Information" (1989) 23 *Taxation in Australia* 656, at 658.
74. OECD, Model Double Tax Convention on Income and on Capital, *Report* (1977), 184.
75. (1990) 171 CLR 338, 356.
76. Article 31(3) of the Vienna Convention on the Law of Treaties.
77. *Minister of State for Immigration and Ethnic Affairs v. Teoh* (1995) 128 ALR 353.
78. See *supra* note 73 at 660.

ed). They may also be limited by local laws (i.e. bank secrecy and privacy laws).[79]

Other practical limitations on the effectiveness of treaties to obtain information held offshore include the reluctance of some governments to provide information. Problems also arise due to the lack of power to ensure that other governments provide timely information and the fact that some revenue offices may not pursue information from third parties. Thus, it is clear that these limitations result in the articles not generally being an effective method for the Commissioner to obtain overseas information.

IV. CONCLUSION

From the above, it is clear that the Commissioner has wide powers to seek information held in foreign jurisdictions via the use of offshore information notices and, to a lesser extent, the exchange of information articles. As *Faulding* has indicated, the Australian Courts have, when interpreting such provisions tried to balance the right to privacy with the needs of the Commissioner. In doing so they attempt to limit any potential abuses by the Commissioner whilst at the same time ensuring that if information is over there it must be declared!.

79. Some specific examples of these protected categories are the papers of a tax adviser or statutory appointed auditor which are safe from disclosure in the United Kingdom (Sec. 20B (9) Taxes Management Act 1970 (UK) and Sec. 144(7) and (8) Finance Act 1989 (UK)); and in the United States, the Internal Revenue Service is only given limited access to Church papers (Sec. 7605(c) Internal Revenue Code (US)). Similar limitations also occur in Australia where the information sought on behalf of a Contracting State is subject say, to legal professional privilege.

NEW ZEALAND

INTERNATIONAL TAXATION: A COMPLETE APPROACH AT LAST?

Adrian J. Sawyer

M Com (Hons), LL B, A.C.A., Barrister and Solicitor of the High Court of New Zealand. **Adrian Sawyer** is a lecturer in taxation and business law in the Department of Accountancy, Finance and Information Systems at the University of Canterbury, Christchurch, New Zealand. He specializes in tax compliance and administration, and effective tax rate research, as well as company and insolvency law. He is a New Zealand correspondent for the *Bulletin*.

INTRODUCTION

New Zealand taxpayers, advisers and researchers have been confronted with a steady onslaught of discussion documents during the first four months of this year on issues as diverse as business compliance costs, tax disputes, rewriting of the Income Tax Act 1976, taxpayer compliance standards and penalties (number 2), and international tax. This article contents itself with reviewing the last of these documents in the context of the existing approach to taxing the worldwide income of New Zealand residents and the income of non-residents derived in New Zealand. [1]

Part I of this article briefly outlines developments in New Zealand's international tax regime. Part II reviews the current system and the process for change as set out in the discussion document and required by the GTPP. Part III reviews and evaluates the proposed changes as set out in the discussion document. Part IV raises some planning opportunities and concerns arising from the proposals, with Part V offering some concluding comments.

I. DEVELOPMENTS IN NEW ZEALAND'S INTERNATIONAL TAX REGIME

Prior to 1984, New Zealand had minimal taxation legislation affecting the international income of either residents or non-residents. Following the deregulation of the financial markets in 1985 and the massive growth and internationalization of New Zealand in the ensuing two years, the New Zealand Government at the time issued a blueprint for the development of tax policy to address the issues arising from New Zealand's growing international economy.[2] A significant number of policy changes were promulgated and legislation followed, frequently implemented retrospectively.

The discussion document was issued on 28 February 1995,[3] setting out the current Government's proposed policy in the international tax area. The discussion document is divided into two parts: a policy framework developed largely by the New Zealand Treasury and reform proposals which comes within the ambit of the Inland Revenue Department (IRD). Submissions could be made to the respective departments prior to the deadline of 12 April 1995. The submission process reflects the operation of the Generic Tax Policy Process (GTPP), where consultation with taxpayers in the policy development phase is a fundamental component. This discussion document is important not only to New Zealand residents with overseas income and business entities, but also to non-residents seeking to invest in New Zealand, or, wishing to maintain their existing investments. A summary of the major developments in New Zealand's international taxation regime appears in Figure 1:[4]

Figure 1. Summary of Developments in New Zealand's International Tax Regime

	Effective Date of Application
New Residence Rules Controlled Foreign Companies Regime Foreign Dividend Withholding Payments Regime Foreign Investment Fund Regime (subsequently repealed) Trust Regime	1 April 1988
↓	
Approved Issuer Levy	1 August 1991
↓	
Attributed Repatriation Rules	Accounting periods ending after 2 July 1992
↓	
Foreign Investment Fund Regime (revised form)	1 April 1993
↓	
Underlying Foreign Tax Credit Regime Foreign Investor Tax Credit regime (for portfolio investors only)	28 September 1993
↓	

1. New Zealand Government, "International Tax – A Discussion Document", Government Printer, Wellington, 28 February 1995.
2. See the Labour Government's Economic Statement of 17 December 1987.
3. See *supra* note 1.
4. This is based on a diagram which appeared in the Tax Education Office Newsletter No. 100, (1995) 23 March 1995, at 3.

Proposed in the Discussion Document

Foreign Investor Tax Credit Regime (extended for all investors)	*Second half of 1995*
Reduction in Non-resident Corporate Tax rate from 38% to 33% (for Branch profits)	*1996/97 income tax year*
Transfer Pricing provisions (revised form)	*1996/97 income tax year*
Thin Capitalization rules (submissions on possible rules sought)	*To be advised*

II. THE CURRENT SYSTEM AND THE PROCESS FOR CHANGE

A. An overview of the existing system

The current approach to taxing the foreign income of New Zealand residents and the New Zealand income earned by non-residents is incomplete and in several instances, fundamentally flawed. A consequence of this failed approach is that the tax system fails to encourage foreign investment in New Zealand. Currently, for a New Zealand resident, income is taxed on a worldwide basis, regardless of its source. That is a New Zealand resident is taxed on income earned directly (such as overseas employment income and interest on overseas bank accounts) and indirectly through separate legal entities. In 1988, changes were introduced through the Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) Regimes. There was also a Foreign Dividend Withholding Payment (FDWP) system introduced at this time. All three regimes are complex and considerable expertise is required to correctly determine the tax liability arising in respect of the foreign-source income of New Zealand residents.

However, operation of the FIF regime was suspended until its modification, which was effective from 1 April 1993. The 1993 version of the FIF regime essentially simplified the definition of an interest in a FIF, provided a Grey List exemption, a *de minimis* rule for small FIF holdings by individuals, introduced four methods for calculating FIF income or losses, and created special provisions for interests in foreign life insurance, superannuation and employment-related foreign superannuation schemes.[5] The CFC regime attributes income of a foreign company to its New Zealand owners where there is a 50 percent or greater controlling interest in the CFC by New Zealand taxpayers, with tax payable on the CFC earnings when income interests are 10 percent or greater. The CFC regime was also modified with effect from 1 April 1993, by the introduction of more stringent control tests, and alterations to the Grey List exemption countries.[6] To further bolster the CFC and FIF regimes, and minimize avoidance opportunities, the FDWP regime was introduced in 1988 and subsequently extended in 1993 to cover attributed repatriations of foreign-source profits. Changes to the tax treatment of foreign tax credits accompanied these reforms, recognizing the need to avoid double taxation on foreign-source income, but ensuring that avoidance opportunities are curtailed.[7]

Non-resident withholding tax (NRWT) applies to most dividends, interest and royalties derived in New Zealand by a non-resident taxpayer. From 1 August 1991, certain interest payments made to non-residents are exempt from NRWT where an approved issuer pays a levy of 2% on interest payments made on registered securities. The approved issuer levy (AIL) is deductible for tax purposes, but is not a tax and will generally not be creditable against tax payable by the lender in the lender's country of residence. This regime has substantially reduced the effective tax rate on investments by non-residents in New Zealand, as illustrated in Table 1.

On the equity side, a Foreign Investor Tax Credit (FITC) regime was introduced with effect from 28 September 1993, in which a tax rebate mechanism was provided at the company level for foreign portfolio investors who had a direct shareholding of less than 10 percent in a New Zealand company. Investors that qualify will have the total New Zealand tax paid on their investment limited to 33 percent, provided they reside in a country which has a double tax agreement (DTA) with New Zealand. Non-resident withholding tax (NRWT) of 15 percent still applies to the dividend, although the effect of the NRWT is negated through the supplementary dividend which is paid to the non-resident shareholder. The amount of the credit is determined by the level of imputation credits attached to the dividend. Where the shareholder resides in a country without a DTA with New Zealand, the higher rate of NRWT of 30 percent applies.[8] In the course of introducing the FITC, it was decided not to repeal the NRWT (as has occurred in Australia), since the supplementary dividend creates a higher after-tax return to the investor and ensures that some tax is paid in the source country rather than entirely in the country of the recipient's residence.[9]

Transfer pricing provisions exist, albeit in an ineffective form and are contained in Section 22 of the Income Tax Act 1976 (GC 1 of the Income Tax Act 1994). Utilization of transfer pricing techniques can reduce the marginal effective tax rate in New Zealand to nil[10] A trust regime also applies, whereby distributions of income classified as beneficiary income are taxed at 38 percent for non-residents and taxed at 33 percent as trustee income.[11]

5. For further discussion see, Tax Education Office Newsletter No. 66, (1993) 25 February 1993, at 1.
6. For further discussion see, Tax Education Office Newsletter No. 67, (1993) 6 April 1993, at 1.
7. For further discussion see, *ibid.* at 9.
8. In effect, the supplementary dividend regime discriminates against foreign investors resident in a country that does not have a DTA with New Zealand.
9. For a further summary of the taxation systems in the Asia Pacific region, see KPMG, *Asia Pacific Taxation*, (KPMG International Centre, The Netherlands, 1993). This is a useful reference for an overview of the New Zealand international tax system as at October 1993.
10. Two articles reviewing the use of transfer pricing in New Zealand under section 22 of the Income Tax Act 1976 (GC 1 of the Income Tax Act 1994) are: M. Stanley, "Transfer pricing", (1991) 9 *Asian Pacific Tax and Investment Research Centre Bulletin*, 232; and D. Trigg, "Transfer pricing under scrutiny", (1993) *NZ Business*, July, 50.
11. For further discussion, Tax Education Office Newsletter No. 76, (1993) 29 October 1993, at 1.

Table 1 summarizes the current taxation situation of payments to non-residents[12]:

Table 1: TAXATION OF PAYMENTS TO NON-RESIDENTS

Component	Debt[13]		Equity					Transfer Pricing[14]	Trusts	
	NRWT @ 10%	AIL @ 2%	Branch	Non-Portfolio Investor		Portfolio Investor (fully imputed)			As Beneficiary Income	As Trustee Income
				NRWT @ 15%	NRWT @ 30%	NRWT @ 15%	NRWT @ 30%			
Profit	100	100	100	100	100	100	100	100	100	100
Tax	(0)	(0)	(38)	(33)	(33)	(21)[15]	(21)	(0)	(38)	(33)
Available for distribution	100	100	62	67	67	79	79	100	62	67
NRWT/AIL	(10)	(1)[16]	(0)	(10)	(20)	(12)	(24)	(0)	(0)	(0)
Cash received	90	99	62	57	47	67	55	100	62	67
Effective New Zealand tax rate	10%	1%	38%	43%	53%	33%	45%	0%	38%	33%

As the above table indicates, the effective tax rate on a non-residents' investment in New Zealand can be as low as nil in the transfer pricing environment (provided the transaction satisfies the revenue authorities), 1.34 percent for debt (AIL), and up to 53 percent for a non-portfolio investor who does not reside in a country which has a DTA with New Zealand. The variance in rates clearly favours debt financing by non-residents, or the use of transfer pricing to minimize exposure to New Zealand taxation, with only the portfolio investor resident in a DTA country facing a comparable effective tax rate in New Zealand to the New Zealand resident equity investor.[17] Clear candidates for reform are the branch taxation regime, non-portfolio investors and trust income distributed as beneficiary income.

B. Proposals for change and the Generic Tax Policy Process

The current situation provides several opportunities for reform as indicated in the preceding section. In late 1994, the Government signalled that changes to the international tax regime would be forthcoming. Prior to this in April 1994, the Generic Tax Policy Process (GTPP) was publicly adopted by the Government, with consultation a key feature. Consultation is to be undertaken at the policy refinement and select committee stages, providing taxpayers and advisers with an earlier indication of the Government's approaches to tax policy. The GTPP also offers opportunities for taxpayers and their advisers to be intricately involved in refining policy formulation and content.[18]

The discussion document is released as the primary policy document for the remaining items in the current round of international tax reforms. It is the opinion of the current Government that the proposed measures will ensure that "... New Zealand will have an effective and comprehensive international tax regime."[19] Underlying the philosophy is a "levelling of the playing field" for resident and non-resident investors and taxpayers. Whether this is achieved depends largely upon the willingness of the Government to relax its firm grasp on the domestic revenue base in the interests of fostering continued economic investment in New Zealand.[20]

The next section commences by specifying a brief overview of the structure of the discussion document, before setting out the detail contained therein.

C. The discussion document approach

1. Policy framework

The first part of the discussion document sets out an introductory overview of the economic situation faced by New Zealand. It recognizes that for continued economic development New Zealand requires foreign direct investment and capital to continue enhancing the infrastructure and to sustain employment growth. A dominant feature is the objective of

12. Based on table in Tax Education Office Newsletter, No. 100, (1995) 23 March 1995, at 4.
13. Interest is fully tax deductible, therefore there is no net company tax on profits repatriated by way of interest payments.
14. This assumes that all New Zealand profit is distributed through an excess payment for goods and services purchased from the non-resident, or by way of an undercharge for goods and services sold by the company to the non-resident. This ignores any action under the current legislation.
15. Company tax of ($ 33) less tax credit ($ 12) gives ($ 21).
16. Actual rate is 1.34%.
17. It is generally accepted that it is preferable to pay tax in one's country of residence rather than in a foreign country. Payment of tax overseas relies upon the acceptance of a tax credit from the foreign country to off-set a tax liability in the country of residence.
18. See Sawyer, A.J., "Broadening the Scope of Consultation and Strategic Focus in Tax Policy Formulation: Some Recent Developments", (1995), paper submitted to *The New Zealand Journal of Taxation Law and Policy*.
19. See *supra* note 1.
20. The general reaction to the discussion document from tax experts has been favourable, with a positive and significant impact on foreign investment in New Zealand the expected outcome. The proposals should also have a favourable impact on the cost of capital to businesses investing in New Zealand. Other commentators consider that the regime is in effect "bowing to the power of the foreign dollar" (editorial, Christchurch Press, 4 March 1995), and the issue of foreign investment has become a decisive aspect of party politics in New Zealand in recent months.

tax neutrality in investment decision-making in New Zealand; as a country New Zealand should be as attractive for offshore investment as it is for domestic investment.

Part A of the discussion document sets out succinctly the policy objectives and considerations. The influences on investment are reviewed, and a progressive development of the proposed economic model of taxing capital flows is delineated. The impact of taxes on the worldwide flows of investment capital is analyzed, from the domestic income of New Zealand residents, to New Zealand residents' worldwide income, and to all New Zealand-sourced income for non-residents. Double taxation issues are confronted, along with the role of tax treaties and administration issues, and the "see-saw" relationship between domestic and international taxation pressures on the same income. This rational economic approach is to be applauded. In this regard, it should be noted that the long-held resistance to permitting tax revenue to be attributed to other nations rather than New Zealand is significantly relaxed. Foreign tax credit recognition is revisited, and the importance of compliance costs in guiding the complexity of the regime is afforded prominent attention.

On the flip-side, the tax planning opportunities created by the proposed relaxation of current policy is highlighted, with the need for the regimes included in the proposed changes to be robust. Broad support from the business community is sought to allow sustainable policy to be implemented; consequently the early signalling of policy and use of the GTPP's consultation facilities are prominent. The policy section then reviews the existing international tax regime's policy in the context of the DTAs impact on the statutory rules for international investment in New Zealand.

The most significant policy objectives underlying the discussion document's proposals are that:

- all investment decisions make the most of New Zealand's resources, and are determined by the intrinsic quality of the investment rather than by tax considerations;
- New Zealand's tax system does not make off-shore investment more or less attractive than domestic investment for New Zealand investors;
- the regime encourages foreign investment into New Zealand and minimizes the cost of capital to New Zealand businesses;
- New Zealand's tax base is protected and the integrity of the tax system is maintained;
- compliance and administration costs are kept to a minimum, while balancing accuracy with simplicity;
- once developed and implemented, the regime is sustainable in the longer term and not subject to significant changes, since a tax regime that constantly changes deters foreign investment;
- there is equality in the effective tax rates imposed on the various forms of investment and investment structures.

2. Reform proposals

The second part of the discussion document (Part B) commences with a review of the existing deficiencies in the cross-border income measurement processes, especially where theoretical ideals are not satisfied. However, the discussion document does not intend to fully satisfy the theoretical ideals, although it wishes to move significantly in their direction. The current deficiencies include, technical problems relating to insufficient statutory rules dealing with the determination of the location of the source, apportionment issues, structural problems and the practical difficulties in implementing source rules. Other deficiencies include inadequate transfer pricing rules from an enforcement perspective and the variability of tax rates. Each of the major reforms is discussed in greater detail in the next section of this article.

III. THE PROPOSED CHANGES

A. Foreign Investor Tax Credit Regime

The FITC regime is to be extended to enable the supplementary dividend to be utilized by non-resident investors who hold more than a ten percent interest in a New Zealand company, to ensure that they only pay tax at a rate of 33 percent on their income from the company.[21] The Government considers that with the substantial improvement in New Zealand's fiscal position from September 1993 (when budget deficits were prevalent) to early 1995 (with significant budget surpluses in the vicinity of NZ$ 2.5b being posted,) economically and fiscally it had become feasible to extend the FITC regime. It is expected that in the medium term, compliance costs of firms will be lowered with the extension of the regime. Forecasts estimate that the initial reduction in tax revenue will be in the region of NZ$ 60 – $70 million, but later higher tax revenues are anticipated with the growth in activity spurred by the reduction in the cost of capital for many firms. This proposed change should be effective by October 1995.[22]

B. Branch Taxation

Accompanying the extension of the FITC regime is a proposed reduction in the branch tax rate to 33 percent to "restore equality", effective from the commencement of the 1996/97 income tax year. This will bring about tax neutrality between an alternative form of investment to the portfolio approach of financing investments. The estimated loss of tax revenue is a paltry NZ$ 5m. This proposed change recognizes New Zealand as a small open economy, drawing upon and investing in a substantially larger global economy.

21. This applies only if the non-resident resides in a country which has a DTA with New Zealand since a NRWT rate of 15 percent is used to calculate the supplementary dividend.

22. Two commentators believe that the concept of the FITC, which is unique to New Zealand, should be revisited. They propose the alternative of an exemption system. This alternative is considered important in the context of the New Zealand Government's criticism of the use of tax credits by Western Samoa and the resulting legislation introduced to combat these initiatives, since the "tax credit" is not a credit recognisable in the overseas country but merely a way to offset the NRWT liability in New Zealand.

C. Transfer Pricing Rules

As a potential check and balance to the increased flexibility in investment vehicles and reduced tax rates, a major revenue protection device is to be given new sustenance: the transfer pricing provisions. The Government intends to adopt new transfer pricing rules which encompass and extend the OECD guidelines published in 1979. Transfer pricing is generally used to refer to the price charged for goods and services supplied between related parties. Currently the Income Tax Act 1994 has only one substantial reference to transfer pricing provisions in Section GC 1 (Section 22 of the Income Tax Act 1976, repealed as from 1 April 1995). Essentially the Commissioner can adjust the income or expenditure of the taxpayer when he considers that the taxpayer's business produces less income than might otherwise be expected to arise from that business.[23]

The existing transfer pricing weaponry has rarely been activated by the Commissioner. Several problems in the existing regime were recognized by the Government in the discussion document[24]:

- "the control tests which must be met before the provision comes into play are limited and therefore can be circumvented;
- insufficient guidance is provided about what is, in terms of the section, the appropriate level of net income to be sourced in New Zealand; and
- the relationship between Section 22 and other sections of the Act is not clear."

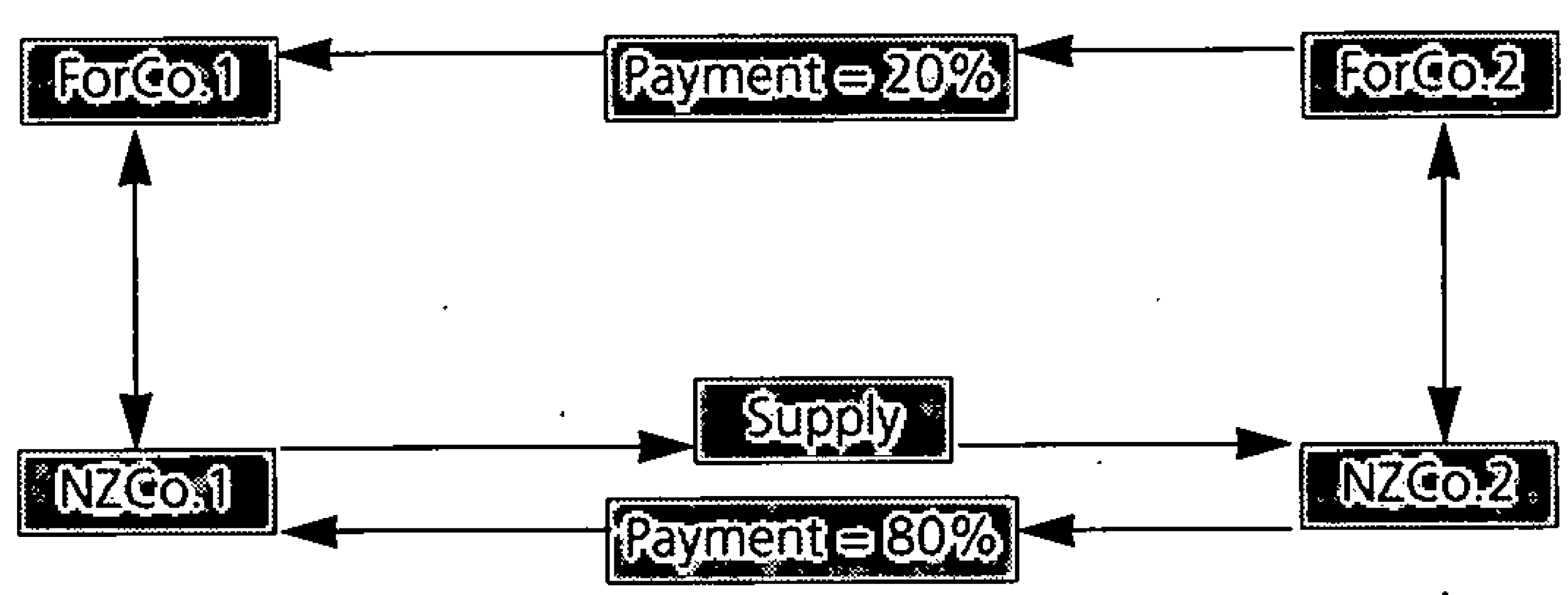
New provisions are proposed which incorporate pricing provisions recognizing the need for improved measurement of income by source and deterring taxpayers from manipulating transaction prices to defer taxes. Consequently the rules will apply to cross-border, non-arm's length transactions that deplete the New Zealand tax base, and domestic arrangements that are a part of a broader agreement involving non-residents, individuals, trusts and companies. The regime will apply to both related and unrelated transactions in order to minimize opportunities to circumvent the rules; an extension to the OECD guidelines. Transactions between a New Zealand company and its branch will be considered as a transaction initiated between two separate entities and will therefore be subject to transfer pricing scrutiny.

Partially in response to concerns of complexity and unnecessary compliance costs, there will be a presumption that unrelated parties transact at an arm's length price, with the IRD having the onus to demonstrate that the parties behaved otherwise. A fundamental issue is the selection of the appropriate pricing methodology in calculating taxable income. The onus is on the taxpayer to apply the appropriate rule within their self-assessment obligations. Interestingly, the Government recognizes that transfer pricing cannot be considered to be an exact science (that is it involves significant estimation). Consequently the estimates need only to be reasonable, with the onus on the IRD to establish that the taxpayer's estimate is unreasonable.

Five possible methodologies are specified for determining an arm's length price and these effectively mirror the OECD recommendations. These methodologies are: the comparable uncontrolled price method, resale price method, cost plus method, comparable profits method and profit split method. The comparable uncontrolled price method is the approach preferred by the Government and if it is used, the Commissioner will not be permitted to apply any other method. If a comparable uncontrolled price is unavailable, then the method providing the most *accurate* and *practical* measure of an arm's length price is required. Guidelines are yet to be released, but in the self-assessment environment, taxpayers are encouraged to apply for a private (advance) ruling under the new binding rulings regime which took effect from 1 April 1995.[25]

Where there is a DTA in existence, the mutual agreement clause will enable disputes over pricing to be resolved, but in other instances the Government acknowledges that there may be situations where double taxation arises when the arm's length price is applied to the transaction. The discussion document favours transfer pricing rules that closely resemble the provisions in the relevant Australian legislation, but with suitable modification to ensure unnecessary rigidity is relaxed. In the discussion document[26] an example is provided where an apparently domestic transaction occurring in two countries has revenue depletion potential in New Zealand, as set out in Figure 2.

Figure 2: Apparently unrelated transactions with transfer pricing implications



23. A.J Easson, *International Tax Reform and the Inter-nation Allocation of Tax Revenue*, (Institute of Policy Studies, Wellington, 1991) is an excellent monograph on how New Zealand's existing international tax regime could be improved. Easson's approach is to avoid promoting radical changes, choosing to encourage greater neutrality, efficiency in resource allocation, and minimisation of transfer pricing abuses. He acknowledges that there are constraints, such as avoiding any fundamental reallocation of tax revenue between countries, that any changes should be able to be adopted unilaterally without significant detriment, and that there should be minimal impact on domestic tax systems. Elimination of withholding tax on payments to non-residents and the non-deductibility of such payments by branches and subsidiaries in ascertaining their taxable profits are promoted in this study.
24. See *supra* note 1.
25. For a discussion on this regime, see Sawyer, A.J., "A Proposed Binding Rulings Regime', 48 *Bulletin for International Fiscal Documentation* (1994) 11, at 582, and Sawyer, A.J., "Update on the new Binding Rulings Regime and amendments to the Entertainment Tax Regime", 49 *Bulletin for International Fiscal Documentation* (1995) 4, at 189. For a review of the US and OECD transfer pricing issues, see Elliott, J., A Study on Transfer Pricing, Paper presented at the 18th European Accounting Association Congress, Birmingham, 10 – 12 May 1995.
26. See *supra* note 1.

In this example, two unassociated groups of companies comprising NZCo.1 and ForCo.1 in one group and NZCo.2 and ForCo.2 in the other group, have agreed that NZCo.1 will receive 80 percent of the arm's length consideration from NZCo.2 in respect of the supply of property in New Zealand. NZCo.1's offshore associate, ForCo.1, will receive the balance of 20 percent of the arm's length consideration from ForCo.2. This is in effect a transfer of New Zealand sourced income from NZCo.1 to ForCo.1, giving rise to transfer pricing implications. These new provisions outlined below are intended to be effective from the commencement of the 1996/97 income tax year.

1. Comparable Uncontrolled Price (CUP) Method

This method involves identifying a price which is set by reference to comparable transactions between unrelated buyers and sellers where the property or services and circumstances involved in the unrelated party transaction are identical or quite similar to the property or services and circumstances involved in the sales between the related parties. There are several aspects that should be considered in determining if a CUP exists, especially where the amounts involved are substantial:[27]

- one-off sales at unrealistic prices and sales which contain price adjustments for market penetration should be excluded;
- the comparable product must be of the same quality;
- similar terms of trade should exist, such as payment, costs of transport, packaging, advertising, marketing and guarantees;
- time of sale is important (e.g. for inflation adjustments);
- the value of trade marks, patents and other intangibles needs to be ascertained;
- the sale should be to the same kind of entity (there is no CUP if the sale is to an end user rather than a distributor, wholesaler, etc);
- the geographic and location market should be the same (there is no CUP if there are mixes of developed and undeveloped markets); and
- prices depend on the volumes of transactions.

2. Resale Price Method (cost based)

Figure 3: Resale Price Method example

Related non-resident→ NZ taxpayer (reseller)→ Third party customer

This is normally an appropriate method where the taxpayer acquires goods from a related non-resident for sale to a third party. In the scenario set out in Figure 3, the arm's length price is determined by deducting from the price charged to the third party customer an appropriate discount for the activities of the reseller. The discount is determined by reference to the gross margin earned by the reseller on the product that is purchased and resold in an uncontrolled transaction in the relevant market. The margin depends on four major factors:

- the mark-up percentage for that particular type of property;
- the geographic market;
- the functions performed by the reseller; and
- the effect on price of any intangibles used by the reseller.

It should be noted that where minor differences between the actual transaction and comparable transaction exist, the margin may also be adjusted.

3. Cost Plus Method (cost based)

Figure 4: Cost Plus Method example

NZ taxpayer supplier→ Related non-resident customer

This method is typically applied where the New Zealand taxpayer sells via contract manufacturing or contract services to a related non-resident party; as depicted in Figure 4. The transfer price is determined by adding an arm's length mark-up to both direct and indirect costs incurred by the New Zealand taxpayer in supplying these goods or services to the non-resident. The percentage to be used is established by reference to sales made to unrelated parties for similar items, with minor adjustments to the mark up being permitted.

4. Comparable Profits Method (profit based)

A "rate of return" ratio earned by persons operating in a similar or very similar industry (or industries) is applied to the New Zealand taxpayer to determine the New Zealand taxpayer's net income. The comparable rate of return ratios underlying the analysis incorporate the return on equity, return on assets and profits to sales ratios. Caution is required when it is applied to intercompany pricing and extreme care should be taken in analysing the results.

5. Profit Split Method (profit based)

This method, one of the inherently weaker approaches, assumes that profits are split equitably between the unrelated parties. To determine the appropriate price, similar facts and circumstances with unrelated parties must be established. Since it is extremely difficult to uncover information which is normally not publicly available, the method lacks objectivity and is open to criticism and attack by the revenue authorities.

In choosing the most appropriate method, the approach taken by the United States is endorsed by the Government. In the United States, consideration is given to the degree of comparability between the third party transactions used in the comparison and the relevant transactions of the taxpayer, the completeness and accuracy of the underlying data, the reliability of the assumptions used, and the sensitivity of the results to potential deficiencies in the data and assumptions. The New Zealand proposals relax the US approach in that the degree of accuracy required will be sufficient to ensure that a reasonable estimate can be made which satisfies the Commissioner upon investigation. Consequentially the weaker

27. Based on TEO Newsletter No. 100 (1995), op cit n 9, at 7.

the comparable transaction information, data and assumptions, the more prone the pricing will be to review and adjustment by the Commissioner.

Certain downward adjustments will be permitted where this offsets an adjustment with the other party to the transaction, provided both sides to the transaction are taxable in New Zealand or when the adjustment constitutes a multilateral competent authority adjustment. The proposed rules will be developed to integrate with the new disputes resolution procedures and proposed penalties. Records necessary to ascertain arm's length price calculations must be retained for the standard seven year period. The proposed rules will supersede the existing provision and will operate in conjunction with the deemed dividend rules in the legislation (Section 4 of the Income Tax Act 1976, or CF in the Income Tax Act 1994).

D. Source rules

The existing source rule difficulties will be eliminated in order to facilitate the proposed transfer pricing rules. Currently New Zealand income tax is payable on the worldwide income of residents and the New Zealand-sourced income of non-residents. A summary of the existing problems is set out below:[28]

- "insufficient statutory detail on where income is sourced;
- lack of explicit apportionment rules;
- structural problems regarding whether statutory apportionment rules apply to gross or net income; and
- practical problems with the determination of source, leading to inconsistent rules and rules that are difficult to apply."

The first of these problems will be addressed during the rewriting of the Income Tax Act 1994. Definitions for New Zealand-sourced income, foreign-sourced income and income that is not exclusively New Zealand-sourced will be developed. Apportionment will be dealt with by the IRD providing "more detailed cross-border apportionment guidelines which are consistent with the transfer pricing rules".[29]

Gross or net income, a common problem throughout the tax legislation, will also come under the spot-light during the rewriting exercise. In addition, the Government acknowledges there are difficulties in applying the value-added principle to debt and equity and considers that the US approach to reduce tax charged on income derived offshore and then distributed to overseas investors deserves further attention, with the proviso that this does not compromise New Zealand's overall international tax regime.

E. Some thoughts on thin capitalization

In perhaps the weakest part of the discussion document in terms of firm proposals, the Government raises the issue of thin capitalization rules to address the scenario where an overseas entity sets up a subsidiary in New Zealand funded wholly or substantially by debt.[30] The discussion document recognizes that many overseas jurisdictions restrict the level of interest deductibility,[31] and that without such provision interest payments will only be subject to either NRWT or AIL, reducing the New Zealand tax base.

The Government has invited submissions as to whether New Zealand needs a thin capitalization regime, and sets out alternative regimes for comment.[32] It acknowledges that in the final analysis, the implications of the proposals on compliance costs will be vital; excessive compliance costs are not to be imposed on taxpayers.[33] The main features of the thin capitalization proposals are:

- all New Zealand taxpayers controlled by a single non-resident would be subject to the regime;
- there would be a safe-harbour debt:equity ratio, set to ensure that most entities operating with normal commercial capital structures would be excluded from the regime;
- where the debt:equity ratio prima facie exceeds the safe-harbour ratio, the entity would be excluded if its ratio was equal to or less than 110 percent of the ratio of the international corporate group of which it is a member;
- where the entity fails either of these two tests, then its interest deductions would be restricted, but the excessive interest would not be treated as a dividend (return on equity);
- the regime would include both third-party and related-party debt.

For these purposes control would exist when the non-resident has at least a 50 percent interest, with the calculation of this interest subject to the "look-through" provisions to determine the ultimate controlling interest of an entity.[34] Overseas safe-harbour ratios vary from 1.5:1 (e.g. USA) to 3:1 (e.g. Australia); submissions are sought on the most appropriate ratio for New Zealand. As at November 1994, a survey of the

28. See *supra* note 1.
29. *Ibid*, at 51.
30. At the same time, this aspect is likely to create the greatest amount of controversy during the submissions process.
31. Countries including Australia, Canada, Germany, Japan, Norway, Sweden, UK and the USA.
32. The size of foreign investment in New Zealand entities other than the Government at 31 March 1994 was NZ$ 4.7b, an important source of capital funding. In the Government sector, foreign investors hold NZ$ 4.67b of Government Stock, NZ$ 3.34b of Treasury Bills, and foreign currency of NZ$ 16.86b as at July 1994.
33. An excellent study on the issues underlying introducing a thin capitalization regime for New Zealand are contained in the monograph by A.M.C. Smith, *Tax Avoidance and Non-resident Investors: The Case of Thin Capitalization*, (Institute of Policy Studies, Wellington, 1992). Smith concludes that whether thin capitalization provisions are introduced should form part of a comprehensive review of taxation of non-residents, which is clearly the focus of the discussion document. Robust transfer pricing rules need to be in place first according to Smith. On balance, Smith concludes that a modified form of the Australian and Canadian model is preferable to the US regime. A suggestion of a more flexible approach by modifying the general anti-avoidance provisions (Section 99 Income Tax Act 1976, or BB 9 Income Tax Act 1994) is acknowledged to introduce its own set of difficulties. Smith concludes that the preferable theoretical outcome requires all jurisdictions to impose taxes on the same basis and at the same rates for the avoidance opportunities of thin capitalization and transfer pricing to be reduced, subject to the remaining inter-jurisdictional competition for tax revenue.
34. See Sections 8A to 8F of the Income Tax Act 1976 and Sections OB 1, OD 2 to OD 6, FF 1 and GC 3 of the Income Tax Act 1994.

NZSE Top 40 companies, as listed on the New Zealand Stock Exchange, had an average debt:equity ratio of 1.1:1 (median 53 percent equity, mean 45 percent equity).

The extension of flexibility in safe-harbour debt:equity where there is a worldwide group has several difficulties, not the least being the practical issues of requiring a multinational to calculate its debt:equity ratio based on New Zealand tax principles, when its operations in New Zealand are likely to be insignificant in global terms. In addition, difficulties persist as to when the debt:equity ratio should be measured and the action required when strict application of the relevant safe-harbour debt:equity ratio leads to inequitable results.

The restriction on the deductibility of interest (and interest expenditure such as interest calculated under the accrual rules), would be calculated in accordance with the formula set out in Figure 5:

Figure 5: Restriction on the Deductibility of Interest

$$\textit{Non-deductible interest expense} = \textit{Total interest expense} \times \frac{\textit{Actual debt} - \textit{Threshold debt}}{\textit{Actual debt}}$$

Threshold debt is the higher of the safe harbour debt:equity ratio and 110 percent of the international group's debt:equity ratio. Many issues remain unresolved such as the off-setting of interest paid and received, back-to-back loans, and foreign exchange gains. This emphasizes that the proposals are exploratory rather than definitive, and provide minimal guidance to the taxpayers likely to be subject to any resulting thin capitalization regime. It should be noted that, in calculating the debt:equity ratio "debt" will be accorded a wide definition, embracing financial arrangements for which an interest deduction is claimed (under the accrual provisions). "Equity" would be defined as gross assets (at book or market value) less interest-bearing debt, implying that interest-free loans are treated as equity. Scope for manipulating asset values exists should a taxpayer be perilously close to failing to satisfy the safe-harbour ratio. It is proposed that the debt figure to be used in the ratio is the highest quantum occurring during the year, with equity calculated at the year end and ascertained from the financial statements. Nevertheless, at the risk of increasing compliance costs, taxpayers will be permitted the opportunity to determine an average debt level at either quarterly or monthly intervals. An annex to the discussion document provides an example of how a thin capitalization regime might work, and it is set out in a modified form in Appendix One to this article.

IV. TAX PLANNING OPPORTUNITIES AND CONCERNS

One opportunity arising from the proposals in the discussion document is for taxpayers to take advantage of the differences in timing between the proposed introduction of the various elements of the changes to the international tax regime. For example, the reduction in branch tax rate from 38 percent to 33 percent is expected to be effective from the commencement of the 1996/97 income tax year, but the FITC regime should be effective from late 1995, making repatriation of profits less expensive under this approach than with the branch structure. Consequently companies should consider restructuring to eliminate branches and form subsidiaries in order to utilize this five percent tax differential.

Additionally, timing of income and expenditure should be structured to utilize the reduction in the tax rate, with front loading of expenses and deferral of income being obvious candidates (subject to satisfying IRD avoidance scrutiny). Accounting date changes should also be considered. Where a company proposes to pay a dividend to a non-resident non-portfolio investor, it should be deferred, if possible, to take advantage of the extended FITC regime which will be effective later this year.

One further planning concern occurs where a wholly-owned holding company owns less than 100 percent of a New Zealand resident operating company and intends to utilize the FITC regime although the New Zealand company's imputation credit account balance is low. Utilization of imputation credits by way of a supplementary dividend will be possible, but it may not be possible to pass the resulting tax benefit back down to the operating company, and therefore the merits of direct ownership structures will need close scrutiny when the new legislation emerges. Care must be taken to ensure that the continuity of ownership requirements are met, that is, there cannot be more than a 33 percent change in ownership, if imputation credits are not to be forfeited on transfer of share ownership. Consequently companies need to carefully monitor their share register under the new proposed FITC regime to ensure that the supplementary dividend may continue to be paid.

Entities should, prior to their introduction in the 1996/97 income tax year, carefully consider the best procedures to adopt to comply with the proposed transfer pricing rules. In particular, it will be essential to provide documentary evidence to support the pricing mechanisms adopted. Meticulous economic, accounting and legal analysis prior to setting a price, or in reviewing existing prices, should be pursued where the dollar amounts in question are substantial.

To ensure that the proposed new penalties arising from a transfer pricing review do not adversely affect either non-residents or New Zealand taxpayers, taxpayers should carefully review the IRD's guidelines when they become available and if necessary, utilize the binding rulings facility to obtain an advance ruling that the proposed pricing mechanism is acceptable to the IRD. Prior negotiation of advance pricing agreements acceptable to the revenue authorities in respect of all countries affected by the arrangement, should reduce the instances of adverse action been taken later against one or more of the parties to the agreement. Where the taxpayer is in an industry that greatly facilitates transfer pricing opportunities, such as banking, computing and pharmaceuticals, expert advice should be sought sooner rather than later in preparedness for action from the IRD. New Zealand companies and non-resident investors potentially subject to transfer pricing scrutiny, should carefully review the OECD's guidelines and legislation in countries that incorporate transfer pricing provisions in their revenue law, such as Australia[35] and the United States.

Opportunities to determine the most appropriate debt:equity ratio for thin capitalization purposes should be utilized, provided the potential tax savings (through mitigating any potential add back of interest) do not give rise to excessive compliance costs. However, there is no necessity for immediate concern, since any resulting legislation is likely to be some time away, requiring a set of initial rules to be promulgated by way of a discussion document, submissions requested and analysed, followed by consultation through the select committee process in Parliament.[36] Where a taxpayer resides in an industry that has unusual debt:equity ratios, such as financial institutions where the ratio may be as high as 9:1, then special dispensations should be sought to ensure that any thin capitalization rules do not distort the operations of these entities.

Other adjustment mechanisms should be considered where the non-resident investor resides in a country that does not have a DTA with New Zealand, to compensate for the higher rate of NRWT and ineffective use of the supplementary dividend under the proposed extended FITC regime. However, where a DTA exists between New Zealand and the non-resident's country of residence, investment in New Zealand will become more attractive for the non-portfolio investor. Consequently New Zealand should become of greater interest to foreign investors.

Closer to home, Australian banks and financial institutions stand to benefit from the proposals, with an increase in repatriation of New Zealand sourced profits as dividends a probable scenario. This should see a significant flow of funds out of New Zealand, but at the same time other foreign investors are likely to increase their financial presence in New Zealand. Nevertheless, should thin capitalization rules be introduced, Australian entities will need to carefully scrutinize their choice of investment vehicle for New Zealand, as will other foreign investors.

V. CONCLUSIONS

The discussion document on international taxation represents, on balance, a positive step forward for non-residents seeking to invest in New Zealand, and for the freeing-up of capital movements to and from New Zealand. New Zealand is a net capital importer, and consequentially attracting foreign investment is vital to facilitating sustained economic growth. The proposed changes, introduced in the now familiar consultative style, should facilitate this objective. Nevertheless, submissions on the proposed transfer pricing rules are unlikely to be entirely supportive, and it would be surprising for submissions to be made identifying that there are thin capitalization problems in New Zealand that require legislative redress! Table 1 can be restated incorporating the proposals in the discussion document, as set out in Table 2.

The multifaceted approach in the discussion document through detailed presentation of the policy options and resulting choices, together with details of the proposed reforms, provides an early opportunity for the taxpaying community and their advisers to gauge the Government's views on international taxation. Nevertheless, caution rather than euphoria should prevail since there is no clear indication of the thin capitalization approach to be adopted, and draft legislation

35. The Australian Tax Office released an 84 page draft ruling clarifying transfer pricing provisions for international transactions in late April 1995, focusing on income and expense allocations between different parts of the same entity.
36. One further concern is that any debt:equity ratio is likely to be set pragmatically rather than through supporting rigorous tax theory, a situation which may reduce excessive compliance obligations, but has the potential to adversely affect economic reality.
37. Interest is fully tax deductible, therefore there is no net company tax on profits repatriated by way of interest payments.
38. This assumes that all New Zealand profit is distributed through an excess payment for goods and services purchased from the non-resident, or by way of an undercharge for goods and services sold by the company to the non-resident. This ignores any action under the current legislation.
39. No changes to the trust structure for distributions as beneficiary income to non-residents are referred to in the discussion document.
40. Company tax of ($33) less tax credit ($12) gives ($21).
41. *Ibid.*
42. Actual rate is 1.34%.

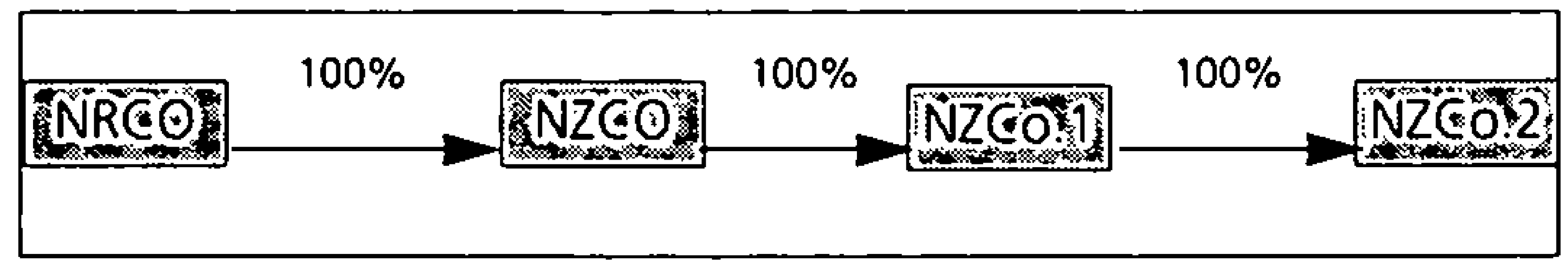
Table 2: PROPOSED TAXATION OF PAYMENTS TO NON-RESIDENTS

Component	Debt[37]			Equity				Transfer Pricing[38]	Trusts	
	NRWT @ 10%	AIL @ 2%	Branch	Non-Portfolio Investor		Portfolio Investor (fully imputed)			As[39] Beneficiary Income	As Trustee Income
				NRWT @ 15%	NRWT @ 30%	NRWT @ 15%	NRWT @ 30%			
Profit	100	100	100	100	100	100	100	100	100	100
Tax	(0)	(0)	(33)	(21)[40]	(21)	(21)[41]	(21)	(0)	(38)	(33)
Available for distribution	100	100	67	79	79	79	79	100	62	67
NRWT/AIL	(10)	(1)[42]	(0)	(12)	(24)	(12)	(24)	(0)	(0)	(0)
Cash received	90	99	67	67	55	67	55	100	62	67
Effective New Zealand tax rate	10%	1%	33%	33%	45%	33%	45%	0%	38%	33%

has yet to appear. In answer to the title of this article, a complete approach to international taxation remains in the domain of the theorizer and philosopher rather than the pragmatist operating in the real world. International tax policy and legislation must be systematically monitored to reflect both the economic conditions in the global economy and the needs of the domestic economy. The discussion document does add another significant and vital chapter to the international tax story, but it is by no means an indication of a completed task.

Appendix one

This is based on the annex to the discussion document, where NRCO is a non-resident company and the debt:equity ratios are determined in several different scenarios.



All of the New Zealand companies have a balance sheet date of 31 December 1994.

Company Assets	$	Liabilities	$	Company Assets	$	Liabilities	$	Company Assets	$	Liabilities	$
NZCO				**NZCo.1**				**NZCo.2**			
Investment in NZCo.1	100	Debt	100	Investment in NZCo.2	100	Debt	100			Debt	100
Plant, etc	100	Equity	100	Plant, etc	100	Equity	100	Plant, etc	200	Equity	100
	200		200		200		200		200		200

From the individual balance sheets, it can be seen that all companies have a debt:equity ratio of 1:1. In substance however, $ 400 is invested in plant, which is in turn funded by $ 300 of debt and $ 100 of equity for NZCO and its subsidiaries on a consolidated basis. Therefore applying the consolidated basis, the group debt:equity ratio of the three New Zealand companies is 3:1. If the safe-harbour ratio is 3:1, then interest deductions would be permitted, other things being equal. If the safe-harbour ratio was 2:1, then the three New Zealand companies would be subject to the proposed regime, with a portion of their interest expenses denied.

An alternative example utilising inter-company advances:

Company Assets	$	Liabilities	$	Company Assets	$	Liabilities	$	Company Assets	$	Liabilities	$
NZCO				**NZCo.1**				**NZCo.2**			
Inter-Co advance	300	Debt	300	Inter-Co advance	300	Debt	300			Debt	300
Plant, etc	100	Equity	100	Plant, etc	100	Equity	100	Plant, etc	400	Equity	100
	400		400		400		400		400		400

In this situation, each New Zealand company has a debt:equity ratio of 3:1 and would satisfy a 3:1 safe-harbour ratio but fail a 2:1 ratio. However, on a consolidated basis, NZCO and its subsidiaries would have a debt:equity ratio of 1:1 and would fall within a safe-harbour ratio of either 2:1 or 3:1. There would be total plant of $ 600, and debt and equity each of $ 300 for the consolidated accounts of NZCO and its subsidiaries. This illustrates the fact that individual and consolidated approaches must both be considered in the context of any proposed transfer pricing rules.

INTERNATIONAL

Taxation of Income Derived from the Export of Technology

Ernst-August Schnieder

Mr Schnieder is a lawyer and formerly worked for the "Institut für ausländisches und internationales Finanz- und Steuerrecht", whose chairman is Prof. Dr Klaus Vogel, at the University of Munich. This article evolved out of research done by the author during his work as a research associate of the International Fiscal Association.

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I. INTRODUCTION

Technology may be exported in different ways, for example by merely delivering the information to the customer, i.e. licensing the right to use a patent, copyright or know-how, alternatively qualified company staff may be provided who use the information for the benefit of the customer i.e. the supply of technical services. The two methods could be respectively described as delivering "know-how" and "show-how".[1] The former category of technology exports generally produces royalty income which is dealt with in Article 12 of the OECD, US and UN Model Conventions (MCs) whereas the latter form generates "technical service fees" which are not expressly dealt with in any of the model conventions.

Broadly speaking, technical service fees represent the remuneration for the provision of services involving special knowledge or skills. These services are often rendered by companies and the remuneration will therefore normally be considered to be business income, at least by developed countries. Article 7 of most of the double taxation conventions (DTCs) provides that business income is only taxable in the state of residence of the company, if the income has not been derived through a permanent establishment in another country. Therefore if a company resident in state A provides technical services to a foreign customer in state B, the remuneration will according to Article 7 of the relevant DTC only be taxable in state A if the remuneration is:

(a) classified as business income; and
(b) the services are not rendered through a permanent establishment in B.

The example of technical service fees reveals, at least from the point of view of a technology importing country, a "gap" inherent in Article 7. Business income of a non-resident is only taxable if it has been derived through a permanent establishment, whereas all other business income of a non-resident is not taxable in the source state. The same problem arises regarding two other forms of technology imports which will be dealt with later in this article, i.e. the import of software and build-operate-transfer projects.

II. GAPS IN ARTICLES 7 AND 12

The classification of income derived from the export of technology as business income, is appropriate if it is applied to developed technology exporting countries, because developed countries normally export technology to each other i.e. imports and exports of technology are in principal balanced between developed countries. However, if this classification is applied between a technology exporting and a developing, technology importing country it fully shifts the tax revenue towards the side of the developed country, if the bulk of the technology is imported without the use of a permanent establishment. In this case the developed country takes full advantage of the taxation rule of Article 7, thus creating a revenue gap for the developing country which it understandably wants to fill.

A similar revenue gap for developing countries is created by Article 12 of the OECD and US-MCs. As the taxpayers producing new technologies will deduct their R&D expenses from their taxable income in their countries of residence thus reducing their tax burden, these countries will seek to tax the income produced by such technology later on. Therefore Article 12(1) of the OECD and the US-MCs grants the sole right of taxation of royalties to the country of residence of the beneficial owner of the royalties which will normally be the country where the R&D-expenses have been deducted. This is a reasonable solution between industrialized countries which export technology to each other, thus in principle all the industrialized countries will profit from the rule of Article 12(1). This rule will again shift the tax revenue fully in favour of the industrialized, technology exporting countries if it is applied between them and developing, technology importing countries. A solution to this problem is provided by the UN-MC: Article 12 (2) of the UN-MC closes this rev-

1. K.R. Evans, Treaty treatment of technical assistance, management and administrative fees in Malaysia, *The CCH Journal of Asian Pacific Taxation*, January/February 1990, at 38.

enue gap by granting a limited right to tax to the country where the royalties arise and most of the DTCs between industrialized and developing countries follow this rule.

Since the beginning of the 1980s the developing, technology importing countries have tried with increasing success to get a share of the tax on income produced by technology exports in the form of technical services. It should be noted that they have already managed to achieve this objective in respect of royalties.

III. TECHNICAL SERVICE FEES

The developing countries have tried to tax the income derived from providing technical services by:

(a) The reclassification of technical service fees to a category other than business income, especially the classification of technical service fees as royalties under Article 12(3) UN-MC.
(b) The alteration of the permanent establishment concept, e.g. by employing the concept of a fictitious permanent establishment in Article 5(3)(b) UN-MC.
(c) The introduction of a new category of income in new DTCs.

In this article only the latter possibility will be discussed.[2]

A. The nature of technical service fees

None of the three model conventions contains a definition of the term "technical service fees" and as far as the author is aware there is no internationally recognized definition of this term. Nevertheless, recent DTCs between developing and developed countries often contain a definition of this term in Article 12. Reviewing a number of these definitions, technical service fees can be broadly seen as the remuneration for the provision of a wide range of services involving special knowledge or skills. Such services may include:[3]

(a) technical assistance or technical support, e.g. maintenance services;
(b) general management and administrative services, e.g. the implementation of an accounting system;
(c) consultancy services, e.g. business, financial or tax planning functions;
(d) training functions, e.g. technical or management training of personnel.

This wide range of possible services shows that the term "technical service fees" is slightly misleading, because its normal usage seems to imply technical services in a narrow sense. Nevertheless this term is used throughout this article because during recent years "technical service fees" has become a common term in international taxation and the definitions given for this notion in recent DTCs are similar.

B. Introduction of a new type of income

In recently concluded DTCs between developing and developed countries, technical service fees are often taxed in the source country through the application of Article 12 UN-MC. Article 12 can be applied in these DTCs because its scope has been widened to expressly include technical service fees, as in the DTC Germany–Indonesia 1990 (Article 12) and in the revised DTC Germany–India 1959 (Article VIII A). Where technical service fees are included in the scope of Article 12, its title generally has the wording "Royalties and fees for technical services". Some DTCs have gone one step further and introduced a separate article dealing with fees for technical services following the structure of the taxation of royalties in Article 12 UN-MC, thus granting a taxation right to the source state. Examples of this are the DTCs China–Pakistan 1989 (Article 13) and Hungary–Pakistan 1992 (also Article 13; not yet in force). As previously explained, the term technical services generally includes not only purely technical services in a narrow sense, but also consultancy and managerial services.

1. The taxation of technical service fees in the source state

It is interesting to note that there are often two different tax rates applied in Article 12 limiting the taxation right of the source state, the higher one applicable to royalties and the lower one applicable to technical service fees. The tax rate for royalties normally approximates to 15 percent of the receipts and the rate for technical service fees is usually about 10 percent. The lower tax rate applying to technical service fees reduces the burden of gross taxation, in a field where considerable costs are incurred by the companies rendering the services. An alternative method to reduce the burden of gross taxation can be found in Article 13 of the DTC China–United Kingdom 1984. In this DTC the gross quantum of the technical service fees is reduced by a fixed rate deduction for expenses of 30 percent, leaving only 70 percent taxable.

An interesting question arises, if a reduced tax rate or a fixed deduction in Article 12 proved to be insufficient to compensate for the exporter's incurred costs, would this constitute a barrier to the import of technology and thus hamper the international transfer of technology?[4] A possible reaction of companies rendering technical services in developing countries might be to raise the prices for the services, in order to shift the economic burden of gross taxation on to their clients. If this happened the overall economic result of the source taxation of technical service fees would be to increase the costs of the technology imports of developing countries. A result which can hardly be in the interest of the developing countries, which probably need technology imports to improve

2. Regarding the first two possibilities (a + b) see: M. Krause, *Vergütungen für technische Dienstleistungen*, *Internationale Wirtschaftsbriefe* 1987, Fach 3, Gruppe 2, at 527; M. Krause, Tax treatment of the provision of technical services, in: *International taxation of services* (Proceedings of a seminar held in Rio de Janeiro in 1989 during the 43rd Congress of the International Fiscal Association), (Deventer/Boston, 1991) at 40.
3. See *supra* note 1, at 12 et seq.
4. This view is shared by E. Gnazzo, Taxation of technical assistance, in: *International taxation of services*, see *supra* note 2, at 29.

their domestic economic situations. Of course it could be argued that higher prices for technical services raise the importing state's tax revenue, but this would be a short-sighted argument since the increase in the tax revenue would have to be borne by the domestic industry and not by the exporters of technology.

2. Technical service fees and other types of income

Under older DTCs not employing the notion of technical service fees in Article 12, developing countries often tried to define the furnishing of technical services as imparting know-how under Article 12 (3) UN-MC ("information concerning industrial, commercial or scientific experience"), thus gaining a right to tax technical service fees received by non-residents. If technical service fees are directly included within the scope of Article 12 this may avoid the problem of distinguishing technical service fees from other types of income, especially royalties. However, if different tax rates are applied to royalties and technical service fees, or a fixed deduction of the technical service fees is permitted, the problem of distinguishing between the two terms remains. An interesting solution can be found in Article 13 of the DTC China–United Kingdom 1984. Article 13 deals with technical service fees but includes within the definition of technical services the use of know-how, therefore removing the need for the problematic distinction between the two terms. On the other hand this creates a new classification problem as a distinction now has to be drawn between technical service fees and business income under Article 7, or income from independent personal services under Article 14.[5]

3. Source rules for technical service fees

It should be noted that nearly all of the DTCs reviewed by the author that deal with technical service fees in Article 12 or Article 13, define technical services as services which are rendered or provided *within* the country where the remuneration is paid from, i.e. the source country. This local restriction in the definition serves as the source rule for the allocation of technical service fees. Nevertheless, this source rule might give companies in industrialized countries rendering technical services to clients in developing countries, a loophole with which to avoid the taxation of technical service fees under Article 12. Those companies might take advantage of modern communication technologies to do as much work as possible in their country of residence. Large parts of the working results could be sent via electronic mailing systems to the client and the company could thereby avoid sending staff to the client's country. This implicitly raised the question as to the meaning of the terms "to render" or "to provide" within the context of DTCs. If "to render" or "to provide" simply denotes the act of producing the services, this will lead to a reversion to the old state of affairs that existed between developed and developing countries, i.e. with the help of modern communications technologies, a large chunk of the services may be produced in the country of residence, thus avoiding taxation in the importing state. If, on the other hand, the terms "to render" and "to provide" mean the act of delivering the services, this could avoid the aforementioned problems since then one might argue that the services are delivered in the country of residence of the importer. Of course it is debatable whether the act of delivering the services takes place at the moment when the information is sent to the client, e.g. via a data network, or at the time the client receives the information.

The developing countries could avoid the problems outlined above by adopting another source rule for technical service fees, i.e. attribute technical service fees to the contracting state in which the technical services are *used or exploited by a person resident in that state*. The DTC Hungary–Pakistan 1992 (not yet in force) has gone one step further in its Article 13 (5) by using the source rule for royalties set out in Article 12 (5) UN-MC for allocating technical service fees; "Fees for technical services shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State." This seems to be a simple yet comprehensive solution!

C. Double taxation of technical service fees

The issues raised so far concern the possible taxation of technical service fees in the source state. This does not create an additional tax burden for the recipient, as long as the recipient's residence state provides for the elimination of double taxation, either under its domestic law or under its treaty law. Double taxation may arise however, in cases where the source country and the state of residence of the recipient categorize the technical service fees differently, e.g. the residence state of the recipient may as an industrialized country classify technical service fees as business income and the source state may consider them to be royalties and may therefore levy a withholding tax. In this case the residence state will adopt the position that there should be no tax levied in the source state, since it considers the technical service fees to be business income, which in the absence of a permanent establishment, is not taxable in the source state. Following from this, as no tax should be levied in the source country, it is likely that no tax credit or tax exemption will be granted to the recipient of technical service fees by his residence state.

Even if the residence state and the source state agree on the classification of technical service fees, e.g. because they are included within the scope of Article 12, or they are dealt with in a separate article, there still remains one issue. Technical service fees are generally taxed in the source country through a withholding tax, which means that the gross fees are taxed. In his country of residence the taxpayer will seek a tax credit for the foreign withholding tax, but the tax credit is often limited by a per-country limitation. To determine the maximum amount of creditable foreign tax, the state of residence will in this case normally apply its domestic tax rate to the *net* income, thus the tax base will be smaller than the gross amount. Therefore, the maximum amount of creditable foreign tax could be lower than the withholding tax actually

5. See also K. Vogel, Double taxation conventions, (Deventer/Boston: 1991), Art.12, para..68.

borne by the taxpayer in the source state, in which case a considerable part of the foreign withholding tax may not be credited thus becoming a final tax burden.

The following simple calculation demonstrates that the quantum of the foreign withholding tax that can not be credited in the country of residence, depends on the relationship of costs to receipts. In example 1, the state of residence employs a corporate tax rate of 30 percent and the withholding tax rate in the source state is 10 percent on the gross amount of the technical service fees. The expenses deductible in the country of residence are 95 percent, 90 percent, 80 percent, 70 percent and 65 percent of the receipts (the gross technical service fees).

Example 1

Receipts: 100
Withholding tax in the source country: 10

Expenses	Taxable income in the country of residence	Tax liability in the country of residence (rate: 30 %) before tax credit = maximum creditable tax	Part of the withholding tax which is creditable
95	5	1.5	15 %
90	10	3	30 %
80	20	6	60 %
70	30	9	90 %
65	35	10.5	100 %

This provides a strong argument for companies rendering technical services, particularly where the relevant costs incurred are high, to try to compensate for the increased final tax burden by increasing prices. This would have the effect of shifting the costs back to their customers in developing countries thereby increasing the costs of technology imports.

IV. IMPORT OF SOFTWARE

A. The problem

The controversial taxation issue concerning income derived from the export of software is whether the income generated, constitutes ordinary sales income taxable under Article 7 MC as business income or falls within the category of royalties taxable under Article 12 MC. This issue is of special interest in cases where software is imported by developing countries, since again in these cases the "revenue-gap" of Article 7 is likely to discriminate against developing countries. If income generated by software exports is classified as sales income, it is not taxable under Article 7 MC provided that the software sales are not conducted through a permanent establishment in the import country. In contrast, a classification of such income as royalties, would give the importing country the opportunity to tax this income on a gross basis, if Article 12 of the respective DTC follows Article 12 of the UN-MC as most of the DTCs between developed and developing countries do.

The conflict of revenue interests is easy to see. Software exporting countries will favour the classification of income from software exports as sales, i.e. business income in order to maximize their tax revenues, since in this case no foreign tax credits have to be granted as there would be no foreign tax levied. Software importing countries will favour the classification of the income as royalties in order to get a share of this income by levying a withholding tax.

B. The OECD view

Given the revenue interests mentioned above, it is not surprising that the OECD Commentary of 1992 on Article 12, considers "payments received as consideration for computer software ... to represent a royalty only in very limited circumstances".[6] The OECD Commentary basically sets out two situations[7] in which software rights can be transferred to varying degrees. The first situation is where less than the full rights in the software are transferred. A software payment under these circumstances generally does not constitute a royalty but is to be treated as business income under Article 7. Strangely, the fact that in nearly all OECD countries software constitutes a copyright, is according to the OECD Commentary "of no relevance". An exception to the classification as business income might arise if the author of the software not only grants the right of use to the person acquiring the software, but also grants additional rights to exploit the software commercially, such as the right to distribute or develop the software. Even though the software payment may be considered to be a royalty it is interesting to note that the OECD has problems conceptualizing software as a copyright of literary, artistic or scientific work under Article 12 (2) since "None of these categories seems entirely apt ...". The author would argue that software should fall within the definition of a scientific work.

The second situation is where the full rights in the software are transferred. According to the Commentary, "It is clear that where consideration is paid for the transfer of the full ownership, the payment cannot represent a royalty ...". Instead payments are in this case considered to be either business income or capital gains.

C. US tax law

The position taken by the Internal Revenue Service (IRS) of the United States is not yet clear, because the IRS has not finalized a revenue ruling concerning the classification of income derived from the transfer of computer software.[8] The present position in US law seems to be somewhat unclear. In 1992 the IRS held in technical advice memorandum (TAM) 9231002, that the payments made to a software company

6. OECD, Model tax convention on income and capital (September 1992, Condensed Version), Paris 1993, Commentary on Art.12, Nos.12, 13.
7. The third situation described in the OECD-Commentary is not relevant for the purposes of this article and will therefore be omitted.
8. J. Turro, U.S. government grapples with treatment of income from software, while industry interests battle among themselves, *Tax Notes International* 20 June 1994, at 1615.

under an extended maintenance contract constituted income from the sale of goods for purposes of the advance payment rules of Treasury Regulation Section 1.451-5. An extended maintenance contract is a perpetual-term, non-exclusive licensing agreement relating to off-the-shelf software developed by the software company, under which the customer is entitled to receive for no extra payment, all future updates of the underlying software. The reasoning given in the TAM is that the payment the software company received under the extended maintenance contract would approximate the amount it would receive if it sold its software outright. Nevertheless, it is important to emphasize that the IRS noted that this characterization as sales income applied *only* for purposes of Treasury Regulation Section 1.451-5 and that the payments could constitute royalties under other provisions of the Internal Revenue Code.

D. The view of a software importing country: Korea (Rep.)

From a revenue viewpoint it is clear that software importing countries will not readily accept the classification of software payments as business income. They probably will try to push for a classification as royalties in order to increase their national revenue. In this regard a rather aggressive stand has been taken by Korea (Rep.), which eventually led to a memorandum of understanding between the US and Korea (Rep.) signed in December 1993. In this memorandum Korea (Rep.) has agreed to employ treaty interpretations which meet the principles and standards laid down by the OECD concerning for example the interpretation of the term "royalties". The somewhat surprising acquiescence of the Korean government is said to be attributable to the fact that Korea is currently seeking OECD membership.[9]

But what was the position taken by Korea (Rep.) which made a memorandum of understanding necessary between the United States and Korea? The Korean tax authorities issued guidelines in 1993 concerning payments for imported software. In these guidelines payments made by a Korean importer for the acquisition of a software copyright from a non-resident with no permanent establishment in Korea, are considered as payments for the use of a copyright under the royalty-article in the relevant Korean DTCs. Payments made for the use of a software copyright under a licence agreement between a domestic importer and a foreign copyright owner, are similarly treated as payments for the use of a copyright. Even if the domestic importer uses the software for his own purposes, the payments made to the foreign software provider constitute royalties, if the imported software contains know-how. Hence the decisive issue is under what circumstances could imported software be held to contain know-how. The following factors are indicative:[10]

- the importer cannot transfer the right to use the software to a third party without the permission of the foreign software supplier;
- the software is designed and developed under the domestic importer's specifications;
- the payment is based upon the place of use, the purpose the software is used for, the period of use, the frequency of use or the amount of products or information produced;
- the importer is obliged to observe confidentiality regarding the software;
- the foreign software supplier trains the domestic importer's staff in the use of the software.

There are, however, two instances where imported software is deemed to contain no know-how and therefore the payments made in respect of this software are not considered to be royalties. The first arises where the imported software is resold in Korea under a standardized licence agreement which takes effect immediately the user opens the software package and the payment is made on a lump-sum basis. Software sold under such standardized licence agreements is known as "box-top" or "shrink-wrapped" software. The second case occurs where the software can be used without the technical assistance of the foreign software supplier (e.g. if user manuals are sufficient) and the users are not obliged to enter into a copyright assignment or copyright licence agreement. This situation is unlikely to arise much in practice.

It is important to note, however, that the payments made under the exceptions may nevertheless still constitute royalties *if the level of technology involved in the imported software is higher than the technology level which can be developed within Korea (Rep.)* and the software cannot be assigned to a third party without the supplier's permission. This roughly means that *anything which cannot be produced in Korea (Rep.) contains know-how* and therefore the relevant payments would constitute royalty income. This is indeed a challenging viewpoint which is likely to prompt controversies with other industrialized countries.

E. A perspective for the taxation of high-tech imports?

If other countries especially the developing ones, adopted the Korean definition of know-how for their treaty interpretation, this could mean that income generated by the export of high-tech goods might not be treated as sales income, i.e. it is quite likely that high-tech goods imported by developing countries cannot be produced within these countries. If such a country adopted the view that all products which cannot be produced nationally contain know-how, then the income derived from the export of such goods may under certain circumstances be considered as income derived from the use of know-how taxable under Article 12.

9. J. Turro, U.S. and Korea sign memorandum of understanding on treaty interpretation, *Tax Notes International* 28 February 1994, at 562 et seq.
10. See *supra* note 9, at 564.

V. BUILD-OPERATE-TRANSFER PROJECTS

A. Background

A problem often faced by governments especially in developing countries, is the financing of capital intensive projects in the fields of power, telecommunications and infrastructure. To get an idea of the sums involved two examples may be cited: Indonesia is building the "Paiton Electric Power Project" with two 660-megawatt coal-fired generators with estimated costs of US$ 2.5 billion and Thailand is planning a new airport northeast of Bangkok, the "Nong Ngu Hao Airport" at an estimated cost of US$ 4.3 billion.[11]

In order to manage and to finance such huge projects Asian governments in particular, are nowadays looking to the private sector, with the consequence that more and more projects are now "privatized" as opposed to being undertaken by the public sector. It is important to note, that industrialized Asian countries are also turning to the private sector for the realization of big projects. The projects planned in industrialized countries sometimes involve even higher costs e.g. the Japanese road project linking Shikoku Island to the Japanese mainland, the "Honshi Kakyo Road and Bridge Network" with estimated costs of US$ 29 billion (!).[12]

B. The BOT method

The most frequently used method for private sector participation in large public projects is the build-operate-transfer (BOT) system. An example of the practical implementation of a BOT where a government wished to build a power plant would be as follows; first a private company has to be found to design, construct and finance the power plant. This company would then build the plant on a turnkey basis and fund the entire cost of its construction. As compensation for the financing and construction costs the company would be granted the right to operate the power plant for a limited period of time, beginning with the completion of the plant. As a counterpart, the government would have the obligation to purchase the electricity produced in the plant for a specified period, at a price which had been agreed in advance. In the case of the Hong Kong based Hopewell Holdings Ltd., which built a power plant for the Shenzhen Special Economic Zone in China's Guangdong province on a BOT basis, the agreed price for the electricity is paid half in foreign exchange to service the debt and to make a profit in "hard" currency and the other half is paid in Chinese Yuan. Hopewell buys Chinese coal with the Chinese currency which is burnt in the power plant.

After a certain period of time, the power plant is handed over to the government which then runs the plant on its own. A BOT can be delineated as follows:

(1) build-phase: A private company builds and finances the project;

(2) operate-phase: The same company operates the project for a limited period of time and thereby makes profits; and

(3) transfer-phase: The project is turned over to the state. It is important to note that this is meant in an economic sense and does not necessarily imply a transfer of legal ownership.

C. Tax aspects of BOTs

The tax treatment of a BOT largely depends upon the question of the ownership of the project. The ownership of an asset for tax purposes can be determined in two ways. One possibility is to attribute an asset to its legal owner, i.e. in this case the same idea of ownership is applied in tax law and in civil law. The other possibility is to attribute an asset to the person that has the right to use and exploit the asset, the so called economic owner, i.e. here tax law and civil law diverge. Both options are employed in the tax laws of different countries, e.g. Germany attributes an asset to its economic owner whereas in France it is the legal ownership that is relevant.

Two basic scenarios are reviewed in order to analyse the tax treatment of a BOT. In the first situation the company is the legal or economic owner of the BOT-project until it is handed over to the government in phase 3. In the second scenario the government is the legal or economic owner of the project right from the beginning.

1. BOT project owned by the company till the handover to the government

(a) In a country which employs the notion of economic ownership in its tax law, the BOT project is likely to be attributed for tax purposes to the private company which has built the project. In this situation the BOT will constitute an asset of the company. The acquisition cost of the asset will be the total construction cost. The same result will be achieved in countries where the legal ownership determines the tax treatment of an asset, if the BOT contract assigns the legal title of the BOT project to the company until its handover to the government. The question arises as to how to classify the profits the company derives from running the BOT project it owns, e.g. in our example the payments for the electricity. One view would be that a BOT constitutes a permanent establishment whose profit is guaranteed by the government. This would mean that the company derives business profits through a permanent establishment which are taxable in the source country under Article 7 MC. This result would especially please governments in developing countries, as the aspect of taxing the BOT profits in the source country, i.e. where the BOT project is situated, will be a major issue. When the BOT project is considered to be an asset of the company, the company can depreciate the asset during the time it runs the project. Thus, by the time the asset is handed over to the government it would have been depreciated to a book value of zero in accordance with the accounting principle that states expenses should match the receipts they generate.

11. *The Asian Wall Street Journal*, Monday, 18 April 1994, S.10.
12. *Id.*

However there may be a problem at the time the BOT-project is handed over to the government. At that time the book value may be zero but for tax purposes if assets are transferred to non-related third parties this often has to be done not at the book value but at the fair market value which may be higher than the book value. Normally this creates a gain, as a company either receives a cash consideration in exchange for the asset or it receives shares in the other company. In the case of a BOT, the company transferring the asset to the government does not receive anything in exchange, although the transfer of the asset at the fair market value creates a gain if the market value is higher than the book value of zero. This problem, however, might not be as significant as it first seems, since it only arises where the market value of the transferred asset is higher than its book value, this is unlikely to be the case for a BOT project. At the time when the handover of the BOT project to the government takes place, the asset is linked or more precisely "burdened" with the contractual obligation to pass it over to a non-related third person. This contractual obligation might well lower the market value of the asset to zero.

(b) Another possibility for the categorization of the BOT-profits would be to treat them as capital gains. The starting point for this view would be that from an economic perspective the BOT-profits constitute the remuneration for the transfer of the BOT-project to the government. The difference between a BOT and an ordinary turnkey project is that the company owns the project until it has been fully paid and therefore the transfer of ownership does not take place until the final payment has been made. Since the company owns the BOT-project, which may consist of both immovable and movable property forming part of the permanent establishment, when the asset is transferred to the government an alienation of the company's property takes place. The payments made by the government before the asset transfer, can be seen as the pre-payment of the sales price. Under this view a BOT would constitute a conditional sale, the asset being transferred to the buyer when the condition is satisfied, i.e. the sale price is paid in full. The sales price could be taxed in the state where the BOT project is situated, under Article 13(1) and (2) MC. Furthermore the company can probably depreciate the asset during the time it is the owner. If the asset is not transferred at the book value but at the fair market value a gain is created by the transfer if the market value is higher than the book value although, as previously mentioned, this situation is unlikely to occur in practice.

(c) A third possibility is the combination of the two aforementioned taxation methods. This means that the profits would have to be broken down into two parts, one part representing a capital gain and the other part representing business income. This would perhaps best reflect the economic structure of a BOT. If we look back at the example of the construction of a power plant, it becomes quite clear that the payments made by the government for the supply of the electricity have to compensate the company for two sources of costs. One source of costs is the construction and the second represents the cost of generating the power plants turnover. The company has to be compensated for these costs, since the plant is to be eventually transferred to the government, without any remuneration at the time of transfer. The former type of compensation clearly represents a capital element, since it is paid in respect of the future transfer of the power station. On the other hand the company also provides electricity during the time it runs the power station, which of course implies another source of costs for which compensation has to be paid. This compensation is business income since it is being paid for the provision of electricity.

2. BOT-project owned by the government

The specification of the BOT-contract may prompt the tax authorities to attribute the economic ownership of the BOT-project to the government, even though the company runs the project. In countries employing the principle of economic ownership, the project would then not be treated as an asset of the company and therefore there would be no entitlement to depreciation allowance. The same result is reached in countries employing the principle of legal ownership, where the legal title is immediately assigned to the government in the BOT contract.

Here there are many similarities to an ordinary turnkey-project. The company constructs the BOT-project on a turnkey-basis and transfers the legal title and/or the economic ownership to its client immediately after the completion of the project. The only difference to a turnkey-project lies in the fact that the company itself not only constructs, but also runs the project for a limited time period. The payments made by the government therefore have two economic purposes, one part of the payment has to compensate the company for the costs of constructing the BOT-project and the other part has to compensate the company for running the project on behalf of the government. However there may be a third economic aspect involved. The BOT may involve a lot of technology in the form of patents and know-how which is effectively being used by the government as the owner of the BOT-project.

The BOT-profits have to be broken down in to their various elements according to the economic reasons the payments are being made.

(a) The payments made for the compensation of the construction costs are business income under Article 7 MC. Whether these profits are taxable in the source country depends on the period of time the construction works last and on how much of the construction work is actually done in the source country i.e. the country where the BOT takes place. Article 5 (3) OECD and US-MCs requires that the construction works last for at least a 12-month period, Article 5 (3) (a) UN-MC only requires a 6-month period. According to Article 7 (1) MC only that part of the compensation attributable to the construction works carried out in the source country is taxable in that country, i.e. payments for the work done outside the source country are not taxable therein. Taxation under Article 7 MC will probably be applied in cases where a lot of public real estate is involved which cannot easily be transferred to a private company and where nearly all the work has to be done in the BOT-country. Accordingly such BOTs are likely to be infrastructure projects like highways or airports.

(b) As the government is the owner of a BOT-project, which may involve technology in different forms, payments made by the government for the use of patents and know-how represent royalties taxable under Article 12 MC.

(c) The company runs the BOT-project for a limited period of time and since the project is owned by the government the managing company acts on behalf of the government. The remuneration paid for the management of the project could depending on the circumstances of the case, be categorized in different ways e.g. business income, technical service fees or even royalties if the project management involves the use of know-how. The taxation treatment of the management income will therefore depend on the relevant DTC.

Conference diary

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

SEPTEMBER 1995

Seminar on corporate income tax, Frankfurt/Main, 2, 9, 23 and 30 September 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

International Tax Avoidance/Anti-Avoidance, Amsterdam, 28-29 September 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

OCTOBER 1995

Transfer Pricing, London, 5-6 October 1995 (English):

Euromoney Tax Training, Chelsea Hotel, Sloane St., London SW1, Marion Oakley, Euromoney Publications PLC, Nestor House, Playhouse Yard, London EC4V 5EX, Tel.: 44-171-799 8601, Fax: 44-171-779 8599.

Practical cases regarding the change of a legal form, München, 6 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

Transfer of business or private assets in order to create usufruct and annuities or other permanent encumbrances, München, 7 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

Taxation of non-profit clubs, München, 9 October 1995 (German):

Seminar-Büro, Scheinerstraße 7, 81679 München, Tel.: 49-89-99 8918-0, Fax: 49-89-99 8918-50.

Meeting of the International Tax Planning Association, Monte-Carlo, 19-20 October 1995 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-173-276 2910, Fax: 44-173-276 3762.

The New Frontiers of International Tax Planning, Le Meriden Hotel, London, 30 October 1995 (English):

Kate Roberts, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

NOVEMBER 1995

Double Taxation Relief, Amsterdam, 2-3 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Tax treatment of derivates, Le Meridien Hotel, London, 5-6 November 1995 and 6-7 May 1996 (English):

International Faculty of Finance, 2nd Floor, Market Towers, 1 Nine Elms Lane, London SW8 5NQ, Tel.: 44-171-344 3833, Fax: 44-171-344 0083.

Getting to grips with UK and International Tax Treatment of Derivatives, Le Meriden Hotel, London, 6-7 November 1995 and 6-7 May 1996 (English):

International Faculty of Finance, 2nd Floor, Market Towers, 1 Nine Elms Lane London SW8 5NQ, Tel.: 44-171-344 3833, Fax: 44-171-344 0083.

Asia-Pacific Tax Conference, Singapore, 13-14 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

INTERNATIONAL

LEGAL ASPECTS OF THE TRANSFER PRICING SYSTEM

Hiroshi Kaneko

Professor Emeritus, Faculty of Law, at the University of Tokyo.

One of the most pressing issues in transfer pricing is how to treat a difference between a transaction price and the arm's length price. National approaches to transfer pricing vary considerably, legislation ranges from extensive and complex to non-existent.

Some countries, for instance the United States and Germany, utilize judicially developed doctrines which are applied in transactions involving non-arm's length transfers of goods and services. In such cases, a transfer pricing adjustment is made by re-categorizing the difference between the arm's length price and the transaction price as either a contribution to capital or a constructive dividend.

Under the contribution to capital method, a parent company is deemed to have contributed capital to a subsidiary company when the parent transfers property to a subsidiary at a price which is below an arm's length price, or when a subsidiary transfers property to the parent at a price above an arm's length price. When such a capital contribution is deemed to have arisen, capital taxation may be imposed.

The constructive dividend doctrine holds that a subsidiary company is deemed to have distributed dividends to the parent company when the parent transfers property to the subsidiary at a price above an arm's length price, or the subsidiary transfers property to the parent at a price below an arm's length price. The difference between actual and arm's length price being treated as a constructive dividend. When such a distribution is deemed to have been made, withholding tax may be imposed on the distributing corporation, whilst the recipient may incur a corporation tax liability.

The following examples analyse the implications of a transfer pricing adjustment, and in particular the application of the deemed capital contribution and constructive dividend doctrines.

Example 1.
Assume that domestic corporation A transfers property to its subsidiary domestic corporation B at a price below an arm's length price. If a transfer pricing adjustment is made, A's income will be increased by the difference between the arm's length price and the transaction price. At the same time, B's income will be decreased by a corresponding amount. Thus far, no economic double taxation arises. However, when the deemed capital contribution doctrine is applied to this transaction, capital taxation may be imposed on B.

Example 2.
Assume that A transfers property to B at a price above an arm's length price. As a result of the transfer pricing adjustment, B's income is increased by the difference between an arms's length price and the transaction price, and A's income is decreased by a corresponding amount. This adjustment does not create economic double taxation. However, if the constructive dividend doctrine is applied to this transaction, B is deemed to have distributed to A, a dividend equal to the difference between the arm's length price and the transaction price. Withholding tax may be imposed on B, and corporation tax, on A.

The taxation of the transferred value as a deemed capital contribution or constructive dividend after the initial transfer pricing adjustment, is generally called a secondary adjustment.

How should the secondary adjustment be evaluated? Economic value is transferred from A to B in example 1, and from B to A in example 2. The re-characterization of income as a deemed capital contribution or a constructive dividend makes sense from an accounting perspective. Nonetheless, taking example 2, economic double taxation is being imposed. This is because the difference between the arm's length price and the transaction price is being taxed twice. Once on B via the original adjustment, and then again on A by virtue of the secondary adjustment. Some might argue that the increase in B's income is offset by the decrease in A's income as a result of the original adjustment and that no further adjustments are necessary. Some might further argue, that the taxation of A by deeming the difference to be a dividend, exceeds the remit of a legitimate transfer pricing regime.

In example 2, the alleged constructive dividend is a fictional income that came into existence as a direct consequence of the transfer pricing adjustment. If A and B are viewed as a single entity; taxing B on the difference between the arm's length price and the transaction price via an adjustment to the price, and taxing A on the same fictional income by virtue of a deemed distribution is economic double taxation.

In reality, not many countries levy a capital tax on the adjustment. Indeed most countries do not impose withholding tax on intercorporate dividends between domestic corporations, nor do they tax dividends received from domestic subsidiaries. Therefore, as far as transactions between domestic corporations are concerned, double taxation rarely occurs.

The situation however is different in cases involving international transactions. Assume in example 2, that A is a domestic corporation in country X, and that B, its subsidiary, is a domestic corporation in country Y. Assume further that Y makes an adjustment, and increases B's income, and that X agrees with Y in its mutual agreement procedure and decreases A's income. At present, most countries impose withholding tax on dividend distributions paid to foreign corporations, and impose corporation tax or income tax on dividends received from foreign corporations. As a result, there is a distinct possibility of economic double taxation. Let us consider several possible cases that might arise under the tax systems of countries X and Y.

Case (i)

Y treats the difference between the arm's length price and the transaction price as a constructive dividend and accordingly applies withholding tax. X imposes corporation tax on the notional dividend received. In this case, economic double taxation will result. Withholding tax will normally be credited under the foreign tax credit system. If credit is not given for the withholding tax the economic double taxation becomes even more oppressive.

Case (ii)

Y does not treat the difference as being a constructive dividend, X does however, and imposes corporation tax on the notional dividend received. Economic double taxation will occur as in Case (i).

Case (iii)

Y imposes withholding tax on the difference as a dividend. However, X does not treat the difference as a dividend and does not impose corporation tax. In this situation, many countries would refuse to give credit for the foreign withholding tax. Economic double taxation will therefore arise if credit for the withholding tax is not available.

Case (iv)

Neither X nor Y treat the difference as a dividend. As a result no withholding tax or corporation tax will be imposed. Economic double taxation therefore does not arise.

Case (iv) is the most favourable scenario as it maintains tax neutrality in international transactions and thus prevents tax from becoming an obstacle to international trade.

Reviewing case (iv), we must now consider the appropriate accounting treatment of the notional income created by virtue of the transfer pricing regime. There is no reason that financial accounting should be affected by a transfer pricing ruling. This is because financial accounting and tax accounting are not synonymous, i.e. tax accounting is simply an adjusted form of financial accounting. The transfer pricing adjustment merely being one deviation from the normal financial accounting practice. With regard to tax accounting, we must make the result consistent by posting the difference to the retained profit and loss account as non-taxable income or as taxed income, either as a matter of statutory interpretation or as a matter of legislative amendment.

Even in Cases (i), (ii), and (iii), it is conceivable that no constructive dividend taxation takes place if A reimburses the difference to B within a specified period after the adjustment. In fact, the United States and some other countries allow such treatment. Admittedly this is one solution and it is not unreasonable to require an actual reimbursement where a non-arm's length transaction was undertaken for tax avoidance purposes. However, I do not believe that it is appropriate to force such reimbursement in non tax motivated cases. In any event, it is problematic to force such reimbursement when we consider the compliance costs that this would impose on the taxpayer. A transfer pricing regime is a system that permits taxation according to a fiction. It should be outside the remit of such a system to require the revision of transactional realities.

It is not entirely clear how Japanese tax law deals with the problem of secondary adjustments. Article 7, clause 2 of the Special Law on the Implementation of Tax Treaty Provisions provides that when a foreign government makes a transfer pricing adjustment, and Japan makes a correlative adjustment to implement the agreement reached in a mutual agreement procedure with the foreign government, then if the full amount of this adjustment is not reimbursed to the foreign affiliates, the amount not reimbursed is included in the retained profit account of the Japanese corporation. Arguably this provision reflects the concepts of constructive dividends and deemed capital contributions. However, the provision does not stipulate whether or not a taxpayer should reimburse to foreign affiliates the amount which is subject to the correlative adjustment. Moreover, such amount is not included in the taxable profit but rather included directly in the retained profit account. If the present law were to have adopted the concepts of constructive dividends and deemed capital contributions, the above amount would have been added to profits. This provision by itself would not therefore seem to impose the concepts of constructive dividends and deemed capital contributions, rather it merely reflects an accounting expediency.

Section 56-5-9 of the Basic Directives of the Special Taxation Measures Law provides as follows:

> The difference between the transaction price and the arm's length price (income that was transferred abroad) is, in principle, treated as a distribution of profits out of the corporation. However, if a corporation decides to obtain reimbursement from its foreign affiliates within a reasonable period and if such corporation reports its decision to the tax office, the amount that is the object of the reimbursement may be treated as a provisional loan, etc.

This section may be interpreted to mean that the difference is treated as a constructive dividend so long as it is not reimbursed, the same result as obtains in the United States. Indeed a Japanese tax official commented that "it is an issue of interpretation of the corporation tax law and the income tax law as to whether or not the difference is treated as a constructive dividend, and we will decide according to the specific facts of each transaction". However, thus far there have been no reports that the Japanese revenue authorities have taxed the difference as a constructive dividend, and tax practice on this point is not yet established.

Incidentally, Article 9 paragraph 2 of the OECD Model Treaty, which deals with correlative adjustments, does not touch upon the issue of secondary adjustments. It should be noted however, that the OECD Commentary appears to permit secondary adjustments when it states that paragraph 2 does not prohibit each country from making a secondary adjustment according to its own domestic law.

To recapitulate, I would argue that drastic measures such as secondary adjustments are unwarranted and may even be harmful to the extent they impede international trade. In the context of international transactions, a transfer pricing adjustment establishes a fiction that a transaction was made at an arm's length price. The purpose of the adjustment (i.e. to prevent a reduction of tax revenue) is achieved when the difference between the actual price and the arm's length price is subjected to taxation. Deeming the excess to be a capital contribution or a dividend is a double fiction, which may be justified as a matter of accounting convenience, but is an undue infringement on private transactions. After the initial adjustment has achieved its purpose, private transactions should not be further interfered with, otherwise the taxpayers freedom of contract is infringed.

In conclusion, it is my opinion that the OECD should discuss the future of transfer pricing adjustments, and that member countries should consult and harmonize in the direction of halting application of the deemed capital contribution and constructive dividend doctrines. As clarification, I would emphasize that my objection is to the application of the doctrines as secondary transfer pricing adjustments, not to the doctrines themselves.

INTERNATIONAL

RECOVERY OF INTERNATIONAL COSTS IN MULTINATIONAL ENTERPRISES

Loek C.M. Helderman

This is a translation of **Mr Helderman's** article. The original article appeared in *Weekblad voor Fiscaal Recht* 1995/6147, 20 April 1995. This article was submitted prior to the publication of part two of the OECD Draft Report. The author was awarded the 1994 "Mr J.F. Udo Prize" of the Netherlands Federation of Tax Consultants, as the best examination candidate in that year. Mr Helderman works as a tax manager at Unilever, Rotterdam.

I. INTRODUCTION

Generally speaking, a country's tax authorities will only allow the deduction of business expenses that are related to the business income earned in that country. This approach is adopted in the Netherlands, *vis-à-vis* the concept of "participation exemption" (*deelnemingsvrijstelling*) as set out in the Corporation Tax Act, 1969 (Article 13, paragraph 1). This provision specifies that when determining taxable profit, the costs relating to a participation are not to be taken into account. For multinational enterprises in particular, a correct allocation of costs is of great importance from the viewpoint of both business economics and taxation. Where a multinational has establishments in a large number of countries, it is essential that there is a proper and reliable system for recovery of international costs.

In this article, I outline some of the problems which may occur in respect of the recovery of international costs. I have devoted attention specifically to the reports drawn up by the Organisation for Economic Cooperation and Development (OECD), i.e. Transfer Pricing and Multinational Enterprises, Report of the OECD Committee on Fiscal Affairs, 1979 and 1984.

II. GENERAL

A multinational enterprise consists of legally distinct companies which are established in different countries. Those companies, therefore, have to deal with different national tax laws and tax authorities. Most tax authorities will ensure that transactions between affiliated companies take place at prices which are also applied in transactions between non-affiliated companies (the arm's length principle). This is the principle which has been chosen as a basis for the determination of intra-group transfer prices for tax purposes.

The continuing process of internationalization, the creation of multinational enterprises and the consequent increase in cross-border transactions have led to a growth in fiscal problems. In an attempt to address these problems, the OECD has set out its position on transfer pricing in two reports. However, these reports were not primarily concerned with the issue of international costs. Instead they focus on general transfer pricing issues, such as the determination of arm's length prices for goods and the level of interest on loans.

The principal objective of the 1979 Report was to explain the considerations that are of relevance in determining transfer prices. The Report was intended to serve as a common framework for both the taxpayers and the tax authorities, so that the problems relating to the determination of intra-group transfer prices could be resolved to the satisfaction of both parties. The 1984 Report (The Allocation of Central Management and Service Costs) sets out the position in greater detail and deals with the criticism which was levelled at the 1979 Report. At the moment work is being done on a revised version of the 1979 Report. This new version will be an amalgamation of the two previous reports and will also discuss recent developments.

III. WHAT ARE INTERNATIONAL COSTS?

In almost every big multinational, certain activities are centralized. Generally speaking, the senior management of the enterprise, as well as the bigger and more important service departments, will be established in the head office which is usually located where the parent company is established. In addition, research and development (R&D) departments will often also be found in one central location.

International costs therefore, are costs which are incurred centrally for the benefit of the units forming part of a multinational enterprise. These costs can be subdivided into two categories, i.e. costs relating to central management services and costs for central research and development work (referred to below as management costs and research costs respectively).

IV. WHY AN ALLOCATION OF INTERNATIONAL COSTS?

If we assume that both the management activities and the research activities have been concentrated in the "home country" of the parent company, then substantial costs will have been incurred in that country. If they are not related to the business result achieved in that country, such costs will not be accepted as tax-deductible. Seen for instance from a Dutch perspective, such costs, i.e. costs which are not charged through to the group companies, would have to be classified as non-deductible costs in conformity with Article 13, paragraph 1, of the Corporation Tax Act. From a tax viewpoint therefore, it is of great importance that the costs should be allocated between the companies forming part of the group. It is specifically the allocation method and the consequential level of the "service fee" that can give rise to discussions between the taxpayers and the tax authorities.

In this context, I would argue that the allocation of these central costs is, under normal circumstances, dictated by business-economic reasons. The management of the foreign operating companies must be made aware of the costs incurred in the centre. The severity of competition and increased integration and internationalization are forcing multinationals to keep these central costs at the lowest possible level. Since all component parts of the group benefit from these costs, it is essential that they are correctly allocated, as a corollary to this, all international costs must be deductible somewhere otherwise double taxation will effectively occur.

V. SYSTEM OF ALLOCATING INTERNATIONAL COSTS

The business-economic motives for an allocation of the international costs are self-evident and have been outlined above. Every multinational enterprise will, for its own benefit, endeavour to allocate costs in such a way that it is possible to ascertain for each of its divisions, that division's economic performance. The allocation method used will therefore have to be accurate.

A. Benefits of centralization

Given the often broad geographical spread of the group's activities and with a view to the economies of scale that can be achieved, it is important to prevent duplication of effort and to ensure that the services and research results are kept as accessible as possible. From the viewpoint of business economics, therefore, centralization of activities can yield major benefits.

Similarly, for the recovery of international costs, a system in which the costs are charged through to the separate units from one central point has many benefits. Even if certain activities take place outside the centre, the possibility of channelling the service fees via the centre should still be considered. This means that the local tax authorities only have to deal with one party and therefore with one or only a few contracts. This approach makes it possible to exercise effective control over a system and also results in lower costs. It prevents complicated structures and intra-group charges which might give rise to (probably unwarranted) suspicion on the part of the tax authorities. This prevents large-scale investigations, lengthy discussions and, ultimately, double taxation.

Centralization may also result in the fact that the know-how, patents and trade marks are held centrally, usually in the parent company. This, too, has advantages. For example it facilitates both internal restructuring operations and the disposal of foreign subsidiaries.

In the case of internal restructuring operations (e.g. in response to the establishment of the Single European Market), the intangible assets can be omitted from the transaction and this therefore prevents valuation problems.

In the event of the disposal of a participation, there is no need for intangible assets to be shifted from the participation to other parts of the group. A consistent application of this system also implies that in the event of acquisitions, attempts will be made to place the know-how, patents and trade marks in the hands of the parent company. The acquisition should then preferably take place in the form of an "asset deal", which might also bring additional operational and tax benefits. The acquired company could be directly integrated within an existing participation and the purchased intangible assets could perhaps be written off by the parent company against its own taxable profit. Obviously, the user should in such a case pay an adequate fee calculated on an arm's length basis.

VI. THE OECD GUIDELINES

The previous OECD Reports are based on the principle that transactions between affiliated companies must take place at arm's length prices, i.e. the price that would be charged to an unrelated third party. The new Report by the OECD, part of which was recently published in draft form, will also adhere to this principle. The arm's length principle is set out in Article 9, paragraph 1, OECD Model Treaty and its aim is to ensure the equal treatment of affiliated and non-affiliated companies.

The 1979 and 1984 Reports are couched in fairly general terms and contain no concrete rules on what action should be taken as regards the allocation of international costs. In this regard, it also appears unlikely that the new Report will set any firm rules.

As regards payments for the groups research activities, a distinction could be made between the specific fees for intellectual property rights (licences for the use of specific know-how, patents and trade marks) and the more general systems in which all research results are made available to the group companies in return for a fee.

A. Shareholder costs

With regard to management activities, much attention is devoted in the 1984 Report to the problems of the "benefit test" and "shareholder costs". It would go beyond the scope of this article to discuss the latter subject in detail. I will limit myself to commenting that *real* shareholder costs are incurred solely for the benefit of the parent company itself, and that they are therefore not eligible for charging through. If the activities of a group are highly centralized, then relatively few such costs will be incurred. The report by the Ruding Committee[1] states that, with regard to the problem of the allocation of central costs, a directive should be issued which would include a definition of shareholder costs. The intention being to prevent the non-deductibility of such costs in any EU Member State.

There are various methods available to ensure the recovery of international costs. The method in which the costs are included in the price of the product is not discussed here, as in most cases, the central research facilities and the head office of the bigger multinationals are not directly involved in the production and sale of products.

B. Licences for know-how and patents

A group may opt to make its internally developed know-how and patents available to its operating companies via a licensing agreement. This means that it can only charge through the costs once a development project has been successful. The price that is charged should also reflect the cost of less successful projects, as the full costs of the R&D department have to be recovered.

This is the reason why it is usually decided to cover R&D costs on an "ongoing basis". The companies benefiting from the expenditure can then either participate in what is known as a "cost contribution" system or pay a royalty for the use of all intellectual property rights possibly even including the use of trade marks. Various forms of such an agreement are possible and may include, for example, the payment of a service fee or royalty for a "package deal" which includes the abovementioned activities together with other services.

Whatever method is used, the price charged should be based on the arm's length principle. A problem that occurs here is that it will often be very difficult to make comparisons with transactions occurring between independent companies. Many factors may influence the price, for instance, the nature of a patent and/or the know-how, the conditions under which it is made available and the duration of the licence. The fact that patents and/or know how are normally highly specific usually makes it impossible to establish any comparable prices. Where these difficulties exist I feel it is realistic to base the fee on the costs incurred or at least to use the costs as a guideline.

It is necessary to be able to demonstrate that the "benefit test" has been satisfied. This means that the tax authorities take the view that the costs incurred must have resulted in income or other specific benefits accruing to the participating company, or that the activities are expected to lead to such benefits. In the case of licensing agreements for specific patents and/or know-how, a benefit test will not usually give rise to too many problems. However, problems may unfortunately arise in respect of the cost contribution systems which are discussed below.

C. Cost contribution

In the 1979 Report two cost contribution systems are discussed, i.e. "cost sharing" and "cost funding". The 1984 Report classified these two methods as being indirect methods of cost charging.

It is debatable as to whether these methods comply with the arm's length principle. As is stated in the OECD Report of 1984, the tax authorities should take into account the specific situation of a multinational company. In many cases, particularly where a high level of integration exists within a group, it will be impossible to compare the system with systems that have been set up between independent companies. This is due to the nature of the costs which often relate to activities which are so specific to the relevant group that a comparison is impossible.

In the 1984 Report it is stated that, if certain conditions are met, these indirect methods ought to be accepted by the tax authorities. As I indicated earlier, the allocation and charging through of international costs is normally dictated by business motives. In this regard, when reviewing the allocation of international costs, the tax authorities must not put on the entrepreneur's hat and contest the business motives on the basis that they themselves would do things differently. The recent "cost decisions" issued by the Supreme Court of the Netherlands on 21 September 1994, may have a negative influence on the acceptance of the international costs of a Dutch group company. In the light of this judgement, it might perhaps be advisable to have a provision included in Article 9 of the OECD Model Treaty specifying that the cost-sharing system would, under certain circumstances, be accepted as an arm's length system.

Under the cost-sharing system, the group companies agree that they will compensate the parent company for the actual net costs (and risks) relating to the research and/or management activities. Each participant contributes towards the costs on the basis of a specific allocation formula. One consequence of this method might be that the participant or its tax authority would claim that it is entitled to the know-how and patents that have been developed and that their "ownership" no longer lies solely with the parent company. However, there is in my view no question of "co-ownership", since the participant merely acquires the right to use the developed know-how and patents.

1. The Ruding Committee is a working group which was set up by the European Commission in 1990 and whose 1992 report dealt with the harmonization of direct taxes in the European Union.

In the cost-funding system, the costs are covered by a contribution from the participants in the form of a fixed fee, which is not necessarily directly linked to the actual costs.

Experiences with the cost-sharing system are generally positive. It is commonly used by big groups which have intensive, wide-ranging central activities. However, the system does have its limitations and may in some countries give rise to difficult negotiations with the tax authorities.

One of the problems with the above methods (albeit one that is not limited to the cost-sharing system) is the "benefit test" which I referred to earlier. In my view, it is impossible for the bigger multinationals, with many central costs, to comply with a (specific) benefit test. The 1984 Report stated that multinationals can comply with such a test, provided that the fee relates to specific services or to the making available of specific property rights. The benefit test should not be applied where activities are undertaken centrally on behalf of the entire group. In this situation, the relevant costs should be charged on the basis of a suitable allocation formula.

In this regard, it is important that the tax authorities should not seek to determine costs by reference to unrepresentative time frames, i.e. one part of the group may make little or no use of the central services in one year, whilst its level of usage in other years might be substantial.

I have already mentioned that the allocation of the costs can take place on the basis of a specific allocation formula. Possible basis might include turnover, value added, profit or capital invested. The nature of the group's activities will determine the choice of the most appropriate method. It is important to ensure that the costs are charged through as much as possible in line with the extent to which the management and/or research activities are used. Obviously, care should be taken to ensure that there is no duplication of cost charges. For instance, if sales to third parties are used as the basis for cost recovery, then a company engaged solely in production should not contribute towards the central costs. As a result, the intra-group transfer prices that the company charges may be lower than the prices charged by independent third parties for an identical product.

Indirect costs must also be taken into account. These are the costs which cannot be allocated directly to a specific activity, for example the costs of supervision, administration and depreciation. In this context, thought should also be given to a realistic contribution to the invested capital (head office building, laboratory, etc.). This is known as the "notional/statistical interest charge".

A problem common to all methods in which costs serve as a basis for the cost-charging system, is whether the costs should be increased by adding a profit mark-up. The 1984 Report states that a profit mark-up is always justified if:

- the provision of services is the main activity of the company concerned; or if not the main activity
- the value which the user attributes to the service is higher than the costs;
- the costs charged through represent a large proportion of the user's operating costs.

On the basis of this non-exhaustive list, it can be concluded that a profit mark-up is, in most cases, desirable or justified.

It should be noted that not every country will accept a statistical interest charge in addition to a profit mark-up. For example, some countries accept a statistical interest charge but then take the view that no profit mark-up may be charged; such countries apply the cost-sharing system very much to the letter. Other countries accept both a statistical interest charge and a profit mark-up. In this situation, there is recognition of the fact that the charging company faces certain risks, for example in respect of bad debts and foreign exchange. The tax authorities of these countries will allow a profit mark-up to compensate for these risks.

VII. THE IMPLEMENTATION

Whichever method of charging through is used, sufficient reliable information should be available in each system to convince the relevant tax authorities of the correctness of the chosen cost allocation method. Experience has shown that a reliable system, supported by valid contracts and, where necessary, by the declarations of external experts, helps substantiate the taxpayer's case. The contracts in particular should be an accurate reflection of what has been agreed between the parties.

A. Adjustment to the costs charged

Sometimes the tax authorities in a country will not (fully) accept a cost charge because they consider that it is not in accordance with the arm's length principle. In order to prevent double taxation, it is then essential for the tax authorities in the other country to accept an identical profit adjustment ("corresponding adjustment"). Normally, where a treaty exists between the two countries, the process is facilitated by applying a provision based on Article 9, paragraph 2, OECD Model Treaty. The multinationals however, indicated in the 1984 OECD Report, that they are in favour of the introduction of a compulsory system for profit adjustments. The reason being that the current treaty mutual agreement procedure does not always lead to an equitable result.

As an alternative to the proposed compulsory system, mandatory arbitration was mentioned. The Arbitration Treaty between the Member States of the European Union, which was signed on 23 July 1990 and entered into effect on 1 January 1995, appears to be a step in the right direction. Perhaps the existence of an Arbitration Treaty will lead to the more frequent and efficient use of the procedure for mutual consultation.

B. Mutual agreement procedure

It is clear that the method of allocation and the consequential level of the service fees can give rise to differences of opinion between the taxpayer and the tax authorities, and also between the tax authorities of the individual countries concerned.

In order to avoid disputes and the double taxation that may result, the possibility exists in a number of countries of obtaining prior approval from the tax authorities for the transfer prices to be applied by the taxpayers ("Advance Rulings", "Advance Pricing Agreement"). The United States of America, Australia and Canada all have implemented such a system.

This rulings procedure can lead to mutual consultation between the tax authorities of the relevant countries so as to arrive at what is known as a *joint* approval. This consultation is based on the treaty provisions for the mutual agreement procedure (Article 25, OECD Model Treaty). On 19 October 1994, the Dutch State Secretary for Finance issued a resolution, implementing a procedure for dealing with requests for approval in the Netherlands.

The experience with "Advance Pricing Agreements", shows that such a procedure frequently requires a substantial effort on the part of the taxpayer, in the sense that a great deal of detailed information must be provided, whilst a recommendation must also be submitted from an independent expert. Good administrative back-up is indispensable and there must in many cases also be a willingness to show complete openness towards the relevant tax authority. However, if the procedure is consistently implemented, this will help to accelerate the process. Advance approval may also have an influence on the attitude of other countries. For example, if the USA has approved a certain system, this may cause the tax authorities in other countries to accept that system as well.

It is clear that many problems may have to be faced in practice. Besides those mentioned above, other possible problems include differences in interpretation of the provisions of the service fee contracts and the tax treaties. The definition of royalties being particularly contentious.

VIII. CONCLUSION

There are many possible methods of allocating international costs within multinational enterprises in a fiscally and business-economically justified manner. It will, therefore, come as no surprise that the problems which occur in this field are highly diverse in nature. In this article, I have attempted to cast some light on the cost allocation problems faced by multinational enterprises. It is to be hoped that in its new report, the OECD Committee on Fiscal Affairs will succeed in presenting this subject matter in a way which is accessible and workable for both tax administrations and multinationals alike.

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Cayman Islands

International trust and corporate services.
Grand Cayman, Deloitte & Touche, One Capital Place, P.O.Box 1787 GT, Grand Cayman, Cayman Islands B.W.I. 1995, pp. 17.
Booklet designed to provide individuals and corporations with essential information about the Cayman Islands environment, including factors to be considered in deciding whether to establish a Cayman Islands entity. Information is based on conditions existing at 1 June 1994.
(B. 18.869)

EUROPE

European Tax Handbook 1995.
Amsterdam, IBFD Publications. 1995, pp. 568. 280.- Dfl. ISBN: 90 70125 79 X.
Annual handbook contains extensive up-to-date summaries of the taxation of corporations and individuals in European countries. Particular attention is paid to non-residents and relief from double taxation. Current tax rates are also included. The taxation systems of over 30 countries from West, Central and East Europe are covered, together with a chapter on the EU.
(B. 114.673)

Kiss, Alexandre; Shelton, Dinah.
Manual of European environmental law.
Cambridge, Cambridge University Press, The Pit Building, Trumpington Street, Cambridge CB2 1RP. 1994, pp. 525.
ISBN: 0 521 46930 9.
Detailed overview of European environmental law. The authors discuss the history, basic concepts, institutions and legal techniques of environmental protection in Europe. In Part Two they provide a detailed analysis of each environmental sector: biodiversity, soil, freshwater and air. Includes urban and rural land use rules and the role of the public and non-governmental organizations in combating environmental harm.
(B. 114.646)

Belgium

Wetboek van de inkomstenbelastingen 1992. (Uitgave 1995.1)
Diegem, Ced Samsom. 1995, pp. 763.
ISBN: 90 5334 308 3.
The book contains the texts of the Income Tax Code 1992 and of the Royal Decree of implementation of the Income Tax Code 1992. In addition, a selection of the most important laws with respect to income tax is provided. The Code is updated up to 28 February 1995.
(B. 114.645)

Tiberghien, Albert.
Tiberghien 1995. Handboek voor fiscaal recht. 16th Edition.
Deurne, Kluwer Rechtswetenschappen. 1995, pp. 1210. 5630.- Bfrs. ISBN: 90 5583 104 2.
The tax handbook is a useful manual about the various taxes in Belgium. It covers income tax, registration duties, death duties, stamp duties, VAT, customs duties, local taxes, social security contributions and international tax aspects. The book is concise but precise.
(B. 114.643)

Crombrugge, Stefaan van.
Ondernemingscoöperatie. De nationale en internationale fiscale aspecten van samenwerkingsovereenkomsten.
Deurne, Kluwer Rechtswetenschappen. 1994. Fiscale Praktijkstudies, No. 1, pp. 133. 1760.- Bfrs. ISBN: 90 6321 988 1.
The book analyses the tax aspects of different types of cooperation: cooperation for distribution, technological cooperation, cooperation for production, management contracts, cost-sharing associations and economic interest grouping.
(B. 114.447)

Deblauwe, Rik; Haelterman, Axel.
Is er nog leven na de Luxemburgse holding?
Kalmthout, Uitgeverij Biblo. 1995. Biblo Dossier, Fiscaliteit No. 27, pp. 61.
Monograph dealing with the tax-free holding in Luxembourg versus anti-holding provisions in Belgian tax law. Attention is paid to the tax consequences of the trust and other legal bodies in Belgium. A concise description of trust and similar entities in the Netherlands, Liechtenstein, France and Belgium, is given.
(B. 114.582)

Fiscolex B.T.W. 1995-1996. Wetboek van de belasting over de toegevoegde waarde met uitvoeringsbesluiten. Wetboek van zegelrechten en Wetboek van met het zegel gelijkgestelde taksen. Richtlijnen van de Raad van de Europese Gemeenschappen. 5th Edition. Samengesteld door Kris Gheysen en Guy Roelens.
Deurne, Kluwer Rechtswetenschappen. 1995, pp. 603. 3632.- Bfrs. ISBN: 90 5583 095 X.
This book contains the VAT Code and the Royal decrees of implementation of the VAT Code, various provisions concerning the stamp duties and the taxes equated with stamp duties, and the text of EC Directives related to VAT. The Code is updated up to 31 December 1994.
(B. 114.644)

Czech Republic

Commercial Code. Act No. 513/1991 Coll. as subsequently amended.
Prague, Trade Links, P.O.Box 131, 11001 Prague 1, Czech Republic. 1995, pp. 340. US$ 53.-.
English translation of the Commercial Code in effect in the Czech Republic as of May 1995. The law is important to those who wish to set up a business or who have already established a company or a branch in this country.
(B. 114.699)

EIU Business Report: Czech Republic and Slovakia.
London, The Economist Intelligence Unit. 1995, pp. 30.
Brief information on the business environment, exporting, sales and distribution, marketing and investing in the Czech Republic and Slovak Republic.
(B. 114.615)

European Union

Survey of the implementation of the EC Corporate Tax Directives.
Amsterdam, IBFD Publications. 1995, pp. 546. 850.- Dfl. ISBN: 90 70125 80 3.
Divided into two sections, this survey examines the Merger Directive and the Parent-Subsidiary Directive. The implementation of the directives is covered country-by-country. Each situation is applied to each country and is then analysed in detail, giving a complete picture of all permutations. Each country chapter concludes with a summary of all aspects of national law which could be in conflict with the Directives. Includes the 12 "older" EU countries. (Austria, Finland and Sweden were not members at the time the survey was carried out.)
(B. 114.754)

EU Direktiver om skatter og afgifter 1994. Compiled by Michael Kirkegaard Nielsen.
Copenhagen, A/S Skattekartoteket Informations- og Servicecenter for skatter og afgifter. 1994, pp. 448. ISBN: 87 7762 106 9.
Collection of EC legislation (consolidated) on direct and indirect taxation including proposals for directives. Notes on literature in Danish. List of European Court of Justice cases that have been published in the Danish periodical "Skat Udland".
(B. 114.162)

Acts of the European Communities in the field of taxation. Volume II (years 1991-1994). Doc. XXI/556/95.
Brussels, European Commission, Directorate-General XXI. 1995, pp. 260.
English texts of Acts of the EC in force in the field of indirect taxation (turnover taxes/VAT/excises).
(B. 114.687)

Finland

Finlands lag – Skatteförfattningarna 1995.
Helsinki, Juristförbundets förlag. 1995, pp. 436. ISBN: 951 640 766 8.
Compilation of tax laws of Finland, in the Swedish language, up to and including No. 186/1995 (13 February 1995) of the Finnish Official Gazette. The most important tax laws included in this book relate to national and municipal income taxes, net wealth tax, social security contributions, VAT, stamp tax, inheritance and gift tax, customs duties and excises, as well as to tax assessment and collection of taxes. Further, the book contains a list of effective tax treaties and the text of the Nordic Income Tax Treaty. In addition, the text of the Accounting Law is reproduced. A topical index is included.
(B. 114.689)

France

Mallard, Jean-Claude.
Fiscalité des entreprises. Vers une stratégie d'optimisation fiscale.
Grenoble, Europole, 25 rue Pierre Semard, 38000 Grenoble. 1994, pp. 196. 328.- Ffrs. ISBN: 2 86717 033 8.
Monograph on the taxation of enterprises in France and the various tax optimization opportunities. With a diskette.
(B. 114.159)

Grèce. Juridique, fiscal.
Levallois-Perret, Editions Francis Lefebvre. 1994.
Dossiers Internationaux Francis Lefebvre, pp. 283. ISBN: 2 85115 266 1.
Monograph describing the Greek business law, tax law (corporate and individual income taxes), VAT and social law. Full text of the France–Greece double taxation convention of 21 August 1963 is reproduced.
(B. 114.270)

Germany

§8a KStG Gesellschafter-Fremdfinanzierung. Debt/equity provisions. Federal Finance Ministry's interpretative letter, dated 15 December 1994. Herausgegeben von Price Waterhouse GmbH.
Düsseldorf, IDW Verlag GmbH. 1995, pp. 73.
German text and English translation of Section 8A of the Corporation Tax Act. The attached translation of the interpretative letter of 15 December 1994 is intended to permit foreign investors to achieve a better understanding of the relevant tax issues involved in the German debt/equity provisions.
(B. 114.655)

Wiemhoff, Karl-Heinz.
Bewertungsrecht Vermögensteuer.
Achim, Erich Fleischer Verlag. 1994.
Grundriss des Steuerrechts, Band 4, pp. 171. 24.70 DM. ISBN: 3 8168 2048 4.
Explanation of the basic principles of the German valuation law and the net wealth tax law.
(B. 114.205)

Herrmann, C.; Heuer, G.; Raupach, A. a.o.
Einkommensteuer- und Körperschaftsteuergesetz. Kommentar. 20th Edition. 18 Bänden.
Cologne, Dr. Otto Schmidt Verlag KG. 1992. 615.19 DM. ISBN: 3 504 23062 2.
Loose-leaf publication existing of 18 volumes updated up to February 1995. Commentary on individual and corporate income tax including subsidiary legislation, contains extensive comments on the amendments by the Individual Income Tax Reform Law and later amendments laws, particularly in the field of: profit computation, including fiscal incentives, company old age pension plans, wage tax withholding procedure, investment allowances. A clear distinction is made between pre-1975 legislation and legislation applicable to the time thereafter by the use of green pages for the supplements on tax reform.
(B. 114.767)

Veranlagungs Handausgaben 1994 Sammelband.
Einkommensteuer, Körperschaftsteuer, Gewerbesteuer, Umsatzsteuer. Mit Richtlinien, Gesetzen, Durchführungsverordnungen und Nebenbestimmungen. Ausgabe April 1995.
Bonn, Stollfuss Verlag. 1995, pp. 3050. ISBN: 3 08 367094 X.
Updated extensive documentation of the Individual Income Tax Act, Corporate Income Tax Act, Business Tax Act, Value Added Tax Act and all administrative guidelines thereto.
(B. 114.606)

Deutsche Steuergesetze 1995. 7. Auflage. Stand: Februar 1995.
Düsseldorf, IDW Verlag GmbH. 1995, pp. 1399. ISBN: 3 8021 0643 1.
Seventh edition of book containing texts of German tax laws, e.g. German Tax Code, income tax, corporate income tax, business tax, net worth tax, inheritance tax, turnover tax, land tax, real property transfer tax, etc.
(B. 114.671)

Wiemhoff, Karl-Heinz.
Lohnsteuer. 10th Edition.
Achim, Erich Fleischer Verlag. 1994.
Grundriss des Steuerrechts, Band 7, pp. 212. 29.80 DM. ISBN: 3 8168 2070 0.
This publication deals with the German wage tax based on the Income Tax Law, the wage tax implementation directives, regulations and developments of the basic principles in the jurisprudence.
(B. 114.206)

Die Veranlagung 1995 Lohnsteuer.
Einkommensteuergesetz, Durchführungsverordnung, Richtlinien, Anlagen, Rechtsprechung, Nebengesetze, Stichwortverzeichnis. 11. Auflage. Stand 1. Februar 1995.
Düsseldorf, IDW Verlag GmbH. 1995, pp. 1680. 72.90 DM. ISBN: 3 8021 0640 7.
Annual updated guide containing the text of the Wage Tax Law, the regulatory ordinance to the Wage Tax Law, case law and other relevant material for the 1994 tax assessment year.
(B. 114.672)

Kellersmann, Dietrich.
Die Abgrenzung der Einkünfte aus selbständiger Arbeit von den Einkünften aus Gewerbebetrieb.
Frankfurt, Peter Lang Verlag. 1994.
Europäische Hochschulschriften, Reihe II, Rechtswissenschaft, Vol. 1583, pp. 215. ISBN: 3 631 47393 1.
The distinction between income derived from independent services and income derived from business.
(B. 114.065)

Einkommensteuergesetz. Kommentar. 14. Auflage 1995. Herausgegeben von Ludwig Schmidt.
Munich, Verlag C.H. Beck. 1995, pp. 2200. 160.- DM. ISSN: 3 406 38531 1.
Updated edition of source book containing detailed practical commentary on the German Individual Income Tax Law as of March 1995.
(B. 114.706)

Schnellübersicht Einkommensteuer. Für den Veranlagungszeitraum 1994. Kurzorientierung durch alphabetische Zusammenstellungen, Tabellen und Übersichten. 29. Auflage. Bearbeitet von Heinz Richter und Willi Winter.
Bonn, Stollfuss Verlag. 1995, pp. 108. 39.80 DM. ISBN: 3 08 314394 X.
Quick reference guide for the 1994 assessment year. Topics of German Income Tax Law as tables, overviews, formulas, deductions, taxation of employees, professional education, ABC of dwelling-houses, income related expenses.
(B. 114.574)

Praktiker-Handbuch 1995 Aussensteuerrecht. Bearbeitet von Karl-Heinz Baranowski. 19. Auflage.
Düsseldorf, IDW Verlag GmbH. 1995, pp. 2412. ISBN: 3 8021 0547 8.
Updated edition of monograph on the German International Tax Law dealing with resident taxpayers with foreign income and non-resident taxpayers with German source income. Relevant tax statutes are appended.
(B. 114.658)

Hussmann, Theo.
Umsatzsteuer. 11th Edition.
Achim, Erich Fleischer Verlag. 1994.
Grundriss des Steuerrechts, Band 3, pp. 150. 23.40 DM. ISBN: 3 8168 2031 X.
Introductory textbook on the value added tax system in Germany, dealing with subjects such

as: what is a supply or service, deductions or liability to tax, tariffs, turnover taxes in the EC, etc.
(B. 114.204)

Wilke, Kay-Michael.
Lehrbuch des internationalen Steuerrechts. 5th Edition.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1994, pp. 220. 48.- DM. ISBN: 3 482 75515 9.
Revised and updated textbook on international tax law, which contains an introduction in international tax law in general as well as chapters on German aspects of international tax law up to January 1994 (Business Location Improvement Act, Anti-abuse and Corrections Tax Act, Frontier Workers Act), Maastricht Treaty, tax treaties, transfer pricing in the case of affiliated companies and the EC tax harmonization.
(B. 114.739)

Wirtschaftsgesetze. 13. Auflage. Gesetzgebungsstand 1.6.1995.
Düsseldorf, IDW Verlag GmbH. 1995, pp. 1215. 58.- DM. ISBN: 3 8021 0659 8.
Revised and updated edition of manual containing texts of Commercial Code, Stock Corporation Law, Limited Liability Company Law, Publicity Law, Reorganization Tax Law, D-Markbilanzgesetz, Company Law, Co-determination Law and more economic, commercial and accounting laws applicable in Germany as of 1 June 1995.
(B. 114.657)

Greece

Grèce. Juridique, fiscal.
Levallois-Perret, Editions Francis Lefebvre. 1994.
Dossiers Internationaux Francis Lefebvre, pp. 283. ISBN: 2 85115 266 1.
Monograph describing the Greek business law, tax law (corporate and individual income taxes), VAT and social law. Full text of the France–Greece double taxation convention of 21 August 1963 is reproduced.
(B. 114.270)

Luxembourg

Deblauwe, Rik; Haelterman, Axel.
Is er nog leven na de Luxemburgse holding?
Kalmthout, Uitgeverij Biblo. 1995. Biblo Dossier, Fiscaliteit No. 27, pp. 61.
Monograph dealing with the tax-free holding in Luxembourg versus anti-holding provisions in Belgian tax law. Attention is paid to the tax consequences of the trust and other legal bodies in Belgium. A concise description of trust and similar entities in the Netherlands, Liechtenstein, France and Belgium, is given.
(B. 114.582)

Gillissen, P.L.
Handboek Vestigen in Luxembourg.
Voerendaal, Uitgeverij Guide Lines, Teggert 60, 6367 XN Voerendaal, The Netherlands. 1995, pp. 220. 52.35 Dfl.
Practical handbook for Dutch legal entities and individuals intending to establish a business or to live in Luxembourg. Subjects treated are: role and scope of the Dutch tax law and legal authorities in cases of income and wealth tax, succession duties, banking, taxes due and social security; some aspects of the tax and legal system in Luxembourg. A list with relevant tariffs and addresses is appended.
(B. 114.633)

Netherlands

Loon, P.M.E.; Bikker, A.C.; Vliet, A.J. van.
Elseviers almanak voor de vennootschapsbelasting 1995. Handleiding voor de aangifte vennootschapsbelasting 1994. 25th Edition.
Amsterdam, Bonaventura. 1995, pp. 238. ISBN: 90 6882 207 1.
Annual updated guide for filing 1994 corporate income tax return.
(B. 114.542)

Financieel Memo 1995.
Deventer, Kluwer. 1995, pp. 240. 28.50 Dfl. ISBN: 90 200 1717 9.
Booklet providing the most important financial and economic data, including tariffs, fees and other payments, for 1995.
(B. 114.623)

Paardt, R.N.G. van der.
Kernboekje BTW voor non-profit organisaties en overheid 1994.
Deventer, Fed. 1994, pp. 165. 38.50 Dfl. ISBN: 90 6002 609 8.
Monograph dealing with the VAT aspects applicable to government bodies and non-profit organizations such as: educational, health care, social and cultural organizations and charities in 1994, also in the context of the EC tax policy.
(B. 114.691)

Herbezinning op het regime voor inkomsten uit aandelen. Pre-advies uitgebracht voor de 41e jaarvergadering van de Nederlandse Orde van Belastingadviseurs – NOB, te houden op 16 mei 1995. Coordinator L.G.M. Stevens.
Amsterdam, NOB – De Nederlandse Orde van Belastingadviseurs. 1995, pp. 172.
Papers presented during the annual meeting of the Dutch Corporation of Tax Advisors on 16 May 1995 under the title "Review of the income from shares system".
(B. 114.690)

Te Spenke, Gerrit.
Taxation in the Netherlands. 3rd Edition.
Deventer, Kluwer Law and Taxation Publishers. 1995, pp. 179. 90.- Dfl.
Third revised edition of book summarizing the main features of the Netherlands tax system. Provides foreign investors and business people with basic information on the tax implications of their business plans in the Netherlands. Deals with income and corporate income tax, participation exemption, death duties, property transfer tax, non-residents and tax treaties.
(B. 114.755)

Gillissen, P.L.
Handboek Vestigen in Luxembourg.
Voerendaal, Uitgeverij Guide Lines, Teggert 60, 6367 XN Voerendaal, The Netherlands. 1995, pp. 220. 52.35 Dfl.
Practical handbook for Dutch legal entities and individuals intending to establish a business or to live in Luxembourg. Subjects treated are: role and scope of the Dutch tax law and legal authorities in cases of income and wealth tax, succession duties, banking, taxes due and social security; some aspects of the tax and legal system in Luxembourg. A list with relevant tariffs and addresses is appended.
(B. 114.633)

Janssen, B.G.; Rooij, K. de; Waaijen, E. van; Wasch, E.P.J.
Kernboekje loonbelasting 1995.
Deventer, Kluwer. 1995, pp. 101. 32.50 Dfl. ISBN: 90 6002 632 2.
Revised edition of monograph dealing with the wage tax for 1995.
(B. 114.634)

Plante-Failé, M.; In 't Veld-Marree, L.
Kernboekje echtscheiding en alimentatie.
Deventer, Fed. 1995, pp. 53. 38.50 Dfl. ISBN: 90 6002 647 0.
Concise monograph dealing with legal and tax aspects of divorce and alimony.
(B. 114.692)

Stevens, L.G.M.
Pensioen in de loonsfeer. 2nd Edition.
Deventer, Fed. 1995.
Fed Fiscale Brochures, pp. 190. 75.- Dfl. ISBN: 90 6002 653 5.
Updated edition of monograph discussing the reform of taxation of life insurance and annuities in the individual income tax and wage tax. A register to the case law is appended.
(B. 114.694)

Kernboekje pensioenregeling van de directeur grootaandeelhouder. Deventer, Fed. 1995, pp. 75. ISBN: 90 6002 607 1.
Brochure describing the integral problems of old-age pension measures to be taken by the director-shareholder.
(B. 114.635)

Almanak voor de invordering 1995. Handleiding voor ondernemers, particulieren, adviseurs en invorderingsambtenaren over de invordering van belastingen.
Diemen, De Bussy Uitgeverij. 1995, pp. 288. 69.- Dfl. ISBN: 90 5471 016 0.
Almanac providing practical information on the collection of taxes in 1995, including an explanation of terms used by the legislator.
(B. 114.629)

Zelst, W.A. van.
Pensioen- en spaarfondsenwet.
Deventer, Fed. 1995.
Serie Pensioenwijzers, No. 5, pp. 119. 32.50 Dfl. ISBN: 90 6002 6241.
Monograph describing the practice of pension and saving fund law from the legal, tax and administrative point of view.
(B. 114.693)

Poland

EIU Business Report: Poland.
London, The Economist Intelligence Unit. 1995, pp. 26.
Country report covering the political, statistical and legal background to business and its real-life implications in Poland. Includes brief information on investment opportunities in the country.
(B. 114.637)

Slovak Republic

EIU Business Report: Czech Republic and Slovakia.
London, The Economist Intelligence Unit. 1995, pp. 30.
Brief information on the business environment, exporting, sales and distribution, marketing and investing in the Czech and Slovak Republic.
(B. 114.615)

United Kingdom

Sandler, Daniel.
A request for rulings.
London, The Institute for Fiscal Studies. 1994, pp. 97. ISBN: 1 899218 05 X.
The author examines main features of advance rulings and his ideas for a rulings system in the Unied Kingdom, formulated through a comparative study of a recently enacted Australian rulings system. (Includes comparisons to the rulings procedures in Canada, Sweden and the United States).
(B. 114.636)

Hardman's tax rates & tables 1995-96. 11th Edition.
Bicester, CCH Editions Limited. 1995, pp. 100. ISBN: 0 86325 386 5.
The material of this booklet is arranged in nine sections: income tax, national insurance contributions, corporation tax, general, capital gains tax, inheritance tax, stamp duties, VAT and insurance premium tax.
(B. 114.651)

British master tax guide 1995-96.
Bicester, CCH Editions Limited. 1995, pp. 1360. £ 29.95. ISBN: 0 86325 387 3.
The guide explains the individual and corporate income tax, capital gains tax, inheritance tax, VAT and national insurance contributions. All relevant provisions of the Finance Act 1995 have been incorporated.
(B. 114.652)

Homer, Arnold; Burrows, Rita.Tolley's tax guide 1995-96. 13th Edition.
Croydon, Tolley Publishing Company Ltd. 1995, pp. 600. £ 24.95. ISBN: 1 86012 014 8.
Annual updated edition dealing with income tax, corporation tax, capital gains tax, inheritance tax, VAT and stamp duty. Includes chapters on council tax and business rates, national insurance contributions and statutory sick pay and statutory maternity pay. This 13th edition gives the position for the tax year 1995-96 and covers all legislation, statements of practice and other relevant sources of information including the provisions of the Finance Act 1995.
(B. 114.661)

Tax technical review 1995-96. 4th Edition.
London, The Professional Training partnership, 1-5 Buckingham Street, Oxford OX1 4LH, England. 1995, pp. 256.
ISBN: 1 898602 04 2.
The book comprises separate chapters encompassing the main changes in the last 12 months. Covers personal and business tax as well as VAT, national insurance contributions and stamp duty.
(B. 114.707)

Steward, Cliff; Taulor, Anthony.
The equitable life tax guide 1995/96. 99th Edition. (formerly Smith's Taxation)
Oxford, Blackwell Publishers Ltd. 1995, pp. 497. ISBN: 0 631 19842 3.
Comprehensive and up-to-date guide to personal and business taxation covering existing law and practice relating to personal taxation, land and buildings, business taxation, capital gains tax, inheritance tax, VAT, council tax, foreign and miscellaneous income. Includes analysis of changes in the treatment of dividends and interest, particularly mortgage interest, and of marriage allowances. This edition covers the provisions of the Finance Act 1995.
(B. 114.748)

Royaume-Uni. Juridique, fiscal, social et comptable. 4th Edition.
Levallois-Perret, Editions Francis Lefebvre. 1995.
Dossiers Internationaux Francis Lefebvre, pp. 526. ISBN: 2 85115 264 5.
Revised and updated edition describing the common law and company law, VAT, labour law, social and accounting regulations as of 1 January 1995 in the United Kingdom. The tax system and the comprehensive income tax treaty between France and the United Kingdom is also dealt with.
(B. 114.628)

Controlled foreign companies. Explanatory Notes on the Provisions of Part XVII, Chapter IV ICTA 1988. Issued by the Board of Inland Revenue, March 1995.
London, Inland Revenue. 1995, pp. 100.
(B. 114.562)

The new current year basis of assessment. A guide for Inland Revenue officers and tax practitioners.
London, Inland Revenue. 1994.
Self Assessment Technical, SAT1, pp. 110. £ 3.-
The guide deals with the current year basis of assessment for income tax and the special rules that will apply in the transitional year, 1996/97, for sources of income existing before 6 April 1994.
(B. 114.467)

Self-assessment: the legal framework.
A guide for Inland Revenue officers and tax practitioners.
London, Inland Revenue. 1995.
Self Assessment Technical, SAT2, pp. 65.
The book deals with the changes in the administration of direct taxation that will apply in the self assessment regime.
(B. 114.468)

Vessey, D.C.
Retirement planning handbook.
London, Longman Law, Tax and Finance, Longman Group Limited. 1994, pp. 295. £ 21.95. ISBN: 0 75200 0772.
Revised and updated edition of concise information book on retirement planning. Taxation aspects are covered in two chapters. Chapter 8 on income tax and capital gains tax and Chapter 9 on inheritance tax. Specifically with income tax, it covers the year of retirement and the taxation of pensions, as well as wills and trusts and retiring abroad.
(B. 114.662)

INTERNATIONAL

Sandler, Daniel.
A request for rulings.
London, The Institute for Fiscal Studies. 1994, pp. 97. ISBN: 1 899218 05 X.
The author examines main features of advance rulings and his ideas for a rulings system in the United Kingdom, formulated through a comparative study of a recently enacted Australian rulings system. (Includes comparisons to the rulings procedures in Canada, Sweden and the United States).
(B. 114.636)

Freight taxes 1995.
Copenhagen, BIMCO Publications A/S. 1995, pp. 160. ISBN: 87 980908 8 7.
This BIMCO annual publication contains updated summaries on freight taxes applied in 63 countries and highlights the more essential sections of the relevant laws.
(B. 114.649)

1995 International tax summaries.
A guide for planning and decisions. Coopers & Lybrand International Tax Network. Editor George J. Yost.
New York, John Wiley & Sons, Inc. 1995, pp. 1400. ISBN: 0 471 11557 6.
This publication contains useful and concise information on the tax systems of 119 countries all over the world. It provides information on individual and corporate income tax laws, and covers the taxation of non-residents and withholding tax rates under double taxation treaties. Furthermore it contains information on important regulatory and tax considerations for foreign investors and provides the basic rules for the computation of taxable income in each of the countries. This edition reflects the tax systems as of 31 July 1994 unless otherwise indicated. A helpful book to assist in the comparison of the tax systems of different countries.
(B. 114.794)

Wilke, Kay-Michael.
Lehrbuch des internationalen Steuerrechts.
5th Edition.
Herne/Berlin, Verlag Neue Wirtschafts-Briefe. 1994, pp. 220. 48.- DM. ISBN: 3 482 75515 9.
Revised and updated textbook on international tax law, which contains an introduction in international tax law in general as well as chapters on German aspects of international tax law up to January 1994 (Business Location Improvement Act, Anti-abuse and Corrections Tax Act, Frontier Workers Act), Maastricht Treaty, tax treaties, transfer pricing in the case of affiliated companies and the EC tax harmonization.
(B. 114.739)

Fiscal and monetary policy. Volumes I and II. Editors Thomas Mayer and Steven M. Sheffrin.
Aldershot, Edward Elgar Publishing Limited. 1995.
The International Library of Critical Writings of Economics, No. 52, pp. 720.
ISBN: 1 85898 009 7.
This two-volume set reprints 28 papers on fiscal and monetary policy interpreted broadly enough to include such issues as the effects of government debt and intergenerational accounting. The publication is divided into three parts: the first deals with the problems that are common to both fiscal and monetary policies; the second deals with fiscal policy and the third with monetary policy.
(B. 114.663)

The Europa World Yearbook 1994. Volume I. Part one: International organizations. Part two: Afghanistan–Jordan.
London, Europa Publications Limited. 1995, pp. 1729. £ 325.-. ISBN: 1 85743 014 X.
(B. 114.621)

OECD

Transfer pricing guidelines for multinational enterprises and tax administrations.
Paris, OECD – Organisation for Economic Co-operation and Development. 1995.
These Guidelines are a revision of the OECD Report "Transfer pricing and multinational enterprises (1979)". Approved by the Committee on Fiscal Affairs on 27 June 1995 and by the OECD Council for publication on 13 July 1995. This loose-leaf publication will be supplemented with additional chapters addressing other aspects of transfer pricing and will be periodically reviewed and revised on an ongoing basis.
(B. 114.784)

Climate change. Designing a practical tax system.
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I. ARTICLES

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NEW ZEALAND

TAXPAYER COMPLIANCE STANDARDS AND PENALTIES: VERSION II SIGNIFIES PROGRESS

Adrian J. Sawyer

M Com (Hons), LL B, C A, Barrister and Solicitor of the High Court of New Zealand. **Adrian Sawyer** is a lecturer in taxation and business law in the Department of Accountancy, Finance and Information Systems at the University of Canterbury, Christchurch, New Zealand. He specializes in tax compliance and administration, and effective tax rate research, as well as company and insolvency law. He is a New Zealand correspondent for the *Bulletin*

I. INTRODUCTION

In August 1994, the New Zealand Government released a discussion document entitled "Taxpayer Compliance, Standards and Penalties", ("the first discussion document"). A commentary was provided by this author on that discussion document.[1] The first discussion document was issued as part of the Generic Tax Policy Process, where consultation is the hallmark of tax policy refinement. The conclusion in the earlier article was that the philosophy underlying the proposals in the first discussion document was correct and that the higher penalties envisaged were needed to help raise the level of tax compliance in New Zealand. Several deficiencies were identified, including a failure to address many of the issues in the tax compliance literature.

The second discussion document entitled "Taxpayer Compliance Standards and Penalties 2" ("the second discussion document"),[2] was released on 11 April 1995, with submissions closing on 12 May 1995. Following the receipt of submissions, draft legislation was introduced to Parliament in early October 1995, and then referred to the Finance and Expenditure Select Committee for further submissions, which are likely to be considered in late November or early December 1995. Comment on the first discussion document was mixed, with concern over some of the proposals and relief that the additional tax imposed on late payments would be reduced. Opinion on this second document has been less conspicuous than for the first document and it has generally been more supportive of the Government's proposals.[3]

The aim of the proposed compliance, standards and penalties regime is to encourage voluntary tax compliance by taxpayers through:

- promoting fairer and more effective enforcement of the tax legislation;
- clearly specifying the obligations and standards expected of taxpayers; and
- improving the consistency of the penalties charged within and across the taxes acts.

A. Part I: Overview of the revised proposed reforms

Taxpayers will be required to exercise reasonable care in complying with and discharging their tax obligations. Penalties will be imposed depending upon the degree of breach, with a higher rate if hindrance occurs. On the other hand, a reduction in the rate will occur if voluntary disclosures are made prior to or during an audit. As in the first discussion document, taxpayers must have a *reasonably arguable position* to support the way they have applied the tax legislation, where the tax at stake is large. Modifications have been introduced to extend this requirement. There will now be a standard penalty where there is a lack of a reasonably arguable position.

Where taxpayers take an *abusive tax position* in relation to a matter in a tax return, they will be liable for a standard penalty on the tax shortfall. Late filing of returns will also attract a standard penalty, which increases depending on the size of the gross income involved. Late payment penalties will be standardized for all types of tax, with an initial rate, and a monthly rate imposed thereafter, until full payment is made. Remission of these penalties is possible where the taxpayer can demonstrate that there was a reasonable cause beyond the taxpayer's control that caused the late filing or late payment to occur. In a similar vein, criminal penalties will be standardized with adjustments to reflect the severity of the offences involved. Finally, as indicated in the first discussion document, a comprehensive two-way interest regime will apply to under- and overpayments of tax.

The compliance and penalties regime will apply to all returns, taxes, withholding deductions, levies and duties due under the Income Tax Act 1994, Goods and Services Tax Act

1. See Sawyer, A. J., "Raising the Threshold for Taxpayer Compliance: A New Era of Compliance Standards and Penalties", 48 *Bulletin for International Fiscal Documentation* 12 (1994), at 655.
2. New Zealand Government, *Taxpayer Compliance Standards and Penalties* 2, (Wellington, Government Printer, 1995).
3. See for example Dodds, J. "Tax document mark II reduces penalties", The Independent, 21 April 1995, at 32.

1985, Stamp and Cheque Duties Act 1971, Estate and Gift Duties Act 1968 and the Gaming Duties Act 1971. The regime is intended to apply to income year taxes from 1997/98 and from 1 April 1997 for non-income year taxes such as GST and FBT. The legislation will predominantly appear in the Tax Administration Act ("TAA") 1994.

B. Part II: Draft legislation and commentary

Draft legislation is included in part two of the second discussion document. The core provisions to accompany the proposals are set out, with the legislation prepared in a manner to reflect the plain English style proposed in another Government discussion document entitled "Rewriting the Income Tax Act: Objectives, Process, Guidelines".[4] A commentary accompanies the draft legislation to enable the reader to ascertain the reasons for the draft clauses, their proposed location and the necessary amendments and associated repeals to the TAA. A total of 55 new or revised sections to the TAA are proposed, adding to the burgeoning size of the revenue statutes.

C. Part III: Practical examples

The third section of the second discussion document is devoted to illustrations of how the proposed penalty and interest regime will work, with the assumption that the interest rate payable to taxpayers by the Commissioner will be 5 percent per annum and 12 percent per annum by taxpayers to the Commissioner.[5]

The three examples given involve: civil culpability penalties imposed on a medium-sized company after a multiple revenue audit, penalties and interest imposed on an employee for late filing and late payment, and penalties and interest imposed on an employer for late payment and overpayment of PAYE tax deductions. Each of these scenarios will be reviewed later in this article. The proposed effective date for the new regime has been postponed one year to 1 April 1997, thus giving taxpayers and their advisors more time to prepare for its introduction.

II. THE REVISED PROPOSED REFORMS

A. Self-assessment

The current Government wishes to support the self-assessment environment through reinforcing and amending tax legislation as it deems appropriate. The compliance and penalty regime proposed in the second discussion document is directed at improving voluntary compliance with the law, through clarifying the standards, obligations and responsibilities of taxpayers *vis à vis* their tax liabilities and associated assessments. This philosophy means that effectively taxpayers raise their own assessments rather than the Commissioner. The legislation will be amended to reflect this new environment as part of the general process of rewriting the revenue statutes.

B. Penalty for failure to file returns

In the first discussion document, the Government proposed to introduce a flat penalty of $ 50 where the annual return for all classes of taxpayers and for annual PAYE and Accident Compensation Employer Premium ("ACC") reconciliation statements were not filed by the due date. The second discussion document recognizes that there maybe reasons beyond the control of taxpayers that cause a return to be filed late. This issue was vigorously raised during the submission process. Following the weight of submissions, the Government has now left the imposition of this penalty at the discretion of the Commissioner. The Commissioner must first give notice to the taxpayer that he intends to impose a penalty, following the granting of an opportunity for the taxpayer to apply for an extension of time. Remissions of the late filing penalty will be rare and limited to circumstances where the late filing was beyond the control of the taxpayer.

In recognition of the fact that $ 50 would not act as an incentive for filing returns when the size of income involved is large, a graduated scale has been introduced. The critical levels in this scale are set out in Figure 1:

Figure 1: Proposed Late Filing Penalties

Gross income (before expenses and losses) up to $ 100,000	$ 50
Gross income (before expenses and losses) $ 100,001 up to $ 1,000,000	$ 250
Gross income (before expenses and losses) over $ 1,000,000	$ 500
PAYE and ACC reconciliations	$ 250

The late filing penalty will be due and payable on the later of:
(a) 30 days after the Commissioner has notified the taxpayer that the penalty is payable; and
(b) either:
 (i) the taxpayer's terminal tax date (for income tax returns), or
 (ii) 31 May (for reconciliation statements).

It is also proposed that the Commissioner be permitted to seek a court order to require a taxpayer to file a return. Currently failure to file a return attracts a maximum fine of $ 1,000 and/or up to three months imprisonment.

4. New Zealand Government, *Rewriting the Income Tax Act: Objectives, Process, Guidelines*, (Wellington, Government Printer, 1994).
5. The current rates for use of money interest for the 1995-96 year are 8.5% for overpaid amounts (assessable) and 14.2% for underpayments (deductible if satisfying normal deduction criteria). This relates to unpaid provisional tax only. Consequently the use of money interest rates applied in the second discussion document examples are indicative only.

C. Late payment penalty

There will be a standardized late payment penalty imposed for all taxes, with interest also to be charged on tax due, in order to reflect the fact that the taxpayer has effectively had use of the money. The existing additional tax provisions will be abolished. The Government is unwavering in its contention that the late payment penalty is not designed to be a revenue-raising measure but simply a catalyst to encourage prompt payment of tax. This is debatable when one considers the fact that the rates payable in respect of underpayments considerably exceed the rates applying to overpayment situations. There will be two late payment penalties, namely a 5 percent penalty levied on the due date if full payment is not made by this date and thereafter an incremental 2 percent monthly penalty on the amount of tax outstanding. This is similar to the current environment for GST. For income tax the current penalties are 10 percent on the due date and 10 percent every six months thereafter (compounding). The proposed penalties will also be compounded, and importantly they cannot be objected to by the taxpayer.

Nevertheless, the Commissioner will be given the authority to remit the penalty where the late payment resulted from factors beyond the taxpayer's control, or where the outstanding tax will be paid by agreed instalments. As a de minimis rule, there will be no late payment penalties on tax due which is less than $ 100. Where the tax shortfall results from a reassessment, then the date from which any late payment penalty will run, will normally be the new due date, set some time after the reassessment notice is issued.

D. Lack of reasonable care

The underlying expectation held by the Government in both discussion documents, has been that all taxpayers are expected to demonstrate reasonable standards of care in the conduct of their tax affairs. The "reasonable care" concept is not intended to be defined in legislation, but instead the commercial and common law usage of the term is to be applied. This approach is intended to ensure that the flexibility of the term is maintained, without imposing any artificial constraints for taxation purposes. Nevertheless, reasonable care is not a concept "cemented in judicial concrete" in New Zealand at the current time.

For example, the expected reasonable care standard for a taxpayer who is an employee, is determined by reference to what a person of ordinary skill and prudence would have done in similar circumstances. This standard would be lower (or easier to achieve) than that required by a self-employed taxpayer or a company. Ultimately the courts will determine what constitutes the reasonable care expected of taxpayers. Only then will taxpayers have a benchmark from which they can ascertain, with reasonable certainty, whether the actions they have taken (or will take) exhibit the necessary characteristics of reasonable care. Reasonable care will need to be exercised in almost all the compliance activities of taxpayers, in order to satisfy their tax obligations.

Lack of reasonable care will apply to relatively minor breaches. The next level of carelessness, i.e. gross carelessness, is intended to be defined, and it is proposed that the term will mean:

"to do or omit to do something in a way or manner that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences ...
[a] taxpayer may be grossly careless even if the taxpayer –
(a) Did not intend to breach a tax obligation, or
(b) Had no knowledge of a tax obligation."[6]

Clearly, it is intended that gross carelessness involves an imprudent disregard for the consequences of action or inaction. However, it is not necessary that the breach was intentional, or that the taxpayer was even aware of the relevant obligation. Without doubt, a high standard is expected of taxpayers if they do not wish to suffer the consequences of being found to have acted in a grossly careless manner.

Evasion is also to be defined, and this involves situations where the taxpayer evades the assessment or payment of tax, obtains a tax refund or credit to which they know they are not entitled, or assists another taxpayer in either of these two instances.

Appeals will be permitted against a determination by the Commissioner that a breach has occurred. No appeal however, is allowed against a penalty. A breach will trigger the imposition of a shortfall penalty. Standard penalties will also be imposed and these are discussed later in subsection G of this part of the article. The point at which the taxpayer's actions will be considered is when the taxpayer makes known his tax position, an event which will generally occur when the return is filed or tax is paid. Reductions in standard penalties will be available where a voluntary disclosure has been made by the taxpayer.

E. Lack of a reasonably arguable position

When the amount of tax at stake is large, taxpayers will be required to have a reasonably arguable position. This term is defined as:

"a tax position that, viewed objectively, is about as likely as not to be the correct tax position".[7]

It is a requirement that the decisions of the Taxation Review Authority and the courts be taken into consideration, along with the legislation, in ascertaining whether this test has been satisfied. The test focuses on the merits of the argument and will not take into account the skill, knowledge and circumstances of the taxpayer concerned; i.e. an objective rather than a subjective test is proposed. The Government contends that in order to assist taxpayers, there is a disclosure facility available which can be used to reduce the applicable level of penalty. Nevertheless, disclosure can be at a cost to the taxpayer. For example the taxpayer may incur compliance costs or need to disclose confidential information, these costs

6. Subsec(s). 27(3) and (4) of the draft legislation.
7. Sec. 26(4).

should not be discounted too lightly. It is the Government's intention that this requirement should not affect ordinary taxpayers.

Submissions on this concept from the first discussion document were generally supportive, but changes have been incorporated to reflect a number of the concerns raised in those submissions. The threshold has been raised so that the test will only apply where the tax shortfall arising as a result of the position taken, exceeds the greater of:

(a) $ 10,000; and

(b) the smaller of $ 100,000 or 1% of the taxpayer's liability for the year determined by reference to their return.

The modifications to the operation of the reasonably arguable position test, will ensure that fewer taxpayers are affected by this requirement than envisaged in the first discussion document. Binding rulings will act as an absolute defence to the lack of a reasonably arguable position, providing a persuasive force for taxpayers to seek a private or product ruling when they have serious doubts of the tax consequences of a particular transaction.[8] However, the question as to whether the taxpayer's interpretation of the applicability of the binding ruling is reasonable, is likely to be a contentious one, the eventual resolution of which may give rise to costly court action.

The Government asserts that the fact that there is minimal case law on the concept of a reasonably arguable position, is to the advantage of taxpayers. It is my contention that this is a naive, perhaps even an absurd view to hold, since uncertainty over a legal term may generate voluminous case law, as evidenced for example, by the absence of a statutory definition for a "going concern" in the GST legislation.[9] Until judicial guidance is received, uncertainty will prevail. Only time will tell how the provision is applied in practice.

F. Tax avoidance

Tax avoidance is a thorny issue that encroaches upon the actions of every Commissioner. Problems abound as to what is meant by the term and what is mere tax mitigation (acceptable tax planning)? The Government proposes to continue with its abusive tax avoidance proposals. A taxpayer will be deemed to have taken an abusive tax position where:

"*(a) at the time the taxpayer takes the taxpayer's position it is not a reasonably arguable position; and*

(b) it is taken in respect of, or as a consequence of entering into, an abusive arrangement."[10]

An abusive arrangement is defined as an arrangement:

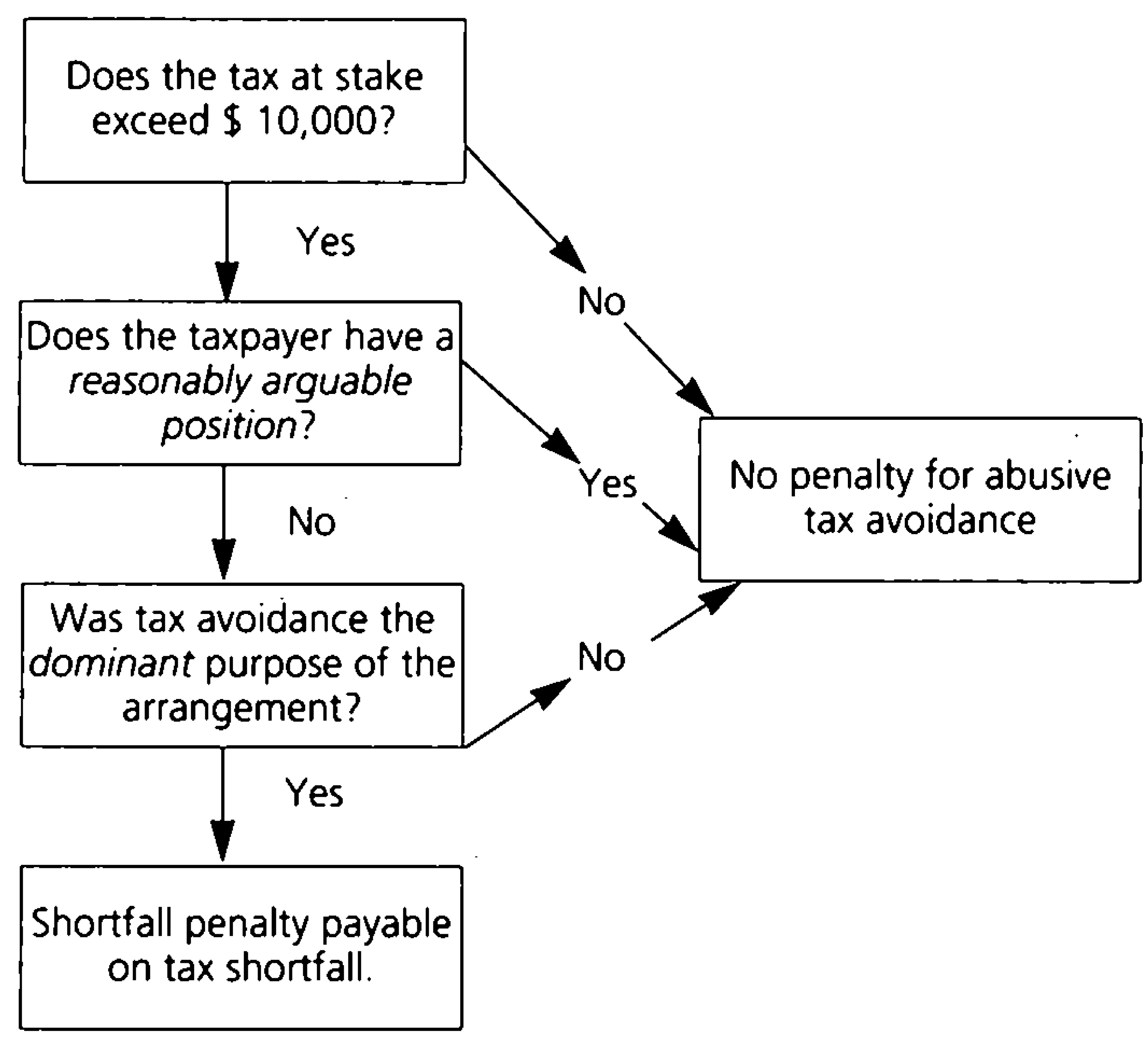
"*that viewed objectively, has a dominant purpose of avoiding tax, whether directly or indirectly.*"[11]

Consequently, to constitute abusive tax avoidance, the taxpayer's position must not be reasonably arguable; that is, it will generally be contrary to the scheme and purpose of the legislation, and the dominant purpose (not merely incidental) must be to avoid tax. There must be a significant shortfall involved, since where the amount of tax shortfall involved is less than $ 10,000, the reasonable care test will apply. Indicators of a dominant purpose of tax avoidance alluded to in the second discussion document include:

- the substance of the arrangement;
- the presence of artificiality and or circularity of funding;
- dependency on concealment of information or non-availability of evidence; and
- the extent to which the economic position of the taxpayer has been altered by entering into the arrangement.

It is not intended to include a schedule of activities that amount to abusive tax avoidance in the legislation. This is to prevent any restriction of the scope of the term, particularly because restrictions are frequently tainted by loopholes. The penalty for abusive tax avoidance will be the imposition of a shortfall penalty of 100 percent on the resulting underpayment of tax. The test can be illustrated as in Figure 2:

Figure 2: Determination of Penalty for Abusive Tax Avoidance



G. Application of civil penalties

The overall intention for imposing civil penalties is to apply a flat rate monetary penalty dependent upon the seriousness of the breach involved. For criminal penalties, the intention is to include both monetary and imprisonment penalties and to more closely align the penalties with similar offences in other areas of the law. A purpose section is to be included concerning the imposition of the new penalties regime:

8. For a commentary on the binding rulings regime in New Zealand, see Sawyer, A.J., "A Proposed Binding Rulings Regime", 48 *Bulletin for International Fiscal Documentation* 11 (1994), at 582, and Sawyer, A.J., "Update on the New Binding Rulings Regime and Amendments to the Entertainment Tax Regime", 49 *Bulletin for International Fiscal Documentation* 4 (1995), at 189.
9. A definition for going concern was inserted into the Goods and Services Tax Act with effect from 10 April 1995, nearly ten years after the legislation was originally drafted.
10. Sec. 28(5)(a) of the draft legislation.
11. Sec. 28(5)(b).

"The purposes of this Part are:
(a) To encourage taxpayers to comply voluntarily with their tax obligations and to cooperate with the Department; and
(b) To ensure that penalties for breaches of tax obligations are imposed impartially and consistently; and
(c) To sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach." [12]

Civil penalties will be imposed for underpayment of tax. A shortfall penalty will apply; where there has been a failure to satisfy the reasonable care tests, a lack of a reasonably arguable position or the taking of an abusive tax position, late filing of returns and late payment of tax. The tax shortfall is calculated as the difference between the correct tax liability and the liability determined by reference to the position the taxpayer took when filing their return. There will be a prorating mechanism to establish the correct amount of each penalty type to be imposed. Each revenue will be treated separately; therefore there can be no offsetting of tax liabilities for different classes of revenue to reduce the applicable penalties. The Commissioner may not vary the amount of the penalty; the prescribed flat rates will apply in every situation, subject to the existence of hindrance or voluntary disclosure.

Even where the taxpayer is in a loss position, the penalty will be determined by reference to the applicable tax rate that would have applied had a "profit" been made. There is no intention to create a distinction between the financial accounting concepts of permanent and timing differences when ascertaining the appropriate penalty.[13] The Government asserts that this approach emphasizes the desirable quality of simplicity, but it is at the expense of equity and fails to recognize generally accepted business and commercial practice concerning timing differences.

Where there is more than one applicable penalty, the taxpayer will only be liable to the larger penalty, and will not suffer double jeopardy for the same action. Failure to pay the shortfall penalty by the due date, will attract the late payment penalty together with interest. Should the taxpayer lodge a competent objection to the imposition of the tax shortfall penalty, then half of the penalty may be deferred until the issue is resolved (as is the situation for deferrable tax currently), with the other half payable immediately to the IRD pending the outcome of the objection. If the taxpayer has available tax losses, these may be used to "pay" the shortfall penalties. The Commissioner will have a minimal level of discretion to remit penalties.

The penalty may be increased if the taxpayer deliberately hinders the Commissioner or an Inland Revenue officer during an investigation. On the other hand, mitigation is possible if the taxpayer makes a voluntary admission of a breach before or during an audit, or discloses (what is later held to be) a non-reasonably arguable position at the time the return was filed. Hindrance causes a 25 percent increase in the applicable penalty rate, whereas disclosure before an audit will introduce a 75 percent reduction in the penalty. Disclosure during an audit attracts a 40 percent reduction. This approach reflects the emphasis in the second discussion document on encouraging taxpayers to disclose what they claim to be a reasonably arguable position in their tax return, if they are in some doubt as to its reasonableness. Taking this action would enable a reduction in penalty should the taxpayer's claim for a reasonably arguable position not be upheld.

The proposed civil penalties (with the penalties proposed in the first discussion document appearing in brackets), are set out in Table 1:

H. Assessments and disputes

In December 1994, a discussion document proposing changes to the Tax Dispute Resolution Procedures between

12. Sec. 20.
13. See Statement of Standard Accounting Practice No. 12, "Accounting for Income Tax", issued by the New Zealand Society of Accountants in 1991 for a definition of these terms in a New Zealand context.
14. A flat penalty was proposed in the first discussion document.
15. This was classified as negligence in the first discussion document.
16. This was classified as gross negligence in the first discussion document.

Table 1: Proposed Breaches and Penalties

BREACH	PENALTY		ADJUSTED PENALTY		
			VOLUNTARY DISCLOSURE		
Culpable behaviour	Primary penalty	If hindrance[14] 25% increase	Before audit 75% reduction	During audit 40% reduction	If disclosure on filing return 75% reduction
Lack of reasonable care[15]	20% (25%)	25 %	5 % (5%)	12% (20%)	n/a
Gross carelessness[16]	40% (100%)	50 %	10 % (20%)	24% (80%)	n/a
Lack of reasonably arguable position	20% (25%)	25 %	5 % (5%)	12% (20%)	5% (n/a)
Abusive tax avoidance	100% (125%)	125 %	25 % (25%)	60% (100%)	25% (n/a)
Tax evasion	150% (150%)	187.5%	37.5% (30%)	90% (120%)	n/a

the IRD and taxpayers was issued.[17] The proposals on compliance and penalties in the second discussion document will therefore be interpreted in conjunction with the outcome of this process. The general requirements for the imposition of the two classes of penalties may be evaluated in the manner set out in Table 2:

Table 2: Penalties for Civil and Criminal Offences: General Requirements

	Civil	*Criminal*
Imposed by:	Commissioner	Courts
Onus of proof on:	Taxpayer	Commissioner
Standard of proof:	Balance of probabilities	Beyond reasonable doubt
Nature of penalty:	Monetary	Fines and/or imprisonment

The Government proposes not to shift the onus of proof from the taxpayer to the Commissioner in respect of civil penalties, in spite of concern that with the increased standards expected of taxpayers, satisfying this onus will be very difficult and in some instances, impose excessive compliance costs on taxpayers. Where an entity is not the taxpayer, then special rules will be applied. For partnerships, each partner will be liable for the shortfall penalties on the shortfall attributable to each partner, with the position taken by the partnership pertinent to ascertaining the reasonably arguable position test. For trusts, since the trust is a separate legal entity, the tax shortfall will be imposed on trustee income and penalties on the trustees. Joint venturers on the other hand, will be liable for any shortfall as independent parties, with expenses and income normally distributed on a *pro rata* basis.

I. Criminal penalties

Existing problems with the criminal penalties regime are readily acknowledged by the Government and it intends to remedy these deficiencies in the following manner. The TAA 1994 will aggregate and consolidate offences across all types of taxes. Certain offences will be removed because of the introduction of new civil sanctions. Penalties will, in other situations, be increased to act as an effective deterrent, with five years imprisonment introduced as a maximum penalty for evasion (with or without a fine). Monetary penalties will be increased up to $ 50,000 for an offence. Certain offences will constitute an offence of absolute liability, that is, no *mens rea* (mental element) is required and in certain circumstances, there will not be an absence of fault defence.

Other offences will require knowledge before there can be liability. Aiding and abetting another person to commit an offence will now be a general offence across all tax types. Obstruction of an Inland Revenue officer is to be introduced as an offence, with vicarious liability introduced where an officer of a corporate body commits an offence. The proposed regime for criminal offences and penalties appears in Table 3:

Table 3: Proposed Criminal Offences and Penalties

PROPOSED REGIME FOR CRIMINAL OFFENCES AND PENALTIES

OFFENCE	PENALTY ON CONVICTION
Absolute Liability Offences: • Failing to keep the required books, documents and other records • Failing to furnish returns or provide information • Failing to register for GST.	First conviction – fine not exceeding $ 4,000 Second conviction – fine not exceeding $ 8000 Third and subsequent convictions – fines not exceeding $ 12,000.
Knowledge Offences: • Knowingly failing to keep the required books, documents and other records • Knowingly failing to furnish returns or provide information • Knowingly providing false, altered, incomplete or misleading returns or information • Knowingly failing to make "withholding tax" deductions – for example PAYE, NRWT, RWT • Knowingly issuing two GST invoices in respect of the same taxable supply	First conviction – fine not exceeding $ 25,000 Second and subsequent convictions – fines not exceeding $ 50,000. (In respect of each conviction for information or disclosure offences relating to the international tax regime, a fine not exceeding $ 50,000).
• Knowingly making "withholding tax" deductions but failing to pay them over to the IRD and instead applying the deductions for other purposes.	In respect of each conviction, a prison term not exceeding five years, a fine not exceeding $ 50,000, or both.
Evasion or Theft: • Evading or attempting to evade the assessment or payment of tax • Obtaining a tax refund or credit for which the taxpayer knows they are not entitled • Assisting any other taxpayer in the above.	In respect of each conviction, a prison term not exceeding five years, a fine not exceeding $ 50,000, or both.
Aiding and Abetting: • Aiding and abetting a person to commit an offence.	Same penalty as may be imposed on the person aided and abetted
Obstruction: • Obstructing an IRD officer in the exercise of their duties.	First conviction – fine not exceeding $ 25,000 Second and subsequent convictions – fines not exceeding $ 50,000.

17. New Zealand Government, *Resolving Tax Disputes: Proposed Procedures*, (Wellington, Government Printer, 1994).

There will be informal sanctions for several offences, although not to the extent as recommended in the literature. See Figure 3[18]:

Figure 3: Offences for which Informal Sanctions are proposed

- A breach for which a civil shortfall penalty for evading the payment of tax is imposed;
- A breach for which a civil shortfall penalty for abusive tax avoidance is imposed;
- A criminal offence of tax evasion;
- A criminal offence of knowingly failing to make a tax deduction when required to do so; and
- A criminal offence of failing to account for tax deductions.

J. Interest

Where underpayments or overpayments arise, the interest provisions will be extended to apply to all taxes and duties in a consistent manner. The imposition of interest is not a penalty but a mechanism which the Government believes will act to *restore the equality between taxpayers so as to remove the advantages or disadvantages that taxpayers experience when they have not paid the correct amount of tax by the due date.* Following the first discussion document and submissions directed at ensuring a simple interest regime, and with a view to minimizing compliance costs, the proposed regime is not overly complex. Interest will be calculated on a daily basis from the later of; the due date, or the date when the return is filed, and charged on the difference between the amount of tax paid and that assessed. It will not be compounded or subject to the late payment penalty; that is, it will be separately identifiable to the tax and other penalties which are due, thus making the interest calculation relatively straightforward. The interest will constitute, as appropriate, a deductible expense (subject to normal criteria) or assessable income for taxpayers, utilizing the current timing provisions of the Income Tax Act. Taxpayers will not be able to object to the imposition and calculation of the interest charged. Limited provision for the remission of the interest will be provided and interest will not be charged where the amount of tax is small (less than $ 100).

The rates will reflect a differential, with the rate for overpayments based on market rates and for underpayments on the Government's cost of funds. Each of these rates will be set six-monthly by Order in Council. This regime will also apply to tax in dispute, with respect to the amount of deferrable tax where this is subsequently found to be due to the IRD, or that which is paid, and subsequently found refundable to the taxpayer. Nevertheless, on appraising the proposed differential, it is blatantly unfair as although the Government will be entitled to recover its cost of funds on underpayments, taxpayers will not be afforded this "luxury" where they have made overpayments. A taxpayer's cost of funds will frequently exceed that of the market rate for short-term funds, especially when the risk premium the taxpayer faces is considered. The interest mechanism in this regard may well have the effect of generating additional revenue for the government.

Whenever a payment is made by a taxpayer who has outstanding tax and interest liabilities, it is first set off against the interest element. The implementation of the interest regime will be delayed until 1 April 1997, to ensure that computer facilities and trained staff are in place, and that educational material can be provided to all taxpayers.

K. Remission of penalties

Remission by the Commissioner of civil penalties (shortfall penalties, late filing penalties, and late payment penalties) and interest will be permitted if:
"*the Commissioner is satisfied that the remission is consistent with the Commissioner's duty to collect over time the highest net revenue that is practicable within the law.*"[19]

Where the contention is over the reasonable care test, remission may occur if the failure was due to a reasonable cause beyond the taxpayer's control and the taxpayer acted to mitigate the circumstances through taking action to remedy the default as soon as practicable.[20] Reasonable cause has been defined as including accident, disaster or other circumstances beyond the taxpayer's control, or emotional and mental stress or other illness experienced by the taxpayer.[21] However, reasonable cause does not include an act or omission of a tax adviser or agent of the taxpayer, or the taxpayer's financial position.[22] The taxpayer's financial position may nevertheless be relevant in arriving at instalment arrangements with the Commissioner. Where departmental error was the cause, or an honest mistake was made by the taxpayer, then remission may only occur if this is in keeping with the Commissioner's duty to collect the highest net revenue over time. Where a taxpayer seeks to utilize instalment arrangements, then there will be reductions in penalties provided the taxpayer adheres to the terms of the arrangement. One situation where interest may be cancelled is when retrospective legislation is introduced.

L. Tax advisers

In the first discussion document there was some effort made to raise the standards expected of tax advisers. This was to be effected by limiting the ability of tax advisers to contract out of their liability for negligent tax advice and by imposing liability for aiding and abetting the putting into place of an abusive tax avoidance arrangement. These proposals have been

18. For a recent discussion on the effectiveness or otherwise of informal sanctions, see G. R. Violette (1989), "Effects of Communicating Sanctions on Taxpayer Compliance", 11 *The Journal of the American Taxation Association*, at 92; and within New Zealand, D. J. Hasseldine and S. E. Kaplan (1992), "The Effect of Different Sanction Communication on Hypothetical Taxpayer Compliance: Policy Implications from New Zealand", 47 *Public Finance*, at 45. These studies provide support for the use of informal sanctions such as the publication of names of taxpayers who have been in breach of their obligations under revenue statutes, especially in the context of tax evasion.
19. Sec. 51 of the draft legislation.
20. See Sec. 48(1).
21. Sec. 48(2).
22. Sec. 48(3).

dropped following some submissions (predominantly those of tax advisers). Taxpayers will therefore be left to utilize other legal means to seek redress against tax advisers where they have suffered from negligent advice.[23] The only concession to this about-face is that the activities of agents and their aiding and abetting of abusive avoidance activity will be monitored by the Government.

As pointed out by this author in an earlier article,[24] there was a failure to consider the United States provisions concerning tax advisers in the first discussion document. Unfortunately the second discussion document has not remedied this omission. Taxpayers will therefore remain primarily liable and the only "control" on the activities of tax advisers, other than market forces, will be their ethical attitudes and professional affiliation requirements.

III. DRAFT LEGISLATION AND COMMENTARY

The second part of the discussion document contains the proposed legislative changes giving effect to the new standards of compliance and penalties. It will be included eventually as part of the TAA 1994,[25] providing a generic blueprint for the administration of all the revenue statutes. The draft legislation sets out only the core provisions and does not attempt to quantify the subsequent amendments to other sections which will be necessary following the proposed changes.

A. Preliminary

The draft legislation commences by setting out the scope of the new provisions, and then provides definitions of essential terms in a coherent and logical manner. This includes an interpretation section, designed to provide guidance on how certain provisions should be applied, along with commonly used shortened expressions.

B. Taxpayers' tax obligations

The second part of the draft legislation sets out the taxpayers' obligations. Essentially taxpayers will be required to:

(i) correctly determine the amount of tax payable by them under the law;
(ii) deduct or withhold the correct amount of taxes as required under the law;
(iii) pay tax on time;
(iv) keep all necessary information and maintain accounts and balances as required under the law;
(v) disclose to the Commissioner in a timely manner all the information he is entitled to under the law;
(vi) cooperate with the Commissioner so as to assist in the exercise of the Commissioner's powers under the law; and
(vii) comply with all other obligations imposed on taxpayers under the law (the "catch all" provision).

C. Court orders

This part of the draft legislation sets out succinctly the type and nature of Court orders available to the Commissioner to force taxpayers to meet their obligations. Included in the draft legislation, is provision for the situation where legal professional privilege is raised.

D. Interest

The fourth part of the draft legislation provides for the new interest regime. It is intended to compensate taxpayers and the Commissioner for loss of the use of money, and to encourage taxpayers to pay the correct amount of tax on time. However, as indicated earlier, the proposed differential in rates creates an imbalance in favour of the Commissioner, making it expensive for taxpayers not to pay the correct amount of tax on time. Interest payable by the taxpayer to the Commissioner is given priority over any tax payments, which implies that payments which the taxpayer may believe are tax payments will in fact first be used to reduce interest liabilities if these exist.

E. Obligation to pay when objection lodged

This part of the draft legislation restates the existing obligations as to payment when there is an objection outstanding to an assessment. It will be subject to future review in order to ensure that the final version is compatible with the proposed new disputes resolution procedures. As noted above, the disputes resolution procedures are also currently under review.

F. Penalties

The largest section in the draft legislation sets out the civil and criminal penalties, providing a discussion on the nature of each penalty, when it is to be imposed, the applicable rate, and any increases or decreases to the standard rate depending upon whether there was hindrance by the taxpayer or voluntary disclosure. The language is clear and should assist taxpayers in ascertaining the relevant penalty that may apply to them. However the penalties, when viewed collectively, reflect the harsher regime and will require higher standards of compliance from taxpayers if they wish to avoid their imposition.

23. The issue of penalties for return preparers has been subject to criticism in the Australian context recently with proposals to introduce penalties on tax agents responsible for tax return preparation put "on hold". See for example, Oats, L., Pinto, D. and Sadler, P., "Tax Returns: Penalties for Preparers", *Taxation in Australia* (Red edition), October (1994), at 82.
24. Sawyer, A.J., op. cit. note 1, at 661.
25. Currently the draft legislation is contained in the generically titled *Taxpayer Compliance, Standards and Penalties Act 1995*.

G. Remissions and cancellations

Procedures dealing with the remission and cancellation of penalties are contained in Part VIII of the draft legislation. The draft legislation sets out the reductions in penalties where there has been a voluntary disclosure and the situation where an automatically imposed penalty will be reduced, consequent to a finding that the taxpayer had a reasonable cause, by way of defence to the action or omission. Furthermore, a reduction in the penalty may occur; where instalment arrangements have been entered into, where objection procedures are under way, where the collection of the highest net revenue over time concept is employed, where refunds are due to the taxpayer and where the de minimis rule for small amounts of tax are relevant. To be entitled to be considered for remission, the taxpayer must write to the Commissioner requesting that the penalty or interest be remitted or cancelled. In addition, all information that the Commissioner requires in relation to this request must be supplied.[26]

IV. PRACTICAL EXAMPLES

The second discussion document provides three examples of how the Government perceives the proposed regime should work. The examples are reproduced in this section with corrections and additional comments added for further elucidation of the underlying principles.[27] The assumed rates of interest are 12 percent per annum payable to the Commissioner (deductible under normal criteria) and 5 percent per annum payable by the Commissioner to the taxpayer (assessable on the taxpayer).

A. Civil culpability penalties imposed on a medium-sized company after a multiple revenue audit

A medium-sized company is audited for income tax (year ended 31 March 1998), goods and services tax (six two-monthly periods from the period ended 31 May 1997) and fringe benefit tax (four quarters commencing with the quarter ended 30 June 1997). A number of discrepancies have been discovered and culpability penalties imposed.

Income Tax shortfalls liable to penalties

During the audit the following discrepancies were found:

	Income ($)	Tax rate (%)	Tax discrepancy ($)
Creditors overstated	100,000	33	33,000
Depreciation over claimed	10,000	33	3,300
Debtors overstated	(50,000)	33	(16,500)
	60,000		19,800

It was established that the overstatement of creditors was due to a lack of reasonable care by the company, and that the over claiming of depreciation was due to gross carelessness. The penalty for each breach is determined as follows:

Breach	Tax Discrepancy ($)	Credit[28] Adjustment ($)	Tax Shortfall[29] ($)	Penalty Rate[30] (%)	Penalty ($)
Lack of reasonable care	33,000	(15,000)	18,000	20	3,600
Gross carelessness	3,300	(1,500)	1,800	40	720
TOTALS	36,300	(16,500)	19,800		4,320

Goods and Services Tax shortfalls liable to penalties

During the audit the following adjustments were found to be necessary:

	Value of supply ($)	GST discrepancy ($)
Private expenditure (disallowed)	90,000	10,000
Input credit disallowed (zero-rated)	20,000	2,222
	110,000	12,222

The GST discrepancy covers the six two-monthly periods during the audited tax year. The company is considered not to have taken reasonable care in calculating the GST liability and so is liable to a shortfall penalty of 20 percent. The penalty is calculated as follows:[31]

Breach	Tax Discrepancy ($)	Credit[32] Adjustment ($)	Tax Shortfall[33] ($)	Penalty Rate[34] (%)	Penalty ($)
Lack of reasonable care	10,000		10,000	20	2,000
Gross carelessness	2,222		2,222	40	889
TOTALS	12,222		12,222		2,889

The tax shortfall was the same for each GST period, so each period is assessed on a tax shortfall of $ 2,037 ($ 12,222 / 6). The penalty for lack of reasonable care breach is $ 333 ($ 2,000 / 6) and for gross carelessness $ 148 ($ 889 / 6).

26. Clause 55 of the draft legislation.
27. Cents have been omitted or rounded to the nearest dollar.
28. For the purposes of calculating penalties, amounts are allocated between credit adjustments and tax shortfalls by taking into account the tax effect of an overstatement (Sec. 24(6)). Accordingly, the overstated debtors resulted in a credit of $ 16,500 which is prorated as follows:
$ 33,000/$ 36,300 x $ 16,500 = $ 15,000; and
$ 3,300 / 36,300 x $ 16,500 = $ 1,500.
29. This is the amount on which penalties are calculated.
30. The penalty for lack of reasonable care is 20% of the tax shortfall (Sec. 25(2)), and the penalty for gross carelessness is 40% of the tax shortfall (Sec. 27(2)).
31. This table has been corrected to remove the errors in the first discussion document (the gross carelessness penalty rate is 40%, and this rate is assumed to apply to the input tax credit disallowed as a result of the treatment in the penalty calculation table).
32. There are no credit adjustments because the taxpayer had not made any overstatements of GST.
33. This is the amount on which penalties are calculated and has been corrected for the gross carelessness penalty which is 40 percent, not using 20 percent as appears in the second discussion document.
34. See *supra* note 30.

Fringe Benefit Tax (FBT) shortfalls liable to penalties

During the audit it was found that the company had failed to account for FBT on two highly-priced cars that it owned and made available for private use. The tax authorities made the following adjustments:

	Taxable value ($)	FBT rate (%)	FBT discrepancy ($)
Cars available for private use	100,000	49	49,000

The FBT discrepancy covers the four quarters of the audited tax year. As the tax shortfall for each quarter $ 12,250 ($ 49,000 / 4) was in excess of $ 10,000 or 1% of the total tax as returned by the company, it was required to have a reasonably arguable position. The company failed that test and so is liable to a penalty for lack of a reasonably arguable position[35]:

Breach	Tax Discrepancy ($)	Credit Adjustment ($)	Tax Shortfall ($)	Penalty Rate (%)	Penalty ($)
Lack of reasonably arguable position	49,000	-	49,000	20	9,800

The tax shortfall was the same in each FBT period. Accordingly, each period will be assessed with a tax shortfall of $ 12,250 ($ 49,000 / 4). Similarly the penalty will be divided equally over each of the four quarters at $ 2,450.00 ($ 9,800 / 4).

Tax shortfall penalties arising from the audit

Notices of assessment will be issued to the company for tax shortfalls and penalties. These amounts will be due, along with the interest on shortfalls, two months after the issue of the reassessment. The interest will be calculated from the original due date for payment of the tax. The shortfall penalties due are:

Income Tax	$ 4,320
Goods and Services Tax	$ 2,889
Fringe Benefit Tax	$ 9,800
	$ 17,009

Interest and late payment penalties

The following sets out the late payment penalties and interest calculations relating to the income tax portion of the company's affairs. (Similar calculations would apply to the FBT and GST discrepancies.)[36] Interest will be calculated from the time the tax shortfall for income tax was originally due, 7 February 1999, until the date the amended notice of assessment is issued, 30 November 1999 (296 days). The amount of tax on which interest is charged ("the unpaid tax") is $ 19,800, being the difference between the tax payable on the original due date and the tax paid. The amount of interest shown on the amended notice of assessment would be: $ 19,800 x 296 / 365 days x 12% = $ 1,927.

If the taxpayer pays the tax shortfall ($ 19,800), the shortfall penalty ($ 4,320) and interest ($ 1,927), by the new due date (30 January 2000) no further charges will accrue. The legislation provides that if the tax, penalties and interest are paid by the new due date, the interest for the period between the issue of the notice of assessment and the due date is cancelled. Details of the amounts to be paid are then shown in a statement of account dated 30 November 1999:

STATEMENT OF ACCOUNT

		Debit	*Credit*	*Balance*
30/11/99	Tax shortfall	$ 19,800		$ 19,800 DR
30/11/99	Shortfall penalty	$ 4,320		$ 24,120 DR
30/11/99	Interest	$ 1,927		$ 26,047 DR

Assume the same facts as previously, but that in this instance the company did not meet the two month deadline, choosing instead to defer payment to 15 April 2000. As the company did not pay the tax shortfall and penalties by the due date, so interest continues to accrue from the day the amended notice of assessment was issued (30 November 1999) to the date payment is made. Late payment penalties are also charged on the tax shortfall and penalties from 31 January 2000. The late payment charges are:

		Debit	*Credit*	*Balance*
30/11/1999	Tax shortfall	$ 19,800		$ 19,800 DR
30/11/1999	Shortfall penalty	$ 4,320		$ 24,120 DR
31/1/2000	5% Late payment penalty (LPP)	$ 1,206		$ 25,326 DR
28/2/2000	2% (LPP)	$ 507		$ 25,833 DR
31/3/2000	2% (LPP)	$ 517		$ 26,350 DR

Interest calculations after the due date are:

$ 24,120 x 61 days (1/12/99 – 30/1/2000)/365 x 12% =	$ 484
$ 25,326 x 28 days (31/1/2000 – 27/2/2000)/365 x 12% =	$ 233
$ 25,832 x 31 days (28/2/2000 – 30/3/2000)/365 x 12% =	$ 263
$ 26,349 x 16 days (31/3/2000 – 15/4/2000)/365 x 12% =	$ 139
	$ 1,119

The total interest charge to 15 April 2000, is therefore, $ 3,046.[37] This is shown in the following statement of account:

35. Sec. 26 of the draft legislation.
36. These calculations are not provided in the second discussion document examples but similar principles to the income tax discrepancies example apply.
37. Interest to 30 November 1999, of $ 1,927 and interest from that date to 15 April 2000, of $ 1,119.

STATEMENT OF ACCOUNT

		Debit	Credit	Balance
30/11/99	Tax shortfall	$ 19,800		$ 19,800 DR
30/11/99	Shortfall penalty	$ 4,320		$ 24,120 DR
31/1/2000	LPP	$ 1,206		$ 25,326 DR
28/2/2000	Incremental LPP	$ 507		$ 25,833 DR
31/3/2000	Incremental LPP	$ 517		$ 26,320 DR
15/4/2000	Interest	$ 3,046		$ 29,396 DR

B. Penalties and interest imposed on an employee for late filing and late payment

The second example provides an illustration of how an employee may be affected by the new regime. The taxpayer earned less than $ 100,000 total income for the year ended 31 March 1998. The taxpayer is liable to pay residual income tax of $ 249 and is required to file the 1998 income tax return by 7 June 1998. The taxpayer fails to file a return even after receiving a letter from the Commissioner in November 1998 requesting the return to be filed, and is, therefore liable to pay a late filing penalty.[38] The return is finally furnished on 5 May 1999.

Because the taxpayer failed to pay the residual income tax by 7 February 1999, he will be charged late payment penalty and interest. The late filing penalty will be included in the amount on which interest and penalties is calculated.[39] A statement of account issued on 6 June 1999, would include the following details:

STATEMENT OF ACCOUNT

		Debit	Credit	Balance
5/5/99	Terminal tax	$ 249		$ 249 DR
7/2/99	Late filing penalty	$ 50		$ 299 DR
8/2/99	LPP	$ 15		$ 314 DR
8/3/99	Incremental LPP	$ 6		$ 320 DR
8/4/99	Incremental LPP	$ 6		$ 326 DR
8/5/99	Incremental LPP	$ 7		$ 333 DR
6/6/99	Interest	$ 12		$ 345 DR

Interest is calculated as follows:

$ 314 x 28 days (8/2/99 – 7/3/99)/365 x 12% =	$ 3
$ 320 x 31 days (8/3/99 – 7/4/99)/365 x 12% =	$ 3
$ 327 x 30 days (8/4/99 – 7/5/99)/365 x 12% =	$ 3
$ 333 x 30 days (8/5/99 – 6/6/99)/365 x 12% =	$ 3
	$ 12

C. Penalties and interest imposed on an employer for late payment and overpayment of PAYE tax deductions

The taxpayer is an employer who pays less than $ 100,000 in PAYE tax deductions per year. Therefore the taxpayer is required to furnish employer deduction forms IR66Ns on a monthly basis.[40] In this example the PAYE periods for the financial year from 1 April 1998, to 31 March 1999, are considered. For some periods, the total amounts shown on the IR66Ns were not paid by the due date, so a late payment penalty and interest apply. However, for the November period the taxpayer had a credit balance resulting from an overpayment, so credit interest will be paid to the taxpayer on this overpayment.

The employer failed to make payment of the April, June and July 1998 PAYE deductions by the due dates of 20 May, 20 July and 20 August 1998, respectively. As a result, interest and late payment penalties were imposed on the amount outstanding in each period,[41] except for the June 1998 period. The reason that interest was not payable for the June 1998 period was the fact that the tax outstanding for this period was less than the $ 100 threshold, and therefore interest and late payment penalties do not apply.[42] A statement of account was issued to the employer on 28 September 1998, showing the following details:

STATEMENT OF ACCOUNT

		Debit	Credit	Balance
April 1998 Period				
20/5/98	Assessment	$ 500		$ 500 DR
21/5/98	LPP	$ 25		$ 525 DR
21/6/98	Incremental LPP	$ 11		$ 536 DR
21/7/98	Incremental LPP	$ 11		$ 547 DR
21/8/98	Incremental LPP	$ 11		$ 558 DR
21/9/98	Incremental LPP	$ 11		$ 569 DR
28/9/98	Interest	$ 23		$ 592 DR
June 1998 Period				
20/7/98	Assessment	$ 750		$ 750 DR
18/7/98	Payment		$ 665	$ 85 DR
July 1998 Period				
20/8/98	Assessment	$ 935		$ 935 DR
5/8/98	Payment		$ 500	$ 435 DR
21/8/98	LPP	$ 22		$ 457 DR
21/9/98	Incremental LPP	$ 9		$ 466 DR
28/9/98	Interest	$ 6		$ 472 DR

Interest imposed in respect of the April and July periods is calculated as follows:

April 1998 Period:

$ 525 x 31 days (21/5/98 – 20/6/98)/365 x 12% =	$ 5
$ 536 x 30 days (21/6/98 – 20/7/98)/365 x 12% =	$ 5
$ 546 x 31 days (21/7/98 – 20/8/98)/365 x 12% =	$ 6
$ 557 x 31 days (21/8/98 – 20/9/98)/365 x 12% =	$ 6
$ 568 x 8 days (21/9/98 – 28/9/98)/365 x 12% =	$ 1
	$ 23

July 1998 Period:

$ 456 x 31 days (21/8/98 - 20/9/98)/365 x 12% =	$ 5
$ 466 x 8 days (21/9/98 - 28/9/98)/365 x 12% =	$ 1
	$ 6

38. Sec(s). 22(1) and (2).
39. Sec. 23(1).
40. Sec. NC15 of the Income Tax Act 1994.
41. Sec(s). 9 and 23 of the draft legislation.
42. Sec. 53.

The employer paid these arrears on 7 October 1998, including additional interest calculated up to that date for both the April and July periods. On 19 December 1998, the taxpayer overpaid the PAYE tax deductions for the November 1998 period. Credit interest was paid on this overpayment from 21 December 1998, (being the day after the due date for payment of the November PAYE tax deductions) until the date of refund on 16 January 1999. A notice of refund dated 16 January 1999, issued to the taxpayer contained the following details:

NOTICE OF REFUND

		Debit	*Credit*	*Balance*
November 1998 Period				
20/12/98	Assessment	$ 675		$ 675 DR
19/12/98	Payment		$ 1,000	$ 325 CR
16/1/99	Interest		$ 1	$ 326 DR
16/1/99	Refund	$ 326		$ 0

Credit interest = $ 325 x 27 days (21/12/98 – 16/1/99)/365 x 5% = $ 1.

V. CONCLUSIONS

The second discussion document emphasizes the importance of making submissions on Government policy, it also demonstrates the fact that consultation with taxpayers may lead to more workable legislation. The consultation procedure has led to the reduction in most of the proposed civil penalty rates from those proposed in the first discussion document. The twelve-month delay in implementing the new reforms has received overwhelming support, since it will enable taxpayers and their advisers sufficient time to prepare for the new regime. Nevertheless with the commencement date 1 April 1997, there is no room for complacency; transactions entered into now are likely to be subject to the new regime's standards and penalties. The importance of forward planning cannot be overemphasized.

Documentation to support action taken will be imperative, particularly in the context of the mitigation of the severe penalties for failing to take reasonable care (or exhibiting gross carelessness), or not having a reasonably arguable position. Familiarity with the legal standard of reasonableness will need to be central to the activities of each taxpayer. Every taxpayer should be intricately aware of what would be expected of a reasonable taxpayer with their level of skill and knowledge. It also remains to be seen whether there will be a tax amnesty to precede the new penalties regime.[43]

A new environment for taxpayers and their advisers is dawning in New Zealand. This has implications not only for New Zealand taxpayers and advisers, but also for overseas taxpayers conducting business in New Zealand. The proposed measures will bring New Zealand's taxpayers closer to the standards expected of taxpayers in many other jurisdictions, especially Australia (New Zealand's closest neighbour), where the reasonable care and reasonably arguable position (or case) tests have been implemented in recent years. Differences between the penalty rates applicable in Australia and as proposed for New Zealand will exist, although these differences are relatively minor and relate predominantly to the penalties applying to the more serious offences such as evasion and tax avoidance.[44]

43. A common practice is to have a tax amnesty preceding a move to more stringent penalties; see for example Hasseldine, J., "Increasing Voluntary Compliance: The Case of Tax Amnesties" (1989) 6 *Australian Tax Forum*, at 509.
44. See for example Stone, P., "Taxation", 67 *The Australian Law Journal*, (1993) February at 152; and Still, D., "The New Self-Assessment Regime: Part II", *The CCH Journal of Australian Taxation*, (1993) October/November, at 4.

UNITED STATES

Copyright Law and Certain Tax Treatment of Software Transactions

Jon A. Baumgarten, Prof. Robert A. Gorman and Eric J. Schwartz

Jon A. Baumgarten is former General Counsel of the US Copyright Office and a partner in Proskauer Rose Goetz & Mendelsohn, LLP. **Prof. Robert A. Gorman** is co-author of *Copyright for the Nineties*, Gemmill Professor of Law at the University of Pennsylvania Law School, and Consultant to the Proskauer firm. **Eric J. Schwartz** is former Acting General Counsel of the US Copyright Office, former Senior Policy Planning Advisor to the Register of Copyrights, and Special Counsel to the Proskauer firm.

I. BACKGROUND

Currently a revenue ruling is sought from the Internal Revenue Service (IRS) regarding the proper characterization of certain transfers of copyrighted computer software for federal tax purposes. If the ruling is accepted, revenue from the following paradigm transactions would be characterized as proceeds from the sale of a product for federal income tax purposes:

> Computer programs are transferred to end users (or to distributors for retransfer to end users) subject to restrictive license or user agreements and generally are packaged together with user manuals. The programs facilitate the performance by end users of certain functions (e.g. word processing, spreadsheets, scheduling, calculations, payroll functions, factory management, engineering modelling, etc.). Typically, the programs are embodied in tangible media that are transferred to end users for an up front lump-sum payment for a single copy. In other cases, however, other methods of delivery (e.g. local area networks,[1] site licenses,[2] or electronic transmission[3]) are used to transfer programs to end users. The restrictive license or user agreements restrict the end user to use of the program for internal purposes only and prohibit the end user from exploiting the underlying copyright on the market. The general prohibition on exploiting the underlying copyright on the market typically includes, but is not limited to, a specific prohibition on the following activities: decompilation, decryption, disassembly, reverse engineering, and copying for unauthorized use or for distribution. Depending on the method of delivery involved, specified copying for internal use may be authorized (e.g. in the case of delivery of a single copy, copying for archival purposes would be authorized, and in the case of delivery of a site license, copying for use by persons at the defined site and for archival purposes would be authorized).

An argument against this ruling would instead characterize these revenues, as royalties from a licence. The underlying reason for putting forward such an argument is largely the fear that the proposed ruling would be treated as precedent in certain copyright law contexts involving software transactions; and would inadvertently permit certain undesirable activities under sections of the Copyright Act and in contravention of the paradigm end user agreements.[4] For the reasons given in this paper, we do not agree with this thesis. There is no reason to expect that any IRS revenue ruling or other tax treatment or authority will or should carry any weight in a copyright law dispute. Copyright law has its own set of policy principles for the treatment of transfers of both physical copies and the underlying copyright itself. These principles have no bearing on, and should not be affected by, policy considerations governing tax law. Additionally, the proposed ruling will not undermine contractual agreements.

II. COPYRIGHT PRINCIPLES

Computer programmes are protected under United States copyright law as "literary works", the same as books, periodicals or manuscripts.[5] There is not a separately enumerated category of work for computer programmes. This approach, well established by administrative and legislative history and case law,[6] has now been emulated by the copyright laws in a

Editorial Note

The views expressed in this article are those of the Business Software Alliance and the Software Coalition. In the Editor's opinion the paper represents an important contribution to the analysis of the intellectual property ramifications of the software revenue characterization tax issue, including the proposed IRS ruling.

1. Local area network arrangements transfer to the end user the right to download or copy a programme, which may have been obtained (subject to licence) by any of the methods described above and in notes 3 and 4, onto a server which can be accessed by a number of persons at a certain location.
2. Site licences permit the end user to reproduce the programme, which may have been obtained (subject to licence) by any of the methods described above and in notes 2 and 4, at a specified site, in exchange for a fixed amount or a fixed amount per additional copy.
3. Through electronic transmission, programmes can be delivered electronically without the need for any tangible media.
4. See generally, e.g. Knowledge and Technology Transfers to and from the United States, Characterization of Transfers of Computer Software, Melvin S. Adess and Barbara M. Angus, 47 *Bulletin for International Fiscal Documentation*, 7/8 (1993), at 414.
5. 17 U.S.C. Sec. 102(a)(1).
6. See Melville B. Nimmer & David N. Nimmer, 1 *Nimmer on Copyright*, Sec. 2.04[C], at 2-51 (1994) (hereinafter "*Nimmer*") ("Computer Data Bases and Programs").

majority of countries. In addition, the United States in many bilateral and multilateral agreements (such as the newly revised General Agreement on Tariffs and Trade) is obligated to uphold the treatment of computer programmes "as literary works" in its domestic copyright law.[7] Indeed, the treatment of programmes fully as literary works has become a centrepiece of this country's foreign policy concerning intellectual property.

This characterization is consistent with the history of computer programme protection under copyright law. The United States Copyright Office accepted copyright registrations of computer programmes as literary works in 1964, long before there was any reference to computer programmes anywhere in the statute or legislative history. This decision was later explicitly endorsed by references to "computer programs" in the legislative reports accompanying the 1976 Copyright Revision Act. It was again reiterated when incorporated into the Copyright Code in 1980 *vis à vis* the definition of a "computer program" based on the recommendations of the National Commission on New Technological Uses of Copyrighted Works (CONTU).[8]

All pertinent copyright rules, including those dealing with transfers by sales and licences, are precisely the same for all literary works (with immaterial exceptions to be noted below). Their treatment for tax purposes is therefore altogether irrelevant to copyright disputes. Even if the IRS or other tax authorities distinguish transactions in computer programmes from those applicable to other literary works, there is no reason for courts resolving copyright disputes to depart from this fundamental and long-standing treatment.

While copyright law does not distinguish between the transfer of the different subject matters of copyright, it *does* make a crucial distinction between the transfer of copies of a work and transfer of the exclusive rights of copyright. One of the fundamental principles of copyright law is the distinction between ownership of copyright and ownership of the tangible object, i.e. the "copy" in which the work is embodied.[9] This necessitates a different analysis to determine whether to characterize a particular transfer involving physical copies as a sale or licence of those copies, from the analysis used to characterize the transfer of the copyright owner's exclusive rights under copyright law. Thus, for example, the fact that a book embodying a traditional literary work or a disc embodying a computer programme is the subject of a sale does not of itself impair the rights of the copyright owner. As a corollary, the fact that copyright interests are expressly reserved, does not mean that the transfer of ownership of the copy is less than a sale.

The revenue ruling pending before the IRS, is focused on the characterization of the transaction involving physical copies of computer programmes; regardless of whether, as described in the paradigm above, programmes are delivered directly, by authorization for replication, by electronic transmission, or by a combination of these methods. The copyright owner maintains exclusive rights in the underlying copyrighted work which are distinct from the ownership of the material object. This is the case irrespective of whether a physical copy is sold or licensed. Thus the copyright owner retains important controls over reproduction and other uses of the computer programme, even when copies of the programme are sold, licensed or otherwise transferred. The exceptions to this rule are the limited statutory prerogatives for redistribution allowed under the first sale doctrine (Section 109), and the narrow exception for making back-up and execution copies (Section 117). The availability of these provisions depends on the characterization of the transfer, not of the copyright but of copies of the work, as determined by the principles, criteria, and analysis of copyright law. Tax law is irrelevant to these considerations.

Section 109, the first sale doctrine, exhausts the copyright owner's exclusive right to distribute a work in certain instances. It states that:

> the owner of a particular copy or phonorecord lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy...[10]

The ownership essential to the application of Section 109 requires a transfer of title to copies of the work.[11] In order to determine whether a particular transaction is such a conveyance of title, the courts in copyright cases look to the terms of the relevant agreement,[12] an interpretative process that properly takes no account of tax determinations. The courts will continue to follow this approach regardless of any IRS characterization based on tax law criteria. In *Hampton v. Paramount Pictures Corp.*,[13] a purchaser of film prints was

7. See Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) of the Uruguay Round Agreements, Art. 10 ("Computer Programs and Compilations of Data") which reads:

(1) Computer programs, whether in source or object code, shall be protected as literary works under the Berne Convention (1971).

See also North American Free Trade Agreement Between the Government of the United States of America, The Government of Canada and The Government of the United Mexican States (1993), Part Six, Intellectual Property, Chapter Seventeen, Art. 1705: Copyright, which reads:

(1) Each Party shall protect the works covered by Article 2 of the Berne Convention...[i]n particular:

(a) all types of computer programs are literary works within the meaning of the Berne Convention and each Party shall protect them as such....

8. Pub.L. 96-517, 94 Stat. 3015.

9. 17 U.S.C. Sec. 202.

10. 17 U.S.C. Sec. 109(a). It is clear that Sec. 109 does not apply to "someone who merely possesses a copy or phonorecord without having acquired ownership of it". H.R. Rep. No. 94-1476, 94th Cong., 2d Sess. (1976) at 80, reprinted in 1976 U.S.C.C.A.N., 5659. See also 17 U.S.C. Sec. 109(d).

The first sale doctrine also does not apply to those who seek to dispose of their copies "for the purposes of direct or indirect commercial advantage...by rental, lease or lending". 17 U.S.C. Sec. 109(b)(1)(A). (There is a separate exclusion from this exception for certain uses by non-profit libraries of computer programmes.) This provision protects the copyright owner from lost revenues because copies of computer programmes are easily exploitable by unauthorized copying facilitated through commercial rental schemes. This "software rental" prohibition further insulates copyright owners from the effect of any IRS determination.

11. *United States v. Wise*, 550 F.2d 1180, 1187 (9th Cir. 1977), cert. denied, 424 US 320 (1977), and reh'g denied, 434 US 977 (1977) (the first sale doctrine [then Sec. 27] requires "a transfer of title rather than mere possession") (citing *Harrison v. Maynard, Merrill & Co.*, 61 F. 605, 609 (2d Cir. 1894); *Platt & Munk, Co. v. Republic Graphics, Inc.* 315 F.2d 847 (2d Cir. 1963)]. See also, 2 *Nimmer*, Sec. 8.12[B], at 8-148 (1995).

12. E.g. *Hampton v. Paramount Pictures Corporation*, 279 F.2d 100, 103 (9th Cir. 1960) cert. denied, 365 US 882 (1960), (court looked to the face of the agreement, and the terms of the contract, to see whether it was an assignment (sale) or licence).

13. *Id.*

sued by the copyright owner of the films, who argued that the purchaser violated an agreement to limit their use to non-theatrical exhibitions. The purchaser/appellant argued that there was an assignment (sale) because the contract

> contain[ed] no limitation as to time; a flat lump-sum payment was to be made for each film transferred; there was no requirement that outstanding prints and negatives were to be returned; no limitation was placed on the right to alter or abridge the films transferred; and the contract gave [the transferee] exclusive territorial rights co-extensive with the rights of [the transferor].

The court stated "[i]f the contract in question were ambiguous with regard to its nature as an assignment or a licence or as to the purposes for which [the transferee] might make reproductions, the fact that provisions of the kind referred to above were present or absent would be helpful in construing the instrument". But the agreement in question expressly provided "that Paramount 'licenses' Kodascope to do certain things, thereby precluding a construction that there was an assignment".[14] The power of the transferee to make reproductions and to sell copies was not unlimited and therefore the agreement was not a sale. The court distinguished this case from another where the sale was "unconditional".[15]

In *Wise*,[16] the courts analysed a series of motion picture transactions, to determine whether any of them could be construed as a sale under copyright law. All but one set of agreements were designated a "license". All purported to transfer only limited rights for the exhibition or distribution of the films, for a limited purpose, and for a limited period of time, and reserved title to the film prints in the transferor. All but one of the agreements prohibited the licensee or any other party from copying or duplicating any film prints. The court found that "none of these agreements constituted first sales, since both on their face and by their terms they were restricted licenses and not sales".[17]

Commenting on the terms of the contracts the court said:

> [a]lthough some of the contracts did not provide expressly for reservation of title in the copyright owner, the remaining terms of the agreements were consistent with the theory of a limited license and inconsistent with the concept of a sale. The mere failure to expressly reserve title to the films does not require a finding that the films were sold, where the general tenor of the entire agreement is inconsistent with such a conclusion.[18]

In other cases, to determine whether the title to physical copies has been transferred for copyright purposes so that the first sale doctrine would come into play, the courts analysed the control the transferee acquired over the copies. In the case of video rental stores, the court looked at the "control" customers had over videotapes they were viewing, and whether the activities of viewing cassettes took place in the home or in the store.[19] In *Columbia Pictures* the court held that customers had limited control over the cassettes because they were viewed in the store and "at all times [the employees of the store] maintained physical dominion and control over the tapes".[20] The patrons of the store neither rented nor owned the tapes, and there was not a "future transfer" so the first sale doctrine was not invoked.[21]

In all cases, then, copyright courts will look to the terms of agreements (such as the detailed understandings and terms characteristic of the paradigm software transactions) and other indicia established in copyright precedent. The courts will therefore disregard mere abstract notions or, indeed, detailed economic analysis or considerations pertinent to separate legal or policy contexts[22] when determining the rights of copyright owners.

Moreover, if there is a transfer of title or ownership in a particular copy (and therefore a "first sale"), the other exclusive rights of a copyright owner are not lost or diminished.[23] Parting with title to a particular copy of a copyrighted work,

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14. *Id.*
15. *Universal Film Mfg. Co. v. Copperman*, 218 F. 577 (2d Cir. 1914), cert. denied, 235 US 704 (1914), "It was there held that where the producer of a photoplay unconditionally sold a positive print thereof, the purchaser and his assigns acquired the right to exhibit such film notwithstanding the fact that the film was later copyrighted". *Hampton*, at 103 discussing the holding in *Universal Film*.
16. 550 F.2d 1180 (9th Cir. 1977) cert. denied, 434 US 929 (1977), and reh'g denied, 434 US 977 (1977).
17. *Id.* at 1190.
18. *Id.* at 1191.

Two agreements were looked at separately by the court. One gave to the licensor a right to "buy" copies back from the licensee. The agreement stated that title to all prints and tapes remained with the licensor and the court found this to be a licence not a sale. The second agreement failed to provide for the retention of title and had a sale-and-buy-back situation, but in the absence of proof as to whether any of the options had been exercised, the court refused to find this a sale. *Id.*

The court also looked at several "V.I.P. agreements" by which film studios provided movie prints to prestige actors. All retained title in the film studios, limited uses by the actors to personal use, and prohibited copying or duplication. The court found all to be loans or licences, not sales. *Id.* at 1192.

One such agreement was distinguished. It contained a provision for payment for the cost of the film which, "standing alone, does not establish a sale...[but]...when taken with the rest of the language of the agreement,...reveals a transaction strongly resembling a sale with restrictions on the use of the print". No evidence was presented with respect to the whereabouts of the print furnished, so the court refused to rule on this agreement. In a case involving the transfer of computer programmes, the court found that where the transferor "only licensed and did not sell its copyrighted software, the first sale doctrine has no application..." *ISC-Bunker Ramo Corp. v. Altech, Inc.*, 765 F. Supp. 1310, 1331 (N.D. Ill. 1990).

19. *Columbia Pictures Indus., Inc. v. Redd Horne, Inc.*, 749 F.2d 154 (1984); *Columbia Pictures Indus., Inc. v. Aveco, Inc.*, 800 F.2d 59 (3rd Cir. 1986).
20. *Id.* at 160.
21. A different inquiry took place in a series of parallel import cases, where the courts looked at the impact of the exhaustion of the distribution right by first sale on the copyright owner's right of importation found in 17 U.S.C. Sec. 602. The courts analysed what was meant in Sec. 109(a) by "lawfully made" copies and where the activities of the manufacturing and/or first sale took place. See, e.g. *Sebastian Int'l. Inc. v. Consumer Contact Ltd.*, 847 F.2d 1093 (3d Cir. 1988) (grey market imports are permissible especially where copyright holder does not own the tangible copy because licensee manufactures copy); *T.B. Harms Co. v. JEM Records, Inc.*, 655 F. Supp. 1575 (D.N.J. 1987) (there is infringement by importation where the third party buyer of copies legally makes and sells them in the United States, and subsequently they are imported back into this country); *CBS v. Scorpio Music Distrib., Inc.*, 569 F. Supp. 47, 48 (E.D. Pa. 1983); *Hearst Corp. v. Stark*, 639 F. Supp. 970 (N.D. Cal. 1986); *Nintendo of America, Inc. v. Elcon Indus.*, 564 F. Supp. 937 (E.D. Mich. 1982) (terms of the distribution agreement violated); *Neutrogena Corp. v. United States*, No. 2:88-0566-1, slip op. (D.S.C. Apr. 5, 1988), and *Parfums Givenchy, Inc. v. Drug Emporium*, No. 92-56359 (9th Cir. 21 Oct. 1994).
22. Contrast the careful analysis of the economic substance of the transaction used in distinguishing sales from leases for tax purposes. E.g. *Frank Lyon Co. v. US*, 435 US 561, 573-574 (1978).
23. See, e.g. *Aveco*, note 19 *supra* at 64 (exclusive right to do or to authorize public performance is not lost by transfer of ownership of copies, upholding the principle of the divisibility of copyrighted rights found at Sec. 201(d)(2)); *Redd Horne*, note 19 *supra* at 160 (transfer of copies would not result in forfeiture or waiver of all of the exclusive rights found in Sec. 106); *T.B. Harms Co. v. JEM Records, Inc.*, 655 F. Supp. 1575 (D.N.J. 1987) (the copyright owner's exclusive rights are limited, not extinguished, by the limitations of Sec. 107 through 118 [now through 120]).

merely divests the copyright owner of the right to control further dispositions (other than commercial rentals) of that particular copy under the first sale doctrine.[24] A particular decision may find that copies of a programme have been sold and that some rights of distribution are lost by the copyright owner. Still, important rights of copyright are retained. This remains true when under certain narrow exceptions, limited rights of reproduction in computer programmes are also lost by the sale of a programme under Section 117 of the Copyright Code.

Like Section 109, Section 117 limits the rights of the copyright owner and gives owners of copies of the work certain limited privileges.[25] In the case of Section 117, it places some limit on the reproduction and adaptation rights of copyright owners of computer programmes under certain specific circumstances.[26] Because of the particular characteristics of using computer programmes (e.g. the necessity of copying in execution and backup), considered in specific relation to the exclusive reproduction and other rights of copyright owners, the owner of a copy of a programme is granted measured, limited and specific rights to copy, archive, adapt and dispose of that owner's copy. To avoid harming the copyright owner's own exploitation of the work and because computer programmes are vulnerable to copying, the conditions of the statutory provisions are very explicit, again demonstrating the particular copyright policies at work (rather than general or extrinsic notions) in this area.[27] As in the case of Section 109, the limited user privileges afforded by Section 117, follow a transfer of title as determined by the terms and conditions of the particular transaction between the parties, measured by copyright law, criteria, and objectives. Cf. *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 519 n.5 (9th Cir. 1993), cert. dismissed, 114 S. Ct. 671 (1994).[28]

Under Section 117 as with the first sale doctrine, substantial rights are retained by the copyright owner even though copies are sold. To the extent that the Section might apply (under copyright criteria), the copyright owner merely loses certain limited rights pertaining to the reproduction and distribution of particular copies. The copyright owner retains all other rights of copyright, as well as all rights of reproduction, adaptation and distribution which exceed the limited exceptions in Section 117. In addition, the copyright owner retains all rights in copyright against those not owning copies.

Note that the CONTU Report explicitly contemplates the contracting away of the exemption. For example, "[s]hould proprietors feel strongly that they do not want rightful possessors of copies of their programmes to prepare such adaptations," said CONTU (at 13-14), "[t]hey could, of course, make such desires a contractual matter".

Thus, the mere characterization of a transaction as a "sale" for tax (or any other extrinsic) purposes is not determinative of whether one owns the copy of a particular computer programme under copyright law. In addition, as discussed in part III below, even when statutory rights may be diminished by a properly found sale of a copy of a copyrighted work, the copyright owner can by contract retain rights in the copy of the work and/or in the copyright. Before considering the con-

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24. See, e.g. *Bobbs-Merrill Co. v. Straus*, 210 US 339 (1908) ("one who has sold a copyrighted article, without restriction, has parted with all right to control the sale of it"); see also, *Wise*, at 1187 ("Where a copyright owner parts with title to a particular copy of his copyrighted work, he divests himself of his exclusive right to vend that particular copy"...[but]..."the proprietor's other copyright rights (reprinting, copying, etc.) remain unimpaired..."); *United States v. Powell*, 701 F.2d 70 (8th Cir. 1983); *United States v. Moore*, 604 F.2d 1228 (9th Cir. 1979), *Redd Horne*, note 19, *supra*; *Aveco*, note 19, *supra*.
Under Sec. 109(c) of the Copyright Act, the owner of title to a particular lawful copy of a computer programme also is entitled to make limited on-site displays of that copy. Although the "display" right is unquestionably assuming greater importance for some works in the electronic age, the extent of application of this provision to execution or screen or any other display of the instructions or interface of a programme (as opposed to merely "showing" a disc) is doubtful, and it does not apply to network or any other transmission beyond the immediate place where that copy resides. Thus, this provision has little if any relevance here (and, again, will not be determined by IRS rulings in any event).
As noted in note 11, notwithstanding a "first sale" programme, copyright owners retain the right to control commercial software rentals.

25. Sec. 117 is an exemption that "applies to 'the owner of a copy of a computer program,' not to the copyright owner of the software itself, who plainly needs no exemption in order to engage in acts of reproduction".2 *Nimmer* Sec. 8.08[B], at 8-113 (1995).

26. It states:
Notwithstanding the provisions of Sec. 106, it is not an infringement for the owner of a copy of a computer program to make or authorize the making of another copy or adaptation of that computer program provided:

(1) that such a new copy or adaptation is created as an essential step in the utilization of the computer program in conjunction with a machine and that it is used in no other manner, or

(2) that such new copy or adaptation is for archival purposes only and that all archival copies are destroyed in the event that continued possession of the computer program should cease to be rightful.

Any exact copies prepared in accordance with the provisions of this section may be leased, sold, or otherwise transferred, along with the copy from which such copies were prepared, only as part of the lease, sale or other transfer of all rights in the program. Adaptations so prepared may be transferred only with the authorization of the copyright owner.

17 U.S.C. Sec. 117.
The copyright rationale for Sec. 117 is best described in the CONTU Final Report:

It is easy to imagine...a situation in which the copyright owner might desire, for good reason or none at all, to force a lawful owner or possessor of a copy to stop using a particular program. One who rightfully possesses a copy of a program, therefore, should be provided with a legal right to copy it to that extent which will permit its use by that possessor. This would include the right to load it into a computer and to prepare archival copies of it to guard against destruction or damage by mechanical or electrical failure. But this permission would not extend to other copies of the program. Thus, one could not, for example, make archival copies of a program and later sell some while retaining some for use. The sale of a copy of a program by a rightful possessor to another must be of all rights in the program, thus creating a new rightful possessor and destroying that status as regards the seller. This is in accord with the intent of that portion of the law which provides that owners of authorized copies of a copyrighted work may sell those copies without leave of the copyright proprietor. [footnote citing 17 U.S.C. Sec. 109(a)]. CONTU Final Report, at 13. See also, 2 *Nimmer*, Sec. 8.08[B], at 8-111 (1995); note 26 (1994) for a description of the importance of the CONTU Final Report as a legitimate part of the legislative history regarding the protection for computer programs.

27. The rights in Sec. 117 apply only to an "owner" of a copy of a programme. The CONTU report proposed legislation granting the Sec. 117 exemptions to any "rightful possessor" of a copy, (Final Rep., at 12), but Congress limited the provisions to owners of copies when it enacted the CONTU recommendations. Although documented legislative history regarding this change is sparse, it is consistent with an intent to allow contracts, not formalistic characterizations, to govern the rights of parties to software transactions.
The copyright policy-driven nature of Sec. 117 is also seen in cases such as *Atari, Inc. v. JS&A Group, Inc.*, 597 F.Supp. 5 (N.D. Ill. 1983) and *Micro-Sparc, Inc. v. Amtype Corp.*, 592 F.Supp. 33 (D. Mass. 1984). In these cases Sec. 117's "archival" copying exception was found inapplicable where the plaintiffs' programme formats were not subject to the particular type of electronic destruction that the courts found underlie that section's limited exception to the exclusive right to copyright a programme.

28. The *MAI* court concluded that because the plaintiff "licensed its software [the defendant customers] do not qualify as "owners" ... and are not eligible ... under Sec. 117". 2 *Nimmer*, Sec. 8.08[B], at 8-113-4 (1995); criticizes the case for failing to analyse the transaction more carefully. Whether *MAI* would have been differently decided on a more detailed analysis is immaterial here. We agree that application of Sec. 117 for copyright purposes should, and will, be determined by examination of contracts and copyright policy and precedent, not by *any* form of summary extrapolation, e.g. from IRS determinations.

tractual protections available to copyright owners, we will consider briefly the policy considerations before the IRS.

III. TAX CRITERIA AND COPYRIGHT POLICY

We have thus concluded that the court's determination of the copyright owner's rights will not be meaningfully affected by the IRS accepting this ruling.[29] Similarly, it would appear unprecedented for the IRS or Tax Court to choose to place a heavy reliance on copyright policy, instead of tax policy in a tax determination. For example, the Tax Court in a decision involving a divorce proceeding said:

> The characterization of the monthly payments [pursuant to the divorce judgment] for Federal income tax purposes, however, is determined under principles of tax law, not bankruptcy law. Considerations unique to bankruptcy law lead bankruptcy courts to take a more expansive view of the definition of alimony than is warranted in the tax field.[30]

This principle was recently reiterated by the Supreme Court.[31] Similarly, it is well established that state law is irrelevant to the determination of whether a transaction is a sale or a lease for federal income tax purposes.[32] Federal income tax law has a different focus and goal from that of state property law and, therefore, in determining the nature of transactions relevant to federal income tax decisions, it is the federal income tax law's definitions and analyses which takes precedence. Federalism makes this conclusion an obvious one.[33] However, it is also true that other federal statutes, such as the Copyright Act, have different purposes and craft particular and specific balances among relevant, competing considerations. Federal statutes can thus readily be expected to reach independent determinations as to whether a transaction is a sale or a licence. If the IRS is either bound by or unduly influenced by a determination or its potential consequences (which might themselves be varied by contract or circumstance), made in the context of another federal statutory scheme, the aim of maintaining a uniform system of taxation would be frustrated, just as it would be if the Tax Court were to follow state law determinations. Therefore, in determining whether a transaction is a sale or a licence for federal income tax purposes, tax authorities should not be bound or influenced by the determination, treatment, or possible resolution of this issue in the context of other federal statutes, such as the Copyright Act. This is consistent, of course, with our conclusion, as stated above, that copyright courts will not be influenced by tax determinations or policy.

IV. CONTRACTUAL REMEDIES

A revenue ruling that certain transfers are characterized as sales for tax purposes, even if potentially affecting copyright cases, would not deprive copyright owners of protection for their interests. Contracts can supplement or substitute for copyright to protect the interests of the copyright owner. Indeed, it appears to be precisely an intent to preserve the ability to rely on those very agreements (which commonly characterize the paradigm transactions at issue) that underlies the argument made against the proposed ruling. However, that argument is unnecessary; the enforcement of these contract provisions should not be undermined by the proposed ruling.

The fear that the tax treatment of transfers as sales, will (by virtue of Section 109(a) and Section 117) impede the owner's economic interests, is unfounded. These statutory exceptions are very narrowly crafted to provide limited rights to those owning copies of works. The provisions are intended to strike a balance between the rights of copyright owners and users of copies, but this accommodation does not preclude separate contractual arrangements.

Copyright owners can retain rights to further exploit the work and prevent erosion of exclusive rights, by contract or licensing agreements, even after the sale of a copy of the work. They do so in the paradigm. And these limitations on the further use of the programme can be upheld against the purchaser, possessor, or other user of copies of a programme. The CONTU Final Report was very clear on this point:

> The [copyright] proprietor of a work in computer-readable form would, under any foreseeable circumstances, be able to control by contract the future disposition of machine-readable copies of his proprietary work. The proprietor of copyright in such a work would always have a valid cause of action, arising either under copyright or contract, if a reproduction of the work were entered into a computer without the proprietor's authorization, or if a

29. Cf. *In re Chateaugay*, 961 F.2d 378, 383 (2d Cir. 1992), reversing 109 B.R. 51 (Bkrtcy. S.D.N.Y. 1990), aff'd 130 B.R. 403 (S.D.N.Y. 1991) ("The tax treatment of a transaction ... need not determine the bankruptcy treatment ... The tax treatment of debt-for-debt exchanges derives from the tax laws' focus on realization events, and suggests that an exchange offer may represent a sensible time to tax the parties. The same reasoning simply does not apply in the bankruptcy context." See also, *Matter of Pengo Industries, Inc.*, 962 F.2d 543, 550 (5th Cir. 1992).

30. *Walstatter v. Commissioner*, 63 T.C.M. (CCH) 2389, 2395 (1992).

31. See *Nebraska Dept. of Revenue v. Loewenstein*, 115 S.Ct. 557, 564 (1994) ("Respondent ... argues that repos are characterized as ordinary sales and repurchases for purposes of federal securities, bankruptcy, and banking law as well as commercial and local government law. We need not examine the accuracy of these assertions, for we are not called upon in this case to interpret any of those bodies of law. Our decision today is an interpretation only of 31 U.S.C. Sec. 3124(a), not the Securities Exchange Act of 1934, the Bankruptcy Code, or any other body of law.")

32. See, e.g. *Weiss v. Wiener*, 279 US 333, 337 (1929) (irrespective of the fact that Ohio would treat these long leases as sales, for the purpose of federal income tax law, the taxpayer only had a leasehold interest and therefore was not entitled to take deductions for estimated obsolescence); *Estate of Starr v. Commissioner of Internal Revenue*, 274 F.2d 294, 294-95 (9th Cir. 1959) (although state law generally will follow the name which the parties give to a transaction, the IRS is not so bound, therefore, despite the fact that a fire sprinkler installation contract was called a lease, the court found that it was a sale for federal income tax purposes); *Strother v. Commissioner of Internal Revenue*, 55 F.2d 626, 629 (4th Cir. 1932), aff'd, *Bankers' Pocahontas Coal Co. v. Burnet*, 287 US 308 (1932) (despite the fact that the law of West Virginia considers a mining lease to be a sale of the mineral in place, the royalties in question constitute taxable income for federal income tax purposes); *Sanborn v. Commissioner*, 46 T.C.M (CCH) 1435, 1445 (1983) (a transaction characterized as a sale-leaseback for federal income tax purposes, is not a financing arrangement, irrespective of the fact that California would characterize it as a secured loan transaction).

Similarly, in the context of determining whether or not a partnership exists for federal income tax purposes, courts have stated that state law does not control. See, e.g. *Commissioner v. Tower*, 327 US 280, 287-88 (1946); *Estate of Herman Kahn v. Commissioner*, 499 F.2d 1186 (2d Cir. 1974); *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954); *Hawaiian Freight Forwarders, Ltd. v. Commissioner*, 196 F.2d 745 (9th Cir. 1952); Rev. Rul. 58-243, 1958-1 C.B. 255.

33. *Burnet v. Harmel*, 287 US 103, 110 (1932).

transferee authorized a third party to enter a copy into the memory unit of a computer in violation of the terms of a valid agreement with the proprietor. That copyright would not provide the sole right and remedy for unauthorized use of a protected work neither is it unique to the protection of proprietary interests in computer-readable works nor is it a situation to be considered undesirable.[34]

Further, the Report said:

Remedies for breach of contract, if the right being protected is not equivalent to copyright, would not be preempted under the provisions of Section 301 of the new law, and would accordingly be available to one who, on the strength of a copyright interest, granted permission to another to make certain uses of the copyrighted work only to have the terms of the authorization violated...[cites House Report, pp. 130-33]...The existence of parallel but not equal rights under state and federal law reflects advantages as well as disadvantages inherent in a federal polity....[35]

Thus copyright owners can protect their interests by contract and such alternate remedies will not be pre-empted by the provisions of federal statutory copyright law.[36] So for example, a purchaser can agree to limit distribution of a copy after a "first sale" even though the statute alone would not give the copyright owner a right to bar further distribution of the work after such sale.

The House Report during Copyright Revision stated that Section 109(a) "does not mean that conditions on future disposition of copies or phonorecords, imposed by a contract between their buyer and seller, would be unenforceable between the parties as a breach of contract, but it does mean that they could not be enforced by an action for infringement of copyright".[37] Such contract rights of the copyright owner have been upheld in court decisions as well. In *Wise* (interpreting "first sale" under the 1909 Act) the court held that, in instances where further transfers occur after a "first sale", "[i]f the vendee breaches an agreement not to sell the copy, he may be liable for the breach but he is not guilty of [copyright] infringement".[38]

As stated by Prof. Goldstein:

Section 117 generally gives full force to Section 106's exclusive right but excuses specific exigent uses in circumstances where it will characteristically be difficult for the owner of the exclusive right and the prospective user of the copyrighted work to negotiate a license.[39]

The statutory "right" found in Section 117, is intended to ground the bargaining position of the owners of copies in any contractual or licensing circumstance, but is not intended to preclude a user of a work from contracting away that right.

These contracts are not however without limitation. The CONTU Report makes reference to limits based on "public policy considerations" but does not specify these boundaries. One case does indicate that limits are found in a *state's* right to pre-empt federal statutory rights. In *Vault Corp. v. Quaid Software*, the court held that a Louisiana *statute* (Louisiana Software License Enforcement Act) allowing for restrictions on copying and adaptation of computer programmes was pre-empted by Section 301 of the Copyright Act.[40] The District Court had held that a severely restrictive licensing agreement, under which the licensor retained title to the copy, and which prohibited all copying, modification, transfer and the like, was unenforceable as a "contract of adhesion". The Appeals Court found that the use by the defendant under the facts of the case, was an essential step in the utilization of the computer programme in conjunction with a machine, as allowed by Section 117(1). The court held that "at least this provision of Louisiana's License Act is pre-empted by federal law, and thus that the restriction in Vault's licensing agreement against decompilation or disassembly is unenforceable".[41]

Vault, though on some footing with respect to pre-emption of state statutes, is, given the extensive legislative history recounted above, simply incorrect in its holding on the ability of parties to contract away statutory rights or limitations. In another case, the court upheld contractual agreements that specifically limited distribution to licensed customers only, and proscribed any further distribution of the software. The court concluded that the transferee never acquired title and knew or should have known that it had no authority to possess or use the disputed software.[42]

In many instances, it is common practice to seek contractual relief from statutory rights, or to waive statutory limitations or defences found in the Copyright Act. Public libraries and archives, for example, routinely accept copyrighted materials under instruments of gift and restrict access, copying, and viewing of these materials by their patrons, notwithstanding the fair use provision and the library copying and interlibrary loan provisions of the Act.[43]

34. CONTU Final Report, at 40.
35. CONTU Final Report, at 40, note 168.
36. 17 U.S.C. Sec. 301.
37. H. Rept. 94-1476, 94th Congress, 2d session, at 79.
Another essential right for copyright owners to retain control of, particularly in contractual arrangements for works transmitted on a computer network, is the right of public display. The House Report accompanying the Copyright Revision Bill stated:

[s]ection 109(b) adopts the general principle that the lawful owner of a copy of a work should be able to put his copy on public display without the consent of the copyright owner. As in cases arising under Sec. 109(a), this does not mean that contractual restrictions on display between a buyer and seller would be unenforceable as a matter of contract law. H.Rept. 94-1476, 94th Cong., 2d Sess. (1976) p. 79.

38. 550 F.2d 1180, 1187 note 10. See also, *Harrison v. Maynard, Merrill & Co.*, 61 F. 689 (2 Cir. 1894), wherein a first sale did not shield a vendee from a breach of contract suit.
39. 1 Goldstein, Sec. 5.2.1, at 539 (1989).
40. *Vault Corp. v. Quaid Software Limited*, 847 F.2d 255, 7 U.S.P.Q.2d 1281 (1988).
41. *Id.*, at 270.
42. *ISC-Bunker Ramo Corp. v. Altech, Inc.*, 765 F.Supp. 1310, 1331 (N.D. Ill. 1990).
43. 17 U.S.C. Sec. 107, 108. It is also clear that certain rights in the Copyright Act cannot be waived regardless of the terms of an agreement to the contrary. The provisions governing termination of transfers and licences granted by the author are expressly assured without regard to the terms of a contract. 17 U.S.C. Sec. 203(a)(5), 304 (c)(5). Also, the rights of certain authors to attribution and integrity cannot be transferred by contract but they are provided explicit waiver provisions in the Copyright Act. 17 U.S.C. Sec. 106A(e)(1). These express statutory constraints on contract in fact strengthen the case for the ability to deal contractually with rights that are not expressly reserved in the Act.

V. CONCLUSION

Adoption of the proposed revenue ruling will not cause the dire copyright policy implications suggested by others. The revenue ruling should be determined based on tax policy, not copyright policy or potential decisions reflecting copyright policy.

Copyright law treats the physical objects of transactions, separate from the intangible rights, as a fundamental principle that remains unchanged by any revenue determination. Even if a particular transfer is characterized as a sale by the IRS, the copyright owner can exercise all rights in the copyright and be subject to all the limitations of the Copyright Act. The narrow exceptions of Sections 109 and 117 are not dependent on and will not be changed by a tax court determination. Finally, even if transfers of software are characterized as sales for tax purposes and even if a court could be persuaded to look to this consideration in a copyright decision, the copyright owner could still, and traditionally (and paradigmatically) does, rely on contractual remedies to protect the exploitation of a computer programme.

CUMULATIVE INDEX -1995

I. ARTICLES

DENMARK

JOINT TAXATION – AMENDMENTS

Bente Møll Pedersen

Lawyer, Kromann & Münter and lecturer in Tax Law at the University of Copenhagen, Denmark.

I. INTRODUCTION

The government's international taxation bill, which was passed in the spring[1], significantly amends the joint taxation regime. The major benefits of joint taxation and the most important requirements and conditions to qualify for such taxation are set out by the author in the November 1994 issue of the Bulletin. The 1995 Act has to some extent reduced the benefits of joint taxation.

As explained in the author's earlier article, a Danish holding company may elect to be jointly taxed with its wholly-owned subsidiaries. Both Danish and foreign subsidiaries may be eligible for joint taxation regardless of the domicile of the subsidiary. It is not necessary that the subsidiaries engage in the same line of business as the holding company. Where joint taxation applies, tax losses in one company may be offset against the profits of other group companies.

II. INITIAL VALUES[2]

New rules apply for determining acquisition dates and values where companies enter into joint taxation during an income year commencing after 2 November 1994.

The new general rule is that when a foreign subsidiary is brought into joint taxation with a Danish parent company, the assets and liabilities of the foreign subsidiary are treated as acquired at market value as at the date on which joint taxation commenced. It should be noted however, that the date of acquisition is deemed to be the date the assets were originally acquired by the subsidiary.

Depreciable assets do not follow the above rule but instead are deemed to be acquired on their original acquisition date at actual cost less the maximum depreciation (as calculated under Danish rules) that would have accrued prior to the commencement of joint taxation. Where the market value as at the commencement of the first year of joint taxation is less than the acquisition cost minus the maximum depreciation, the market value is then taken as the initial value.

The above rules mean that when commencing joint taxation, all depreciable assets and their acquisition prices and dates have to be identified, e.g. buildings, fixtures, plant and machinery, and improvements. In addition, acquisition costs and dates have to be ascertained for goodwill and other intangible assets. Acquisition costs for goodwill which the foreign company has acquired can be depreciated. However, goodwill which the company has built up itself cannot be depreciated. Even where the foreign company has built up rather than acquired goodwill or other intangible assets, the market value of such assets still has to be determined at the date of commencement of joint taxation. This is because these values will be needed for the purposes of future computations should the relevant assets later be disposed of. The tax authorities' guidelines in the "goodwill statement of practice" are presumably to be followed in these cases.

Notwithstanding the above, small assets, operating equipment with a short life, operating equipment for experimental and research purposes, and software, which can all be written off in the year of acquisition, are ignored.

III. TAXATION UPON DISPOSAL[3]

If a jointly taxed foreign subsidiary sells an asset which it has depreciated for tax purposes via joint taxation, recaptured depreciation has to be calculated. This is calculated as the disposal sum less the written down value for tax purposes. If the disposal sum exceeds the initial value calculated, the recaptured depreciation is reduced by the difference between the initial value calculated and the disposal sum. This ensures that notional depreciation attributed to the period prior to the commencement of joint taxation is not taxed. The reduction cannot be greater than the calculated maximum notional depreciation as at the date of commencement of joint taxation. These provisions ensure that a liability to tax arises only in respect of any increase in the value of an asset.

A further restriction applies, upon the sale of depreciable assets, where the disposal price exceeds the actual acquisition price. Where this occurs the gain is reduced by the difference between the actual acquisition cost and the market value at the date of commencement of joint taxation.

To comply with these rules it will be necessary after setting initial values to keep accounts for all the depreciable assets during joint taxation.

The initial value provisions are effective from the income year 1995. Where the income year commences before 2

1. L. 35 Act No. 312 of 17 May 1995.
2. Corporate Tax Act Sec. 31 (5-6).
3. Corporate Tax Act Sec. 31 (7-8).

November 1994, the rules are applicable from the income year 1996.

IV. RECAPTURE OF LOSSES UPON TERMINATION OF JOINT TAXATION[4]

It was originally proposed that, upon termination of joint taxation with a foreign subsidiary, the parent company was to be taxed as if the subsidiary's assets and liabilities had been sold at market value. This proposal was dropped during the bill's passage through the Danish Parliament. However the existing rule in Section 33 of the Danish Tax Assessment Act on recapture of deficits previously deducted against tax, has been tightened up in respect of the withdrawal of a foreign subsidiary from joint taxation. If the withdrawing subsidiary has, throughout the period of joint taxation, contributed net deficits which have been deducted in calculating the taxable income of other group companies, the net deficit will be recaptured.

Deficits are recaptured by including an amount corresponding to the deficits in the parent company's taxable income. Recapture of deficits upon termination of joint taxation may not exceed the hypothetical gains for tax purposes which would be made by selling the subsidiary's assets. If previously deducted deficits are not recaptured immediately in connection with the termination of joint taxation, deficits can be recaptured later as the parent company receives dividends or gains on shares from the foreign subsidiary. If the dividends or gains are exempt (e.g. under domestic law, or under a treaty) an amount equal to the dividends or gains shall be included in the taxable income of the parent company. Dividends or gains which are exempt and distributed to the parent company before termination of the joint taxation will not affect the recapture. If the dividends or gains are taxable, the recapture is treated as having taken place in connection with the ordinary calculation of the taxable income when including these amounts. See Section 33E(2) of the Assessment Act.

The recapture of deficits rules apply to deficits deducted in the 1992 income year and thereafter. The rules on recapture of previously deducted deficits as the parent company receives dividends are to apply where the subsidiary withdraws from joint taxation during or after the 1996 income year. This means that these rules will only apply if the subsidiary has been included in joint taxation for 1995.

Due to the recently introduced rules on recapture of deficits, the advantage of joint taxation with foreign subsidiaries has, to a large extent, been restricted to the cash flow benefit of deferring tax. Although until 1999, it will still be possible to obtain relief for foreign source income[5]. Despite the new restrictions, joint taxation may nevertheless be advantageous where a foreign subsidiary at the beginning of its life has losses from its ordinary activities. This benefit of course will be reduced if recapture of losses upon termination takes place. In the context of the above it should be noted that in September 1995 the Danish tax minister announced that he is considering reducing the remaining benefits.

V. RELIEF RULES[6]

The rules for double taxation relief for income of a jointly taxed foreign subsidiary have also been changed. Hitherto, Denmark granted relief for double taxation of income from certain countries according to the exemption method, which meant that Denmark did not tax income from a foreign country at all, irrespective of how much or how little tax was paid in that other country. In future, the relief is to be given in accordance with the credit method, so that Denmark will tax the income of the jointly taxed foreign subsidiary, but reduce the Danish tax on the foreign income with the amount of tax paid in the other country. This method ensures that the total tax paid is at least equal to the Danish tax.

The new rules apply from the 1995 income year onwards. After this date, it is of no consequence whether the relevant double taxation agreement provides for relief under a method other than the credit method. As the rules, in the opinion of the Danish authorities, do not constitute double taxation for the purposes of the double taxation agreements, Denmark is, at least in the opinion of the Danish authorities, entitled to implement the taxation regime outlined above.

VI. CONCLUSION

The government's legislative amendments in Spring 1995 have somewhat reduced the benefits of joint taxation with foreign companies. In particular, the introduction of rules on recapture of deficits upon termination of joint taxation have, to a large extent, restricted the benefit of joint taxation to the cash flow benefit of deferring tax. Nevertheless, if the foreign company has losses from its ordinary activities and does not have appreciating assets it may still be very beneficial to opt for joint taxation.

4. Tax Assessment Act Sec. 33 E.
5. This is a national calculation rule which provides that a company with foreign jointly taxed subsidiaries may obtain relief amounting to 50% of the Danish corporation tax levied on the net taxable income of the foreign subsidiary. The effective Danish tax rate of 34% may therefore be reduced for a company with jointly taxed foreign subsidiaries. However, the relief for foreign-sourced income is being gradually phased out between 1994 and 1999. The relief is reduced by $^{1}/_{7}$ in each of the income years in question.
6. Tax Assessment Act Sec. 33 (6).

CANADA

DEPARTURE TAX – INDIVIDUALS

Robert Couzin

Société Juridique Internationale, Paris correspondent of Stikeman, Elliott

In 1972, Canada introduced a tax on realized capital gains.[1] Perhaps ahead of its time, the new statute also imposed in certain instances, a charge to tax on accrued gains. Examples of the occasions giving rise to a charge on accrued gains include gift, death and cessation of Canadian residency. The purpose of this article is to explore the so-called departure or exit tax, whereby taxpayers are required to bring into account upon emigration from Canada, gains and certain other items of income which would otherwise be deferred until realization.

While these comments relate principally to the Canadian tax system, their potential scope is a little broader. Without attempting an essay in comparative law, I will note briefly, certain elements of departure tax or similar levies in other countries, in order to highlight the character of such taxes, likely trends and practical implications.[2] In addition, because of the lengthy experience with departure tax in Canada, an analysis of the law and its impact on taxpayer behaviour may prove useful to those considering implementing similar measures.

The Canadian rules apply, with necessary modifications, to corporate entities and trusts as well as individuals. However, the differences between the systems, their application and their rationales are so fundamental that it is more convenient to treat companies and individuals in separate reports. This article deals solely with physical persons. Trusts and corporations will be examined in a subsequent instalment.

I. POLICY

The ex-Soviet Union gave exit taxation a bad name. Western observers saw through the recapture of the cost of educational benefits for what it was, an attempt to control the export of people. However, the underlying concept was not ridiculous. In a way, the design of taxation and spending systems presupposes that people stay put. Otherwise, there is a danger that they will reside in a particular country when they are net beneficiaries of public spending and the other advantages the State has to offer, but not when they would be net contributors to the public purse.[3]

Today, restrictions on such freedom of movement are not well received. It is unlikely that any attempt to match taxing jurisdiction with receipt of benefits would be acceptable, even if it were possible. On a narrower basis, however, within the confines of an income tax system, there is a perfectly credible argument in favour of departure taxes. As a consequence, it is likely that we may see more of this form of taxation.

The theory underlying income taxation is not always easily reconciled with the practicalities of imposing and collecting the tax. A comprehensive definition of income, ideally, would include all increments to wealth as they accrue. Yet, almost all tax systems accept the deferral of certain types of income until the taxpayer converts it to cash. This is typically the case with capital gains earned by individuals from the disposition of investments or other properties. There are many arguments for (and against) deferral of taxation of such gains.[4] Suffice it to say that deferral is the rule and accrual taxation the exception.

If some find the deferral of taxation of gains until realization unfair, when compared to the taxation of other forms of capital income, clearly the complete exoneration of the gain is even more problematic. Hence the need to consider what happens when the taxpayer packs up and leaves.

The basic theory is straightforward. The residence principle of taxation requires that an individual should pay tax in respect of all sources of income, to the country in which he or she resides. Under this rule, income which accrues during a period of residence should also be taxable, regardless of when it is received. Perhaps the most logical solution would be for the State to tax all gains realized by former residents, to the extent that they can be considered to have accrued during the period of residence. There are several problems with that system. There is firstly the practical problem of enforc-

1. The 1972 tax reform package created the statute now cited as the *Income Tax Act*, RSC 1985 (5th supp.) to which reference will hereafter be made as the "ITA".
2. I am indebted to valuable assistance regarding non-Canadian tax regimes from colleagues in the United States (Rick Taylor and Mark Watson, KPMG Washington, DC), Denmark (Christian Emmeluth, Koch-Nielsen & Grønborg, Copenhagen) and Germany (Martin Keßemeier, Dehnen and Partner, Düsseldorf). Naturally, any errors and omissions remain my responsibility.
3. Interestingly, the US Treasury explanation of President Clinton's departure tax proposal, dated 7 February 1995 and discussed briefly below, makes just such an argument. It observes that expatriates "are fleeing the tax system that all developed countries must impose to maintain a standard of living demanded by their citizens and residents – including those who choose to expatriate". That is, the expatriate is implicitly avoiding taxation which, in some sense, funds (perhaps by paying interest on prior deficit financing) benefits he or she has enjoyed.
4. See Couzin, "Capital Gains: Tax Policy Alternatives", *Canadian Public Policy*, in press.

ing compliance with a requirement imposed on non-residents to report and pay tax on gains on foreign property dispositions. From the point of view of international comity, there is also the matter of allocation of taxing jurisdiction under bilateral treaties, or a more general principle of mutual respect among States.

In light of the above, the original policy underlying the Canadian system of departure tax was to subject accrued gains or income to tax at the moment of departure from Canada, but with some administrative relief permitting continued deferral. This was designed so as not to disadvantage the taxpayer compared to the situation which would have prevailed had he or she remained in Canada. In order to tax only the income which accrued while the person lived in Canada, recognition was given for the portion of any gain or other income which accrued during earlier periods of non-residence.

II. THE CANADIAN LAW

The departure tax system in Canada remained remarkably stable for 20 years, until alterations were made in 1993, not surprisingly to expand its scope. The essential elements are the categories of property concerned, the determination of the tax base and administrative measures regarding payment and deferral of payment.

A. The property

Like other tax systems, the Canadian regime has elements of both residence and source taxation. Canadian residents are taxable on income from all sources anywhere in the world. Non-residents are taxable only on defined Canadian sources of income. When Canada started taxing capital gains in 1972, a decision was made as to which gains would be considered to have their source in Canada so that, subject to international tax treaties, Canada would assert taxing jurisdiction over non-residents who realized gains from the disposition of these defined classes of "taxable Canadian property". The design of the departure tax is intimately linked to that source definition. Some find it counter-intuitive, but it is actually quite logical. Since Canada taxes non-residents on gains from the disposition of taxable Canadian property, the departure tax only applies to property other than taxable Canadian property. Where an individual ceases to be resident in Canada, he is deemed to have disposed of, immediately prior to cessation of residence, all of his property other than taxable Canadian property.[5] So, if a taxpayer owns two properties, one a taxable Canadian property and one not, he or she is required on departing from Canada to recognize the accrued gain on the latter but not the former, since the gain on the taxable Canadian property will, in any event, be subject to Canadian tax on realization.

While the scope of the defined classes of property is a subject unto itself, it is important to grasp the general thrust of the definition in order to appreciate the effects of the departure tax. "Taxable Canadian property" includes real property situated in Canada, capital property used in carrying on a business in Canada, shares of Canadian resident private corporations (essentially, resident corporations not listed in Canada or controlled by Canadian listed companies) and substantial (25%) interests in Canadian public (listed) corporations or mutual funds. There are additional categories to deal with more arcane forms of property.[6]

Since departure tax applies only to property which is not taxable Canadian property, there is an automatic constriction on the scope of the tax whenever the legislator sees fit to expand the definition of Canadian property. An important recent example is found in proposed legislation.[7] The draft law would include within the scope of taxable Canadian property, shares of non-resident companies where at least 50% of the assets of the company consist of taxable Canadian property (e.g. a foreign company which holds Canadian private corporation shares or Canadian real estate). If enacted, this would constitute a major extension of taxing jurisdiction over non-residents. It would also eliminate departure taxation on this class of asset.

The foregoing discussion deals with capital properties, assets the disposition of which gives rise to capital gains. Under Canadian law, such gains are taxed only upon realization (hence the logic of a departure tax) and at a preferential rate ($^3/_4$ of the gain is considered ordinary income). Until 1993, the departure tax was concerned only with capital gains. However, the government eventually determined that there were other categories of Canadian-source income which could also be deferred, and which should be taxed upon exit lest the income escape Canadian taxation. It should be noted that other provisions of the law already applied to terminate deferral on a change of residence. For example, where a Canadian taxpayer disposes of property and the proceeds of sale are payable on an instalment basis, the taxpayer is permitted to defer recognition of the capital gain over a period of up to five years. Deferral is not possible once the taxpayer ceases to reside in Canada.[8]

The deemed disposition on departure now applies to all properties, subject to a prescribed class of exceptions. Taxable Canadian property remains exempt from departure tax, as discussed above. Canadian business inventories also escape taxation on emigration, for the same reason. A non-resident person carrying on business in Canada would normally be taxable on business profits, including gains on the sale of such inventory (subject, of course, to the application of tax treaties). Foreign inventory properties are, however, within the scope of departure tax. While it would be unusual to find an individual carrying on a direct commercial or industrial

5. The deemed gain on departure was originally found in Sec. 48 ITA. With the amendments effective in 1993, it was removed and expanded in a new Sec. 128.1.

6. See Para. 115(1)(b) ITA.

7. Draft Legislation to Amend the Income Tax Act and Related Statutes, tabled 26 April 1995, Sec. 46. This is an example of killing a mouse with an elephant gun. Apparently, the originally identified problem concerned non-residents holding vacation or other real properties through special purpose foreign companies. The very broad text published in April has been roundly criticized for going too far, and changes to the draft would not be surprising.

8. Subpara(s). 40(1)(a)(iii) and (2)(a)(i) ITA.

business undertaking abroad, the inclusion of non-Canadian non-capital properties is important because it extends the scope of departure tax to foreign assets which, under Canadian case law, would be considered "trading" properties. In particular, there is considerable jurisprudence dealing with the question of whether gains on the sale of real estate should be considered on capital or income account, based essentially on the operating motivation at the time of acquisition (investment versus resale). Canadian resident individuals who realize gains on the sale of real estate properties naturally argue for capital treatment. Before 1993, the emigrating individual with foreign real estate holdings could argue the reverse and, if successful, escape Canadian taxation. No longer. The same considerations apply to venturers or venture capitalists whose share investments might be considered to give rise to gains on income account.

Also within the scope of departure taxation are properties which, under the peculiarities of Canadian taxation, are not subject to the capital gains regime. Gains on the sale of natural resource properties, for example, are generally fully taxed (subject to recognition for acquisition costs). Foreign resource properties are now subject to departure tax, although Canadian resource properties, over which Canada asserts taxing jurisdiction regardless of the residence of the owner, remain excluded.

The expansion of the departure tax to all property could have untoward results. For example, the Canadian tax administration normally considers deferred employment income including unexercised stock options, as subject to Canadian tax upon future receipt, even if the employee no longer resides in Canada.[9] Logically, therefore, the accrued value of unexercised employee stock options should not be subject to the departure tax. Indeed, there is a statutory exception for that particular type of property.[10]

Finally, in an effort to simplify the application of the departure tax system in a world of ever increasing mobility, the legislator had the foresight in 1971 to exempt from the tax base, property owned by an individual immediately before immigration to Canada, if the individual remained in Canada no more than five years (or, more precisely, no more than 60 months in the ten years preceding departure). Property acquired by bequest or inheritance is treated as if it had been owned before the acquisition of Canadian residency.[11]

B. Measurement of the base

Mobility implies people will move into, as well as out of Canada. The philosophy of departure taxation is to recoup for Canada income (gains) earned (accrued) during Canadian residence. Therefore, as a counterpart, the law must provide some mechanism to exclude income accrued during periods of non-residency.

Essentially, this is accomplished by the legislation providing for a deemed acquisition of certain assets on acquiring Canadian residency. Under the pre-1993 system, where an individual became resident in Canada, he or she was deemed to have acquired, at fair market value, the properties which might ultimately be subject to departure tax, i.e. capital properties other than taxable Canadian properties. The new more sophisticated system in effect achieves the same result. The immigrating taxpayer is now deemed to have disposed of all the assets to which departure tax may apply, immediately before acquiring Canadian residency and to have reacquired the properties at a cost equal to fair market value.[12]

The combination of a deemed acquisition on immigration and a deemed disposition on emigration, both at fair market value, should limit the charge to tax to the element of the gain accrued while in Canada. With respect to assets prone to considerable fluctuations in value, "spot" valuations may yield harsh (or beneficial) results. The acquisition or cessation of residence may coincide with high or low points on the value curve. Furthermore, the Canadian tax system, like most others, requires that cost and proceeds of disposition be determined in domestic currency. This can have a dramatic effect. If an asset has retained its value in a foreign currency throughout the period of Canadian residency, it may have either appreciated or depreciated considerably when the gain is determined by reference to Canadian dollars.

The extension of departure taxation to non-capital properties, also has an effect on the computation of the tax liability in respect of certain properties which had been previously included in the base. This is the case, in particular, for depreciable assets, such as rental real estate. Before 1993, foreign real property investments were subject to departure tax, but only the capital gain was taxed. Now not only the gain, but also any recapture of tax depreciation allowances falls within the Canadian tax net on emigration.

C. Administrative measures

Since income tax is paid in cash, any rule which accelerates the timing of the taxation of income to a date prior to the date cash is received upon realization, can be viewed as unfair and is often impractical. Emigrating taxpayers may not be in a position to fund the departure tax. Moreover, unlike taxation of accrued gains on death, this is a levy for which most could not have planned. While owners of appreciated assets sometimes purchase life insurance to lighten the burden on their heirs, it would certainly be unusual (and perhaps impossible) to insure against the risk of emigration. In addition, taxpayers may find harsh the imposition of taxation upon accrued gains which are likely to evaporate over time, for example where the gain is due to currency volatility (although, admittedly, that problem exists at death as well).

Thus, the Canadian departure tax system permits the individual to choose to defer the tax.[13] The elective procedure only applies to capital property (not inventory) which would otherwise be deemed to have been disposed of on the change

9. See *Hurd v. The Queen*, [1981] CTC 209; *Hale v. The Queen*, [1990] 2 CTC 247.
10. Subpara. 128.1(4)(b)(vi).
11. Former Subsec. 48(4), now Subpara. 128.1(4)(b)(v) ITA.
12. Former Subsec. 48(3), now Subsec. 128.1(1) ITA.
13. Subpara. 128.1(4)(b)(iv) ITA.

of residence. There is a hitch. The consequence of the election is that the property is thereafter considered to be taxable Canadian property; i.e. any gain on its subsequent disposition may be subject to Canadian tax. Therefore, the price of deferring taxation may be the incurring of a greater tax liability later, if the property continues to appreciate. I say "may" because of the potential application of bilateral tax treaties, discussed below.

Not surprisingly, the law requires that the taxpayer electing to defer departure tax provide acceptable security for the payment of the tax. In the absence of such security, the election (which must be filed generally by 30 April of the year following emigration) is invalid.

Alternatively, the taxpayer may choose not to defer the tax, but merely its payment. In this case, future appreciation is not taxed. The taxpayer may elect to pay the departure tax in up to six annual instalments, with interest.[14] Once again, acceptable security must be furnished.

The requirement for acceptable security in both these elective procedures is intended to protect the tax authorities against the risks associated with trying to collect tax from a non-resident, who may have no Canadian assets. The reader may well wonder how effective such protection is, given that the provision of security, and the election itself, occur after the taxpayer has already left. We shall return to the issue of compliance below.

III. TAX TREATIES

There are two basic issues under this heading. First, do international tax conventions restrict the right of a State to impose departure tax? Second, how do treaties affect the jurisdiction of the former State of residence in respect of income realized after departure?

The first question has a short answer, at least in Canada. The deemed income is realized "immediately before" the taxpayer leaves Canada, while he or she is still a resident. Case law confirms that bilateral treaties do not limit Canada's right to tax its own residents, and therefore do not affect the imposition of departure tax.[15] This conclusion has obvious implications for the design of departure taxes elsewhere.

The second issue is more complex. Recall that the Canadian departure tax entails a deemed realization of accrued income or gains in respect of certain properties, but not others. The theory is that the excluded properties are those over which Canada retains jurisdiction. However, that ulterior jurisdiction is affected by tax treaties. Under most treaties, Canada only reserves the right to tax gains from the disposition of Canadian situs immoveables (including certain indirect interests in such immoveables) and Canadian business assets. Thus, the class of properties over which Canadian jurisdiction is preserved is smaller than the class of taxable Canadian properties. Therefore, if a Canadian resident emigrates to a treaty country, gains arising from the disposition of properties which were spared from departure taxation (such as shares of non-real estate private corporations) could also be spared from Canadian taxation on realization.

To make matters more complicated still, one important class of taxable Canadian property which would almost invariably benefit from treaty protection, is the "deemed" taxable Canadian property resulting from a taxpayer's election to defer the gain. Where a resident departs Canada owning appreciated foreign assets or publicly traded securities, and elects not to be treated as having disposed of such assets at the time of emigration, the gain resulting from a subsequent actual disposition of the property would normally fall outside the scope of the gains over which Canada retains jurisdiction to tax under the treaty.

To support the operation of the departure tax, Canada has negotiated into most of its treaties an extended period of jurisdiction following a change of residence. The gains articles usually include a provision that withdraws treaty protection in respect of gains arising from the alienation of property by an individual; who was resident in Canada at any time in the preceding five years, and is a Canadian national or a person who resided in Canada for at least 15 years.[16] These treaty exceptions thwart short-term plans to leave Canada in anticipation of the realization of gains, a practice in vogue in the early 1980s. Note that the usual text requires a minimum period of non-residency from Canada, but not necessarily residency in the particular treaty partner.

After any such cooling-off period provided in the treaty, the usual treaty restrictions on source country taxation apply. If a resident of Canada emigrates and, after expiry of the extended period of Canadian gains taxing jurisdiction, the individual, now resident in a treaty country, sells the property, then treaty protection may apply to prevent Canadian tax whether or not the host jurisdiction taxes the gain. Treaties rarely deal with this issue, and it creates opportunities which are an important aspect of the planning considerations below.

A. Some non-Canadian comparisons

Canada is not alone in worrying about the erosion of its tax base through emigration. International comparisons are useful in this context in order to understand the options available for dealing with migratory taxpayers, and perhaps predicting likely trends in legislation.

B. Extending jurisdiction in time

An alternative to taxing residents on their departure is simply not to let them go!. I intend here not the prohibition against emigration (although that certainly works), but rather the refusal to relinquish jurisdiction over former tax residents. This is not the same as the extended jurisdiction in Canada's

14. Subsec. 159(4), (4.1), (7) ITA.
15. *Davis v. The Queen*, [1980] CTC 88 (FCA)
16. The details vary somewhat. For example, under the important Canada–US Convention, the first branch of the test refers to the preceding ten years, and the second to residence for at least 120 months in the preceding 20 years.

treaties, referred to above. Departure tax merely enables Canada to tax, for a time, the gains it considers as having a Canadian source, including those which were deferred by agreement.

One obvious way to keep former residents within the tax net is to base taxability on citizenship rather than (or in addition to) mere residence, as is the case in the United States. However, some residents are not citizens, and some citizens may be prepared to change their nationality. Under current US law, there is no provision to deal with the first problem, emigration of resident aliens (as they are referred to under US tax law). As for former citizens, the Internal Revenue Code provides that a person who gives up his or her US nationality is subject to a special expansive tax regime for the next ten years, if the loss of citizenship had as one of its principal purposes, the avoidance of tax.[17] The former citizen is taxable on a broader class of US source income than the usual non-resident alien, and at the rates applicable to US citizens. There is no particular logic to the limitation to US source income. The tax which the expatriate had avoided might well have related to gains accrued on foreign assets held while an American citizen. To make matters worse, the system is rife with loopholes. US assets can be converted to foreign assets through judicious use of tax-deferred reorganization provisions.

A recent legislative proposal would toughen up the US expatriation provisions, without changing the underlying principles.[18] The bill establishes a kind of reverse onus on wealthy expatriates: they would be deemed to have a tax avoidance motive unless they applied to the Secretary of the Treasury for a ruling. The proposals would extend the classes of property subject to taxation over the ten year period, eliminate some of the escape opportunities available under current law, provide tax credits to prevent double taxation and override tax treaties. An innovation is the extension of the provisions to include former long-term resident aliens. But, even with all these changes, the US law would still be based entirely on the extension of its taxing jurisdiction for ten years after expatriation, and still limited essentially to US source income.

Other countries, although not espousing taxation by citizenship, also attempt to retain a tax grip on former residents. For example, until this year (when these rules were repealed), Danish tax legislation treated individuals who had been resident in Denmark for at least four years as taxable for a further period of four years after leaving the country, unless they became subject to sufficiently high taxation in another country. For these purposes, the Danish authorities established a list of acceptably onerous taxing jurisdictions. One problem with this approach is that countries which would otherwise appear to have onerous regimes, may prove to be havens in certain circumstances. The United Kingdom, for example, was on the Danish "approved" list notwithstanding its remittance taxation system.

Germany has a similar system, but with some added wrinkles. Former residents may be subject to an extended (ten year) period of taxation, if they become resident in a tax haven (or nowhere). In general, a tax rate at least $^1/_3$ lower than German taxes is prima facie evidence of a tax favoured regime, but the new country of residence may also be considered a tax haven if it provides particular privileges such as negotiated fixed tax liability, remittance basis of income calculation, etc. The tax base during the extended ten year period is essentially limited to German source income, with a few specific base-broadening source rules, rather like the US approach. Also like the US, Germany generally applies its domestic progressive rate structure to such emigrants.

This approach to emigrating taxpayers, i.e. extending the period of time during which their liability to local taxation subsists, presents a number of drawbacks, not least compliance problems. Moreover, it is not particularly satisfactory from the tax policy standpoint. While the purpose of these rules may be to impose tax on deferred gains and income which the taxpayer's emigration was intended to avoid, the period of the extension is arbitrary, and the mechanics of deemed residence is inconsistent with both the residence and the source principles of taxation. Limitation to domestic source income, while perhaps practical, is not really consistent with the protection of the tax base which these rules are, presumably, intended to achieve.

C. Taxation on departure

Departure taxation is a finer instrument, and Canada is not entirely alone in adopting it. The German system, in addition to negating the effect of a residence change in certain cases, also contains a limited departure tax. This tax applies where an individual who has been a German resident for at least ten years, owns a substantial participation (more than 25%) in a German corporation. The accrued gain is taxed, although at a potentially preferential rate. Like the Canadian system, the German rules permit a step-up in the cost of the property for purposes of the departure tax to fair market value, if the taxpayer owned the shares when he or she became a resident of Germany. What is odd about this provision, when compared to the Canadian system, is that it only applies to a "local" asset. Presumably, subject to tax treaties (which could be part of the perceived problem), Germany could tax non-residents on dispositions of substantial interests in German corporations. In that case, no tax would be required on exit. The German departure tax could, therefore, be said to be broader than necessary. On the other hand, it is also narrower than the Canadian tax, since it does not extend to gains from other assets.

Denmark has a general departure tax, more on Canadian lines. The emigrating Dane is taxable on accrued capital gains in respect of shares (with a minor and limited exception for publicly listed shares held for at least three years). The rule extends to both foreign and domestic investments, because Denmark does not attempt to impose tax on non-residents selling Danish shares. The tax also applies to gains on certain debt obligations and financial instruments. It was recently extended to depreciable business assets if they do

17. Sec. 877 of the *Internal Revenue Code*. See Sec. 2107 regarding estate taxation.
18. The *Expatriation Tax Act of 1995*, H.R. 1812, introduced on 9 June 1995, amended 13 June 1995.

not form part of a permanent establishment in Denmark (since only assets associated with such an establishment would be subject to taxation in the hands of a non-resident). Another similarity to the Canadian system is the provision allowing the emigrant to post security in lieu of paying the tax.

Some countries do not impose departure taxes as such, but do accelerate the timing of recognition of income on a change of residence. In France, income is normally subject to tax when the individual has disposition over the funds, e.g. for salary this would be when it is paid. If the person transfers his or her tax residence abroad, the concept of "revenus acquis" applies to determine taxable income. This concept seems to suggest something between "due" and "earned".[19] "Revenus acquis" does not appear to be a sufficiently broad expression to require the valuation of contingent rights. Nor does the French rule purport to deal with capital assets.

The US tax proposals relating to the ten year extended period of taxing jurisdiction referred to above, were actually introduced in replacement for, and in response to, an earlier administration plan to enact a departure tax based, to some extent, on the Canadian experience. The President's proposals included a departure tax on all the property of a person relinquishing US citizenship, based on a deemed disposition at fair market value. The plan attached the same consequences to long-term non-citizen permanent residents, i.e. those who surrender a green card after ten years' residence in the US. The ten-year period is perhaps an expanded version of Canada's five-year term, although rather less generous as it was not limited to property owned when the person became a US resident. The administration plan had a very substantial threshold for its application: deemed gains in excess of $600,000. This could be perceived as unfair, but it presented substantial administrative advantages. The high threshold was also probably intended to present the political advantage of affecting fewer voters but, judging by subsequent events, that was a miscalculation.

IV. PRACTICE

There are lessons to be drawn from the Canadian experience with departure taxation. My aim is not so much to explain how Canadians have adapted to this fiscal scheme, but rather to draw conclusions which may be valid for the future experience of others.

A. Compliance

Enforcing tax obligations against non-residents is not easy if they do not have assets within the jurisdiction. Even where the tax liability can be established, most countries are loath to enforce foreign tax judgments. While there has been some tentative movement on that front, the situation is unlikely to change in the medium-term. Leaving aside circumstances in which criminal activity such as fraud may be alleged, tax debtors do not normally face restrictions on their personal movement or activities, although they are obviously wary of holding property which might be seized by the creditor government. This state of affairs explains why most countries tax non-residents through administrative systems based on the concept of withholding by residents, people over whom they have more effective jurisdiction.

The attempt to impose more burdensome tax liabilities on former residents or citizens merely compounds the usual compliance problems affecting taxation of non-residents. This did not escape the attention of US legislators. The House Ways and Means Committee minority, opposing the recently introduced proposal to reinforce the expatriation rules described above, cited its "nonadministrability" (sic) as a fatal flaw, and concluded that the "only answer to tax avoidance by expatriates is to impose a tax before they leave".[20] They implied that this is just what an exit tax accomplishes.

But a departure tax, such as that imposed in Canada, while technically a tax on Canadian residents rather than non-residents, faces similar compliance problems. Unless Canada is prepared to require production of tax returns, perform audits and engage in collection procedures before allowing people to leave the country, the departure tax must necessarily be collected from, as opposed to imposed on, people who no longer live in the country. Unfortunately for the House Ways and Means Committee minority, one cannot impose tax on "expatriates before they leave", because before they leave they are not expatriates. Thus, departure tax, like extended taxing jurisdiction after departure, is viewed by some as a kind of "voluntary" tax, applicable only to those who choose to honour their obligations.

Of course, in a self-assessing system, the same can be said of a number of income sources. However, the inability to collect the departure tax does put starkly the moral choice facing the departing Canadian. Consider the situation of Mrs A, a Canadian citizen and resident who has, over the years, built up a thriving management consulting business consisting of a Canadian corporation and an American corporation, both directly owned by her. She decides to move to a sunny, tax-free location and, eventually, sell the businesses. When she leaves Canada, there is no deemed disposition of the shares of the Canadian company, but there is a realization for tax purposes of the gain accrued on the shares of the US company. If she plays by the rules, Mrs A can either pay tax on that latter gain (immediately or, posting security, over time) or elect that the gain be deferred and the shares of the American company thenceforth regarded as taxable Canadian property. If she makes that election, the eventual sale of the business will create a Canadian tax liability on the entire gain, including the element which accrued after she left. Security will have been provided for at least part of that tax (on the gain accrued to departure). There would be no US tax on the sale of the company (assuming no real property is involved).

Mrs A may be sorely tempted to ignore the departure tax. She will still be taxable on the eventual sale of the Canadian

19. Art. 167, *Code Général des Impôts*
20. Daily Tax Congressional Documents, 19 June 1995, at 4288.

shares. But the Canadian authorities may or may not ever discover the existence of the US company, and will certainly have difficulty doing anything about it if, by that time, the Canadian asset has been sold and the proceeds removed from Canada. Of course, Mrs A may feel uncomfortable with her status as a "tax fugitive", but comfort has its price. As a Canadian citizen she can still travel back to Canada. If she has committed no offence, she cannot be physically detained for her tax debts.

It is hardly a remarkable discovery that tax systems are much tougher on those who would comply than on those who choose not to. What is noteworthy is how this gap widens when the law seeks to tax non-residents. It is unlikely to narrow in the near future.[21]

This phenomenon is probably unavoidable in departure taxes. Those systems that seek to treat former residents as continuing taxpayers face the same collection problems. Even taxing on the basis of citizenship is no solution. Citizens can also remove assets from the jurisdiction. Failure to pay taxes is not likely to be grounds for loss of nationality. Governments would be well-advised to reflect on the damage done to compliance generally by unenforceable rules.

B. Expatriate executives

As a "branch plant" economy, Canada has long played host to many foreign executives, well before the era of internationalization. Those temporary, unwilling participants in the Canadian tax system have, like their colleagues elsewhere, faced the complexities and burdens of a new tax regime, and their employers the cost and pain of equalization payments. Migrating employees must always consider the implications of overlapping tax jurisdictions (selling a home after changing residence, maintenance of foreign retirement savings plans, participation in group-wide pension arrangements, ownership of foreign tax shelters or other investments, etc.). Departure tax is a special and additional source of concern.

There are several practical reasons for accommodating these particular emigrants. The country to which they depart probably does not have the same tax rules as Canada. In that case, there will be no step-up in cost for the purposes of future taxation of gains, and double taxation will result from the imposition of Canadian departure tax. If all tax systems had Canadian style departure taxes, that problem would go away. Nonetheless, migrating employees would probably still find difficulty with repeated deemed realizations of their assets.

Whether the purpose is to relieve such fiscal hardship, or to permit and promote the economic benefits which follow the (relatively) free movement of senior employees, Canada does provide relief to temporary residents. As already noted, the departure tax does not apply to properties owned by the individual when he or she became resident in Canada (or acquired by bequest or inheritance during the period of residence,) provided that the individual's stay in Canada does not exceed five years. This rule has led to several types of planning for executive movement which may be of general application.

The restriction of the exemption to property owned when the person became resident is important. Tax systems, by necessity, tend to follow legalities rather than economic realities. Suppose Mr X comes to Canada owning an investment portfolio. He will probably not be surprised that Canadian taxation applies to gains realized while he is a resident. Indeed, he may be either pleasantly or unpleasantly surprised to find that the gain is normally measured only by reference to the value of the asset at the date he arrived. His mood being affected by whether the value at the date of immigration was higher or lower than his cost. He will certainly not be pleased that, on departure, even within the five years, the accrued gains on replacement investments will be taxed, and quite likely without a corresponding step-up in the next country of residence. Depending upon the possibility of treaty relief, it may be desirable for Mr X to defer the departure tax by making the election that the investment be treated as taxable Canadian property.[22] For the migratory executive, who does not know upon arrival in Canada where he or she is likely to be next, it would be better to plan for departure tax in advance.

One possibility is for Mr X to place the investments in a vehicle which will remain unchanged during the period of Canadian residency. For example, subject of course to tax considerations in the country where he then resides, he might place the investments in a holding company. If he retains the shares of that company throughout his stay in Canada, provided his stay is less than five years, there is no departure tax. However, unfortunately there are other problems. Canada has a well-developed regime for the current taxation of passive income accumulating in offshore companies. Mr X would almost certainly find himself caught in that system. While conceptually he is no worse off in respect of some types of investment income, such as interest (on which he would have paid tax anyway), there are anomalies and double taxation traps galore, and some costly and complex compliance.

Mr X would be more likely to opt for the creation of a non-Canadian trust. The rules respecting accumulating passive income apply to trusts as well, but there is a special exemption during the first five years of residency of a settlor (subject to a number of conditions and restrictions regarding the constitution of the trust). This dovetails neatly with the five year departure tax exemption. It can permit Mr X to avoid the unpleasantness of future departure tax and, at the same time, reap the benefits of tax free accumulation of investment income (unless, of course, he happens to be a US citizen).

Not all problems are so neatly dealt with. Ms Y has also come to Canada to work temporarily and, while she has no appreci-

21. The proposed Canadian legislation expanding the definition of "taxable Canadian property", referred to above, is a case in point. A tax levied on non-residents on the disposition of foreign company shares falls even more squarely in the category of "voluntary taxation", and puts yet more strain on taxpayer morality.

22. For repeated migrants, the election raises a terrifying prospect of the same asset being deemed to be taxable in several jurisdictions, if his or her other tax homes had similar rules to Canada, extended jurisdiction, or whatever. The Canadian tax system does provide a foreign tax credit to the non-resident taxable elsewhere on such property: Subsec. 126(2.2) ITA. However, as departure taxes become more popular, the likelihood of smoothly overlapping taxing jurisdictions decreases, probably geometrically.

ating (or potentially appreciating) investments, she does own shares of the foreign employer corporation, being part of the management group which bought it a few years ago. She has no plans to dispose of the shares, and no dividends are anticipated. She would probably have no reason to lodge the shares in a holding company. However, while she is in Canada, the foreign company undergoes some kind of corporate reorganization. Such a reorganization could be a taxable event in Canada. Even if it is not (for example most recapitalization transactions would qualify for Canadian roll-over relief), the shares she owns when she leaves may be considered to be a different property from the shares she owned when she arrived, and therefore not protected from departure tax. This example highlights the need for careful tax planning to avoid the pitfalls inherent in departure tax.

As more countries climb on the departure tax bandwagon, we are likely to witness increased sophistication and diversity in the techniques designed to permit executives to move about without triggering repeated and costly tax liabilities.

C. Tax planning generally

If every country had the same tax system, life would be simpler (although considerably less interesting and lucrative for tax advisors). On the assumption that the Canadian system was made the model, then each country would tax gains accrued during periods of residency, and provide a step-up in cost on entry. There would be no double taxation, and no gains would escape taxation. One might argue that departure tax could just as well be abolished. We could have pure residence based taxation, or perhaps the mixed version which forms the basis of tax treaties, where gains are taxable in the country of residence with a few particular elements of source taxation preserved, mainly immoveables. True, that would mean that some gains which accrued during a period of, for example, Canadian residency would not be taxed in Canada (except for real estate), but they would be taxed somewhere else, and Canada would get to tax gains realized by its residents that accrued while they lived elsewhere. In effect, this is the model of taxation within Canada, and most other federal States. There is no departure tax when individuals move from one province to another, and gains are taxed by the province of residence at the time of disposition.[23]

But the fact is that national tax systems differ. Even within the European Union there are wide variations. Harmonization of something as simple as VAT rates still escapes the European partners. It seems clear enough that national sovereignty and jealous protection of the national tax base will prevent for the foreseeable future, the kind of integration which would be required to harmonize departure taxation.

In this state of affairs, where domestic tax rules on emigration and immigration are not coordinated, there will necessarily be both planning opportunities and traps for the unwary, loopholes and potholes, if you will. One source of both is the determination of the cost of an asset on immigration. A country with a full or even a partial departure tax will normally provide a step-up in cost upon the taking up of residency, in order that only gains accruing during the period of residency are taxed on departure. Countries with no departure tax generally do not address the question of step-up, with the implication that the cost of an asset is to be determined under the normal domestic rules, i.e. usually historical cost.

Consider, first, a pothole. Mr Q was born and raised in Canada, built up a successful business, acquired investments and now plans to retire to somewhere warm (climate is a recurrent theme in Canadian tax planning). On departure from Canada, Mr Q must recognize accrued gains in respect of property other than taxable Canadian property, or alternatively he might choose to defer the gain by making the election to treat that property as taxable Canadian property in future. There is no deemed disposition of taxable Canadian property, such as Canadian real estate or shares of a Canadian private corporation. After he leaves, Mr Q eventually disposes of all these assets (or perhaps he dies while owning them which, under Canadian tax law, has the same effect). Subject to treaty protection (which, it will be recalled, normally requires a minimum period of non-residency, usually five years), Mr Q is taxable on the gains in respect of actual or deemed, taxable Canadian property. His new tax home may well also impose tax on gains and, if it is not a departure tax state, is likely to measure that gain based on the historical cost of the asset, without any step-up to the date of immigration. He is at the mercy of the foreign tax credit system. He has also unwittingly subjected to tax in his new home country gains, accrued while he lived in Canada.

If departure taxes become more widespread, we may anticipate further attention to such issues in tax treaties. Canada has taken some very small relieving steps in this direction,[24] but there is much left to be done. Until then, Mr Q might be better advised to adopt a policy of self help. Planning for his departure could involve a transaction to realize gains, for purposes of taxation in the new tax home, without realizing them under Canadian principles. For example, perhaps Mr Q could transfer his investments to a Canadian corporation under the protection of a Canadian domestic tax-deferral provision.[25] The laws of the future residence state might consider this a taxable transaction, but without imposition of tax since Mr Q does not yet live there.

The other side of the tax system arbitrage coin is that a step-up in one jurisdiction without taxation in the other can be beneficial. The simplest case is Mrs Z, an elderly resident of a non-departure tax country who owns a substantial portfolio of appreciated publicly-traded securities. A rather simple form of tax planning would be for her to move to Canada, and

23. The Province of Ontario recently underwent an examination of its tax system by an independent Commission. The Commissioners did fleetingly consider whether a provincial departure tax would be a good idea. While conceptually attractive, supporting a comprehensive income tax imposed by the Province, it was quickly rejected as both impractical and inconsistent with the existence of the Canadian confederation and the mobility presupposed by it.

24. See the Canada–United States Tax Convention, Art. XIII(7) which bridges some of the gap created by Canadian deemed dispositions and Art. XIII(6) dealing specifically with the principal residence.

25. Sec. 85 ITA permits an individual to transfer most types of property to a Canadian corporation in exchange for shares free of tax.

then realize the portfolio. The original country of residence does not impose tax on her emigration, nor does it purport to tax her on a subsequent realization of the investments. Canada obligingly offers a step-up in the cost of the portfolio investments to the value at the time Mrs Z acquires her Canadian residence. If Mrs Z's State of original tax residence has an extended period of taxing jurisdiction, the plan may still work, although with a bit more effort. First, one must examine the domestic rules in Mrs Z's former tax home to see if the deemed residence provision applies where the new residence is Canada. Second, one must consider any applicable tax treaty, although most treaties do support such extended jurisdiction for some period of time. If all else fails, Mrs Z can stay however many years are required in Canada (or perhaps in Bermuda, and the last year in Canada) to weather the deemed residence period. As a precaution Mrs Z may be advised to enter into some kind of estate freeze to prevent further appreciation while she is resident in Canada. Note that Canada does not impose any death duties, although there is a deemed realization of gains on death. If there are no gains from the date of immigration, there is no tax on death. Tax planning becomes a matter of staying alive.

Returning to Mr Q, the emigrating Canadian who fell into the trap of double taxation, he too might turn the rules to his advantage. Perhaps the simplest example is where he finds a new tax home in a treaty country which will not tax him on realized gains. There are a number of countries, Belgium being but one, which, although certainly not tax havens, provide special exemptions for all or some capital gains realized by individuals. If Mr Q emigrates, elects to defer deemed gains under the Canadian departure tax, remains outside Canada the requisite number of years under the bilateral treaty and ends up in the privileged tax home, he may be able to realize all the deferred gains completely free of tax, and recover the security originally posted with the Canadian tax authorities.

An interesting possible destination is the United Kingdom. An individual resident but not domiciled in the UK is generally exempt from tax in respect of capital gains not remitted to the UK. Many Canadians live in England and benefit from this rule. Unfortunately, the Canada–UK Income Tax Convention withdraws protection in respect of items of income which are taxed on a remittance basis and are not remitted. Assuming this provision applies to gains,[26] Mr Q may nonetheless find an appropriate solution. Once he has resided in the UK for five years (so that treaty protection on gains is generally available), he might engineer a transaction which is not taxable in the UK. It is important that the non taxation does not rely on the UK remittance provisions. A gift to his spouse or a corporate reorganization might suffice. Such an operation would be protected from Canadian taxation (by the treaty), and yet could increase the cost of the asset for Canadian tax purposes. A subsequent sale without remittance of the proceeds would do the trick: there would be no Canadian taxation (because there is no gain measured under Canadian rules) and no UK taxation (because there is an unremitted gain).[27] Another alternative would be for Mr Q to engage in the converse form of transaction, stepping up his cost for UK purposes without incurring tax. For example, he might, while still resident in Canada, reorganize his affairs in a manner which fits Canadian but not UK roll-over rules. This can provide a new base cost for UK tax purposes. He then emigrates to the UK, waits five years, and sells the asset, remitting the gain. There is no Canadian tax because of the treaty and UK tax is limited by virtue of the higher base cost.

The moral to these examples is that gaps will arise where departure taxation is not uniform. International tax practitioners will necessarily become adroit at exploiting the opportunities while avoiding the traps. The Canadian experience should be useful to those entering upon this road for the first time.

26. There has been an argument for some time as to whether "gains" are "income" for the purposes of this provision, Art. 27(2). See J.F. Avery Jones and J.D.B Oliver, "How Others See Us", [1988] *British Tax Review* 437-40, reacting to a decision regarding a similar provision in the UK–Sweden Convention, Judgment 1169-1987, 23 Dec. 1987, RÅ 1987 ref. 162.

27. I should not leave the impression that such a plan can be accomplished without careful attention to both technical details and considerations of tax avoidance doctrines and legislation, in both Canada and the UK.

SOUTH AFRICA

1995 TAX AMENDMENTS

Marius van Blerck and Paul de Mare

Mr Marius van Blerck is Group Tax Consultant, Anglo American Corporation; Chairman of the Scientific Committee of the South African branch of IFA; and founding editor of the *SA Tax Review*. **Mr Paul de Mare** is a senior divisional tax adviser to Anglo American Corporation

I. INTRODUCTION

The following is a summary of the more significant amendments to the South African tax legislation promulgated in July 1995. All of the measures announced in the 1995 Budget have been implemented, and since these were detailed in the May 1995 issue of the *Bulletin*, they are not repeated here unless the context so requires. Other tax developments are noted briefly where relevant.

II. COMPANIES

A. Value of trading stock

Under current legislation when a company distributes any trading stock in specie, the market value of such trading stock must be included in the company's income. The new amendment requires that this inclusion must take place not only where the distribution includes a reduction in the company's share capital, but also where it involves a reduction in its share premium account.

B. Sale and leaseback

Section 23D of the Income Tax Act (the Act) provides that where certain assets which are let by a taxpayer to a lessee were originally acquired from the lessee, the applicable capital allowances are calculated on an amount not exceeding the lesser of the original cost of such asset to such lessee or the market value thereof on the date of acquisition by the taxpayer. These provisions have now been extended to include assets which consist of intangible property, such as inventions, patents and similar assets, as contemplated in Section 11(gA). Furthermore, an amendment has been introduced which now widens the scope of Section 23D to cover the situation where a sublessee or a connected person in relation to such sublessee is interposed between the taxpayer and the lessee.

C. Transfer pricing and thin capitalization

For the first time, South Africa has specific tax rules for transfer pricing and thin capitalization. The provisions of the new Section 31 are intended to address tax avoidance schemes involving the setting of non-arm's length prices for goods and services in cross border transactions between connected persons. The new transfer pricing rules are also intended to counter excessive thin capitalization.

D. Secondary tax on companies (STC)

The possibility of amending the current two-tier system of corporate taxation is currently under review by the Katz Commission. The outcome of this review may result in the modification of the current system (with the retention of STC), or alternatively the abolition of STC, with or without a dividend withholding tax in its place. The Commission is expected to make its recommendations in sufficient time to allow the planned changes to be announced in the 1996 Budget in March.

In the interim, it is of some significance that the United Kingdom tax authorities have, after much deliberation, announced that STC qualifies as a tax on income for the purposes of the South Africa–United Kingdom Double Tax Treaty.

As far as tax amendments go, two existing STC exemptions have been extended as follows:

1. STC exemption 1

Section 64B(5)(c) of the Act provides an exemption from STC in respect of dividends declared out of profits derived during years of assessment ended not later than 31 March 1993, if such dividend was declared in the course of the liquidation or winding up of a company, or in anticipation of the deregistration of a company under a rationalization scheme envisaged in Section 48 of the Taxation Laws Amendment Act, 1988.

The exemption has been extended to include:
- all pre-31 March 1993 non-capital profits distributed in anticipation of liquidation, winding up or deregistration; and
- all capital profits (whatever their timing) distributed in anticipation of liquidation, winding up or deregistration.

A proviso to this is where the company is not liquidated or deregistered within six months from the dividend distribution date (or such further period as is in the circumstances of the case reasonably necessary), the exemption will be deemed not to have applied. STC will then become payable and will be recovered from the shareholders in the same proportion as the dividend was distributed.

These amendments apply to dividends declared on or after 19 July 1995.

2. STC exemption 2

In 1994 a new exemption was introduced, allowing a wholly owned subsidiary to elect for a STC exemption in respect of a dividend distribution to its holding company provided:
- the holding company has its place of effective management in South Africa; and
- all its profits are of a South African source.

The application of this exemption has now been restricted further by the following requirements:
- the holding company must have held all the shares in the subsidiary for at least 12 months prior to the declaration of the dividend; and
- the dividend must be declared solely out of profits earned by the subsidiary while it was wholly owned by the holding company.

There is also an exemption which favours the taxpayer. The requirement mentioned above that the holding company's profits be solely of a South African source is modified, in that such profits now specifically exclude dividends. Thus, for example, the fact that a holding company receives dividends from a foreign company does not disqualify the subsidiary company from applying for the exemption.

These amendments apply to dividends declared on or after 19 July 1995.

E. Unbundling and rationalization provisions

The tax authorities have recently issued a practice note (No. 38 of 5 May 1995) dealing with the rationalization of a group of companies, following the 1994 tax amendments which enabled rationalizations to take place in a relatively tax-neutral manner. The practice note deals largely with administrative issues.

As far as legislation is concerned, the date of 4 November 1994 on which an existing shareholding had to be in existence in order to qualify for the application of either the unbundling or the rationalization legislation has now been extended to 19 June 1995.

III. INDIVIDUALS

A. Taxation of lump-sum benefits

As announced in the budget speech, amendments to the tax law have now considerably restricted the ability of persons retiring on or after 1 September 1995 to reduce the tax rate applicable to the taxable portion of retirement lump sums.

The fact that public servants are not taxed at all on such lump sums is an anomaly yet to be addressed.

The tax authorities have now issued a practice note (No. 40 of 19 June 1995) to provide clarity in respect of those employees who retire but then wish to continue to provide their knowledge and skills to their former employer. The Commissioner's office will accept this "re-employment" provided it is in a different capacity. The concept of a different capacity would cover for example an employee joining as a consultant and undertaking functions similar to those previously carried out, provided that the person no longer qualifies for membership of the pension/provident fund and medical aid (other than in the same way as other pensioners) and that the new contract differs from the previous employment contract.

A further requirement is that an employee who is a member of both a pension and a provident fund is required to retire simultaneously from both funds and receive the retirement benefits of each fund.

IV. GENERAL

A. Tax amnesty

A tax amnesty was mooted in the 1995 Budget, and has now been legislated for. The period during which people may apply for the amnesty runs from 19 July 1995 until 31 October 1995 and there is provision for its possible extension. Legal persons such as companies as well as natural persons may apply for the amnesty if they were not registered as taxpayers on 26 April 1994, or if their whereabouts were unknown on that date.

B. Practice notes

The following is a list of practice notes issued by the tax authorities in the current year.

Practice note No. 36 of 13 January 1995
Income tax: valuation of trading stock.

Practice note No. 37 of 13 January 1995
Deduction of fees paid to accountants, bookkeepers and tax consultants for the completion of income tax returns.

Practice note No. 38 of 5 May 1995
Group rationalization schemes.

Practice note No. 39 of 10 May 1995
Income tax: deduction in respect of wear and tear or depreciation in terms of Section 11(e) of the Income Tax Act: machinery, plant, implements, utensils and articles (supplement to practice note No. 19).

Practice note No. 40 of 19 June 1995
Income tax: lump sum benefits derived from a pension or provident fund on retirement.

IFA NEWS

SOME HIGHLIGHTS FROM THE SECRETARY GENERAL'S 1994/95 GENERAL REPORT

J. FRANS SPIERDIJK

INTRODUCTION

Shortly after Professor Augusto Fantozzi and I had completed our IFA-promotion trip to India and a number of other countries in South-East Asia, the Chairman of the Permanent Scientific Committee (PSC) was appointed Minister of Finance of Italy, in January 1995. Of course we congratulate Professor Fantozzi wholeheartedly with his honourable high position. We believe him to be extremely well qualified for this responsible and demanding office. At the same time we regret to lose him as far as his direct active involvement in the PSC is concerned.

IFA's Italian President, Prof. Avv. Pietro Adonnino, I am very glad to report, continues to actively lead our Association. With the consent of the General Council a proposal will be made to the General Assembly in Cannes to reappoint him for a second term of two years.

At the General Secretariat we will celebrate that on 4 August 1995 Nel Slingerland completes 20 years of employment with IFA. Everybody who has ever been in touch with her, be it as a Chairman, a Committee member, a Panellist, a Reporter or in any other capacity will agree that Nel is extremely pleasant and efficient to deal with. She works for IFA as if it were her own business and is a vital factor in making the IFA machine run smoothly.

Also in this year sadly IFA lost a number of its prominent members. On 6 August 1994, Professor G. van Fraeyenhoven died. He had been Chairman of the Belgian Branch for a long period, General Reporter in 1987 and an active IFA member in many respects. Dr A. Hörtlehner from Austria, a long-time Secretary of the Branch passed away on 31 October 1994. In March 1995 we lost Professor N. Amoros Rica, Honorary Member of IFA and long time Chairman of the Spanish Branch, a driving force behind IFA particularly in the Spanish speaking world. In the 1995 IFA Yearbook Mr Marin Arias, Secretary of the Spanish Branch, pays tribute to him in his *In Memoriam*.

TORONTO CONGRESS

The second Congress in Canada, the previous one being in Montreal in 1982, proved to be a success from all points of view, and I would like to express a note of sincere thanks to the Canadian Branch, and to Mr Bob Dart, Mr John Haag and Mr Gordon Williamson in particular, for this achievement. I would also like to acknowledge the excellent services of Congress Canada, the Professional Organizers, who did a wonderful job in looking after all our needs before and during the Congress week. The Congress was attended by 1,154 participants and 472 accompanying persons. A very interesting scientific programme was offered, which was well attended. As in Florence in 1993, an early time schedule was observed, which worked very well.

Many of you will remember the Opening Ceremony at Roy Thomson Hall, Toronto's architecturally renowned glass enclosed concert hall, which included performances by the professional "Hannaford Street Silver "brass band; the reception at the Royal Ontario Museum, where the museum's entire collection of cultural and natural history was accessible for viewing; the Ballet at the O'Keefe Centre, where Canada's National Ballet starring Karen Kain, Canada's world famous ballerina and Rex Harrington performed Pacquita and Elite Syncopations and last but not least the Gala Banquet, where participants could dance the night away with the Guido Basso Orchestra while enjoying a dinner of international cuisine.

The new procedures for the Working Sessions, implemented on a trial basis in 1993 in Florence, were continued in Toronto and were generally regarded as a success, leading to lively and constructive discussions. The discussions on both Main Subjects had been thoroughly prepared and were carefully and effectively presented. The draft résumé and the resolution were mailed to registered participants four weeks in advance of the Congress, enabling them to thoroughly prepare themselves. The success of the discussions was achieved due to the commitment and input of the General Reporters, Prof. B.J. Arnold (Canada) for Subject I and Prof. Dr A. Rädler (Germany) for Subject II, and the Discussion Leaders, respectively Prof. P. McDaniel (USA) and Prof. L. Denys (Belgium), as well as the members of their Panels, who are to be congratulated on the quality of their work. The Panel for Subject I consisted of Prof. C. Blum (USA), Mr F. Jacob (Germany), Mr W.R. Lawlor (Canada), Mr A. Overbosch (Netherlands) and Prof. R. Vann (Australia), and Mrs K.V. Penny (Canada) as Secretary. On the Panel of Subject II were Mr M. Gammie (UK), Mrs A. Rutberg (Sweden), Prof. W.P. Streng (USA), Mr G.O. Teijeiro (Argentina) and Mr J.M. Tirard (France), with Mrs C.B.E. Smit (Canada) serving as Secretary.

Subjects I and II had 29 and 28 National Reports respectively appearing in the 1994 Cahiers. Turning to the Seminars of the 1994 Congress, two Seminars deserve special mention: firstly, the "Recent Transactions of Interest", ably presented by Messrs J.D.B. Oliver (UK) and D.R. Tillinghast (USA), which was very well received by the participants. It is intended to repeat this kind of Seminar during future Congresses, if not every year. Mr H.K. Kroppen (Germany), R. Raizenne (Canada) and P. Sleurink (Netherlands) served as Panellists. Secondly, the joint project between IFA and the OECD, the Seminar on "The OECD Model Treaty – 1994 and beyond", chaired by Prof. Dr K. Vogel (Germany), which was a first trial and, according to feedback received, was a success. I am very pleased about this cooperation, which will be continued during the Cannes and future Congresses, and which enables IFA to reinforce its role as a forum which brings together representatives from the private and public sectors. Mr R. Aguirre (Mexico), Prof. R.L. Doernberg (USA), Prof. K. van Raad (Netherlands) Mr J. Sasseville (Canada) and Prof. D.W. Williams (UK) served as members of the Panel, while Mr D. Lüthi and Mr J. Owens gave a significant contribution on behalf of the OECD. Mr B. Elvin (USA) acted as Secretary to this Seminar.

The other Seminars were the following. Seminar A "Harmonization of tax under the North American Free Trade Agreement" was chaired by Mr W.G. Williamson (Canada), and Mr D.K. Dolan (USA), N. Loveland (Canada), E. Romano Mussali (Mexico) and M. Taly (France) served as members of the Panel. Mrs S. Peterson (USA) chaired Seminar B "Secondary adjustments and related aspects of transfer pricing corrections", while Mr H. Becker (Germany), E. Hess (Switzerland), R. Himino (Japan), Mrs F. Horner (USA) and Dr A.R. López (Argentina) were members of the Panel, and Mrs L. Eastmond (Barbados) was the Secretary.

"How domestic anti-avoidance rules affect double taxation conventions" was the title of Seminar C, with Mr D.A. Ward (Canada) in the chair, while the Panel consisted of Mr R. Gustafsson (Sweden), S.I. Katz (USA), Prof. Dr G. Laule (Germany), Dr A.V. Lowe (UK) and Dr H. Torrione (Switzerland). Mr I. Crosbie (Canada) acted as Secretary.

On behalf of IFA I would like to express our deep gratitude to all the people mentioned above and to all who have actively participated in the Working Sessions of both the Main Subjects and the Seminars or have otherwise made the Toronto Congress such a success.

It is worth mentioning here that we are hoping to be able to publish the proceedings of at least four of the Toronto Seminars in the "IFA Congress Seminar Series". Some of these publications will already be available by the time of the 1995 Congress. Details on where these booklets may be purchased are given in the 1994 IFA Yearbook.

PERMANENT SCIENTIFIC COMMITTEE

The PSC met in Paris in early February, upon the invitation of the French Branch, who provided excellent facilities. The meeting was very interesting and fruitful. Professor Fantozzi, despite his busy schedule, managed to come to Paris and even chaired the meeting in his usual effective and charming way. During the Cannes Congress we shall have to say goodbye to Dr A. Rafael (Israel) and Prof. L. Fischer (Germany), who both tendered their resignation. The PSC is considering their succession. The name of Mr Tadatsune Mizuno (Japan) will be proposed to the Executive Committee and General Council as the permanent deputy of Prof. H. Kaneko (Japan), while Mr L. Teixeira Pinto (Brazil) was confirmed as Mr A. Toffoli Tavolaro's permanent deputy. In view of his new obligations Professor Fantozzi requested Mr D.R. Tillinghast, Vice-Chairman of the PSC, to attend to the business of the Committee until the time of the Cannes Congress, where more definite decisions are going to be taken. IFA is very fortunate in having such an outstanding Vice-Chairman, and I would express my sincere appreciation to Mr Tillinghast for his willingness to take on this responsibility.

Mr E. Schnieder (Germany), 1994 research associate, assisted the PSC in organizing the scientific programme of future IFA Congresses, particularly the 1997 New Delhi event. Seven applications, from Argentina, Austria, Japan, Sweden, South Africa and the USA were received for the 1995 function. Upon the recommendation of the Research Subcommittee, the PSC decided to engage Mr Yoshihiro Masui (Japan), Associate Professor at Tokyo University, for the 1995 position.

Initiated by our Mexican friends for the 1992 Cancún Congress, the early time table will be implemented again during the 1995 Cannes Congress. It is hoped and expected that this will be an additional help in getting participants to attend the scientific sessions, while enabling them to have some free time to enjoy the many distractions the beautiful city of Cannes has to offer.

The Poster programme, where young and promising people are given the opportunity to present to the Congress participants the outline of the doctoral thesis they are working on, was regarded a success in Toronto, and will be repeated in Cannes. The Chairman of the PSC has contacted a number of Universities for candidates.

The preparations of Seminars and Main Subjects for Cannes were found to be proceeding satisfactorily. 28 National reports were received for Subject I "International income tax problems of partnerships", for which Prof J.P. le Gall (France) is General Reporter; and 29 for Subject II, a very topical subject, which will examine the fundamental questions of the measurement, timing, and character of income and deductions from derivative financial instruments and the tax effects of cross-border transactions in derivatives. Messrs H.D. Rosenbloom and Ch.T. Plambeck are the General Reporters, and Mrs D. Ring is assistant General Reporter. Needless to say IFA is greatly indebted to the General and National Reporters for their contributions. The Seminars in Cannes will treat:

A: The OECD Model Treaty – 1995 and beyond
Chairman: Professor Dr K. Vogel (Germany)
B. Dividend access shares (stapled stock)
Chairman: Mr P. Derouin (France)
C: VAT in internal markets – European experience
Chairman: Professor F. Vanistendael (Belgium)
D: Taxing regimes applicable to headquarters
Chairman: Mr B. Gouthière (France)
E: Taxation of non-resident entertainers
Chairman: Dr J. Killius (Germany)
F: Tax reform on the Southern side of the Mediterranean Sea
Chairman: Professor C. David (France)

The two Main Subjects for the 1996 Geneva Congress will be:

I. "Principles for the determination of the income and capital of permanent establishments and their application to banks, insurance companies and other financial institutions", with Dr P. Athanas (Switzerland) as General Reporter; and II. "International aspects of thin capitalization", for which topic Professor Dr D.J. Piltz (Germany) will act as General Reporter. For 1997 the two Main Subjects were definitely fixed, as being: I. "The taxation of income derived from the import of technology", with Dr A. Bagchi (India) and Mr S. Lainoff (USA) as General Reporters; and II. "The taxation of investment funds", where Mrs L. Ed (UK) and Mr P. Bongaarts (Netherlands) agreed to serve as General Reporters.

Initial discussions were held on an interesting and stimulating scientific programme for the 1998 London Congress, in close consultation with our friends from the UK Branch.

EXECUTIVE COMMITTEE

The French proved again to be excellent hosts during the 30 April 1995 meeting of the Executive Committee, which took place in Cannes at the Hotel Majestic, situated very close to the Palais des Festivals, venue of the 49th Congress. President Adonnino welcomed Dr M. Desax (Switzerland), Mr T. Miyatake (Japan) and Mr J.D.B. Oliver (UK) as new members. At the last Executive Committee meeting during the Cannes Congress we shall have to say goodbye to Messrs Ian Harris (Hong Kong/UK), and Sanford H. Goldberg (USA) since their final term under our Articles has come to an end. I wish to take the opportunity of thanking them for their devoted services towards the Executive Committee and the Association as a whole. New candidates for Executive Committee membership will be submitted to the General Council in Cannes.

A long list of household matters were discussed and decided upon. Worth mentioning here is an analysis regarding language representation of the IFA membership as a whole and during annual IFA Congresses which was brought to the attention of the meeting. These figures showed that from the participants in a Congress, roughly speaking about 70% expressed themselves in English, the remaining 30% was divided between the German (about 13%), French (about 13%) and Spanish (about 4%) speaking groups. The Committee discussed these figures and arrived at the conclusion that under present circumstances IFA should maintain the practice of providing translation and interpretation in the three official IFA languages, and, during annual Congresses, in Spanish. However, since an Association such as ours cannot afford to stand still, and should continuously appraise the existing desires and objectives of its membership, it was decided that this issue should be carefully evaluated again at some future date.

The meeting noted with regret that the Press Release issued at the close of the Toronto Congress, which had been circulated to the professional press worldwide, had resulted in limited coverage. Professional advice on how to proceed in the best and most effective way for the Cannes Congress is being sought, and I will report in my next Annual Report on the results of this endeavour.

Other matters reviewed and discussed by the Executive Committee are mentioned under the headings hereunder.

THINK TANK

The Think Tank Committee presented its final report, which was discussed at the 30 April 1995 meeting of the Executive Committee, and which has been circulated to the General Council for discussion during their 1995 Cannes meeting. The National Branches have been provided with a copy, with grateful thanks to those who cooperated in responding to the questionnaire which this Committee issued.

The report contains some very useful recommendations which I hope the General Council will endorse for the benefit of improving our scientific work.

Since it was felt that a Committee should look at change from time to time and not continuously, the Think Tank Committee, formed as a Special Committee for a period of two years commencing October 1992, has been abolished as of the Toronto 1994 Congress. Needless to say all IFA members are very welcome indeed to write to their National Branch or to the General Secretariat directly if they have proposals or comments of whatever nature which they would like to make. On behalf of the Association I would thank the members of the Committee, Prof. L. Fischer (Germany) and Mr D.R. Tillinghast (USA), and especially its Chairman, Dr J.F. Avery Jones (UK), very much indeed for their valuable work.

MEMBERSHIP FEES

After careful consideration, the General Treasurer will propose to maintain the membership fees for 1996 at the level of the previous year, that is:

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.

Thanks to the continuous efforts of the General Treasurer and the cooperation of the National Branches an improvement in the collection of membership fees has been achieved over the years, but we can always do better! I am sure to speak on behalf of Mr Westerburgen if I urge all members and all National Branches to meet their obligations in this respect. There is no question that IFA offers a lot, (just think of the Cahiers and the Yearbook), for a relatively low fee. This fee should be paid promptly.

NATIONAL BRANCHES AND MEMBERSHIP

During the Toronto Congress we recognized two National Branches, in the Czech Republic and in Luxembourg.

D. Safarik, lawyer in Basle of Czech origin, has been instrumental in the preparations for the establishment of the Czech Branch, and we are very grateful for his efforts.

The Belgian/Luxembourg Branch is one of the oldest IFA Branches having some founding members of the Association in its midst. The Luxembourg Branch, which has always submitted National Reports since the tax systems in Luxembourg and Belgium are different, had requested to become a separate Branch. This request has been honoured.

On our trip to South-East Asia Prof. Fantozzi and I paid visits to our Branches in Indonesia, Malaysia, India and Sri Lanka. In Thailand we met with a number of people in an effort to help an IFA Branch in that country to take shape. Much assisted by a letter of introduction from the Chairman of our Branch in Taiwan (R.O.C.), Vice-Minister Cheng I Wang, we were received by the highest officials at the Ministry of Finance in Bangkok. In the meantime the Revenue Department of the Ministry of Finance has become a corporate IFA member and we are looking forward to further developments with confidence.

In Indonesia we were able to see how active the Branch has become under the leadership of Chairman Drs A. Prijohandojo and Secretary Drs S. Pranoto. At a Branch meeting with cocktails and dinner we were able to meet and address many members and invitees and at the Ministry of Finance we were received by a number of high officials. It seems that there is a serious desire to organize some sort of regional IFA event in Indonesia and we have offered our assistance should this be further pursued. In Kuala Lumpur we met with the Board of the Malaysian Branch and were introduced to the right people at the Ministry concerned. We explained that IFA can play an important role for both the private and the public sector. I am glad to report that we shall have Mr S. Sivalingam from Malaysia to participate in the Panel of the Seminar in Cannes on "Taxing regimes applicable to headquarters".

Of course the visit to India was mainly to further promote the New Delhi Congress in 1997. Mr O.P. Vaish, our PSC member from India and Chairman of the Branch went out of his way to introduce us to many of the crucial IFA members and officials. I mention here that we had most interesting and useful contacts and conversations with the Minister of Finance, the Secretary of Finance, the Chief Justice, the Chairman and Members of the Revenue Board, the Chairman of the prestigious National Institute of Public Finance and Policy and his staff and with many more people. We also looked at possible Congress venues, had discussions with Professional Congress Organizers and studied the availability of hotels. Follow-up on these practical aspects was done during a subsequent visit by Mrs Nel Slingerland and Mrs Thea van Dijk of the General Secretariat. We are all of the opinion that New Delhi has everything to make our 1997 Congress a success and a great experience and I would urge all members not to miss this opportunity to visit and experience India.

In Sri Lanka our IFA Branch, chaired by Mr J.A.R. Felix has been active ever since it was founded by D.S. Ambalavaner. Our visit was planned to coincide with the date of the annual Ambalavaner Memorial event which gave Prof. Fantozzi the opportunity to present the Ambalavaner-lecture on VAT in a developing country, which was highly appreciated. Also in Sri Lanka we paid visits to the high officials concerned.

In Europe I had the opportunity to attend the IFA Benelux Colloquium in Ghent (Belgium), the "Hamburger Tagung zur Internationalen Besteuerung", the "Münchener Steuerfachtagung" as well as the "Münchener Symposium zum Internationalen Steuerrecht" (organized and chaired by Prof. D. K. Vogel), and a meeting of the French IFA Branch in Paris, where the National Reports for Geneva (1996) were on the Agenda. In Vienna I was able to witness the renewed vitality of the Austrian Branch at a Seminar and meeting where D. Robert Halpern, already a Honorary Member of IFA, became Honorary Chairman of the Branch.

In the Americas I addressed the Argentinean Branch in their own premises in Buenos Aires. Not only does the Branch have regular meetings, but well attended courses on taxation, lectures and the like are also organized. I should add here that our President, Prof. Avv. P. Adonnino, had an opportunity to also address the Argentinean Branch at another occasion. After the Toronto Congress Prof. Adonnino travelled to Costa Rica as well, in a further effort to promote IFA there. The annual meeting of the US Branch in March 1995 in Washington was another example of how important and influential IFA is as a forum to discuss matters of international taxation at the national level. I was particularly pleased to note from an address by Mr L. Samuels, Assistant Secretary (Tax Policy) of the Treasury, how highly IFA is regarded by the United States Government.

In conclusion, let me refer to the Newsletter which we send quarterly to all National Branches, provided there is sufficient news to convey. I note with regret that of late there seems to be a lull in the stream of information that reaches the General Secretariat. I would therefore like to urge you to let us know what is going on in your Branch, for the benefit of other Branches.

CONTACT WITH INTERNATIONAL ORGANIZATIONS

I refer to the reports of our Ambassadors as published in the IFA Yearbook. We are grateful to them for their significant contribution in maintaining close contact with the fiscal activities of other international organizations. New Liaison Officers have been appointed, as follows:

Mr J. Owens (OECD, Paris), Prof. H. González Cano (Argentina, OAS), D. Schelpe (EU, Brussels) and Mrs D. Yong-d'Hervé (ICC, Paris).

In October 1994, I attended the CIAT Technical Conference in San Carlosde Bariloche, Argentina. D.J. Luque Bustamante, Chairman of the Peruvian IFA Branch, represented IFA at the CIAT General Assembly in Lima in March 1995.

I myself continue to participate in the Tax Committee of the International Chamber of Commerce in Paris. In August 1995 I will attend the 51st Congress of the International Institute of Public Finance (IIPF) in Lisbon. In December 1995

IFA will be represented at a meeting of the UN Ecosoc Council's Ad Hoc Group of Experts on International Cooperation in Tax Matters.

MITCHELL B. CARROLL PRIZE

The Jury decided to award the 1994 Prize to D. Michel de Wolf (Belgium) for his work entitled "Souveraineté Fiscale et Marché Intérieur dans la Jurisprudence de la Cour de Justice des Communautés Européennes et de la Cour Suprême des Etats-Unis". This work has been accepted by the University of Louvain as a legal thesis. D. de Wolf chose an ambitious, wide-ranging and difficult subject for his thesis and tackled it with commendable thoroughness. The Prize was officially awarded during the Toronto Opening Ceremony by Prof. DDr H.G. Ruppe, Chairman of the Jury.

The Jury's decision was not at all easy. Mr Daniel Sandler (UK) submitted an interesting study titled "Pushing the Boundaries" on the relationship between double taxation conventions and CFC legislation. This paper is precise, contains a wealth of comparative legal information and discusses unusual theories. The Jury decided that Mr Sandler's work deserved an honourable mention.

FIVE ENTRIES HAVE BEEN RECEIVED FOR THE 1995 PRIZE

The Executive Committee decided, as of 1996, to increase the Prize money from US $ 1,500 to NLG 5,000.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

The relationship with the IBFD continues to be a very fruitful one. We value the input of Prof. Hamaekers in our PSC meetings and I take pleasure in being aware of the many interesting developments at the IBFD through my membership of the Board of Trustees. The joint research project is proceeding in a way satisfactory to both our organizations. Prof. H.J. Ault, Chairman of our Research Subcommittee, plays a key role in formulating recommendations in this area to the PSC.

THE 49TH CONGRESS IN CANNES, 17-22 SEPTEMBER 1995

The number of registrants to date (more than 1,800) confirms our expectations of a great attendance. We are looking forward to our fourth Congress in France (the three previous ones being in Paris in 1953, 1963 and 1980) with anticipation and confidence.

Our very best wishes to the enthusiastic Organizing Committee, and in particular to Mr Georges Dominjon, President of the Congress, and Mr Guy Delorme, Chairman of the French Branch, who have devoted a lot of their time to ensure the smooth running of the Congress.

Conference diary

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

NOVEMBER 1995

Double Taxation Relief, Amsterdam, 2-3 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Tax treatment of derivates, Le Meridien Hotel, London, 5-6 November 1995 and 6-7 May 1996 (English):

International Faculty of Finance, 2nd Floor, Market Towers, 1 Nine Elms Lane, London SW8 5NQ, Tel.: 44-171-344 3833, Fax: 44-171-344 0083.

Getting to grips with UK and International Tax Treatment of Derivatives, Le Meriden Hotel, London, 6-7 November 1995 and 6-7 May 1996 (English):

International Faculty of Finance, 2nd Floor, Market Towers, 1 Nine Elms Lane, London SW8 5NQ, Tel.: 44-171-344 3833, Fax: 44-171-344 0083.

Asia-Pacific Tax Conference, Singapore, 13-14 November 1995 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

DECEMBER 1995

Practical tax treaties, the Churchill Hotel, London, 6 December 1995 (English):

Kate Roberts, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

Transfer pricing policies, the Westbury, London, 7 December 1995 (English):

Kate Roberts, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 48-52 of the January 1995 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

Books

EUROPE

European tax systems. Volumes 1 and 2.
London, Financial Times Insurance & Professional Publishing. 1995, pp. 400.
ISBN: 1 85334 304 8.
Publication designed to demonstrate and explain the extent to which EU initiatives have penetrated into tax law in Europe and analyses the scope and significance of these initiatives. It deals with the main focus of international cooperation on tax matters and explains in detail the nature of European VAT and the main features of the national VAT systems, EU rules on excise duties and the rates of excise duty applicable in each country, examination of EU role in coordinating corporate taxation policies, explanation of the position of the EU on social security contributions and the scope of its intervention and summarizes the national rules on social security contribution in each country, taxes on capital or on CO_2 emissions to levies to protect copyright.
(B. 114.647)

Austria

Hlavenka, Andreas.
Der Eigenkapitalausweis bei Personenhandelsgesellschaften.
Vienna, Linde Verlag Wien GmbH. 1995, pp. 300. 496.- AS. ISBN: 3 85122 461 2.
The disclosure of equity as regards partnerships.
(B. 114.674)

Helml, Herbert; Kirschner, Franz X.
Betriebliche Investitionen über die Grenze Österreich/Deutschland. Vienna, Linde Verlag Wien GmbH. 1995, pp. 209. 490.- AS.
ISBN: 3 85122 488 4.
Cross-border business investments. The book is a practical guide on cross-border, Austria–German, business investments.
(B. 114.643)

Belgium

Weyts, Luc.
Notarieel fiscaal recht. Deel 1: De registratie van notariële akten en hun gevolgen op fiscaal vlak. 3rd Edition.
Deurne, Kluwer Rechtswetenschappen. 1995. Reeks Notarieel Recht, pp. 470. 5712.- Bfrs.
ISBN: 90 5583 014 3.
Notarial tax law. The author explains in detail tax implications of the writing of notarial deeds. In the first part of the book, principles common to all deeds are explained. The second and main part deals with specific acts, among others, mortgage, marriage settlements, sales contracts, auctions, incorporations of a company and other deeds concerning companies, leasing contracts, donations and wills. The explanations are illustrated with examples of clauses and coupled with numerous references.
(B. 114.702)

European Union

Towards greater fiscal discipline. European economy – Reports and studies, No. 3, 1994.
Brussels, European Commission, Director-General for Economic and Financial Affairs. 1995, pp. 422. 80.81 Dfl.
ISBN: 92 826 8687 6.
Results of experts' research covers: "An assessment of margins for consolidation in the Member States of the EU" by C.A. de Kam; "Fiscal evolution in Germany, 1980-92" by W.W. Pommerehne; "Fiscal developments in Greece, 1980-93" by N.M. Christodoulakis; "Fiscal policy in Spain" by J. Gonzales Paramo and others; "Fiscal policy in France" by J. le Cacheux; "Fiscal developments in Italy and possibilities for reducing public deficits" by V. Chiorazzo and others; "Fiscal policy in Portugal" by A. Nogueira Leite and "Fiscal developments in the UK" by N.R.S. Smith. The second part of this publication deals with the impact of national budgetary procedures on fiscal performance.
(B. 114.710)

Germany

Birk, Dieter.
Steuerrecht I. Allgemeines Steuerrecht. Ein Studienbuch. 2. Auflage.
Munich, Verlag C.H. Beck. 1994, pp. 292. 39.80 DM. ISBN: 3 406 37896 X.
Tax Law I. General tax law. Textbook for students.
(B. 114.723)

Crezelius, Georg.
Steuerrecht II. Die einzelnen Steuerarten. Ein Studienbuch. 2. Auflage.
Munich, Verlag C.H. Beck. 1994, pp. 456. 44.- DM. ISBN: 3 406 38023 9.
Tax Law II. The specific taxes. Textbook for students.
(B. 114.724)

Steuervereinfachung. Festschrift für Dietrich Meyding zum 65. Geburtstag. Herausgegeben von W. Bühler, P. Kirchhof und F. Klein.
Heidelberg, C.F. Müller Juristischer Verlag. 1994, pp. 278. 103.21 DM.
ISBN: 3 8114 9894 0.
Tax simplification. Publication on the occasion of Dietrich Meyer 65 birthday.
(B. 114.526)

Klein, Franz; Orlopp, Gerd.
Abgabenordnung. Einschliesslich Steuerstrafrecht. 5. Auflage.
Munich, Verlag C.H. Beck. 1995, pp. 1609. 128.- DM. ISBN: 3 406 38588 5.
Commentary on the German Fiscal Code and the Tax Penalty Law.
(B. 114.640)

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Verdeckte Gewinnausschüttungen und verdeckte Einlagen. 3. Auflage.
Bonn, Stollfuss Verlag. 1995, pp. 550. 56.80 DM. ISBN: 3 08 316203 0.
Hidden profit distributions and hidden contributions. The book contains valuable and detailed information on the two issues in particular taking into account the legal situation after the implementation of the Business Location Improvement Act of 13 September 1993 and the Anti-abuse and Correction Tax Act of 21 December 1994.
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(B. 114.698)

Article 26 – Limitation of benefits in the new US–NL tax treaty.
Rotterdam, Loyens & Volkmaars, 325 Weena, P.O. Box 2888, 3000 CW Rotterdam. 1995, pp. 150.
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(B. 114.695)

Poland

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United Kingdom

Foreman, A.
Tax handbook 1995-96. 3rd Edition.
London, Pearson Professional Limited, Maple House, 149 Tottenham Court Road, London W1P 9LL; Allied Dunbar Assurance Plc. 1995, pp. 608. £ 23.-. ISBN: 0 7520 0030 6.
This third edition deals with income tax, capital gains tax, inheritance tax, corporation tax, VAT, stamp duty and national insurance contributions. Numerous examples illustrating ways in which payments can be reduced. Fully up-to-date to the Finance Act 1995.
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London, Butterworths. 1995, pp. 2720.
ISBN: 0 406 04040 0.
The guide considers in detail all the principal taxes, showing how they work, and the policy behind statutory provisions. Specific problems of case law are isolated and discussed and there are numerous examples and tax tables. This edition incorporates all the changes resulting from the 1995 Finance Act including new Schedule A rules, consolidation of VAT legislation in the VAT Act 1994, 1994 Pensions Bill, introduction of venture capital trusts.
(B. 114.703)

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(B. 114.782)

Loose-leaf Services

Received between 1 and 30 September 1995

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UNITED KINGDOM

THIN CAPITALIZATION IN THE UNITED KINGDOM

Amanda K. Rowland

Solicitor, Paisner & Co.

I. INTRODUCTION[1]

Whether a company is thinly capitalized within the rules of any particular jurisdiction will depend on the acceptable levels of debt to equity in that country. Some jurisdictions have approached the question of thin capitalization by providing in their legislation fixed debt: equity ratios beyond which a company will automatically be treated as thinly capitalized. For example, in Germany the ratio, broadly speaking, is 1:2 for profit-related debts, 3:1 for non-profit-related debts and as much as 9:1 for holding companies.[2] Canada, too, has opted for the advantage of certainty over flexibility in adopting a fixed 3:1 ratio. Other jurisdictions have no fixed ratios but have thin capitalization rules which treat as a distribution interest payments made which exceed those which would have been made between parties acting at arm's length either by reference to the amount of interest due on the debt itself or by reference to the fact that the loan would never have been granted by an independent lender. The OECD in its Report on Transfer Pricing and Multinational Enterprises recommends the adoption of the flexible approach although it recognizes that this involves a sophisticated analysis and may cause problems for some tax administrations. Nevertheless, it is regarded as unsatisfactory that the same financial transaction may, under the present system, be treated as a loan by one country and an equity contribution by another.

The United Kingdom has chosen to adopt the more flexible route in its legislation although it has certain informal ratios which it applies as a guideline in assessing whether an independent lender would have made the loan. The UK Inland Revenue has stated that in every case it focuses on what would have happened at arm's length. This often means that a debt-equity ratio of 1:1 and earnings cover of 3:1 over interest is regarded as acceptable. However, according to statements made by the Revenue it cannot be assumed that these ratios will always be applied. The Revenue states that it applies similar considerations to those used by independent lenders. For instance, regard may be had to the fact that certain financial concerns and property holding companies are generally allowed to gear up to a greater extent than other borrowers, or the consolidated debt-equity position of the group may be taken into account rather than concentrating solely on the borrower's. In addition, in deciding whether to lend an independent entity will have regard to factors other than these ratios including the state of the relevant business sector, the nature of, and title of the borrower to, any assets which might provide security, the cash flow position of the group and the general state of the economy.

II. THE OLD LAW

Prior to the recent changes in UK law which take effect in relation to any interest payment or other distribution made after 29 November 1994, the United Kingdom had no easily recognizable thin capitalization rules. It had, and retains subject to the amendments made in this year's Finance Act, a set of rules contained in Section 209 Income and Corporation Taxes Act 1988 (ICTA), which operate to treat certain interest payments on loans and securities as distributions (i.e. deemed dividends) for tax purposes. Where these rules apply, the paying company has a liability to account for advance corporation tax ("ACT") of an amount equal to one quarter of the distribution or re-characterized interest payment. In addition, the company is, of course, deprived a tax deduction for the amount of the interest payment treated as a distribution.

Prior to 30 November 1994 situations where a distribution would have been deemed to have arisen included the following:

(i) where interest was paid out of assets of the issuing company in respect of securities held by a company not resident in the United Kingdom of which the issuing company was a 75% subsidiary or where both the issuer and holder of the securities were 75% subsidiaries of a third company (Section 209(2)(e)(iv) ICTA); and

(ii) where interest was paid in respect of securities held by a company not resident in the United Kingdom where less than 90% of the share capital of the issuing company was directly owned by a UK company and both the issuer and the non-resident were 75% subsidiaries of a UK resident company (Section 209(2)(e)(v) ICTA).

These two provisions have been repealed as a result of the recent changes.

Where an appropriate double tax treaty exists between the United Kingdom and the country of residence of the beneficial owner of the interest, (i) and (ii) were often dis-applied. Many treaties contain an express provision that rules of domestic law which treat as a distribution only interest paid to a non-resident corporation shall not apply to interest payments to which the treaty applies.

For example, the US–UK double tax convention states in Article 11(7):

1. The author has published previously on this topic. See "Impenetrable Drafting", *Taxation* 6 April 1995, at 9.
2. "Holding company" is defined to mean a company the main activities of which are the holding of shares in companies and the financing of those companies. It also includes the situation where more than 75% of a company's assets are stakes in companies.

"Any provision in the law of either Contracting State relating only to interest paid to a non-resident corporation shall not operate so as to require such interest paid to a resident of the other Contracting State to be treated as a distribution by the corporation paying such interest..."

The interest article in most of the United Kingdom's tax treaties reduces the rate of withholding on interest payments from the United Kingdom from the basic rate of 25%, which applies under UK domestic law, either by eliminating it altogether (United States) or reducing the rate to, for example, 10% (Portugal) or 15% (Belgium). This reduction is generally stated not to apply where, due to a special relationship between the parties, the amount of the interest exceeds the amount which would have been paid in the absence of the special relationship. Depending on the treaty in question the excess interest is either determined by reference to the overall position or only by reference to the terms of the particular loan or debt in question. Article 11(5) of the US–UK treaty looks at the overall position of the company, stating:

"Where, owing to a special relationship between the payer and the person deriving the interest or between both of them and some other person, the amount of the interest paid exceeds FOR WHATEVER REASON the amount which would have been paid in the absence of such a relationship ..."

The comparable provision in the UK–Netherlands treaty suggests that it is the terms and the amount of the relevant loan to which regard is to be had in determining whether the provision should apply. It states, in Article 11(4):

"Where, owing to a special relationship between the payer and the beneficial owner ... the amount of the interest paid exceeds the amount of interest which would have been determined, taking into consideration the terms and the amount of the debt claim which would have been agreed upon, by the payer and the beneficial owner in the absence of such relationship, ..."

By referring to the "amount of the debt claim which would have been agreed upon" this treaty permits the re-characterization of the whole of the interest payment on the basis that the loan would not have been granted by a lender acting at arm's length.

The OECD Model Convention's "special relationship" provision in Article 11(6) states:

"Where, by reason of a special relationship between a payer and the beneficial owner ... the amount of the interest, HAVING REGARD TO THE DEBT CLAIM FOR WHICH IT IS PAID, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship ..."

This is followed in the UK–Austria treaty. This does not allow consideration of whether the loan would have been made but only of the amount of interest payable on the loan in question.

Where, whatever its terms, such a provision applies, the reduced treaty rates do not apply to the amount of the interest payment which exceeds that which would have been paid between independent parties. The now repealed provisions of domestic law described in (i) and (ii) above would then have operated to treat the excess as a distribution.

The Inland Revenue have sought to argue in the past, and no doubt will continue to do so, that the interest article should not apply where, in their view, a company is thinly capitalized using as guidelines the ratios set out above.

III. OTHER PROVISIONS AFFECTING DEDUCTIBILITY OF INTEREST

The distribution legislation described above is not the only way in which the Inland Revenue may seek to disallow the deductibility of interest payments. A deduction as a trade expense may be denied to the extent that interest which exceeds a reasonable commercial rate is paid to a person not resident in the United Kingdom. It should be noted that a deduction as a trade expense is, for UK corporation tax purposes, only available for payments of short interest[3] unless it is interest on a loan from a UK bank on an advance made in the course of its banking business.

A deduction for payments of yearly interest or interest to a UK bank may be available as a charge on income. However, the availability of this treatment is subject to the fulfilment of many conditions. In particular, where the payment is made to a non-resident, no deduction will be permitted unless tax at the appropriate rate has been withheld. This requirement to withhold tax is removed where the Inland Revenue has given permission to pay interest gross following a claim under a double tax treaty.

A very wide-ranging provision, but one which is used relatively infrequently by the Inland Revenue, is Section 787 ICTA. This stipulates that relief is not to be given for interest payments under any provision:

"if a scheme has been effected or arrangements have been made (whether before or after the time when the payment is made) such that the sole or main benefit that might be expected to accrue to that person from the transaction under which the interest is paid was the obtaining of a reduction in tax liability by means of any such relief".

The major difficulty in applying this provision would seem to be the "sole or main benefit" requirement.

IV. THIN CAPITALIZATION IN THE UNITED KINGDOM AFTER 30 NOVEMBER 1994

The provisions of Section 209 ICTA dealing with securities held by non-residents outlined above have been repealed. They are replaced by a provision treating as distributions interest payments made between companies in specific circumstances where there is a "special relationship, connection or arrangement". As stated in the introduction a flexible approach has been maintained and no specific debt-equity ratio or other test has been introduced to assist taxpayers or their advisers in determining whether the new provisions will be triggered.

Before proceeding to discuss the new rules in more detail it should be noted that where a double tax treaty applies in relation to any interest payments the treaty provisions take precedence over domestic law. UK domestic law will only apply

3. Short interest is interest on a loan intended to be outstanding for less than a year.

where there is no relevant treaty or the treaty does not apply to all or part of the interest payment.

Section 87 of the Finance Act 1995 introduces a new Section 209(2)(da) ICTA. It will apply where the issuer and holder of the security are 75% subsidiaries of a third company or where the issuer is a 75% subsidiary of the holder. Where that relationship exists and:

> "the whole or any part of the distribution represents an amount which would not have fallen to be paid to the other... if the companies had been companies between whom there was (apart from in respect of the securities in question) no relationship, arrangements or other connection (whether formal or informal)"

the interest payment (to the extent only that it is such an amount) will be treated as a distribution.

The provision may therefore apply where there is a 75% subsidiary relationship between payer and payee and a "relationship, arrangements or connection" (referred to collectively in this article as a "relationship") exists.

The legislation provides no easy answer or solution to assist companies in determining whether a "relationship" exists at all. Presumably, the 75% shareholding is itself evidence of a "relationship" but it is not at all clear what other factors are to be taken into account. The phrase "relationship, arrangements or other connection" is potentially so wide that we are unlikely to know what limits may be placed on it until the Inland Revenue issues some guidance in practice statements or correspondence or there is case law on the question.

According to Inland Revenue statements on the new provision, the relevant time is the time the security was put in place or, if applicable, the time of the assignment.

To determine whether the amount of interest exceeds that which would have been paid in the absence of the "relationship" reference is to be made to Section 808A ICTA. This provision was introduced in 1992 to provide guidance in the interpretation of the "special relationship" provision typically contained in the interest article of the United Kingdom's double tax treaties and described above. Section 808A ICTA provides that in determining the amount of interest which would have been paid in respect of the security in the absence of the "relationship" all factors are to be taken into account, including the following. Assuming the absence of a "relationship";

(i) would the loan have been made or would the security have been issued;
(ii) what would have been the amount, if any, of the loan; and
(iii) what rate of interest and other terms would have been agreed?

In considering all the factors, no account is to be taken, in respect of those matters set out in (i) – (iii) below, of any *other* relationship, connection or arrangements between the issuer and any person except where the other person:

(a) is not connected (a term very broadly defined in the legislation) with the issuer; or
(b) is a member of the same UK group as the issuer.

The specified matters are:

(i) the appropriate level of overall indebtedness for the issuer;
(ii) whether it might have been expected that the issuer and another person would enter into a transaction involving the issue of a security, the making of a loan or a loan of a particular amount; and
(iii) the rate of interest and other terms which might be expected to be applicable.

It is reasonably clear that this exception has the effect that, in determining the above matters, only arrangements with independent parties and UK group members may be considered. There are to be left out of account, in considering the above matters, any relationships, arrangements or connections between the issuer and connected person in the United Kingdom (unless that person is a member of the same group) and between the issuer and any overseas person with whom the issuer is connected.

The exception may enable the Revenue to ignore, for example, guarantees and other security provided by overseas parent or group companies in determining whether the security in question would have been taken up. This has the unjust result of permitting the Revenue, in looking at a company's indebtedness from the perspective of an independent lender, to take into account a substantial loan to the issuer but to leave out of account the fact that repayment of such loan is guaranteed by an overseas parent company. This omission may well completely distort the overall impression of a company's debt position. On the other hand, loans from overseas connected parties must presumably also be ignored in determining whether the new security would have been issued and taken up by independent lenders.

The Revenue say that as the provision as a whole was introduced to protect the UK tax base, the limitations to the extent to which the wider group is taken into account were necessary. No attempt has, however, been made to demonstrate why the limitations are needed.

The predecessor to the new provision was clearly discriminatory towards non-UK resident companies in making interest payments to such non-residents by UK companies distributions where they would not be if made to a UK company. The law has now been changed to apply in the same way regardless of company residence. This may have come about as a result of the decision in *Halliburton Services BV* (1994) STC 655. In that case the European Court held that the Dutch tax system could not discriminate against companies established outside the Netherlands by providing tax reliefs only to companies established in the Netherlands. It is interesting to note that the Dutch authorities argued, unsuccessfully, that the unavailability of the relief only affected the Dutch company as that was the company required to pay the tax. It was pointed out by the court that the imposition of any additional tax would adversely affect the transaction as a whole and therefore the position of the non-resident company. The same argument could be applied to the old UK provisions. Even though it is the UK company which is denied a deduction and which incurs the ACT liability, the non-resident was also affected under the old provisions, in that restrictions were imposed on the non-resident's freedom of activity as a result of an adverse tax regime.

Although the new provision removes the obvious discrimination against non-resident taxpayers, the requirement that certain arrangements with connected overseas parties should be ignored may indirectly discriminate against non-residents. Whether this discrimination will occur in practice depends upon how the Revenue seek to apply the provisions. As loans from overseas connected parties are presumably also to be disregarded, the treatment, although different, may not be discriminatory.

The change in the law appears to bring the UK distribution rules closer in operation to the treatment of interest payments under typical UK double tax treaty arrangements. Rather than automatically treating interest payments as a distribution once a particular shareholder relationship exists it is now required to determine whether and to what extent such interest payments would have been made to an independent third party lender.

When considering the potential scope of the legislation, it is important to point out that the Inland Revenue believe:

> "that the legislation is extremely broad in its scope. It is capable of applying where, even though a loan could have been obtained from a third party on identical terms, the transaction would not have taken place but for the group relationship. Such a case might arise where, for example, a company has a fixed-term third-party loan bearing interest at LIBOR + 1.00% which still has three years to run at the relevant time. This loan is repaid and replaced by a three year intra-group loan carrying interest at LIBOR + 1.50%, but which otherwise has terms and conditions identical to the third-party loan it replaces. It is accepted that, arm's length interest rates having increased since the original loan was obtained, LIBOR + 1.50% is an arm's length rate for a three year loan at the time the new loan is made. Nonetheless, given the lack of commercial logic in this change, we would contend that the arrangement would not have been entered into but for the group relationship and that the legislation applies with the result that all of the interest will be a distribution".[4]

Whether the legislation does apply in the above situation is a matter of some debate. There may very well be situations where a third party debt is replaced by an intra-group loan, for commercial reasons, e.g to employ group funds more effectively, terminate guarantees made to third parties, etc. The point that requires underlining, however, is the aggressive stance being adopted by the Inland Revenue.

The changes may adversely affect intra-group loan arrangements made between UK companies. In the past these were made without regard to thin capitalization issues as interest payments would not have been treated as distributions on that basis. Such groups will need to review their funding arrangements to ensure that they do not fall foul of the new rules.

In the case of those countries which have no double tax treaty arrangements with the United Kingdom the position may now be more advantageous to 75% groups as there will no longer be an automatic distribution treatment and denial of a deduction for interest payments. For example, interest payments on a loan from a Cayman parent company to a UK subsidiary will not automatically be classified as distributions.

Example

A UK Company (UK Sub) is the wholly owned subsidiary of a US parent company (US Co). US Co owns 1,000 £ 1 ordinary shares in UK Sub. UK Sub has two loans, one of £ 20,000,000 from a French associate and one of £ 5,000,000 from a UK bank. US Co is to lend an additional £ 10,000,000 to finance further expansion of European operations. US Co seeks a tax deduction for interest payments on the loan.

US Co has guaranteed repayment of the UK bank loan and the loan from the French affiliate has no fixed repayment date.

Clearly, UK Sub is thinly capitalized in general terms. The issue, however, is whether any part of the interest payment will be treated as a distribution for UK tax purposes.

There must be a "relationship" for the purposes of Section 209(1)(da) ICTA. The next question is whether that amount of interest would have been paid by UK Sub to an independent lender. The amount could be different either because the loan would never have been made or because the terms of lending would have been different. In answering these questions all factors must be taken into account including those specifically referred to in Section 808A ICTA, i.e. whether the loan would have been made at all, the amount of the loan and the interest rate and other terms which would have been agreed. However, in accordance with the legislation the loan from the French associate and the guarantee from US Co must be ignored in determining:

(i) the appropriate level of UK Co's indebtedness;
(ii) whether, if independent, the companies would have become parties to the transaction; and
(iii) the rate of interest and other terms that might have been agreed.

What is left is a £ 5,000,000 un-guaranteed loan from a UK bank. On that assumption it may be that an independent party would have granted the loan. If the facts had been different and the French loan had in fact been made by a member of the same UK group of companies as UK Sub, the guarantee would be ignored but UK Sub would already have £ 25,000,000 of borrowings. Clearly, whether the loan would be made will still depend on other issues including the net assets of UK Sub, the strength of its business and whether earnings cover likely interest payments. However, this simple example serves to demonstrate how the new UK rules may adversely and arbitrarily affect the UK borrower.

V. FINAL COMMENTS

The new UK thin capitalization rules described in this article and the other provisions re-characterizing certain interest payments as dividends apply only to payments made in

4. *Tax Bulletin* June 1995 at 219.
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Each issue of the Tax Bulletin contains certain qualifications which should be referred to before reliance is placed on an interpretation.

respect of "securities". Despite the fact that the term is defined to include securities not creating or evidencing a charge on assets and that interest paid on money advanced without the issue of a security or other consideration given for money advanced is to be treated as interest paid in respect of a security, not all types of financing will fall within the scope of the provisions. Consider, for example, a company acquiring a large amount of inventory from an associated company and leaving the amount due outstanding on trade account. There is certainly no security nor even any money advanced. There is only a sum outstanding in respect of goods supplied. However, where interest is charged in relation to the amount due a similar result may be achieved as on the issue of an interest bearing security. There may therefore be some scope for arranging group financing to ensure that the thin capitalization provisions are not triggered. However, this requires careful consideration taking into account the particular facts and circumstances of each case.

CUMULATIVE INDEX -1995

I. ARTICLES

INTERNATIONAL

DOCUMENTATION OF TRANSFER PRICES

Helmut Becker

Tax lawyer, Düsseldorf

I. INTRODUCTION

Documentation of transfer prices has become very significant in international taxation. It is a highly contentious issue and is much discussed both between individual governments and between governments and multinationals. Although the OECD has published new rules on documentation, it is still unclear as to whether these will prove to be universally accepted.

The requirement that transfer prices charged between related companies are to be accompanied by appropriate documentation is not new at all. All tax authorities confronted with transfer prices require documentation to enable them to check whether arm's length prices were used. However, in the past the amount of detail to be included in such documentation was continuously growing, as was the administrative burden being placed upon multinationals in complying with their obligations. Milestones for documentation were set by the US regulations and by the new OECD guidelines.

II. US REQUIREMENTS FOR DOCUMENTATION

In the United States two sets of rules concerning documentation have to be considered:
- the Final Regulations to Section 482 Internal Revenue Code (IRC), effective since 8 July 1994; and
- the Temporary Regulations to Section 6662 IRC, dated 27 January 1994.

The first set of rules concerns the determination of the appropriate transfer pricing method, the second set concerns the imposition of penalties after a transfer pricing adjustment.

A. Regulations to Section 482 IRC

Section 482 IRC only deals with the question as to whether the taxpayer reports its true taxable income, and whether or not this result is consistent with the taxpayer's books. Therefore, statutory bookkeeping represents the basic documentation. This documentation, however, becomes more specific regarding the rules for determining the type of method that will be applied to evaluate whether controlled transactions are at arm's length. Those rules apply with equal force to both the taxpayer and to the authorities for the purpose of determining and reporting the true taxable income. The taxable income will be determined by the "best method rule". This rule prescribes that an arm's length price must be determined using the method which provides the most reliable measure of an arm's length result given the relevant facts and circumstances. Therefore, two primary factors have to be considered: the comparability and the quality of data and assumptions. This is the point where specific documentation becomes important.

Section 1.482-1(c)(2)(ii)Reg. applies in determining: whether a method provides the most reliable measure of an arm's length result, it states that this "depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions". It further states: "The completeness and accuracy of the data effects the ability to identify and quantify those factors that would affect the result under any particular method."

It is therefore clear that the taxpayer is well advised to document the relevant data because otherwise he takes the risk that the method he adopts will not be accepted by the tax authorities. They may then use another method detrimental to the enterprise. In simple cases the documentation only refers to the transfer pricing method actually applied and does not expressly oblige the taxpayer to establish certain documentation. This, however, changes for specific situations. Sometimes enterprises follow a market strategy to penetrate, maintain or expand a market. "Such strategy would be reflected by temporarily increased market development expenses or sales prices that are temporarily lower than the prices charged for comparable products in the same market." (Section 1.482-1 (a)(4) Reg.). In such situations the taxpayer is permitted to deviate from the appropriate prices otherwise charged. However, "the effect of a market share strategy on a controlled transaction will be taken into account only if ... the taxpayer provides documentation that substantiates the following:

(A) The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;

(B) The market share strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

(C) The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented (Section 1.482-1 (d)(4)(8) Reg.)."

The above requirements focus on:
- the costs incurred by the strategy;
- the objective of reasonable profits to compensate for the costs incurred;
- the length of the period in which the strategy will be applied; and
- the timing of the strategy which requires that the documentation be created prior to its implementation.

Documentation is also expressly required in connection with set-offs. Set-off transactions of a related taxpayer which are to his disadvantage will be compensated for by other related transactions which are to his advantage. No transfer pricing adjustments will be required to the extent of the set-off. "Such set-off, however, will be taken into account only if the requirements of Section 1.482-1 (g)(4)(ii) are satisfied" (Section 1.482-1 (g)(4)(i) Reg.).[1]

B. Proposed regulations to Section 6662 (e) IRC

The second set of rules concerns the imposition of penalties under Section 6662 (e) IRC where net transfer pricing adjustments are required by virtue of Section 482 IRC. For the purpose of applying those penalties a distinction is made depending on whether the taxpayer has used a specified or unspecified transfer pricing method. Likewise the documentation required depends on which method is used. In both cases, however, the taxpayer must have prepared documentation articulating the required analysis at the time that the tax return was filed. This documentation must be submitted to the Internal Revenue Service (IRS) within 30 days of a request for such documentation.

The penalties imposed for a deviation from the arm's length price are high. They amount to 20 percent if a substantial valuation misstatement has occurred and to 40 percent if there has been a gross valuation misstatement. A gross valuation misstatement, among other criteria, is defined as a misstatement of $ 20 million. As this amount could easily be involved in transactions between bigger multinationals, these penalties are very severe.

The taxpayer can escape these penalties if he has reasonable cause and has acted in good faith. To achieve that, he has to meet the requirements of Section 1.6662-6 T-(d) Temp. Reg.[2]. Part (d)(2)(iii) B of that paragraph sets out the necessary documentation required where a specified transfer pricing method will be used, similarly part (d)(3)(iii) operates in the case of an unspecified method. Again in both cases, documentation must be in existence when the tax return is filed and must be produced to the IRS within 30 days of a request.

Whatever method of transfer pricing is used, a distinction has to be made between principle documents and background documents. "The principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. The documentation must include the following:

(1) an overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its goods or services;
(2) a description of the taxpayer's group structure [3] ... covering all related parties engaged in transactions potentially relevant under Section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;
(3) any documentation explicitly required by the regulations under Section 482;
(4) a description of the specified method selected and an explanation of why this method was selected;
(5) a description of the unspecified methods that were considered and an explanation of why they were not selected;
(6) a description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions;
(7) a description of the comparisons that were used, how comparability was evaluated, and what (if any) adjustments were made;
(8) an explanation of the economic analysis and projections relied upon in developing the method; and
(9) a general index of the principal and background documents and a description of the record-keeping systems used for cataloguing and accessing those documents" (Section 1.6662-6 T-(d)(2)(ii)(B) Temp. Reg.)

The background documents are listed in Section 1.6038 A-3(c). These documents only have to be maintained in specific circumstances and only have to be provided if requested by the tax authorities.

To determine the most accurate measure to establish an arm's length price the taxpayer "must engage in a reasonably thorough search for the data necessary to determine which method should be selected and how it should be applied" (Section 1.6662-6 T-(d)(2)(ii)(B) Temp. Reg.). The cost for such a search will be reasonable provided it does not exceed $ 25,000 for intercompany transactions with a total value of $ 25 million, i.e. 0.1 percent. (Explanation of Provisions under Factors.)

These rules stipulate that a taxpayer is obligated to engage in a search for comparable transactions and other data necessary to apply the methods under Section 482 IRC. This means that to determine the "best method" all other methods have to be researched and documented as well. Otherwise, the taxpayer would not be in good faith and runs the risk of penalties being imposed of up to 40 percent of the additional tax.

1. This clause further refers to Section 1.482-1 (g)(2) Reg.) dealing with collateral adjustments.
2. Section 1.6662-6 T (b)(3) and (c)(6) temp. Reg. with reference to Section 6664 IRC as well as to Section 1.6662-6 T-(d) temp. Reg.
3. A diagrammatic illustration must be included, showing the shareholding relationship between the companies.

III. THE OECD REQUIREMENTS FOR DOCUMENTATION

The US rules for documentation were not internationally accepted. Therefore, intensive discussions within the OECD took place. The first draft of the documentation requirements was not accepted because the requirements were too harsh. The final version has become far more moderate. However, this might not be the end of the matter: "The Committee on Fiscal Affairs intends to study the issue of documentation further to develop additional guidance that might be given to assist taxpayers and tax administrations in this area" (Paragraph 5.29).

The OECD Report provides a chapter on documentation (Chapter V). In the introductory subchapter A the report sets out the proposition that there is a relationship between documentation and the burden of proof. "In fact, where the taxpayer does not provide adequate documentation, there may be a shifting of burden of proof in some jurisdictions" (Paragraph 5.2). This proposition does not hold true in all cases. In Germany, for example, the burden of proof is always on the tax authorities.[4]

In Paragraphs 5.18 to 5.27 some documentation requirements are listed. However, Paragraphs 5.16 et seq. clearly indicate that this list only describes useful information which could become relevant depending on the individual circumstances. The list therefore "should not be viewed as a minimum compliance requirement" (Paragraph 5.16).

A characteristic of the report is it's flexibility. In several passages the report refers to the prudent business management principles and states that usually documentation should be of the type that has been prepared or obtained other than for tax purposes. Additional documentation only has to be produced if it is "indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle". However, even this requirement is subject to the reasonableness of the cost incurred (Paragraph 5.7) and "the tax administration should take great care to balance its need for documents against the cost and the administrative burden to the taxpayer of creating or obtaining them" (Paragraph 5.6).

Apart from that "there is no contemporaneous obligation at the time the pricing is determined or the tax return is filed" (Paragraph 5.4) and "the document storage process should be subject to the taxpayer's discretion" (Paragraph 5.5). Also "taxpayers should not be obliged to retain documents ... (for) years for which adjustment is time barred" (Paragraph 5.8). And "Tax administration further should not require taxpayers to produce documents that are not in the actual possession or control of the taxpayer or otherwise reasonably available" (Paragraph 5.10).

Very important is the statement in Paragraph 5.9 of the OECD Report ruling that transfer prices should be based upon "information that reasonably could have been available at the time transfer pricing was established". This prevents the tax authorities from considering information which becomes available afterwards or, even worse, from requiring the production of such documentation at a later date.

Although much of the OECD Report is to be commended, certain requirements of the Report do not seem to be appropriate. Paragraphs 5.4 and 5.6 require "the taxpayer to prepare or refer to written materials". This, of course, will be the normal procedure. However, exceptions must be possible. In current business practice a lot of transactions are not documented because all participants know the conditions. This has to be accepted by the authorities. Following from this it should be permitted to document certain facts by a witness. Further, the report states that "the taxpayer should ... comply with reasonable requests for translation of documents that are made available to the tax administration" (Paragraph 5.5). This should be subject to certain restrictions. The international business language all over the world nowadays is English. Therefore there should be no requirement to translate documents written in English. The authorities should ensure inspectors engaged in transfer pricing audits are proficient in the English language. Neither should a translation be required where enterprises are located in the border area of a country if the documentation is produced in the official language of the neighbouring country.

The useful information not viewed as a minimum compliance requirement (see above) is focused on:

"(I) an outline of the business;
(II) the structure of the organization;
(III) ownership linkages within the multinational group of enterprises;
(IV) the amount of sales and operating results from the last few years preceding the transaction;
(V) the level of the taxpayer's transactions with foreign associated enterprises, for example the amount of sales of inventory assets, the rendering of services, the rent of tangible assets, the use and transfer of intangible property, and interest on loans" (Paragraph 5.18).

Paragraph 5.17 sets out the following further matters that may be relevant: "the associated enterprises involved in the controlled transactions, the transactions at issue, the functions performed, information derived from independent enterprises engaged in similar transactions or business, and other factors discussed elsewhere in (the OECD) Report". The following factors should also be taken into consideration; "the nature and terms of the transaction, economic conditions and property involved in the transactions, how the product or service that is the subject of the controlled transaction in question flows among the associated enterprises, and changes in trading conditions or renegotiations of existing arrangements".

The guidelines concerning documentation are very flexible and are intended to facilitate the appraisal of specific transactions. The prudent business management principle is predominant. However, "taxpayers should recognize that, notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm's length transfer pricing even if the information available is incomplete" (Paragraph 5.14). Therefore, taxpayers are

4. If, however, the taxpayer does not meet the requirements of appropriate co-operation, the tax authorities may conclude its results from the existing facts using the likelihood based on the experience of life.

well advised to consider adequate record-keeping practices and the voluntary production of documents. Both would improve the persuasiveness of its transfer pricing arrangements.

IV. EVALUATION OF THE PRESENT SITUATION

The present situation is characterized by uncertainty. In the OECD guidelines documentation has been regulated in a separate chapter five after chapter four which deals with penalties and other administrative considerations. However, the sections on documentation and on penalties do not expressly refer to each other. Therefore, the significance of the documentation provisions in the OECD guidelines seems to be unclear.[5]

Notwithstanding the above, the similarities between the two chapters do point to their common purpose. For instance the Report in chapter four concluded that unfair and unduly onerous penalties should not be applied (Paragraph 4.25). Paragraph 4.28 of the guidelines describes that situation in more detail. It would be unfair and unduly harsh to make an adjustment if the taxpayer "made a reasonable effort in good faith". The same applies "for failing to consider data to which (the taxpayer) did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer". These sentiments echo those expressed in the chapter dealing with documentation.

In addition to the above it should be noted that former drafts of the guidelines contained the following sentence: "The chapter (on documentation) does not discuss penalties imposed on transfer pricing adjustments". This sentence has been deleted in the final version of the guideline. Also worthy of note is the fact that the chapter on documentation which had previously been placed ahead of the section on penalties, is now placed behind it. From all these indications one could conclude that documentation in the OECD guidelines apply to both the arm's length principle and to the penalties.

Before bringing this article on documentation to a close, it is important to underline the fact that the US regulations on penalties are still temporary. Final regulations are bound to come. Only then will it be clear whether the United States will maintain its existing very strict rules, or instead opt for the less stringent OECD standards.

5. In this context it has to be recalled that in the United States documentation has been partly described in the regulations to Section 482 IRC concerning the arm's length rules and partly in the regulations to Section 6662 IRC concerning penalties. The very strict rules had been provided by the penalty regulations and not by the arm's length regulations.

Conference diary

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

DECEMBER 1995

Practical tax treaties, the Churchill Hotel, London, 6 December 1995 (English):

Kate Roberts, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

Transfer pricing policies, the Westbury, London, 7 December 1995 (English):

Kate Roberts, IBC Legal Studies and Services Ltd., Gilmoora House, 57-61 Mortimer Street, London, W1N 7TD, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

RISK 2nd annual conference, Tax planning using Financial instruments, London, 7-8 December 1995 (English):

The Lanesborough, Hyde Park Corner, London SW1 X7TA, Tel.: 44-171-259 5599, Fax: 44-171-259 5606.

JANUARY 1996

Principles of international taxation, Amsterdam, 22-26 January 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

MARCH 1996

Application of tax treaties, Amsterdam, 4-6 March 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

Meeting of the International Tax Planning Association, Budapest, 7-8 March 1996 (English):

Elizabeth Husband, ITPA Convention Bureau, P.O. Box 134, Sevenoaks, Kent TN15 6SZ, England, Tel.: 44-173-276 2910, Fax: 44-173-276 3762.

APRIL 1996

International tax planning techniques, Amsterdam, 11-12 April 1996 (English):

International Tax Academy, Attn: Ms Anselien School, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397.

UNITED STATES

THE TAXATION OF INCOME FROM INACTION: AN AMERICAN PERSPECTIVE

Sanford H. Goldberg
Roberts & Holland LLP, New York and Washington, DC

I. INTRODUCTION

An issue that has not been specifically dealt with in the Model Double Taxation Convention on Income and on Capital ("OECD Model Treaty"), nor in many other bilateral income tax conventions, is the treatment for inaction, either the non-performance of services or the non-performance of the sales of goods.

Examples of the activity, or more particularly the non-activity, are payments for a covenant not to compete, payments for stand-by time, payments for sign-on bonuses not conditional on the future performance of services, and payment for commitment fees. These examples are not exhaustive. There may be others. The fact patterns may differ but the question remains the same: How to characterize the consideration received, i.e. what class does it fall within? Should it be characterized as service income, either independent or dependent services (Articles 14 and 15), business profits (Article 7), or does it fall by default into the category of other income (Article 21)?

Article 21 (Other income) of the OECD Model Treaty provides that "Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of the Convention shall be taxable only in that State". The income concerned is not only income of a class not expressly dealt with, but also income from sources not expressly mentioned (Article 21, Commentary 1).

Thus, there is a minimum of two questions under the Commentary – class and source. Assuming that the class can be determined, the more difficult question is determining the source of the income. Finally, although not mentioned specifically in the Commentary, is the income attributable to a fixed base or permanent establishment? The answer to these questions will determine whether the country of source or the country of residence will have primary tax jurisdiction.

II. CHARACTERIZATION PROBLEMS

The characterization of the class of income and the source of income for activities that have not been performed is a difficult task since it is speculative. What would have happened? How would it have happened? Where would it have happened? The agreement between the parties could, but seldom does, answer all of these questions. When it does, it would appear reasonable to tax the income as if the transaction had taken place, although this conclusion is not a necessary one. Inaction need not be taxed in the same manner as action.

When the agreement between the parties does not answer all of these questions (what? how? where?), it would be reasonable to use historical precedents as a means of decision. Again, a reasonable conclusion, but not a necessary conclusion. Future activities might not have followed historical precedents. Finally, there are situations where none of the questions (what? how? where?) are covered by contract or presumable from experience. In most of the situations the issue is whether the payments are compensation for services. Under this characterization it is unlikely that the issue will ever arise under the present OECD Model Treaty since the receipts would not be subject to tax in the absence of a permanent establishment or a fixed base, neither of which is likely to exist in the years in question. The only category of income that may prove troublesome is a commitment or stand-by fee to lend money or a guaranty which might not require a fixed base or permanent establishment if it is assimilated to interest.

The treaty parties should consider whether they wish to cover these situations explicitly in the treaty rather than permit them to fall into the category of "other income not expressly dealt with or expressly mentioned". See, for example, paragraph 4 of Article XVI of the United States–Canada Income Tax Convention.

III. THE US TAXATION TREATMENT OF INCOME FROM INACTION

Since the author is familiar with US taxation, the focus of this article is on the US taxation of that income.

Under the provisions of the US Internal Revenue Code (the "Code") the income of a non-resident alien individual engaged in a trade or business in the United States during the taxable year is subject to tax at graduated rates on the income which is effectively connected with the conduct of a trade or business with the United States.[1] Other income from US sources, including income for services, is generally subject to a 30 percent tax.[2] Identical provisions apply to foreign corporations.[3] Taxation is not dependent upon the foreign person

1. IRC Sec. 871(b).
2. IRC Sec. 871(a).
3. IRC Sec. 882(a).

having a fixed base or a permanent establishment in the United States.

A. Services

The term "trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year.[4] Compensation for labour or personal services performed in the United States is treated as income from sources within the United States.[5] The Treasury regulations provide that the residence of the payer, the place in which the contract was made, or the place or time of payment are irrelevant.[6] Thus, whether income for the performance of services is subject to tax will depend on the source of the income.

The regulations permit the parties to specifically allocate the amount paid for labour or services to those services performed in the United States and those services performed without the United States.[7] If no accurate allocation or segregation of the compensation for labour or personal services performed in the United States is or can be made, or when such labour or personal services is performed partly within and partly without the United States, the amount to be included in US income is determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.[8]

B. Stand-by fees

A "stand-by fee" is a payment for being on call and being ready to perform services that may or may not be used, depending on the course of future events. Examples of a stand-by fee are payments to disaster workers, such as fire fighters, who may be called upon to perform services in the territories covered under their contract, which may be anywhere in the world.

In a rather simple fact pattern the Treasury regulations provide an example of a non-resident alien who was employed under a contract that did not specify the amount allocated to the United States. The example does not specify where the services were to be performed, although it implies that the services were to be performed both within and without the United States. Under his contract the individual was subject to call at all times by his employer and was in a payment status on a 7-day week basis and received his pay regardless of the days he actually performed services. Without any analysis, the regulations concluded that the income was compensation for services and allocated the income to the United States based on the number of days the individual was *present in the United States* compared to the total number of days the individual was on call.[9]

This example is not very helpful since it does not state whether the individual performed services while in the United States, although by not so stating that he did perform services in the United States, it implies he did not. If by contract the individual could have been requested to perform services anywhere in the world, and no such services were performed, it is not irrational to tax the individual on the basis of where he was every day during this contract on the theory that the services contracted for were not only for actual performance but for the act of being ready to perform. Nevertheless, the analysis and conclusion are not very satisfying. Note that under the OECD Model Treaty the services would have to be attributed to a fixed base or a permanent establishment. Contrast this conclusion with the taxpayer's argument in the *Korfund Company, Inc.* case, *infra.*

C. Covenant not to compete

A covenant not to compete is by definition a payment for not performing services, i.e. not competing. Usually the territory in which the taxpayer will not compete is defined in the contract. When this territory is broader than where the taxpayer has performed services in the past, or could reasonably be expected to perform services in the future, most courts in the United States will restrict the covenant to those territories. However, limiting the territories may not determine the proper allocation among those territories.

In *The Korfund Company, Inc.*, 1 T.C. 1180 (1943), a US person entered into agreements with two European competitors under which the latter agreed (a) not to compete in the United States and Canada or to give advice to any company that competes in the same territory and (b) to give technical advice to the US person when requested. The US person agreed not to compete in Europe. Neither the agreements nor the payments apportioned the consideration, nor was any evidence offered. In the absence of evidence the court concluded that no part of the payments was for compensation for services performed. The issue then was whether the US person had an obligation to withhold Federal income tax from the payments. The taxpayer argued that the payments were not for services but were for negative acts – refraining from action. That such acts were based upon a continuous exercise of will which had its source at the location of the individual and that the mental exertion occurred in Germany, not in the United States. The Government's position was that the place of performance would have been in the United States if the payees had violated their obligations, and abstinence of performance occurs in the same place. The court agreed with the Government and concluded that the payments were from sources within the United States and held the taxpayer liable for failing to withhold on the payments. A similar analysis was followed in Private Letter Ruling 8401041 stating that the income from a covenant not to compete was taxable in the same manner as the income it replaced, in this situation, industrial and commercial profits.

If there had been a history of prior services, it does not seem unreasonable to treat a payment for a covenant not to compete in the same manner as the prior services and to allocate

4. IRC Sec. 864(b).
5. IRC Sec. 861(a)(3).
6. Reg. Sec. 1.861-4(a).
7. Reg. Sec. 1.861-4(b)(1).
8. Reg. Sec. 1.861-4(b)(1)(i)
9. Reg(s). Sec. 1.861-4(b)(1)(ii), Example (1).

it on the basis of historical services. Also, when the payer is interested in specific territories only, it would not seem unreasonable to treat the payment as a payment for services in those territories and allocate the income to those territories based upon their importance to the payer. However, when the restricted territory is not one in which the taxpayer has performed services in the past, the conclusion is more difficult.

The premise in both *Korfund* and the private letter ruling is that the income is earned in the country in which the service would have been performed if the taxpayer violated the contract. However, that analysis is incomplete. In *Korfund* the taxpayer could have violated the agreement in a number of ways, all of which would have resulted in differing tax consequences. One restriction was that the taxpayer would not give advice to a competitor. The violation could have taken place where the taxpayer resided or could have taken place in the country in which the other contracting party operated. The advice could have been given by telephone, fax or computer without the taxpayer leaving his country of residence, in which case it appears that the source would be the country of residence. The competitor could have been from a third country and the services performed there. Since the contract was not violated, we do not know where that violation would have taken place nor what form it would have taken.

D. Sign-on bonus

A sign-on bonus is a payment for signing a contract under which the taxpayer agrees to perform services in the future. However, the contract may not be conditional on future services and may be only a contract not to perform services for anyone other than the contracting payer. However, when payments are not conditional on future services, the source of the income is more speculative.

In *Ken Linseman*, 82 T.C. 514 (1984), the taxpayer, a non-resident alien, received a non-refundable sign-on bonus to enter into an agreement to play professional hockey for a US domestic professional sports club. The issue was how to allocate that income to sources within and without the United States. Since the payment was not conditional on the future performance of services, neither the taxpayer nor the Internal Revenue Service (IRS) contended that the income was compensation for services the taxpayer was expected to perform. The court analysed the contract as a covenant not to compete and decided that its "locus" is where the taxpayer forfeits his right to act. Where the contract does not specify a territory, the court stated that it could be argued, at least in theory, that the taxpayer forfeits his right to act in any place where he might otherwise act, which in the case of hockey could be worldwide, referring to the National Hockey League, the World Hockey Association, minor league hockey, European hockey, etc. and decided that such analysis would be exceedingly complex. The court decided that a more practical analysis was required and that the primary purpose for such a bonus was to induce the player to sign a contract with the bonus-paying club and therefore the most reasonable allocation was on the basis of the number of games that the club contemplated playing within and without the United States during the next season. The conclusion seems reasonable, since it undoubtedly was the parties' expectation. Accord, Rev. Rul. 74-108, 1974-1 C.B. 248 treating the sign-on bonus as a covenant not to compete.

The point at issue in the *Linseman* case was a dispute between the two states as to who should tax, i.e. Canada *v.* United States. This issue is now dealt with in the US-Canada Income Tax Convention of 1984. Paragraph 4 of Article XVI provides that:

> "Notwithstanding the provision of Articles XIV (Independent Personal Services) and XV (Dependent Personal Services) an amount paid by a resident of a Contracting State to a resident of the other Contracting State as an inducement to sign an agreement relating to the performance of the services of an athlete . . . may be taxed in the first-mentioned State, but the tax so charged shall not exceed 15 percent of the gross amount of such payment."

This is the only US treaty that deals with such payments.

In contrast to the *Linseman* decision and Revenue Ruling 74-108, earlier revenue rulings determined that a re-enlistment bonus paid to a non-resident alien serving in the US military for remaining in the military for another year was payment for the act of re-enlistment and treated as compensation earned for services performed on *the day* that he had re-enlisted, and since this was performed in the Philippines, the income was from sources without the United States. Revenue Ruling 72-125, 1972-1 C.B. 211. See also Rev. Rul. 71-343, 1971-2 C.B. 92. These rulings are inconsistent with the *Linseman* case and the *Korfund* case, and the IRS has announced that this rule applies only to military services. GCM 35396 (1973).

The Korfund Company, Inc., *Ken Linseman*, and the Revenue Rulings all deal with the source of the income; each of them specifically acknowledging that they were not dealing with compensation for services. They answer the question of "where" earned; not "what" character or "how" performed. They did not involve treaty questions and leave open whether Article 14 and Article 15 deal with them, and, if so, in what manner should we speculate they would have been performed.

E. Income from the sale of property

In order for a foreign person to be subject to tax on income from the selling of inventory in the United States, the Code requires a foreign person to be engaged in a trade or business in the United States.

In *Korfund*, discussed above, the taxpayer agreed not to compete in the United States. Competition would have included selling inventory into the United States. The United States does not tax the income from the sales of property unless the source of that income is in the United States,[10] or the taxpayer has an office or a fixed place of business in the United States to which the income is attributed. Accordingly, without further facts indicating an actual breach of the contract, it

10. This is generally determined by the passing of title to the property.

is impossible to know whether the income would be subject to tax. What is the source of the income? Where would title have passed? Would the foreign taxpayer have had an office or fixed place of business in the United States? Is there an agent with power to contract in the name of the taxpayer or with a stock of goods? Is there a permanent establishment under a treaty? All of these facts are unknowable, speculative. It does not seem proper to tax a foreign person in this situation, at least in the absence of a prior course of action.

F. Income from financial services

1. Commitment fees

The previous examples involve a fee for the commitment to refrain from personal services by an individual or a corporation. A similar and related issue is a fee in return for committing oneself to take certain action in the future of a financial nature. For example, a financial and sometimes a non-financial institution will receive a commitment fee for agreeing to provide additional funds in the future if they are required. The issues are similar. Assuming that the funds are not used, what is the character of the income and what is the source of the income, and in both cases how will it be treated under internal tax rules and is the treatment any different under an international income tax convention? (It is necessary to assume in making this theoretical analysis that the person receiving the fee is not engaged in a trade or business in the country of non-residence).

Where the commitment fee is paid up front in cash or other readily realizable property, the first issue from the United States viewpoint is to determine whether the income can be characterized as a type of income for which the Code dictates rules for determining source. In this connection, the question of character and source is alike. Interest has classically been defined as compensation for the use or forbearance of money. *Deputy v. Dupont*, 308 U.S. 488 (1940), 40-1 USTC ¶9161. A commitment fee is generally paid in consideration of the prospective lender's promise to advance funds to the prospective borrower when needed. In one respect the fee is compensation for the lender's keeping funds available which the borrower may "draw down" at the agreed time or during the agreed period. It could thus be argued that the fee, while not compensation for the use of money, is in a sense compensation for the forbearance of use of money since the obligation to keep the funds available diminishes the ability of the lender to freely use his funds in other profit-making ways. In other words, while the prospective lender does not fully forebear from the use of his money, he forebears from full use of his money. If the fee were held to be interest, it would constitute US-source income since interest paid by a US resident is US-source income and would be subject to US withholding tax at a 30 percent rate, unless it qualified as portfolio interest under the Code, or at a treaty rate which is generally lower. It is unlikely, however, that the word "forbearance" was intended to cover a situation such as this, and in any case commitment fees consistently have been held not to constitute interest. See Rev. Rul. 54-43, 1954-1 C.B. 119; Rev. Rul. 70-540, 1970-2 C.B. 101. Compare the discussion, *supra*, of covenants not to compete.

The next possibility is to characterize the income as compensation for services. A few of the IRS's private rulings have done so. See PLR 7808038 and PLR 7306191420A. This characterization is questionable. There does not appear to be any material aspect of labour inherent in the granting of a commitment. Nevertheless, the IRS seems to like the idea of characterizing the transaction as service income. The difficulty inherent in such a conclusion is to identify exactly "what services were performed" and, more importantly, "where" they were performed, often an exercise boarding on the impossible. For example, in PLR 8338043 it was held that discount income derived from purchasing debt obligations at a discount and holding them to maturity constituted service income derived from services rendered to the seller. In that case the "services" performed by the purchaser apparently were, according to the IRS, (1) assessing the risk of non-payment, (2) assuming the risk of non-payment, and (3) keeping track of the amount due and of the payments made. See also GCM 39220 (31 May 1983). In the case of commitment fees the IRS has apparently held, at least under the facts of one ruling addressing the issue, that the relevant "labour" is performed in relation to the "authorization of the funds and the raising of the funds" (PLR 7808038 (25 November 1977)). It is not exactly clear what "authorization of the funds" means. Is this the decision to commit the funds? If so, one would have to analyse the operations of each particular transaction to determine where the individual who made the determination was present at the time of the determination. Much more difficult is determining what "raising of the funds" means. It may refer to the location from which the particular loan was made or, on an overall basis, where all of the funds of the financial institution have been raised since funds are fungible. On the other hand, that analysis is inconsistent with the actual terms of the agreement which is the agreement to perform services, whether or not the funds ever have to be borrowed or gathered, i.e. there may be no need to borrow or gather any such funds at the outset or even in the future. This entire approach would introduce an ingenuous tracing concept into the financial affairs of a multi-billion dollar entity with far flung financial resources. If that characterization stands, the source of the fee would depend upon where those services were performed, noting that they can be performed partly within and partly without each country. If performed within the United States, in the absence of a treaty they would be subject to withholding. If a treaty exists, a permanent establishment or fixed place of business would be required to tax the income.

Another possible characterization of commitment fees is that they constitute industrial or commercial profits. This analysis does not advance the issue very far since even if they are industrial or commercial profits, it would introduce the fixed place of business or permanent establishment requirement. The OECD Model Treaty provides that the source country may not tax the industrial and commercial profits of a resident enterprise, except those allocable to a permanent establishment in the country of source. Generally, the commitment fees activities can take place in the country of residence without any major presence in the country of source. However, if the fee is analysed as compensation for services performed, in all or in part, an analysis would have to be made of what services were performed in either country and whether the recipient of the fee had a permanent establishment in the source country. If it does not, the fees would be exempt under the treaty. The Commentary in Article 7, Paragraph 35, of the OECD Model Treaty would apparently classify the income as industrial or commercial profits and, thus, would require a permanent establishment or fixed base in order for the fees to be subject to tax under the treaty.

2. Acceptance fees

Another type of financial income is an acceptance fee. Frequently a bank will earn income by substituting the bank's credit for that of another party in an international transaction. The *Bank of America v. United States*, 680 F.2d 142, 50 AFTR2d 82-5043 (Ct. Cl., 1982), involved fees received by the Bank of America from foreign banks for confirming letters of credit issued by banks to their customers and for accepting commercial paper issued by customers of the foreign banks. The Bank of America argued that the fees should be treated as foreign-source income from the foreign banks since they paid it while the Government argued that these fees were income for services and these were performed in the United States by the Bank of America. The issue in this case was not whether US withholding tax was applicable, but what was the amount of foreign-source income for the purpose of determining the foreign tax credit limitation in the United States. While recognizing that the fees were not exactly interest income, the Court of Claims held that the fees should be sourced by analogy to the statutory rules for sourcing interest income. The Court held that while a bank earning an acceptance commission does in fact perform certain personal services as part of the transaction, such services are not the predominant feature of the transaction. The predominant feature of the acceptance transaction was held to be the substitution of the bank's credit for that of the other party. If the court had decided that the income was for services, the court would have then had to decide what were the services: (1) the act of deciding to do the transaction; (2) the act of committing particular funds or authorization; (3) the act of raising the funds, or (4) none of the above.

3. Guarantee fees

Another form of financial income is guarantee fees. In an early published ruling, ARR 723 I-1 C.B. 113 (1922) declared obsolete by Revenue Ruling 78-435, 1978-2 C.B. 181, the IRS held that payments by a US company to a foreign guarantor of its obligation was payment for services performed by the guarantor outside of the United States. The payments, therefore, generated foreign-source income and were not subject to non-resident withholding tax. The IRS has never formerly revoked this position (declaring a ruling obsolete is not synonymous with revocation of a ruling). However, later cases question whether guarantee fees should be treated as compensation for services. These cases appear to have concluded that guarantee fees are more in the nature of interest payments than payments for services because the guarantees are viewed essentially as an extension of credit to the company. In *Centel Communications*, 920 F.2d 1335 (CA7, 1990), affirming 92 T.C. 612 (1989), the court specifically stated that the warrants issued for making a guarantee were not received for the performance of services.

There is no clear characterization of the income earned for entering into a commitment or a guarantee, nor is there any clear source rule for the receipt of the commitment or guarantee fees and, accordingly, since it is not dealt with, they should be taxed under Article 21, assuming they are not business profits attributable to a permanent establishment.

GREECE

Tax Evasion: The Case of Greece

George Agapitos and Dr George Mavraganis

George Agapitos is Associate Professor of Economics (Public Finance) at Athens University of Economics and Business, and former Minister of Finance.

Dr George Mavraganis is a Tax Lawyer-Consultant in Athens.

I. INTRODUCTION

It has been acknowledged that the imposition of any kind of tax induces taxpayers to take steps aimed at reducing their tax liability. Such behaviour has since ancient times been considered to be a form of resistance and protest against the State and the services it provides to its citizens. This is attributed to the fact that taxes had been levied by tyrants or conquerors, and as a result the political struggles carried out by citizens against the tyrannic regimes took the form of fiscal war. In addition, Plato believed the taxation of work and property was not consistent with the spirit of a free citizen. As a result, the Athenian democracy strongly favoured indirect taxation.

II. THE CONCEPT OF TAX EVASION

Nowadays, although the reason inducing such behaviour has changed, the behaviour *per se* has remained intact following new patterns. The modern reaction to taxation is expressed primarily in four ways, one of which is tax evasion, the others being tax avoidance, tax planning (or tax saving) and tax shifting.[1]

A. General

The concept of tax evasion includes any illegal act or omission by which the taxpayer intends to reduce his tax liability or postpone tax payment. Thus tax evasion presupposes the violation of the provisions of the tax laws in force, for example by non-filing of tax returns or the filing of inaccurate tax returns and the issue of fictitious tax records, etc.

Tax avoidance on the other hand is aimed at minimizing the taxpayer's liability or postponing tax payment by legal acts and by taking advantage of loopholes and violating not the letter but the spirit of the law (abuse of the law). Tax avoidance schemes are usually based on sham transactions or on transactions not justified by economic reasons. For example, Greek tax law provides that spouses are to be separately assessed, thereby inducing a transfer of economic activity or assets to the spouse with the lower income with the aim of achieving taxation at lower rates.

The third form of reaction to taxation is tax planning or tax saving.[2] This is defined as the mitigation of a taxpayer's tax liability by means the law did not intend to cover, especially by taking advantage of tax incentives, refraining from taxable behaviour, having advanced knowledge of the tax system and by studying the tax implications of future actions and opting for the course of action with the lowest tax liability. Thus, it becomes apparent that the decisive difference between tax planning and tax avoidance is the legislative intent.

The last form of reaction is tax shifting according to which the tax is shifted from the taxpayer who is responsible for the payment of the tax to the tax bearer, the person who ultimately bears the burden of tax when a transaction is carried out. Tax shifting may be forward (to the final consumer of products by increasing their price) or backward (to the taxpayers and the rates applying to their incomes by reducing their net income/ profits/salaries). In addition, it should be noted that in certain cases shifting of taxes is provided for by law especially with regard to indirect taxes. These taxes are imposed by the legislator with the purpose of being shifted and burdening the final consumer (e.g. VAT). Hence, shifting of indirect taxes is legal, although in certain cases it is used as a vehicle for tax evasion. In particular, when the vendor charges VAT for a transaction and the buyer pays it, but the former instead of rendering it to the State illegally withholds it.

Mention must also be made to the fact that although direct taxes imposed on income or property are intended to burden those who pay them, in practice they can be shifted to some extent. For example, when the client requests a receipt from his doctor for the medical services provided, the fee is increased by the amount of income tax the doctor is expected to pay. Furthermore, it has been concluded from econometric models[3] that corporate income tax on corporate profits is shifted to consumers *vis à vis* increases in product prices. This is also undoubtedly true of the payroll tax burden.

B. The concept of tax evasion in Greek law

The concept of tax evasion has been defined by Law 1591/1986, as subsequently amended. The crime of tax evasion is committed when:

1. R. Musgrave, *The Theory of Public Finance*, 1959; C. Shoup, *Public Finance*, 1969; L. Johansen, *Public Economics*, 1971.
2. Prof. V. Uckmar, "Tax Avoidance? Tax Evasion", *General Report, Cahiers de Droit Fiscal* Vol. 68a, at 20 et seq.
3. M. Krzyzaniack & R. Musgrave, *The Shifting of the Corporation Income Tax: An Empirical Study of its Short-Run Effects upon the Rate of Return*, Baltimore, 1963, John Hopkins Press. G. Agapitos, Inflationary Effects of Profit Taxes With Reference to the UK Manufacturing Sector, *Finanzarchivband* 85, 1976 at 235-237.

- no tax return is filed or when the tax return that is filed is inaccurate with regard to those taxes which have been withheld but not subsequently rendered to the State provided the amount of tax exceeds a certain amount;
- no income tax return has been filed provided the tax due exceeds 300,000 Drs.;
- no tax records, as required by Greek tax law (receipts, invoices and dispatch notes), are issued;
- the tax records previously mentioned are inaccurate provided the inaccuracy leads to a difference exceeding 10% between the actual quantity or value and the inaccurate one;
- the entrepreneur's or professional's or company's books and records (as set out in the Books and Records Code) are not accurately kept. For this provision to apply it is necessary that the difference between the actual gross income (as it was identified during tax auditing) and the one declared in the annual income tax return exceeds 20% and is not less than 1,000,000 Drs.;
- a taxpayer does not abide by his obligation to safe-keep books and records as required by the Books and Records Code;
- a taxpayer issues a false or fictitious invoice; and
- a taxpayer transports goods without the accompanying records required by the Books and Records Code.

III. TAX EVASION DETERMINANTS

A. General

Tax evasion has become an international phenomenon. However, the extent to which it exists varies from country to country and depends on the degree of sophistication of the public sector and the structure of the economy. It has been acknowledged that a significant black economy, a high percentage rate of self-employment and high tax rates all increase the likelihood of high levels of tax evasion.

The old view was that there were only two determinants of tax evasion, namely the level of education of the residents and the level of economic development of a country. Nevertheless, in practice it was realized that, although the level of education and economic development has become high in many countries, tax evasion in these countries has been continuously increasing. Thus, after considerable research and study it has now been admitted that the determinants of tax evasion include many factors, some of which are not related to taxation. In particular the following factors have been identified:

- the level of the tax rates;
- the structure of the economy and economic activity; for example the size of the black economy, the percentage of employees in the work force and the agricultural sector's percentage of GDP;
- the public sector's ability to register economic activities accurately;
- the efficiency of the tax authorities in the assessment and collection of taxes and in particular their ability to cross-examine tax data;
- the absence of a real estate register;
- the government's policies and especially the administration of public finances with emphasis on tax revenue;
- the quality of public services;
- the gravity of penalties imposed for tax evasion crimes;
- the stage in the economic cycle which the economy of a country has reached (recession – unemployment – inflation); and
- the size of the public sector and the degree of State intervention in economic activity.

From the above it is obvious that high tax rates, a large black economy, inefficient public services and tax authorities, a lack of a real estate register, a non-democratic way of governing, waste in administering public finance, trivial penalties for tax evasion offences and an overbearing public sector whose intervention oppresses economic activity constitute the principal determinants for the level of tax evasion.

B. The Greek case

In Greece the size of the black economy exceeds 40% of GDP, over 55% of the workforce are self-employed, income tax rates reach 45%, the public sector has a productivity estimated to be nil, the tax authorities are inefficient, the penalties for tax evasion offences are light, there is no real estate register, the economy is in recession, the public sector is twice as large as the private sector and unnecessarily intervenes in its economic activity and large amounts of public resources are squandered.

In addition, the principle of equity has been continually undermined, through the ever increasing exemptions offered by the State to certain social groups. This undermining of the principle of equity has been used as the basis for the justification of tax evasion. More specifically, according to estimates included in the 1995 Budget tax exemptions cost nearly 1,000 billion Drs.! This means that certain social groups pay less tax compared with other taxpayers on the same level of income and under otherwise identical circumstances, simply because they have succeeded in obtaining tax privileges from the State.[4] Moreover, the tax amnesty, which is periodically offered, contributes to a further violation of tax equity. Faced with this grossly unfair situation those taxpayers who cannot enjoy the tax exemptions, selectively offered to certain categories of taxpayers, or who cannot enjoy the benefits of tax amnesty, since they have been honest in the past, may choose tax evasion as the vehicle for accomplishing a "de facto" tax equity.

4. The only exception is tax exemptions for disabled people and people with special needs. Even tax incentives are not accepted any more as a vehicle for development since the benefits they offer are less than the distortions they cause to the free market and competition.

Another crucial factor is the underlying structural weaknesses of the Greek tax system,[5] which is attributed to the fact that the Greek tax system has deviated from many generally accepted principles of taxation. In particular, as already has been mentioned, the Greek tax system violates; the principle of tax equity (horizontal-vertical); the principle of tax neutrality (by imposing certain tax behavioural patterns through incentives and exemptions); the principle of certainty (by continuous, repetitive changes);[6] the principle of administrative feasibility and efficiency and the principle of flexibility. As regards the last principle, it should be noted that certain protective taxes such as the special consumption tax on cars, which remain in force, and certain EU measures such as the Mergers Directive (90/434) dealing with tax issues, which have not been implemented into Greek tax law, play a significant part in undermining the competitiveness of the Greek tax system within the Single Market and simultaneously impede free competition. As a result of the deviation from the established principles of taxation, the Greek tax system does not produce the expected tax revenue and this in turn explains the strange phenomenon taking place in Greece, where although tax rates are high the average tax burden is lower than in other EU countries.[7]

Turning to the relationship between tax evasion and the black economy, it should be noted that tax evasion is not synonymous with the black economy. It is worth mentioning that there are certain activities included in the concept of the black economy, which due to their illegal nature could never become an object of taxation (e.g. drug traffic). In addition, certain enterprises in the official economy may evade tax. Given that tax evasion is not confined to the black economy, the black economy therefore merely represents a sub-total of the total quantum of evasion.

On the assumption that tax evasion in the black economy depends on the marginal tendency to consumption of those involved in the black economy, where the marginal tendency to consumption is equal to 1,[8] *ceteris paribus*, the loss of indirect tax revenue is nearly nil.[9] Consequently, although the black economy and tax evasion may have a negative impact on the effectiveness of economic policy, they do not necessarily result in a reduction in the level of total indirect tax revenue. A conclusion that has led certain authors to maintain that the black economy may actually generate an increase in indirect tax revenue![10]

The existence of a black economy together with tax evasion may retard the effectiveness of economic measures. This is because economic policy relies on the official statistical data, and therefore the results will not be as anticipated when the real data diverges markedly from the official data. Unfortunately this divergence exists in Greece. Moreover, another conclusion of economic science has been confirmed in the case of Greece, namely that the recession of the official economy is very likely to force people to do part-time jobs (private lessons, commerce, etc.) and this constitutes part of the black economy and tax evasion problem.

In Greece it is very common for unemployment benefits to be claimed unlawfully by people in part-time employment. This behaviour is encouraged by employers who wish to reduce their costs by avoiding the payment of their share of the employees' social security contributions. The whole problem is aggravated by the presence of refugees and illegal immigrants whose number's have increased dramatically in Greece recently. Finally, it should be noted that increases in inflation and unemployment has lead to cheaper goods and services being produced by the black economy which in turn acts as an incentive for tax evasion.

It is apparent from the above analysis that the existing situation in Greece creates an environment conducive to tax evasion. Tax evasion is likely to be encouraged further by the expected change in the taxation (especially of VAT) affecting imported goods when the transitional VAT regime ends after 1997. Admitting that the transitional regime has already caused serious VAT evasion problems in Greece, as will be shown below, it is reasonable to expect that the change-over from the destination principle to the origin principle after 1997 will cause further tax evasion problems.[11]

IV. IDENTIFICATION AND SIZE OF TAX EVASION IN GREECE

A. Direct taxes

As shown in Table 1, direct tax revenue in 1995 represented 36% of total revenues with indirect tax revenue claiming the remaining 64%. Direct tax revenue includes revenue from income taxes (individual and corporate), property (capital) taxes and fines. Income taxes constitute the larger part of direct taxation, whereas property taxes always produce a low tax yield. Under the 1995 Budget individual income taxes derived from the taxation of individuals and general or limited partnerships is expected to produce 42% of direct tax revenue, whereas corporate income tax revenue derived from the taxation of corporations, limited liability companies, cooperatives, public or municipal companies and branches of foreign enterprises will amount to 25%. A significant amount of direct tax revenue is derived from the special banking tax (14.4%) and from taxes assessed in previous years but collected in 1995 (10.8%). Property taxes produce only 4% of direct tax revenue.

5. For more on the Greek tax system, see Dr. G. Mavraganis, "Greece: The 1994 Tax Reform", *European Taxation* 1994(7), at 219 et seq.
6. Tax Acts are often amended in some cases twice per year and in certain cases are given retrospective effect.
7. See Table 3.
8. This means that what has been acquired due to the black economy is being consumed.
9. A. Peacock & K. Shaw, "Tax Evasion and Tax Revenue Loss", 1982 *Public Finance*, Vol. 27, at 269-278; W. Von Zumeck "Tax Evasion and Tax Revenue Loss", 1989 *Public Finance*, Vol. 44, at 308-315.
10. C. Lai & W. Chang, "Tax Evasion and Tax Collections", 1988 *Public Finance*, Vol. 43, at 138.
11. See G. Agapitos, "The VAT Harmonisation", *Institute of Economic and Business Research*, Athens, 1990.

Table 1

Category of tax	Amounts in billion Drs.	Percentage in direct tax revenue
I. Income taxes	1,715	77.3
– Individual	870	(39.2)
– Corporate	475	(21.4)
– Other	370	(16.7)
II. Property taxes	88	4
– Inheritance, Donation	88	(4)
III. Third party tax	0.8	–
IV. Previous years taxes	240	10.8
– Individual	65	(2.9)
– Corporate	85	(3.8)
– Other	90	(4.1)
V. Fines	56	2.5
VI. Other direct tax	120	5.4
Total	2,220	100.0
Percentage of total tax revenue	6,162	36

Source: Ministry of Finance.

The fact that taxes paid late account for 10.8% of direct tax revenue (240 billion Drs.) indicates that taxpayers, particularly businesses, have an interest in delaying the payment of the assessed taxes (a type of tax evasion), since they know that the Finance Minister is likely to propose a special legislative solution to the problem (tax amnesty), which will discharge taxpayers from the payment of fines and additional taxes in respect of the late payment. The delay in payment of those taxes would produce an annual profit of 40 billion Drs. if the tax involved was invested to produce interest. Of course this ultimately represents a real cost to the State Budget.

At this point it is worth considering the present structure of income taxation in order to identify the categories of taxpayers declaring the highest incomes. As indicated in Table 2, employees and pensioners, while only representing 60% of total taxpayers, declare 70% of the total taxable income.

Table 2:
STRUCTURE OF INDIVIDUALS' INCOME TAX FOR 1993 BASED ON 1994 TAX RETURNS

Taxpayer	Number	%	Income	%	Tax	%
Rentier	294	9.1	333	4.5	21	5.8
Traders	689	21.4	1,303	17.5	73	20.1
Farmers	122	3.8	128	1.7	3	0.8
Employees	1,379	42.8	3,767	50.7	161	44.5
Professional	121	3.8	476	6.4	45	12.4
Pensioners	614	19.1	1,428	19.2	60	16.5
Total	3,219	100	7,435	100	363	100

Source : Ministry of Finance; numbers in thousands, incomes in billion Drs., tax in billion Drs.

Table 3:
AVERAGE TAX BURDEN (1975-90) AND STRUCTURE OF TAX REVENUE IN GREECE AND THE EU

Average tax burden

	1975	1980	1990	1995
Greece	24.6	29.4	35.1	36.5
EU	33.4	36.4	39.4	40.8

Structure of tax revenue 1990

	Income	Soc. sec.	Property	Consump.	Other
Greece	20.4	28.4	4.8	45.7	0.7
EU	33.9	28.4	4.6	31.9	0.8

Source: OECD Revenue Statistics (1990).

As the figures in Table 4 indicate the percentage contribution from employee taxpayers is continually increasing. This is despite the fact that the percentage of employees *vis à vis* the total urban and semi-urban work force has been steadily declining. The disproportionate tax burden faced by employees can be attributed either to the fact that the State does not subject trading (including professional) or property income to tax or to the inability of the State to identify and assess such income.

In our view, in Greece both the aforementioned causes apply. The repercussions of such phenomenon are mainly the increase of tax evasion due to the increase in the size of the black economy and the increase of the tax burden placed on employees, a burden destined to meet the ever increasing public spending.

The tax evasion carried out by those who are not employees has continually increased. This is evidenced by comparing the figures of the national accounts with the corresponding ones derived from the annual income tax returns of employees and non-employees (Table 4). More specifically, in 1990 the declared income from employment amounts to 75% of wages and salaries registered in the national accounts, whereas the corresponding figure for non-employment income is 32%. The conclusion that can be drawn is that tax evasion in income from employment is almost nil, tax allowances and credits, justifying the divergence between the figures contained in the national accounts and those declared in the tax returns. Conversely, tax evasion in respect of income from sources other than employment exceeds 80% of the income declared taking into account the underestimation of the figures in the national accounts brought about by the black economy.

The conclusion that can be drawn from an analysis of Table 4 is that tax evasion with regard to individuals' income tax in 1993 reached 550 billion Drs. This estimate is based on the moderate assumption that the average income tax rate is 20%. The main perpetrators of income tax evasion are professionals, other self-employed persons, small enterprises and building contractors. However, it should be underlined that civil servants and pensioners with a second job (the so-called "moonlighters") also evade taxation.

Table 4:
CORRELATION BETWEEN INCOME RECEIVED AND INCOME DECLARED BY INDIVIDUALS IN BILLION DRS. (1975-1993)

Income	1975	1980	1985	1990
National accounts[12]				
1. Salaries-wages[13]	192	562	1,592	3,504
2. Income from property and trade[14]	221	519	1,107	3,438
Annual tax returns				
3. Salaries-wages	82	312	1,036	2,621
4. Income other than 3.	63	170	455	1,099
Relation in %				
5. (3)/(1)	43%	56%	65%	75%
6. (4)/(2)	29%	33%	39%	32%

Lastly, it should be remembered that the inefficiency of the tax administration and its inability to carry out proper tax auditing in combination with the large number of small enterprises and the transfer pricing schemes big multinational companies often undertake, lead to the distortion of the tax base and to the disappearance of taxable income.

Another serious problem is that relating to the benefits in kind (company cars, school fees, etc.) which companies often offer to their managers. Such benefits are entered in the companies' accounting books as business expenses. Unfortunately this accounting treatment in conjunction with the periodic tax amnesty and weak tax auditing may lead to the managers evading income tax on the benefits. Social security contributions may also be evaded in this way.

Finally, it should be reiterated that the data set out in the Tables reveals the existence of serious tax evasion. For 1995 the quantum of evasion is expected to reach 700 billion Drs. or some 40% of the collected direct taxes.[15]

B. Indirect taxes

VAT was introduced in Greece in 1987 resulting in the abolition or merging of many indirect taxes; its introduction raised high expectations that the evasion of indirect taxes would be significantly reduced. However, such expectations did not materialize due to the retention in force of many general and specific taxes and due to the fact that at the time VAT is charged there is a mutual interest among the vendor and the buyer for not issuing an invoice. The creation of conflicting interests between the contracting parties by allowing a full deduction from the buyers' taxable income of the amount shown on the invoice might lead to a reduction in the evasion of VAT.

As has already been mentioned, indirect taxes now constitute 64% of total tax revenue, whereas in 1991 the figure was 70%. The reduction of indirect taxes and the corresponding increase of direct taxes constitute, according to the prevailing view, a sign of improvement in the composition of tax revenue. However, such view is called into question given that all taxes can be shifted to prices. Indeed increases in direct taxation has the definite disadvantage of reducing both savings and investment.

Table 5:
REVENUE AND STRUCTURE OF INDIRECT TAXES IN BILLION DRS. (1993 & 1995)

Category of tax	1993	1995	Percentage/total of indirect taxes	
			1993	1995
1. *Taxes on domestic transactions*	1,577	2,137	50.3	54.2
– VAT	(1,254)	(1,750)	(40.0)	(44.4)
– capital transfer tax	(83)	(101)	(2.6)	(2.6)
– stamp duty	(160)	(215)	(5.1)	(5.5)
– banking tax	(80)	(46)	(2.5)	(1.2)
– other taxes	–	(25)	–	(0.6)
2. *Domestic consumption taxes*	1,131	1,356	36.0	34.4
– turnover tax	(24)	(33)	(1.0)	(0.8)
– car tax	(66)	(61)	(2.1)	(1.5)
– excise duties on fuel	(674)	(733)	(21.5)	(18.6)
– other excise duties	(275)	(406)	(8.8)	(10.3)
– other special taxes	(11)	(15)	(0.4)	(0.4)
– circulation duties	(51)	(55)	(1.6)	(1.4)
– other vehicle taxes and duties	(28)	(51)	(0.9)	(1.3)
– other	(2)	(2)	–	–
3. *Consumption taxes on imports*	372	332	11.9	8.4
– VAT	(290)	(255)	(9.2)	(6.5)
– vehicle taxes	(36)	(31)	(1.1)	(0.8)
– excise duties on fuel	(35)	(35)	(1.1)	(0.8)
– other excise duties	(11)	(11)	(0.4)	(0.3)
4. *Third-party taxes*	12	14	0.4	0.4
5. *Previous years' taxes*	29	80	0.9	2.0
6. *Additional taxes* – fines	15	22	0.5	0.6
7. *Import Levies and other indirect taxes*	2	1	–	–
Total	3,138	3,942	100.0	100.0
Total tax revenue	4,493	6,162	70	64
Total state revenue	4,971	6,935	63	57

General indirect taxes include stamp duty and turnover tax and constitute 57% of State revenue. Special indirect taxes encompass tobacco excise duties, excise duties on alcoholic drinks as well as excise duties on fuel and cars, and represent

12. In Tables 1, 3 and 4 the agricultural sector as well as pensions have not been taken into account.
13. Pensions of regular civil servants and employers' share of employees' social security contributions were deducted.
14. Undistributed profits of corporations were deducted and direct taxes on corporations were added.
15. K. Kanellopoulos et al., "Tax Evasion and Underground Economy: Economic Impact", *Center of Planning and Economic Research*, Athens, 1992.

35%. Capital transfer tax and the indirect taxes of prior years make up the remaining 8% of indirect tax revenue.

The "flowering" of the black economy, combined with the tax administration's inability to scrutinize the transport of goods and to cross-check tax data, adversely affects the collection of revenue from indirect taxation. The following factors may lead to the evasion of indirect taxes:
- the complexity of the system, the existence of a great many general and specific taxes in conjunction with the vast number of tax provisions and the lack of certainty as to what constitutes the taxable base;
- the high tax rates particularly of special taxes and the accumulative taxation of the same object;
- the non-issue of tax records or the issue of false or fictitious tax records; and
- the crediting of input tax never paid and the adoption of transfer pricing schemes.

Tax evasion in the area of indirect taxes mainly concerns those taxes levied on domestic products and particularly VAT, stamp duty, turnover tax and capital transfer tax. Given that as indicated in Table 5, the taxes on domestic goods and services exceed 85% of the total indirect tax revenue, tax evasion is obviously very significant. Conversely, tax evasion with regard to imported goods and services is deemed to be on a lower scale, though continuously increasing and now extending even to the evasion of customs duties.

For 1995 revenue from indirect taxation is expected to be comprised as to 54% for taxes on transactions and 34% for consumption taxes, with only 8% being derived from imported goods. General taxes on domestic goods and services exceed 50% of indirect tax revenue, VAT alone accounting for 44.4%.

From past studies it has been calculated that the level of tax evasion is about 40% of indirect tax revenue. Assuming that tax evasion has not further increased (an unrealistic assumption), 1,400 billion Drs. of indirect taxes will be evaded in 1995. The Ministry of Finance has calculated that the loss of revenue due to the evasion of tobacco excise duties alone amounts to some 50 billion Drs.

V. ATTEMPTS TO COMBAT TAX EVASION

During the last two decades Greek Governments have attempted to reduce the phenomenon of tax evasion by adopting piecemeal measures. Before considering such measures, it is worth mentioning three reasons why they have not had the desired effect. Firstly, in certain instances the enforcement of measures has not been completed. Secondly, the measures were introduced piecemeal, i.e. not as part of a comprehensive well thought out anti-evasion policy. Thirdly, the large scale of the black economy prevents the application of governmental economic policies and therefore undermines the effectiveness of anti-evasion measures. To understand the philosophy underlying the Government's measures, it is useful to categorize them by reference to the objective they were intended to accomplish.

A. Improvement of the quality level and structure of tax administration

(i) Computerization

The computerization of the Greek tax administration has been one of the main targets of all Greek Governments since the 1970's. The Ministry of Finance's Computer Centre has been set up with the task of processing income tax returns and cross-checking sales and purchases made by professionals, traders and enterprises. There is also a network of local tax offices which enjoys restricted hardware and software support. These have the task of gathering data on taxpayers falling within their jurisdiction. Furthermore, a very ambitious computerization project (the so-called "TAXIS") is being carried out and is due to reach completion within the next couple of years. The project purports to create a database containing information on every taxpayer. All local tax offices will have access to this information. This will facilitate the continuous updating of each taxpayer's file. In addition tax auditors will be supplied with computers and software which will facilitate the execution of their duties.

(ii) Training of the tax authorities staff

The training of the tax authorities staff has always been a priority of the Ministry of Finance. The importance of such training has been underlined by the constant changes the Greek tax system has undergone. The aim of the training is to familiarize staff with the use of hardware and software as well as to keep them informed on developments in tax law.

(iii) Establishment of special bodies

A number of special bodies were set up by the Ministry of Finance by Law 2214/1994. These bodies, listed below, are intended to be deployed in combating tax evasion:
- the Council of Fiscal Studies, whose task is the submission of proposals on issues of fiscal policy;
- the Bank of Tax Data, whose function is to aid tax auditing;
- the Special Legal Office of Taxation, whose aim is to provide legal support to tax authorities in tax litigation; and
- the Price Inspection Office, whose function is to provide advice on transfer pricing issues.

Finally, in October 1995 the Bill providing for the setting up of a special body (the so-called fiscal police) which will have the task of persecuting economic crime, became law (Law 2343/1995).

B. The reliance of the Greek tax system on predetermined criteria

Because of the inability of the Greek tax authorities to carry out comprehensive tax auditing they have relied too heavily on predetermined formulae and criteria when determining a taxpayer's tax liability. The most important criteria are the following:

- pursuant to Law 814/1978 the taxable profits of enterprises which do not supply services and keep accounting books of the first or second category, are calculated by multiplying their annual gross income by a predetermined rate of net profit which has been set by reference to the type of activity they carry out;
- Law 820/1978 introduced and subsequent laws extended the so- called "criteria for living expenses" according to which the ownership of certain goods (car, plane, boat, etc.) or the receipt of certain services (private lessons, housemaids, etc.) results in a "presumed income" which cannot be lower than the declared income;
- according to Law 1249/1982 and the subsequent Ministerial Resolutions, the price of real estate which constitutes the tax base for inheritance and donation tax, property transfer tax and real estate duties is calculated by reference to a predetermined rate per sq.m.; and
- Law 2214/1994 provided for a minimum taxable income with regard to enterprises who must maintain records of the first or second category and for certain professions, which is calculated by applying predetermined factors and rates.

C. Property acquisition criterion

Law 820/1978 introduced and subsequent laws extended the criterion according to which the purchase of certain goods must be justified by the income the taxpayer has declared, otherwise the amount paid for such purchases is deemed to be income and is subject to income tax. The items falling under this rule concern the purchase of cars, bikes, boats, planes, movables over 1,000,000 Drs., enterprises (in whole or in part), the increase of a company's share capital, the purchase of homes over 120 sq.m. not destined to be used as the taxpayer's principal residence, the allocation of loans, donations and the expenses for meeting interest on loans or credits.

D. Attempt to register property assets

In 1992 the Ministry of Finance obliged taxpayers to file with their annual income tax return a list of their real estate property held at 31/12/1991. In 1995 taxpayers were again obliged to file a list of their real estate property, this time as at 31/12/1994. These measures will enable the tax authorities, provided there is corresponding hardware and software support, to inspect changes in the taxpayers' assets and to identify cases of tax evasion.

E. Scrutiny of private contracts

According to Law 1882/1990 copies of private contracts should be filed with the taxpayer's tax office to enable the tax authorities to gather information on the income of the contracting parties. Non-filing, apart from the imposition of fines, can lead to the contracting parties being debarred from taking legal action relating to the proper execution of the relevant contract.

F. Tax amnesty

The Ministry of Finance has in the past on many occasions offered tax amnesties. The rationale behind these amnesties was to allow the ministry to focus all its resources on combating current year tax evasion. Such amnesties were offered in 1967, 1974, 1978, 1984, 1988, 1989, 1990, 1992 and 1994. However, it should be noted that although the legislative intent of offering amnesties was to aid the fight against tax evasion, such leniency in practice may actually have encouraged it.

G. Punishment of tax evaders

Since the 1970's tax evasion for certain offences has become a minor criminal offence. In this regard the 1990's have seen an increase in the range of offences falling within this category. In addition, taxpayers who evade taxes are subject to supplementary administrative penalties such as the temporary closure of their enterprises, refusal of driving licence applications, the denial of the right to request tax certificates necessary for carrying out certain transactions and denial of the right to tender in public bids, etc.

VI. CONCLUSIONS AND POLICY PROPOSALS

From the foregoing analysis it is estimated that for 1995 the total quantum of evasion of direct and indirect taxes will exceed 2,000 billion Drs., i.e. 32% of total tax revenue! In this regard it should be noted that we have ignored the evasion of social security contributions.

A. Conclusion

The scale of tax evasion in Greece deprives the State of vital funds, which are essential for meeting the rapidly increasing public expenditure. Without these funds the State has inevitably been forced to seek recourse to expensive borrowings. Furthermore, the loss of tax revenue and the loan raising it induces prevents Greece from meeting the conditions of the Programme of Convergence with the EU.

In addition tax evasion adversely affects the rational allocation of resources, the fair distribution of the tax burden, the funding of the public sector and the supply of social services and the successful implementation of an effective fiscal and development policy.[16] The worst effect of tax evasion, however, is that it promotes social injustice, since it results in the redistribution of income in favour of tax evaders and at the expense of honest taxpayers. Such redistribution is particularly undesirable because, as was previously seen, the majority of tax evaders are non-employees and usually belong to higher income groups. Finally, it has been acknowledged

16. E. Feige, "The UK's Unobserved Economy: A Preliminary Assessment", 1981 *Economic Affairs*, Vol. 1, at 205-212.

that, when wide-spread tax evasion exists, any measure intended to contribute to a fairer distribution of official GDP may when implemented actually have the opposite affect!

B. Policy proposals

The serious structural problems and macro-economic imbalances of the Greek economy in combination with the poor performance of public administration and the complex Greek tax system are the main factors responsible for the high level of tax evasion. In view of this and taking into account what has been mentioned in Section III, it can be seen that, to be effective, the anti-tax evasion policy must be coordinated, systematic and efficient.

In summary to deal effectively with tax evasion requires:

– improvement of the Greek tax system and its administration by applying the principles and institutions adopted by modern tax systems (such as modern anti-transfer pricing measures, controlled foreign corporation legislation, thin capitalization legislation, anti-treaty shopping legislation, and special rules for benefits in kind), by broadening the tax base, by reducing tax rates, by abolishing tax exemptions and old-fashioned protective taxes and by improvement of the Ministry of Finance's human and technical resources;
– effective management and allocation of tax revenue, rational distribution of public spending, increases in the productivity of the public sector. Such increase will be attained by reducing the size of the public sector which absorbs over 60% of the available funds of the economy. This of course implies the privatization of all the states' entrepreneurial activities; and
– introduction of severe criminal and administrative penalties for serious tax evasion offences and abandonment of the method of tax amnesties which, together with an end to the continuous amendments made to tax law will establish the principle of certainty in the Greek tax system.

INDIA

TAX EXPERIMENTS AND THE MOTOR VEHICLES TRADE

Shyam Nath

Professor of Economics University of Mauritius, Reduit, Mauritius

I. INTRODUCTION[1]

Interstate shopping is a tax avoidance technique which takes advantage of differences in tax rates between states. It occurs when a consumer resident in one state makes an out of state purchase in order to avoid the higher tax rates applying in his home state. Interstate shopping thrives where there are large differences in tax rates and where transport and other incidental expenses are minimal. Commodities most commonly associated with interstate shopping are those easy to transport and which yield reasonable tax savings relative to purchase value, e.g. electrical goods and light consumer durables. Loss of tax revenue due to interstate shopping induces governments to design compatible tax systems. Despite such attempts, tax havens and zero rate zones do exist and attract shoppers, on the one hand and tax analysts and policy makers on the other.

In recent years the interstate trade in motor vehicles in India has increased dramatically. This increase is a direct consequence of interstate sales tax differentials. Not surprisingly, the trade in motor vehicles tended to gravitate towards zero or low tax states. In an attempt to counter this trend, some of the adversely affected state governments decided to levy a tax on the entry of motor vehicles purchased outside the state for use or sale within the state (entry tax in lieu of sales tax). This tax experiment has been successful and has compensated to a large extent for the loss of legitimate sales tax revenue caused by tax avoidance based upon sales tax rate differentials. Opponents of the tax have tried to portray it, rather unconvincingly, as an obstacle to freedom of trade and commerce among the federal states. Tax analysts, on the other hand, find this new tax measure a desirable fiscal development. It would be instructive therefore, to discuss different aspects of this fiscal development, particularly because its introduction is currently being considered by certain other state governments. This paper covers the following aspects;

(i) tax differentials and operational aspects of interstate trade in motor vehicles;
(ii) impact of entry tax intervention on trade flows and public finances;
(iii) constitutional validity of such a tax measure; and
(iv) implications of this experiment for tax administration policy.

II. THE IMPACT OF TAX DIFFERENTIALS ON INTERSTATE TRADE

The rates of sales tax on motor vehicles differ from one state (or union territory) to another. In addition, in most states rates vary according to the category of the vehicle, namely motor cars, jeeps and pick-ups, scooters and motorcycles and motor chassis. However, in some states such as Maharashtra and Rajasthan a single rate is prescribed for all categories. A look at Table 1 reveals that interstate variations are sharp, rates ranging from 3 to 15 percent. This is true despite interstate tax competition, which in recent years has led to a general reduction in rates. There have, however, been some notable exceptions to this downward trend, rates having risen in Maharashtra, Madhya Pradesh (a few vehicle categories) and Rajasthan. The extent of the differential in the tax rates has been large enough to induce trade to be diverted from high-tax to low-tax territories.

Often the diversion of trade occurs on paper only. For instance, one of the biggest manufacturers of diesel vehicles in Maharashtra employs local dealers in low-tax territories to sell its products to consumers all over the country. However, where the tax rates differ widely in adjoining states, dealers located in low-tax territories act as agents for purchasers from the states with high tax rates. The vehicles do not move physically but the sales are shown as having taken place outside the high-tax state. The tax payable in the state where the vehicle is finally used is evaded. The price of a vehicle is thus reduced to the extent of the sales tax differential between the purchaser's state of residence and the state to which the sale is attributed. Sometimes the purchaser's home state and the place of delivery are the same, but the transaction is shown as "interstate" only. For instance, purchase orders are made in Bombay (Maharashtra) and vehicles are also delivered there, but transactions are shown to have taken place in Vapi (Gujarat), Daman or Silvasa.

1. This article is derived from a study entitled Taxes on the Entry of Goods into a Local Area: An Assessment conducted by a staff team consisting of Shyam Nath, Amaresh Bagchi and Shekhar Mehta at the National Institute of Public Finance and Policy, New Delhi. The views expressed in this article are those of the author and not necessarily of the organization to which he belongs. Sincere thanks are due to Geraldine Govinden for expert word processing.

Table 1:
CHANGES IN RATES OF SALES TAX ON MOTOR VEHICLES IN SELECTED STATES (%)

	1975-76 (%)	1980-81 (%)	1981-82 (%)	1982-83 (%)	1983-84 (%)	1984-85 (%)	1985-86 (%)	1986-87 (%)	1987-88 (%)	1988-89 (%)	1989-90 (%)
Motor car											
Andhra Pradesh	12	6	8	8	8	8	8	5	5	5	5
Tamil Nadu	–	7	7	7	9	9	9	9	5	5	5
Maharashtra	12	12	12	12	12	12	12	12	12	15	15
Madhya Pradesh	8.5	8.5	8.5	8.5	8.5	8.5	8.5	10	10	10	
Orissa[1]	12	13.7	13.7	12.6	12.6	10.6	10.6	10.6	10.6	10.6	10.6
Pondicherry	–	–	–	–	–	–	4	4	4	3	3
Daman	12	6	7.5	12	12	3	3	3	3	3	3
Gujarat	9	9	12	12	12	5.5	2.7	4	4	4	4
Rajasthan	–	10	10	10	10	10	10	10	10	12	12
Jeeps and pick-ups	–	–	–	–	12	12	8	5	5	5	5
Andhra Pradesh	12	12	12	8	8	8	8	8	8	8	8
Tamil Nadu	–	–	–	–	12	12	12	8	5	5	5
Maharashtra	12	12	12	12	12	12	12	12	12	15	15
Madhya Pradesh	–	8.5	8.5	8.5	8.5	8.5	8.5	8.5	10	10	10
Orissa	12	13	13	12	12	10	10	10	10	10	10
Pondicherry	–	–	–	–	4	4	4	4	–		
Daman	12	6	7.5	12	12	3	3	3	3	3	3
Gujarat	9	9	12	12	12	5.5	2.7	4	4	4	4
Rajasthan	–	–	–	–	10	–	–	–	–	–	12
Scooters and motor cycles	–	–	–	–	–	–	4	4	4	4	–
Andhra Pradesh	12	12	10	10	10	8	8	8	8	8	8
Tamil Nadu	–	15	15	15	15	15	15	15	8.4	4[2]	4
Maharashtra	12	12	12	12	12	12	12	12	12	15	15
Madhya Pradesh	–	13.5	13.5	13.5	13.5	13.5	13.5	13.5	16	10	10
Orissa	12	13	13	12	12	10	10	10	10	10	10
Pondicherry	–	–	–	–	–	–	7	7	7	3	–
Daman	12	6	7.5	12	2	3	3	3	3	3	3
Rajasthan	–	–	–	–	10	–	–	–	–	–	12
Motor chassis											
Andhra Pradesh	12	12	10	10	8	5	5	5	5	5	5
Tamil Nadu	–	15	15	15	9	6	6	6	6	6	6
Maharashtra	12	12	12	12	12	12	12	12	12	15	15
Madhya Pradesh	–	10.5	10.5	10.5	10.5	6	2	2	3	3	3
Orissa	12	13	13	12	12	10	10	10	10	10	10
Pondicherry	–	–	–	–	–	3	3	3	–	–	–
Daman	12	6	7.5	12	12	3	3	3	3	3	3
Rajasthan	–	10	10	10	10	10	10	10	10	12	12

Notes:
– not available.
1. 7 percent on motor cars; later 6 percent was levied on 1,000 cc cars.
2. 4 percent on mopeds.

Source: sales tax departments of states concerned.

This diversion of trade is illustrated by considering the situation that existed in Madhya Pradesh prior to the introduction of the entry tax. For quite some time most of the local demand in Indore (Madhya Pradesh) was met through the dealers in Silvasa, one of the union territories where the manufacturing company had an assembly unit which got exemption from sales tax on its products under the provisions of the union territory's industrial policy. Motor vehicle parts were taken to Silvasa from the place of manufacture. The vehicles were then assembled in Silvasa to avail of the tax concession. The local demand for cars in Bombay was met by the stockyards of the manufacturer in Daman, Vapi and Silvasa. Motor vehicles which should have been despatched to Bombay against local orders there were transported to Daman, Vapi or Silvasa purely for tax reasons.

The above example illustrates the distortions which are caused by interstate tax rate differentials and the revenue loss suffered by the states having relatively high rates of tax. The trade diversion also deprives local bodies of *octroi* (a local tax imposed on the entry of goods into a municipal area). The diversion of trade is facilitated by the fact that it is possible for a vehicle registered in one state to be used in another state for a period of 15 months from the date of that registration without being re-registered. In addition to the loss of tax revenue to the state and local government, such diversion also wastes both time and fuel.

III. THE INTRODUCTION OF STATE ENTRY TAX

In an attempt to counter the loss of business, some of the states have decided to levy a tax on the entry of motor vehicles purchased outside the state with the intention of evading the state sales tax, and brought into their territory for use or sale therein. As indicated earlier, this tax is called entry tax in lieu of state sales tax (state entry tax). This tax should be distinguished from the entry tax in lieu of *octroi*. The purpose of state entry tax is to stem the loss of business induced by sales tax rate differentials. In order to exclusively target tax avoidance on new vehicles no tax is levied on motor vehicles which are already registered in any other state or union territory for a period of 15 months or more prior to the date on which they are liable to be registered in the state in question. The two states which first introduced the tax are Maharashtra and Rajasthan,[2] Even earlier in 1986 Madhya Pradesh raised the rates of entry tax in lieu of *octroi* on motor vehicles to accomplish the same objective. The introduction of an entry tax is currently now under active consideration in certain other Indian states. Here it should be noted that of the court cases which have attempted to challenge the validity of the tax, no judgement has been given against the measure.

Entry tax becomes payable upon the entry into the state, for use or sale, of all kinds of vehicles (except tractors) from a place within the territory of the Union of India. In Madhya Pradesh the entry of motor vehicles from districts within the state are also taxed if no sales tax has been paid on the earlier transaction. The tax is collected by the state sales tax department at the point where vehicles are brought in for registration. The tax base is the purchase value of a motor vehicle, as ascertained from the original invoice and includes the value of accessories fitted to the vehicle, insurance, excise duties, countervailing duties, sales tax, transport fees, freight charges and other charges. Where the vehicle was acquired, other than by way of purchase estimated market value is substituted for the purchase price.

The rates of the state entry tax are 15 percent of the purchase price in Maharashtra and Rajasthan, and between 3 percent and 14.5 percent in Madhya Pradesh. These are equivalent to their sales tax rates on motor vehicles. The tax is in addition to the tax levied and collected as *octroi* by local authorities in Maharashtra and Rajasthan. The effective tax rate is reduced in these states to the extent of sales tax paid in the other state or union territory by an importer who, not being a dealer registered under the sales tax, has purchased the motor vehicle in that state for his own use. In Madhya Pradesh, however, no such reduction is available. In all three states the tax is administered by the state sales tax department. Sales tax rules regarding appeals, penalties and non-payment have been adopted by the state entry tax. The tax is collected and the proceeds retained by the state governments in Maharashtra and Rajasthan; local bodies do not get any share of this. In Madya Pradesh, however, the entire proceeds from this tax is devolved to local bodies.

The experiment first started in Madya Pradesh where the sales tax rate on diesel vehicles was reduced from 10 percent to 6 percent and further to 3 percent in an attempt to reduce the sales tax rate differential. This brought about a sharp rise in the number of sales taking place inside as opposed to outside the state (see Table 2). Thus trade in motor vehicles which had been lost to Silvasa was restored to Indore. Convinced by the efficacy of this move, the government of Madhya Pradesh continued to resort to undercutting the sales tax rates on motor vehicles. The same objective was later achieved by introducing a state entry tax in 1986. The Maharashtra experience also achieved similar results. However, here the experiment started not by lowering the sales tax rate but by raising it in conjunction with the introduction of a state entry tax. The trend of decline in sale appears to have been reversed with the introduction of the tax.[3]

2. Maharashtra Tax on Entry of Motor Vehicles into Local Area Act, 1987 and Rajasthan Tax on Entry of Motor Vehicles into Local Area Act 1988, respectively.

3. There were instances where a small reduction in sales value was witnessed in Maharashtra. However, this reduction can be partly attributed to the hike in the sales tax rate on motor vehicles from 12 to 15 percent, which made transactions in low tax territories, namely Vapi, Daman or Silvasa retain some attractiveness.

Table 2:
DELIVERY OF DIESEL MOTOR VEHICLES IN INDORE BY A LEADING MANUFACTURER AND SALES TAX RATES IN MADHYA PRADESH

Year	Entry tax rate (%)	Sales tax rate (%)	Delivery of vehicles (number)	Annual percent change
1980–1981	–	10	834	–
1981–1982	–	10	808	- 3
1982–1983	–	10	806	- 1
1983–1984	–	10	532	- 52
1984–1985	–	6	1,227	131
1985–1986	3	3	1,417	15
1986–1987	3	3	1,783	25
1987–1988	3	3	2,289	28

Note:
In 1983–1984 such a decline in delivery of diesel motor vehicles is reported to be the result of around 400 motor vehicles delivered from Silvasa. In the following year some vehicles were delivered from Daman also.

The effect of the diversion of trade discussed above, had an impact on the collections of sales tax, state entry tax and *octroi*. The success of the state entry tax policy in the case of Maharashtra is reflected in the sudden increase in its collection of all three taxes (see Tables 3 and 4).

Table 3:
SALES VALUE OF MOTOR VEHICLES AND SALES AND ENTRY TAX RATES IN MAHARASHTRA

Year	Sales value of motor vehicles (RS million)*		Sales tax rate (%)	Entry tax rate (%)
	one leading manufacturer	all		
1983–1984	144.3	1,500.0	12	–
1984–1985	101.2	1,135.4	12	–
1985–1986	28.3	1,744.8	12	–
1986–1987	160.6	1,917.0	12	–
1987–1988	463.0	2,852.2	12	12
1988–1989	380.6	3,081.4	15	15

Note:
* Derived by dividing sales tax revenue by sales tax rate on motor vehicles.

Source: Office of the Commissioner of Sales Tax, Bombay, Government of Maharashtra.

Table 4:
SALES TAX REVENUE FROM MOTOR VEHICLES IN MAHARASHTRA

Year	Four-wheeler	Two/three-wheeler	Total	Entry tax in lieu of sales tax
1983–1984	150.3	51.2	201.5	–
1984–1985	84.3	68.5	152.8	–
1985–1986	148.7	86.0	234.5	–
1986–1987	182.7	98.9	281.6	–
1987–1988	312.0	107.0	419.0	48.7*
1988–1989	324.5	231.7	556.2	129.1
1989–1990	–	–	–	18.2**

* October 1987 to March 1988
** April to June 1989.
Source: as for Table 1.

Two important points are worth noting. First, since in Madhya Pradesh state entry tax is a composite tax embracing both state entry tax and entry tax in lieu of *octroi*, the tax gain is reflected in one figure, i.e. entry tax collection. In Maharashtra, however, because of the separate identity of the two taxes the tax gains are distinct. Second, whereas state entry tax has played an identical role in the two states, sales tax rate structures have been different. It has been noted earlier that Madhya Pradesh started with a sales tax reduction on motor vehicles which was complemented later by the introduction of the state entry tax. In Maharashtra, however, sales tax rates were in fact raised when the state entry tax was introduced!

IV. CONSTITUTIONAL POSITION

It has been shown in the preceding section that the state entry tax has produced the desired effect on trade flows. In a federation such as India, however, the constitutional validity of a new tax measure is of paramount importance. In this regard Articles 301 and 304(a) and 304(b) of the Indian Constitution are relevant. Article 301 states that (subject to other provisions) trade and commerce throughout the territory of India shall be free. Article 304(a) stipulates that states may impose on goods imported from other states or union territories, any tax to which similar goods manufactured or produced in that state are subject, so as not to discriminate between goods imported and goods manufactured or produced in that state. Article 304(b) provides that the state can impose such restriction on the freedom of trade and commerce as may be required in the public interest.

It appears that state entry tax meets the requirements postulated by Article 304(a). Goods imported into a locality from another state are subjected to tax at the same rate as charged on goods purchased in the importing state. Although goods imported into a district from another district within the same state do not attract state entry tax in Maharashtra and Rajasthan,[4] in terms of tax treatment there is no discrimination. The import of a motor vehicle into a locality can be effected either by a dealer or an individual. The state entry tax applies in both cases. The contention that this tax exclusively falls on goods coming from outside the state and hence violates the prohibition in Article 304(b) of the Constitution does not seem to be tenable given the fact that the rate of state entry tax is set to equate with the sales tax payable on domestic sales, in this way Article 301 is also satisfied. Similarly, it is difficult to accept the contention that merely because a neighbouring state is levying lower taxes, a discriminatory tax on goods imported from that state cannot be justified. It has been further argued that this tax effectively constitutes a sales tax on sales made outside the state. However, the sale only takes place outside the state to evade sales tax, i.e. the vehicles are intended for use within the state.[5] State entry tax

4. In Madhya Pradesh local movements are also taxed if sales tax has not been paid earlier.
5. In many cases what actually happens is that the purchase order and delivery take place in the same state, but on paper the transactions are shown to have taken place outside the state, clearly evidencing an intention to evade sales tax.

therefore only falls on those motor vehicles that would have been purchased in the state in which they were imported into and used, had it not been for the high rates of sales tax applying therein.

V. ADDITIONAL EVIDENCE FROM COURT CASES IN THE UNITED STATES

It has been noted that state entry tax does not discriminate between imports and locally produced goods provided it equates with the sales tax chargeable on domestic sales. It may be argued that as this tax measure has been designed in an attempt to prevent tax avoidance, it should originate in Entry 54 of the State List which is the source of state sales tax. In other words, taxes originating in two different entries of the Constitution cannot be complementary to each other, and so state entry tax is unconstitutional. Another possible argument against the validity of the tax is that this tax can be held as violative of the provisions of entries 92A and 92B of the Union List which together stipulate that only the parliament is competent to tax interstate sales or purchases or consignments of goods.

It may be relevant here to examine the logic of the court decisions in the United States in respect of a similar tax known as *use tax*. Like state entry tax in India, *use taxes* have been adopted by sales tax jurisdictions in the United States, both to safeguard their revenues and to protect local merchants against loss of trade to low sales tax jurisdictions. The US Supreme Court was faced with the question as to whether these taxes were invalid as levies discriminating against interstate trade and commerce particularly in view of the fact that motor vehicles purchased within the states typically are not subject to the tax. The court held that *use tax*, viewed in the context of the sales tax it complemented, was designed to put out-of-state and in-state purchases on an equal footing. It rejected the argument that this tax was equivalent to a protective tariff. Instead, it found that the states levy this tax with the objective of ensuring local and out-of-state sales are treated in a tax neutral manner in order to prevent loss of state revenues *vis à vis* local traders loosing business to dealers outside the state.

However, any attempt by a state to charge higher rates in respect of *use taxes* on out-of-state purchases than those payable as sales tax on in-state purchases, has not been upheld by the courts in the United States. The states' contention that additional administrative burdens are imposed in collecting the tax directly from the users has failed to persuade judicial authorities to permit higher taxation of out-of-State purchases. Thus the court did not uphold the assessment where a Pennsylvanian buyer who purchased an automobile in New Jersey was assessed for the *use tax* in Pennsylvania on the full purchase price because if he had bought the car in Pennsylvania, the sales tax would only have been payable on the net price paid after deducting the trade-in-allowance for the old car. *Commonwealth v. Smith*, 75 Dauph. 22 (Pa. Comm. Pleas, Dauphin Co. 1960).[6]

The ground on which the US courts upheld *use taxes* on goods purchased outside a given state and transported to the buyer within the state is that they are imposed on intra-state use, the buyer's taking the goods into his possession or his acquiring title to them. The reasoning implicit in the US court decision that *use tax* is a tax on intra-state use of commodities is important as it largely puts an end to the immunity on interstate sales from state sales tax in the importing state. As states seldom tax or tax at lower rates goods exported to other states, these decisions greatly reduced the unjustified competitive advantage, dealers in interstate trade enjoyed of not being obliged to collect or pay sales taxes in any state.

To take the example of state entry tax, dealers in Bombay used to show the transactions as taking place in Silvasa where vehicle assembly is exempt from sales tax. They did not pay any sales or state entry tax in Bombay as these vehicles were duly registered in Silvasa. Since no tax is payable on the interstate consignment of motor vehicles, the dealer had managed to avoid paying any tax. This business scenario was completely changed when state entry tax was introduced as tax has to be paid, when goods are imported for use in the state (see Table 5). The tax restores to state governments the revenues siphoned off from their treasuries through artificial avoidance techniques.

The use of state entry tax, however, does not invalidate the collection of sales tax on the same commodity again in the state of entry. From the court rulings in the United States it is clear that any sale by a local merchant to an out-of-state purchaser (including a business purchaser) who receives delivery of goods in the state for immediate transportation by him outside the state constitutes an interstate sale that is taxable in the state of purchase. This is because the taxable event is the transaction which is separate from transportation and interstate trade. Thus even in the presence of a sales tax by the out of state government, a state entry tax (or *use tax*) is justified by the importing state as necessary to accord equal treatment to home purchases and purchases from outside.[7] It should be noted that the courts in the United States. have taken the view that it was not mandatory to allow a deduction for taxes paid to other governments.

VI. LESSONS FOR TAX ADMINISTRATIONS

State entry tax (*use tax*) is an experiment designed basically to eliminate sales tax rate differences between constituent state governments in a federation. State governments suffering from a revenue loss due to undercutting of rates by

6. In another case the State of Louisiana was stopped from introducing a sales tax-*use tax* differential in the case of equipment manufactured by a Louisiana taxpayer outside the state, i.e. in Oklahoma, for use in Louisiana in its own business. The collector assessed a *use tax* on the value of the cost of articles purchased plus labour and shop overheads. If the business had purchased the material in Louisiana and had produced the equipment in that state, it would have been subjected to a sales tax only on the cost of the articles purchased, excluding labour and shop overheads. *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963).

7. In this context both Maharashtra and Rajasthan allow credit for the tax paid in the state of purchase. However, in Madhya Pradesh no such deduction is allowed.

adjoining states should not retaliate by cutting their own rates but instead should safeguard their legitimate tax revenue by introducing a sales entry tax. Taken to its logical conclusion if this strategy was universally adopted, there would seem to be no incentive to cut taxes merely to attract business.

The most pertinent point, however, is that a state entry tax in relation to motor vehicles may be desirable because an alternative strategy of undercutting other states' sales tax rates on motor vehicles would be considered as unsound and iniquitous especially if as a result commodities like food grains were subjected to sales tax. Further, the competitive undercutting may introduce an element of uncertainty in rates and tax collections. Hence introducing an equalizer, i.e. taxing out-of-state purchases at a rate applicable to in-state purchases. The rate of equalizer can be high or low, depending on the sales tax rate differential. In this way tax rate differences can be perpetuated because some states may decide to maintain a higher tax rate. The use of an equalizer therefore does not ensure uniform sales tax rates.

The administrative feasibility of an equalizing tax depends on the category of goods being considered. Automobiles are an ideal candidate, since out of state purchases can be policed through automobile registration. On the other hand, applying an entry tax to diamonds would be most inappropriate as it would be almost impossible to enforce. In any event, the benefits to be gained by introducing an entry tax depends on the extent of the interstate tax rate differential. For small differences a state entry tax may not be administratively cost-effective.

Table 5:
OCTROI COLLECTION ON MOTOR VEHICLES IN BOMBAY

Year	Amount (RS)	Annual percentage change
1984–1985	28,371	–
1985–1986	31,498	11.09
1986–1987	34,382	9.16
1987–1988	40,274	17.13
1988–1989	47,388	17.66

Source:
Office of Assessor and Collector, Municipal Corporation of Greater Bombay, Government of Maharashtra.

AUSTRALIA

AUSTRALIA–NEW ZEALAND TAX TREATY

Michael Dirkis

Michael Dirkis LL M (Comm)(Adel.), GDLP (SAIT), BEc (ANU), FTIA, is Senior Lecturer in Law at the University of Canberra, Australia. He is admitted as a Barrister and Solicitor, is a member of the Law Society of the Australian Capital Territory's Revenue Law Committee and is one of the correspondents for the *Bulletin for International Fiscal Documentation*. He has also written a number of articles in leading journals. His major interests include revenue law, corporation law and corporate crime.

I. INTRODUCTION

A revised tax treaty between Australia[1] and New Zealand[2] (the Treaty) was signed on 27 January 1995. The Treaty entered into force on 1 April 1995.[3] It was incorporated into Australian law by the Income Tax (International Agreements) Amendment Act 1995 (the Amendment Act),[4] and into New Zealand law by way of an Order-in-Council. It replaces the existing tax treaty between the two countries, concluded in 1972 (the 1972 Treaty). The new Treaty was made necessary due to the increased economic integration between the two countries, arising from the Closer Economic Relations (CER) agreement, as well as by the substantial reforms to taxation law that has occurred in both countries since the original agreement was concluded.[5]

This paper highlights the major changes between the new Treaty and the 1972 Treaty, and also any inconsistencies with the OECD 1992 Model Treaty (the Model Treaty)[6]. It concludes by exploring any weaknesses that may exist in the new Treaty.

II. DATE OF EFFECT

The Treaty came into effect in both countries for withholding taxes in respect of income derived on or after 1 April 1995. For other taxes, the Treaty has effect in New Zealand from the income year commencing 1 April 1995, while in Australia the Treaty has effect from the income year commencing 1 July 1995.

III. THE AGREEMENT

The new Treaty contains 29 articles that allocate the taxing rights in respect of:
- income from real property (Article 6);
- business profits (Article 7);
- ships and aircraft (Article 8);
- associated enterprises (Article 9);
- dividends (Article 10);
- interest (Article 11);
- royalties (Article 12);
- alienation of property (Article 13);
- independent personal services (Article 14);
- dependent personal services (Article 15);
- fringe benefits (Article 16);
- directors' fees (Article 17);
- entertainers (Article 18);
- pensions and annuities (Article 19);
- government service (Article 20);
- students (Article 21); and
- other income (Article 22).

Although many of these articles are similar to those contained in the 1972 Treaty, many changes have occurred. Also, despite the general consistency of these articles with similar articles in the Model Treaty there are significant variations. These differences and variations are highlighted in the following paragraphs.

(a) Definition changes

There are a number of newly defined terms and updated definitions in Article 3. There are three new definitions that are consistent with those contained in Article 3(1) of the Model Treaty. These definitions are of:
- the term "person", which has been modified to include an individual, a company and any other body of persons;[7]
- the term "company", which is defined to include not only a body corporate but entities that are treated as a company or body corporate for tax purposes.[8] Thus, a unit trust which is taxed as a company under New Zealand law would fall within this definition[9]; and
- the term "international traffic", which is defined to mean any transport by a ship or aircraft operated by an enterprise of a country, except where the ship or aircraft is operating solely within that country.[10] This definition, which replaces the term "profits from operating ships or aircraft" in the 1972 Treaty, is relevant to the application of Article 13 (alienation of ships and aircraft) and Article

1. Australia: Treasurer's Press Release No. 6/1995 of 27 January 1995.
2. New Zealand: Ministers of Finance and Revenue Press Release of 27 January 1995.
3. Australia: Treasurer's Press Release No. 40/1995 of 4 April 1995.
4. No 22 of 1995, which received royal assent on 29 March 1995.
5. *Supra* note 1 at 1.
6. OECD, *Model Tax Convention on Income and Capital* (1992).
7. Art. 3(1)(j).
8. Art. 3(1)(c).
9. McCormack, J. and Archer, A., "The New Australia/New Zealand Double Tax Agreement: A review of the critical Issues" (1995) *ATAX Second Annual International Tax Weekend Workshop* paper at para 2.1.2.
10. Art. 3(1)(9).

15 (wages of the crew of the aircraft or ship engaged in international traffic).

The other new definitions (which are not consistent with the Model Treaty) are of the terms "paid", "pay", "payable" and "payment". These terms are defined widely to include any amounts ". . . distributed (in cash or property), credited or dealt with on behalf of a person or at that person's direction".[11] A further change to the 1972 Treaty is the deletion of the definitions of "natural resource royalties" and "industrial or commercial profits".

Where a term is not defined in the Treaty, Article 3(3) states that the term shall be interpreted in the light of the meaning ascribed to it by the domestic laws of the country seeking to apply the Treaty, i.e. not by reference to the international meaning of that word. The term does not have to be defined under domestic law, it is sufficient merely that it has a meaning under that domestic law.[12] The inclusion of the words "from time to time in force" in Article 3(3) is to ensure that any terms undefined in the Treaty are interpreted in light of the law as it operated when the Treaty is sought to be applied. This is to ensure that the Treaty remains contemporary with the developments in the domestic law of the two countries.[13] This clause is also generally consistent with Article 3(2) of the Model Treaty.

(b) Residency

The Treaty describes a person to be an Australian resident if the person is resident in Australia for the purposes of Australian tax. This test is less prescriptive than that applying under the 1972 Treaty. The definition of a New Zealand resident is unchanged, that is, a person will be a resident of New Zealand under the treaty if that person is resident in New Zealand for the purposes of New Zealand tax.[14]

Where a person is a resident of both countries (a dual resident), new tie-breaking tests, consistent with Article 4(2) of the Model Treaty, have been introduced. An individual's residency will be determined by the following, listed in order of primacy:
- availability of a permanent home in the State;
- the personal or economic relations;
- the place of habitual abode; and
- citizenship.[15]

This is a change from the 1972 Treaty where the "place of habitual abode" had precedence over the "personal or economic relations" criteria. It is claimed that the relegation of the "place of habitual abode" test will make it more difficult for individuals to lose their original residency status.[16]

The tie-breaking test for a non-individual's residence is now also consistent with Article 4(2) of the Model Treaty. The residency of a non-individual is that non-individual's "place of effective management".[17] However, the adoption of this test has created uncertainty as the term "place of effective management" is undefined in the Treaty and in the Explanatory Memorandum to the Australian Amending Act (the Australian Explanatory Memorandum). The traditional New Zealand interpretation of the term "place of effective management" is that it is the place where the practical day to day management resides, irrespective of the exercise of overriding control.[18] However, this view does not appear to be supported by Australian officials.[19] McCormack and Archer argue that the term under Australian law could refer to the place of actual or overriding management (that is, the place where real control is exercised) rather than the centre of day to day management.[20]

(c) Permanent establishment

Although the circumstances that give rise to a "permanent establishment" listed in Article 5 of the Treaty effectively mirror those contained in Article 4 of the 1972 Treaty, there are a number of minor differences.[21] The Treaty specifies that the circumstances in which a permanent establishment is deemed to arise include the existence of a building site or construction, installation or assembly for a period exceeding six months. Although this is in general accord with the Model Treaty,[22] the new Treaty extends the definition to encompass supervisory activities in connection with a building site or construction, installation or assembly.[23] The Treaty also contains a provision that aggregates all the periods where associated activities are conducted in connection with a building site or construction, installation or assembly. The purpose of this aggregation clause[24] is to overcome the practice of contract splitting that was possible under the 1972 Treaty.[25]

The concept of a "permanent establishment" is further extended in Article 5(4)(b) to include activities "connected with, the exploration for or the exploitation of natural resources". This wording is quite wide and will catch all technical consultative services associated with exploration and exploitation.[26] Management or financial services rendered to a subsidiary by a parent also possibly fall within the scope of the definition.

Contract manufacturers who make goods that are owned by a non-resident are expressly included within the definition of "permanent establishment".[27] This variation is consistent

11. Art. 3(1)(i).
12. Australia: Explanatory Memorandum to the Income Tax (International Agreements) Amendment Bill 1995 at 14.
13. *Ibid* at 13.
14. Art. 4(1).
15. Art. 4(3).
16. *Supra* note 9 at para 2.2.3.
17. Art. 4(4).
18. OECD, *Model Double Tax Convention on Income and on Capital*, Report (1977) at 57.
19. *Supra* note 9 at para 2.1.2.
20. *Ibid.*
21. Art. 5(1) to (3) are consistent with Art. 5(1) to (3) of the Model Treaty except that the circumstances in Art. 5(2)(g) have not been adopted and the time limit in Art. 5(3) is shorter.
22. The shorter period of six months instead of 12 months specified in Art. 5(3) of the Model Treaty is consistent with New Zealand's traditional reservation on the Art. – see *supra* note 18 at 69.
23. The supervisory circumstance contained in Art. 5(4)(a) is consistent with Australia's traditional reservation on this Art. – see *supra* note 18 at 69.
24. Art. 5(5).
25. Contract-splitting is a process by which the construction period is split into periods of less than six months to avoid the project being deemed to be a permanent establishment.
26. *Supra* note 9 at para 2.4.3.
27. Art. 5(7)(b).

with similar articles in the Australian/Chinese and the Australian/Vietnamese double tax treaties.[28]

A further anti-avoidance measure is found in Article 5(7)(b). This measure is aimed at combating the so-called "cost-toll" arrangements. An example of a "cost-toll" arrangement is "... where a refining company is set up by the joint venturers to refine their minerals. The minerals are refined at cost, so that the plant makes no profit. Title in the minerals remains the property of the venturers and profits are derived on off shore sales".[29]

It is argued by the Australian Government that deeming such an arrangement to be a permanent establishment is consistent with its policy of retaining taxing rights over the exploitation of its minerals and that such a plant's attributed arm's length profit should be taxed in Australia.[30]

(d) Taxation of gains from real property

The Treaty contains a new Article 6 that gives the right to tax income derived from the direct use, letting or use in any other form of real property to the country in which the property is located.[31] In essence it is similar to Article 6 of the Model Treaty but contains a number of variations. First, as the term "immovable property" is relatively unknown in New Zealand and Australian law the term "real property" is used. Secondly, apart from the difference in terminology, the definition of "real property" varies from the Model Treaty's "immovable property" definition in a number of ways. One difference is that income from agriculture and forestry activities is not included. Similarly excluded is income from livestock and equipment used in conjunction with these activities. In the Treaty these activities are dealt with under the business profits article (Article 7). Another difference is that the definition of "real property" is extended from the direct use, letting or any other use of mineral, oil or gas deposits or other natural resources to include rights to explore for or to exploit mineral, oil or gas deposits or other natural resources.[32]

Consistent with the Model Treaty, Article 6 also includes income arising from the real property used by an enterprise or used for the performance of personal services. This ensures that either country can tax income derived from the use of real property irrespective of the existence of a permanent establishment.

(e) Business profits

The business profits article in the 1972 Treaty has been substantially revamped in Article 7 of the Treaty to make it generally more consistent with Article 7 of the Model Treaty. It is assumed that Article 7 covers profits arising from regular trading as well as those arising from an isolated activity.[33] However, its scope is uncertain as the term "business profits" is undefined. What is certain is that the term "business profits" does not include any income or gains dealt with under other articles.[34] This means, for example, that income derived by a permanent establishment in Australia from the leasing of industrial, commercial or scientific equipment and containers would be taxed by Australia as a royalty, rather than as "business profits".[35]

A major change from the 1972 Treaty is the removal of the "force of attraction rule". Under the 1972 Treaty where an enterprise was carried on through a permanent establishment, any profits made in that country were attributed to that enterprise under the "force of attraction rule". There was no requirement that the profits be attributable to the permanent establishment. Under the new Article 7 only the profits attributable to the permanent establishment are taxed.

Consistent with the 1972 Treaty, Articles 7(2) and (3) provide a transfer pricing mechanism that allocates profits and deductions on a "distinct and separate" enterprise basis. Further, Article 7(5) permits the operation of the countries' transfer pricing legislation where inadequate information is available to the competent authority.

A variation to the Model Treaty and further change to the 1972 Treaty is contained in Article 7(7), which treats the profits derived by a beneficiary of an interposed trust as being earned through a permanent establishment. This will occur where the beneficiary is presently entitled to a share of the business profits of an enterprise and the trustee of that enterprise has a permanent establishment in the country. Article 7(7) does not apply to trusts that are treated as companies for tax purposes. McCormack and Archer see this requirement as being onerous and inequitable.[36] They illustrate their argument by comparing the tax treatment of New Zealand-resident unit holders in an Australian unit trust investing in Australian shares and debentures, with the taxation treatment of Australian-resident unit holders in a New Zealand unit trust, investing in New Zealand shares and debentures. Due to the operation of Article 7(7) the New Zealand-resident unit holders are assessed on the income earned at their personal tax rates rather than the withholding tax rates. However, as a unit trust is a company under Income Tax Act (NZ) 1976, the Australian-resident unit holders escape the operation of Article 7(7). They are assessed on income earned at withholding tax rates.

Finally, the operation of this Article is further limited as it does not apply to any income, profits or gains derived from the business of insurance. Each country retains the right to apply in their domestic law any special provisions in respect of income from insurance. The Australian Explanatory Memorandum explains that this reservation is made to preserve the application of Division 15 of Part III of the Income Tax Assessment Act 1936 and is in accordance with the traditional Australian observation on Article 7.[37]

28. Editor, "Revised Australia/New Zealand double tax agreement" [1995] *Butterworth's International Tax Bulletin* at para 1.
29. *Supra* note 12 at 21.
30. Ibid.
31. Art. 6(1).
32. Art. 6(2).
33. *Supra* note 9 at para 2.5.1.
34. Art. 7(8).
35. Australia has lodged a reservation on Art. 7 of the Model Treaty to this effect – see Australian Explanatory Memorandum *supra* note 12 at 26.
36. *Supra* note 9 at para 2.5.5.
37. *Supra* note 12 at 26.

(f) Dividends

Article 10(3) introduces a new definition of dividend. A dividend is defined to be "... income from shares and other income assimilated to income from shares by the law, relating to tax, of the Country of which the company making the payment is a resident. ...". Despite this new definition the income classified as dividends and the rate of tax applicable has not varied greatly from the 1972 Treaty. As with the 1972 Treaty, the maximum tax chargeable on the gross amount of dividend is no more than 15 percent.[38] Where dividends are effectively connected with a permanent establishment or a fixed base, then they are not subject to this tax rate limitation, being instead dealt with under Article 7 or Article 14.[39]

Where Section 204M of the Income Tax Act (NZ) 1976 deems a dividend to arise from the business of life insurance, the Treaty provides that the deemed dividend is subject to a maximum rate of tax of five percent.[40] This rate variation was inserted to ensure that dividends remitted by a New Zealand subsidiary to an Australian parent were subject to the same effective tax rate as the profit remittances of a New Zealand branch.[41] The five percent withholding tax reflects the five percent branch profits tax imposed by New Zealand. As the five percent withholding tax is calculated on the after tax profits, it was conceded that a slight concessional treatment would exist for subsidiaries compared to branches operating in New Zealand.[42] Thus, rather than achieving equity, the Treaty has resulted in a reversal of the previous inequity with the effective tax rate being less on dividends remitted by a New Zealand subsidiary to an Australian parent than on the profit remittances of a New Zealand branch.[43] The introduction into the New Zealand Parliament on 17 August 1995, of the Taxation (International Tax) Bill, which reduces the branch profit tax rate to the company rate of 33 percent, does not alter this imbalance.

(g) Interest

Article 11(2) restricts the right of the country of source to tax gross interest to 10 percent. "Interest" is defined in Article 11(3) to include:

> "... interest on indebtedness of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and in particular, interest from government securities and income from bonds or debentures, including premiums and prizes attaching to such bonds or debentures, as well as all other income assimilated to income from money lent by the law ... but does not include any income which is treated as a dividend under Article 10."

This definition of "interest" is consistent with the definition of "interest" contained in Article 11(3) of the Model Treaty. An important change from the 1972 Treaty relates to interest paid to associated parties. Under Article 9(3) of the 1972 Treaty the rate limitation of 10 percent did not apply to interest received from an associated entity. Thus, an Australian lender who received interest from a New Zealand associate could have been subject to a rate of tax in excess of the Australian rates on that interest. Article 11 removes this impediment, subjecting all interest paid to 10 percent tax. McCormack and Archer comment that this change means that Australian groups will no longer need to use "artificial" lending structures (such as back-to-back loans) to limit the New Zealand tax applicable.[44]

A possible inequity can arise from the fact that the Article does not apply to income that is "interest" in nature, if it is deemed by the domestic law of the country to be a "dividend". The reason being that Article 10 defines dividends according to the domestic law of the country in which the paying company is resident, and Article 11 excludes from its scope income treated as "dividends" under Article 10. An example of this problem occurs in respect of debenture interest payments arising from floating rate debentures and debentures issued in substitution for shares in New Zealand. These "interest" receipts are treated as dividends under Sections 192 and 195 of the Income Tax Act (NZ) 1976. Therefore, the payments are treated as dividends under Article 10, being subject to a 15 percent rather than a 10 percent tax rate.[45]

(h) Royalties

Unlike Article 12 of the Model Treaty, royalties are taxed under this Treaty by reference to source, rather than the place of residence of the beneficial owners. Both New Zealand and Australia have traditionally reserved the right to tax royalties on a source basis.[46]

A major change from the 1972 Treaty is that the tax payable in respect of gross royalty income has been reduced from 15 percent to 10 percent.[47] The definition of royalty has also been changed and has been expanded from that contained in the 1972 Treaty to include payments "... whether periodical or not, or however described or computed":

- in connection with the transfer of visual images or sounds, or both, transmitted by satellite, cable optical fibre or similar technologies to the public where the payments relate to;
- the reception of;
- the right to receive;[48]
- the right to use in connection with television and radio broadcasting;[49] or
- the forbearance to use or supply such property.[50]

It also includes payments for "... the supply of scientific, technical, industrial or commercial knowledge or information".[51] The Australian Explanatory Memorandum makes it clear that this provision encompasses "know how" and

38. Art. 10(2).
39. *Supra* note 12 at 31.
40. Art. 10(2).
41. *Supra* note 1 at 2.
42. *Ibid.*
43. Green, M. and Lewis, G., "Double tax agreement between Australia and New Zealand" [1995] *CCH Tax Week* 89 at 90.
44. *Supra* note 9 at para 2.8.3.
45. *Supra* note 9 at para 2.8.4.
46. *Supra* note 18 at 119.
47. Art. 12(2).
48. Art. 12(3)(f).
49. Art. 12(3)(g).
50. Art. 12(3)(h).
51. Art. 12(3)(c).

excludes payments in respect of a contract for services.[52] Australia has adopted as the definitive test for distinguishing between "know how" and a contract for services, the test used by the German Supreme Court in *Bundesfinanzhof*.[53] The test is that a contract will be for "know how" if it is "... one for the supply, for the use by the buyer of a 'product' which is already in existence (or substantially so)", but will be a contract for personal services if it is ". . . one which requires the contractor to apply special skills and knowledge for his own purposes in order to bring the 'product' into existence for the 'buyer'."[54]

Expressly excluded from the royalty definition are any payments earned by a non-resident either operating via a permanent establishment in the country of source or performing personal services from a fixed base in that country. In these situations Articles 7 or 14 have precedence. Despite the removal of an express exemption for natural resource royalties contained in the 1972 Treaty, such payments continue to be excluded from the definition of a royalty. This occurs as such payments are caught within Article 7 as they arise in connection with a permanent establishment.[55]

The Treaty does not provide a consistent treatment for income that is derived from pre-packaged software.[56] Under New Zealand's domestic law payments in respect of pre-packaged software constitute royalties. However, such items may be excluded from the tax rate limitation under Article 12 as the payments do not fall within the definition of royalty in Article 12.[57]

On a more positive note, the classification as royalties under the 1972 Treaty of payments made in respect of management services not connected with a permanent establishment has now been removed. This has been welcomed by trans-Tasman groups which suffered the inconvenience of having payments made to compensate visiting executives subjected to withholding tax.[58]

(i) Alienation of property – capital gains

As income arising from the alienation of property (capital gains) was not generally taxable in either New Zealand or Australia, the 1972 Treaty did not contain an alienation of property article. In recognition of Australia's introduction of a capital gains tax in 1985,[59] the new Treaty includes Article 13 that provides that income, profits or gains arising from the alienation of real property (as defined in Article 6[60]) will be taxed according to the laws of the country in which it is situated. However, where the property is a business asset of either a permanent establishment or of a provider of independent personal services with a fixed base in the jurisdiction, the income will be taxed in the country where the permanent establishment or fixed base is situated.[61] Similarly income arising from ships and aircraft used for international traffic is taxed in the country of residence of the operator.[62]

The Article is generally consistent with Article 13 of the Model Treaty but does contain a number of differences. Firstly, as with Article 6 the terms "property" and "real property" are used in preference to "movable property" and "immovable property". Secondly, where the income arises from the alienation of shares and comparable interests in a company whose assets principally consist of real property (a real estate company) the Treaty assigns the taxing right on those shares to the country in which the real property is situated.[63]

Finally, the Treaty includes a sweep-up provision. This provision ensures that the domestic laws of each country which tax gains on the alienation of property will have precedence where the income is not expressly dealt with under the Treaty.[64] The purpose of the clause is to ensure that Australia's right to tax capital gains (not the subject of Article 13) is not indirectly overridden by the operation of the business profits article (Article 7) or the other income article (Article 22), thereby creating the possibility of tax-free gains. The reason why the gains would be tax-free is that New Zealand does not have a general capital gains tax regime. Despite this intention to limit the operation of the Treaty, McCormack and Archer argue that if the gain was income in nature, but still subject to Australian capital gains laws, the business profits article would provide relief from Australian tax, provided the taxpayer operated through a permanent establishment.[65]

(j) Income from personal services

The personal service article contained in the 1972 Treaty has been modernized in accordance with the Model Treaty. The Treaty introduces two personal service articles, one dealing with income from independent personal services (Article 14), the other with income from dependent personal services (Article 15).

Under Article 14 income derived by an individual from professional services will generally be taxed only in the country of residence. However, where the services are performed in the other country and the individual is present in that country for a period or an aggregate of periods exceeding 183 days in any 12-month period or has a fixed base in that country, that other country is entitled to tax so much of the income as is attributable to those services. The major change from the 1972 Treaty is the way in which the 183- day test is applied. Under the 1972 Treaty the 183-day test applied in an income

52. *Supra* note 12 at 34.
53. No IR 44/67 of 16 December 1970.
54. *Supra* note 12 at 34.
55. They are caught by Art. 7 due to the operation of Art. 5(4)(b) that deems any activities "connected with, the exploration for or the exploitation of natural resources" to constitute a permanent establishment.
56. *Supra* note 43 at 91.
57. *Supra* note 9 at para 2.9.2.
58. *Ibid.*
59. Introduced by *Income Tax Assessment Amendment (Capital Gains) Act 1986* (No. 52 of 1986).
60. Art. 13(6).
61. This is consistent with the rules taxing business profits contained in Art. 7 and the rules taxing income from independent personal services contained in Art. 14.
62. This is consistent with the rules taxing profits from operating ships and aircraft contained in Art. 8.
63. Art. 13(3).
64. Art. 13(5) states "Nothing in this Agreement affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of any property other than to which any of the preceding paragraphs of this Article apply."
65. *Supra* note 9 at para 2.11.2.

year. Thus, it was possible to avoid income tax in the country in which the services were performed where the 183 days straddled two income years.

Under Article 15, generally salary and wages and similar remuneration of employees are taxable in the country where the employment is exercised. This does not apply to short visits nor where the income is dealt with under other articles (for example, fringe benefits,[66] directors' fees,[67] pensions and annuities,[68] and government service[69]).

(k) Fringe benefits changes

Both Australia and New Zealand tax employers on the value of certain fringe benefits provided to employees. Due to the high degree of similarity in the systems for taxing fringe benefits and in recognition of developments in trans-Tasman labour markets,[70] the Treaty includes a unique article that allocates taxing rights in respect of fringe benefits.[71] Article 16 allocates the right to tax fringe benefits, where a fringe benefit is taxable in both countries, to the country with the sole or primary right to tax the remuneration from employment to which the benefit relates. The "primary taxing right" is defined to lie with the country that does not have to provide relief under Article 24 for tax paid on the employee's remuneration.[72]

(l) Other income

Article 22 of the Treaty allocates the taxing rights where the Treaty is silent. It varies from Article 21 of the Model Treaty in that income derived by a resident of one country will be taxable in that country of residence, unless it is sourced in the other country. In these circumstances the country of source also has the right to tax. Relief from double taxation would be provided by Article 24 that requires the country of residence to provide tax relief.[73]

(m) Other changes

There are a number of minor changes from the 1972 Treaty and variances from the Model Treaty that are worth noting. They are:

(i) the professors and teachers article contained in the 1972 Treaty (Article 15) has not been incorporated into the Treaty. Such persons fall within the personal service articles (Articles 14 and 15);

(ii) Article 18 that deals with entertainers includes a unique provision that allocates taxing rights in respect of members of rugby league teams playing in a trans-Tasman competition. They will be taxable in the country of residence;

(iii) Article 19 that deals with pensions and annuities varies from the Model Treaty in that alimony and other maintenance payments are dealt with under this Article. However, unlike pensions, which are assessed on the basis of residency, alimony and other maintenance payments are taxable in the country of source;

(iv) the new mutual agreement procedures contained in Article 25 impose a time constraint of 3 years on persons seeking redress under these procedures. This is consistent with Article 25 of the Model Treaty and will override domestic statutes of limitations. No such provisions were included in the 1972 Treaty; and

(v) the Treaty does not contain a non-discrimination article.

IV. DEFECTS

There are a number of perceived flaws in the Treaty. First, it is claimed that the Treaty fails to deliver "... an entirely neutral position on withholding taxes to the detriment of certain Australian interests."[74] Essentially, a bias still exists in favour of New Zealand companies with Australian subsidiaries compared to Australian companies with New Zealand subsidiaries. This inequity arises from the fact that New Zealand imposes withholding tax of 15 percent on fully franked dividends while no withholding tax is imposed by Australia in similar situations.[75]

A second area of concern is that the Treaty has failed to provide mutual recognition of dividend imputation rebates. It has been claimed over a number of years that the inability of both Australian and New Zealand individual shareholders to use dividend imputation credits arising from tax paid on the other side of the Tasman is a major impediment to trans-Tasman investment.[76] The reasons for the reluctance by Australia to accept such a change are based upon revenue costs, concerns about quarantining the arrangement to New Zealand and potential avoidance problems as a result of New Zealand's lack of a capital gains tax.[77] There are also concerns that while New Zealand continues to decline to change its withholding tax arrangements in respect of fully franked dividends, such a change would result in a net shift in investment away from Australia.[78]

66. Art. 16.
67. Art. 17.
68. Art. 19.
69. Art. 20.
70. *Supra* note 1 at 2.
71. Specified in Art(s). 2 and 16. To further reflect this change the Australian Amendment Act amended the long title of its principle Act (the *Income Tax (International Agreements) Act 1953*) to now be called the *Income and Fringe Benefits Tax (International Agreements) Act 1953*. The short title remains the *International Agreements Act 1953*.
72. Art. 24 seeks to eliminates double taxation on income subject to tax in both countries by requiring the country of residence to give credit, against its tax, for the tax levied in the country of source.
73. *Supra* note 12 at 49.
74. Per Rocher in the Australian House of Representatives during debate on the Treaty – see *House of Representatives Hansard*, 28 February 1995 at 1152. Similar views were expressed by Truss in the same debates – at 1165.
75. Tanner in the Australian House of Representatives during debate on the Treaty claims that Australia pressed New Zealand for a change to this situation, but New Zealand refused – see *House of Representatives Hansard*, 28 February 1995 at 1158.
76. See "NZ-Aust closer economic ties now at turning point" *Australian Financial Review* 25 July 1995 at 14; Cooper, G., "Dusting Off the Old NZ Relations" (1995) 29 *Taxation in Australia* at 547; Froebel, G., "Trans-Tasman Issues: The long white tax cloud" (1995) 3 *Taxation in Australia Red Edition* 276 at 277; Benge, M., "Company Tax Integration: Did we get it right" (1995) *ATAX Tax Summit Conference paper* at 25-7; and "Tax anomaly hurts investment: expert" *The Canberra Times* 4 October 1995 at 37.
77. *Ibid* Benge at 26.
78. *Supra* note 75.

Other lesser problems are that the Treaty does not resolve the issues of inter-country taxation of superannuation contributions, fund income and pay-outs[79] and does not resolve the differing tax treatments of prepacked software.

V. MUTUAL CO-OPERATION

It was intended that the new Treaty will provide for co-operation between the tax authorities of both countries to prevent tax evasion.[80] To facilitate this aim and to ensure closer ties a Memorandum of Understanding between the Australian Taxation Office and the New Zealand Inland Revenue Department was signed on 16 August 1995. The Memorandum:
- formalizes the current close administrative links;
- requires both revenue authorities to co-ordinate investigations where practical; and
- is expected to facilitate the investigation and detection of trans-Tasman tax avoidance activity.[81]

VI. CONCLUSION

It is claimed that the new Treaty will reduce compliance costs, stimulate and strengthen trans-Tasman trade and investment, and protect both countries' revenue bases.[82] In general, this claim is supported despite the problems associated with the recognition of imputation credits. On balance, the Treaty is a great improvement over the 1972 Treaty, removing a number of the impediments to trans-Tasman trade and investment, such as the "force of attraction rule" in respect of the profits of permanent establishments, the reduction in the withholding tax rates for royalties and the removal of double taxation in respect of fringe benefits.

79. "NZ Tax pact helps Aust investment" *Australian Financial Review* 30 January 1995 at 3, *supra* note 9 at 1.3 and *supra* note 74, Rocher at 1156.
80. *Supra* note 1 at 1.
81. Australia: Treasurer's Press Release No 111/1995 of 16 August 1995.
82. *Supra* note 1 and the Second Reading Speech to the *Income Tax International Agreements Amendment Bill* 1995 reported in *House of Representatives Hansard*, 28 February 1995 at 1152 and in *Senate Hansard*, 1 March 1995 at 1206.

IFA NEWS

RESOLUTIONS – 49TH IFA CONGRESS, CANNES

SUBJECT I: INTERNATIONAL INCOME TAX PROBLEMS OF PARTNERSHIPS

RESOLUTION (ORIGINAL VERSION)

The 49th IFA Congress, having regard to the National Reports and the General Report on the International Income Tax Problems of Partnerships, as published in vol. 80a of the "Cahiers de Droit Fiscal International", taking note of the discussions during the Congress, has adopted the following resolution.

I. TRANSPARENCY OF LAW AND TAX NEUTRALITY

Tax legislation and treatment for tax purposes in the national as well as in the international context should, as far as possible, be framed in a way that partnerships – being an important and indispensable factor of modern business life – are able to carry on their activities under clear-cut rules and under conditions that do not impede a choice to use a partnership form for non-tax reasons.

II. BILATERAL ISSUES

II.1.1. If States consider partnerships fiscally transparent entities, the income derived by such partnership should be regarded as the income of the partners.

II.1.2. For the application of Article 7 OECD Model, the participation in a partnership (treated as transparent by both contracting States) should be regarded as a separate enterprise of the partners provided that the partnership itself carries on an enterprise within the meaning of the Model. Likewise, the permanent establishment of an enterprise carried on by a partnership should be regarded as the permanent establishment of the partners.

II.1.3. To overcome the practical difficulties originating from the transparency concept of partnership taxation in connection with tax treaties States should:

- assign a tax residence to the partnership for purposes of the treaty;
- or at least entitle the partnership to claim treaty benefits on behalf of its partners (to the extent that the income is taxable in the State where the partnership is resident).

II.1.4. In Article 10, para. 2(a), OECD Model the words "other than a partnership" and "directly" should be deleted.

II.2.1. In the case where a partnership is treated as a taxable entity by the partnership State and as fiscally transparent by another State in which the partner is resident, the partner should be allowed, even in the absence of any special agreement in the treaty, to obtain double tax relief from his country of residence (including tax credit for his proportionate share of taxes paid by the partnership). Conversely, the State of the partnership should provide for double taxation relief in respect of items of income which it would not have taxed but for the residence and separate taxation of the partnership.

II.2.2. In the case where a partnership is treated as fiscally transparent by the partnership State and as a taxable entity by the State of the partner's residence, the State of the partner's residence should provide for double taxation relief to the partner in respect of items of partnership income arising outside that State (which it would not have taxed but for the residence and separate taxation of the partner).

II.3. Business profits of a partnership should be attributed to only one single permanent establishment. Consequently, States should not tax non-resident partners on income that is attributable to and has the closest economic connection with a permanent establishment in another country.

III. TRIANGULAR SITUATIONS

III.1. If the partnership State taxes a non-resident partner on partnership income, then the partnership State should give appropriate double taxation relief to such non-resident partner on income received from third country sources. This should be done by national law as well as by treaty provisions or – in the absence of specific provisions – on the grounds of Article 24, para. 4 of the OECD Model (resp. Article 52, para. 2 E.C. Treaty).

III.2. Where a partner in a third country has received the benefit of a treaty between the partnership State and another State, the partner shall be free to claim such further benefit, if any, to which the partner would have been entitled had the share of partnership income allocated to him been received directly by him.

III.3. Permanent sub-establishment: Income earned by a domestic partnership (treated as a fiscally transparent entity) by means of a foreign (third country) permanent establishment should be attributed according to No(s). II.1.2. and II.3. of this resolution directly to the partners (being residents or non-residents of the partnership State).

IV. GUARANTEED PAYMENTS

IV.1. Even under a transparency approach of partnership taxation, guaranteed payments stipulated in a contract between a partnership and its partner should be considered as payments made by the partnership itself (or for its permanent establishment if effectively connected with such an establishment), and not by the partners.

IV.2 (a) In a tax treaty context, no State shall treat a guaranteed payment as having a domestic source, unless the payment is made for an asset, capital or services used in and effectively connected with a permanent establishment in that State.

IV.2 (b) The Congress recognizes that States apply different rules as to the tax treatment of specific remunerations between partnerships and their partners. Nevertheless, the Congress recommends that in a tax treaty context the States should treat guaranteed payments based on an arm's length agreement between the partnership and the partner according to their legal nature, i.e. as interest, royalties etc.

V. PARTNERSHIPS AND ARTICLE 15 OECD MODEL

Under Article 15 of the OECD Model, exemption for non-resident employees should be given where the employees' contract is with a partnership established in a foreign country irrespective of whether partners of said partnership are residents of the domestic country.

VI. SOURCE AND CHARACTERIZATION DIFFERENCES

Conflicts in source and character of income, including whether such determinations should be made at the partnership level or the partner level, to the extent not dealt with in a treaty, should be resolved by the respective competent authorities on a case by case basis, or by arbitration to the extent that is provided for by the applicable treaty.

Comments on the resolution concerning subject I by Prof. Hans Georg Ruppe, discussion leader.

1. The debate on the general subject "International Income Tax Problems of Partnerships" was based on a working paper which had been worked out in the months leading up to the Congress by the moderator together with the General Rapporteur and the other panel members. The working paper sought to break this complex topic down into typical case patterns and to combine them by means of a draft resolution. As a result, after a short introduction the debate first covered bilateral situations, then triangular situations, ending with guaranteed payments followed by individual special questions.

The General Rapporteur introduced the subject at the start of the general debate, stressing that as far as taxation of partnerships was concerned, individual States applied different concepts of transparency, a factor which complicated matters when it came to applying double taxation treaties.

2. The first part of the resolution refers to the fact that the legal situation with regard to taxation of partnerships in many countries and especially in the international context is viewed as unclear and unsatisfactory, and that the choice of a partnership form for international business translations is consequently impeded by tax regulations. Dr. Lethaus further drew attention in this connection to the fact that choice of a legal form of partnership can give rise to special problems as far as estate duties are concerned.

3. In connection with bilateral problems, the panel discussed the following situations:

(i) A partnership in State A whose partners are residents of the same State but who receive income arising in State B;

(ii) A partnership in State A whose income arises in that same State but whose partners are residents of State B; and

(iii) A partnership established in State A whose income arises in State B and whose partners are also residents of State B.

4. During the discussion of point II.1.1 of the resolution, the participants discussed in detail whether income from a partnership taxed according to the transparency concept should always be considered as *pro rata* income of the partners or whether it might be possible to assign certain income shares of the partnership to given partners using the nomination approach. The majority of the participants were against the *pro rata* concept.

5. Mr Olsson defended point II.1.2 of the Resolution. This has to do with the interpretation of Article 7 of the OECD Model Treaty, which cannot be applied automatically to partnerships when the transparency principle is used. This part of the resolution was adopted without amendments. In a discussion paper, however, Mr Avery Jones (UK) drew attention to the fact that, with certain variants of the transparency concept, it was not possible to say that the partner operated an enterprise separately or received a certain share of the income; that applied to cases where transparency was limited to the payment of taxes by the partners or where the enterprise was operated jointly by the partners. In such cases, interpretation of the double taxation treaty was not enough on its own to achieve the desired effect of the resolution, and precautionary measures had to be incorporated in national law or special treaty provisions.

6. Part II.1.3 contains a key point, which pertains to the treaty entitlement of partnerships. Here, the resolution basically follows the General Rapporteur, who worked out clearly (General Report No. 112) that it would be a good idea to assign partnerships to a given State and to empower them to claim treaty benefits themselves (in case of taxation according to the transparency principle, admittedly only on behalf of the partners).

The discussion on this point was very lively and led to several amendments. There was no majority for keeping the reference to the regulation stipulated in several double taxation treaties, namely, that partnerships should be granted treaty benefits if 75% of the profits are for resident partners.

7. Point II.1.4, which proposes deleting the words "other than a partnership" in Article 10, para. 2(a) of the OECD Model Treaty, also gave rise to lengthy debate. Mr. Avery Jones expressed the view that the arguments put forward in support of this proposal were not convincing and that the words were necessary for certain cases. The Congress adopted that section notwithstanding, but decided in favour of deleting the word "directly".

8. There was also an in-depth discussion of points II.2.1 and II.2.2 of the resolution, which Mr Burke presented and defended and which deal with the problems of double taxation with diverging classification criteria for partnerships. As a result of the debate, editing rather than substantive changes were made to the resolution. Basically, it advocates that in cases where partnerships are treated differently in the countries concerned (transparency vs. taxable entity), treaty benefits should nevertheless be applied to the partner to which the income is assigned under national law. The second sentence in point II.2.1 is meant to imply that even though a State is not obliged to provide for double taxation relief in respect of income which it would have taxed anyway as the State of the source of income, it should do so in respect of income arising outside that State which it considers as income of a resident, even if the other State taxes it as the income of another person (the partner).

9. Behind II.2.2 is the notion that the State of which the partner is a resident (which treats the partnership as a taxable entity and therefore only makes the partner pay taxes on dividends) should provide the partner with double taxation relief, even if this State, in accordance with its national law, considers taxes paid abroad as taxes of the partnership. In conclusion, Prof. Burns presented the Padmore case and discussed its consequences and implications.

10. Point II.3 refers to the delicate case in which a partnership has partners who are non-residents of a State and who also derive their income from a permanent establishment abroad. Here as well, when the transparency concept is applied, a permanent establishment is created in the partnership State owing to the company management. The resolution recommends in this case attributing profits to the permanent establishment with which the closest economic connection is maintained.

11. In the discussion of triangular cases, Prof. Daniels first discussed the problem of permanent sub-establishments. In this connection, point III.3 was adopted without further discussion. Dr. Lethaus then showed that many problems tied to triangular situations could be solved if the exemption method were used instead of the credit method.

12. Point III.1 refers to cases in which a partner with limited tax liability is liable for taxation in the partnership State on income from third countries. This part of the resolution gave rise to a lively exchange of views and was subsequently amended. It calls for national law or treaty provisions to take such cases into consideration or at least to ensure that the partner benefits from the ban on discrimination.

13. Mr Burke then defended point III.2, which specifies that the foreign partner should be free to claim further treaty benefits based on the double taxation treaty of his State with the State in which the income arises.

14. The subject of guaranteed payments was introduced by Prof. Burns. The panel discussed some case patterns in the international context which primarily underscore the classification criteria applied to the problem of double taxation. Points IV.1 and IV.2 were defended by Prof. Daniels and adopted without significant change. Compliance with this resolution should make it possible to avoid double taxation of guaranteed payments.

15. With regard to point V of the resolution – partnerships and Article 15 of the OECD Model Treaty – there was a discussion as to whether the resolution covered all aspects of the subject. In the end, the Congress rejected the proposal, which had been defended by Mr Olsson.

16. Following a lively discussion, a reference to the possibility of arbitration was added to point VI of the resolution.

SUBJECT II: TAX ASPECTS OF DERIVATIVE FINANCIAL INSTRUMENTS

RESOLUTION (ORIGINAL VERSION)

PREAMBLE

The 49th IFA Congress recognizes that for several decades one of the most pervasive features of the world financial markets has been the integration of national markets into a single global market. The reasons underlying this process are many and varied but some of the most important are: deregulation of financial markets, the emergence of global competition for capital, advances in information and communications technologies, and refinements in analytical, valuation and pricing techniques.

The Congress further recognizes that the above process has taken place against a background of fundamental changes in the financial environment that have brought about unprecedented uncertainty and volatility in foreign exchange rates, interest rates and commodity prices. Derivative instruments represent the response which the capital markets have made on a global basis to a demand for ways of protecting against this volatility and risk.

RESOLUTION

Against this background and having regard first to the National Reports and the General Report on tax aspects of derivative financial instruments and secondly to the discussions held during the Congress, the following resolution has been adopted by the Congress.

1. The Fundamental Importance of the Appropriate Taxation of Derivative Financial Instruments

1.1. The Congress urges countries that, in considering both the effectiveness and application of existing tax provisions to derivative financial instruments and in considering the introduction of new provisions, countries have particular regard to the fundamental importance of derivative financial instruments in both domestic and the international capital markets. Fiscal authorities should recognize that taxation may significantly affect the efficiency and economic results of these transactions. Derivatives are an essential instrument of modern finance, and tax authorities should strive to remove tax impediments to their use.

1.2. The Congress urges countries that have not already done so to introduce specific legal and, where necessary and appropriate, regulatory provisions (collectively a "tax regime") to determine the tax treatment of derivative financial instruments within the jurisdiction. The basic issues that must be confronted include (1) defining the transaction being taxed; (2) deciding what accounting conventions should apply to determine the recognition of income in a particular accounting period, and (3) determining how international transactions should be treated.

1.3. The Congress recommends that any such new tax regime, as well as existing regimes, should be guided by the following principles.

1.3.1. *Certainty.* The use of a derivative financial instrument should have a definite and predictable tax result. This result should not be contingent upon classifications, characterizations, or determinations that are ambiguous or subject to retrospective alteration.

1.3.2. *Consistency.* To the greatest extent possible, different classes of taxpayers and instruments which are fundamentally similar should be taxed consistently one with another. Violations of this principle should be infrequent and should require specific justification.

1.3.3. *Fairness.* A tax regime should be fair, simple, and practical and should recognize that both users of derivative instruments and the instruments themselves differ in their sophistication, and that users further differ as to the volume of transactions into which they enter, their motives for using such instruments and the use to which they are put.

1.3.4. *Flexibility.* Derivative instruments are dynamic. It is essential, therefore, that any new tax regime created for derivative financial instruments and any existing regime be flexible enough to reflect the preceding principles continually over time, even though the universe of derivative instruments to which these principles are being applied will change.

2. Specific Application of These Principles

2.1. *Tax Policy Should Be Guided By the Principle of Consistency.* Whether a country should adopt a separate transactions approach or an approach which integrates separate transactions is a fundamental accounting choice, and there are strengths and weaknesses to each. Whichever approach is taken, however, the resulting consequences in terms of the characterization of income and when it is recognized should, to the extent possible, be consistent with the taxation of other transactions.

2.1.1. *Integration* with underlying transactions should be at the taxpayer's election but retrospective integration, using the benefit of hindsight, should be avoided. Any requirement to integrate should not disrupt the goal of certainty.

2.1.2. The *bifurcation* of single transactions rarely yields benefits commensurate with the complexity of this approach and the uncertainty it creates.

2.2. *Timing Should Reflect Economic Income.* With respect to the timing of income and expense recognition, the decision whether to tax derivative instruments on an economic accrual basis or a mark-to-market basis is similarly a fundamental structural decision, with advantages and disadvantages to each approach. Whether, in any given set of circumstances, one approach is adopted in preference to another should depend on which is considered to produce a result that most closely mirrors the economic value accumulated by a taxpayer within an accounting period and which preserves something which becomes particularly important in hedging transactions, namely symmetry with the taxation of other instruments.

2.3. *No Taxation at Source.* Countries should not impose source basis taxation on income derived by non-residents from derivative instruments in the absence of a branch or permanent establishment to which such income is attributable.

2.3.1. It is the general practice not to impose withholding tax at source on payments made under derivative financial instruments. This is appropriate and should be universally adopted.

2.3.2. Apart from withholding tax, profits, gains and losses with respect to derivative instruments should be exempted from tax at source under domestic law or applicable income tax treaties on the ground that they represent:

2.3.2.1. business profits, exempt from tax in the absence of a permanent establishment;

2.3.2.2. capital gains; or

2.3.2.3. "other income" exempt under the "other income" article of an applicable treaty.

2.4. *Clarification of Residence Taxation.* In imposing residence taxation on income derived from derivative instruments, the residence principle should be: (a) reinforced by application of a country's anti-deferral regimes, where appropriate; and (b) clarified in the case of global trading, split hedging, and inter-branch transactions. In this connection, countries should consider entering into Advance Pricing Agreements in appropriate cases. In computing the taxable income of a branch of a foreign taxpayer, inter-branch or branch/home office transactions in derivative instruments are taken into account in some countries but not in others. The treatment of these transactions should be harmonized and the OECD should be encouraged to continue its work on the subject.

An explanatory note on the resolution for subject II by Richard Briffett, discussion leader for the panel.

1. The Draft Resolution for Subject II presented to the Congress had been drafted by the Panel Members and the General Reporters with certain clear objectives in mind. These were as follows:
   (i) The form and structure of the Draft Resolution should be consistent with the analytical framework for discussing derivative financial instruments adopted by the General Reporters in their General Report.
   (ii) The Draft Resolution should recommend unequivocally that countries recognise the fundamental importance of derivative financial instruments in the world's domestic and international capital markets and that steps be taken to remove any tax impediments to the greater and more efficient use of such instruments in protecting against volatility and risk in the global financial markets.
   (iii) Given that the overall response of national tax systems to derivative financial instruments is, with certain notable exceptions, still in its infancy, the Resolution adopted by the Congress should embody a clear statement of the principles that should shape and inform individual tax regimes that are applicable to these instruments. The lead that Congress can best provide is to create a general framework within which further evolution and development can take place.

2. The Panel Members and the General Reporters also felt that in view of the objectives summarised above, the Draft Resolution, despite its separate clauses and sub-clause, constituted an integrated text that did not lend itself easily to debate in a piecemeal fashion. Consideration of, and debate on, the Draft Resolution was, therefore, conducted as a single, uninterrupted process after the Panel's introduction to the core derivative products and the key tax issues that they present.

3. During the debate, amendments to paragraphs 1.1 and 1.3.3 were proposed but not accepted. The thrust of these amendments was to introduce as one of the guiding principles that should shape a tax regime applicable to derivative financial instruments, the interest of national tax authorities in preventing erosion to the tax base arising from the use of these instruments. While acknowledging that the proposed amendments address a perfectly legitimate and, indeed necessary concern, the Panel felt that the issue raised was a general one and not in any sense specific to derivative instruments and that it was really an aspect of implementation detail rather than a key element of a policy framework.

4. Two amendments were proposed, one of which was adopted, designed to acknowledge and encourage the work that the OECD has carried out, particularly as regards the international tax issues posed by the mobility of international capital flows and the global nature and operation of the financial markets. The amendment had the support of the Panel and its wording is reflected in paragraph 2.4.

5. Concern was expressed, and an amendment submitted to this end, on the reference in paragraph 2.3.2.3 to the use of the "other income" article in an applicable double taxation agreement as a way of avoiding taxation at source on profits or gains derived from derivative financial instruments. The amendment was not adopted, the Panel's response being that the reference to the "other income" article in paragraph 2.3.2.3 should be seen in the context of paragraph 2.3 as a whole. The Resolution clearly states that source basis taxation should not be applied to non-effectively connected income derived by non-residents from derivative instruments. The primary mechanism for enforcing source basis taxation in this situation is the application of a withholding tax. However, the paragraph then goes on to suggest that attempts to impose source basis taxation by a mechanism other than withholding tax could be defeated by one of three other means of which the "other income" article is, in a descending order of means, no more than the ultimate "backstop".

6. Clarification of paragraph 1.3.3 was sought via a proposed amendment and a change in wording was subsequently adopted, to make it clear that derivative instruments themselves, as well as their users, operate within a range of sophistication. However, the central thrust of the paragraph remains in that a tax regime relating to derivative financial instruments should be fair in the sense of not imposing either a compliance burden or a monetary liability on unsophisticated users of derivative instruments who may not be able to make the same kind of analysis of the tax issues presented by these instruments as major corporate or institutional users.

7. Finally, paragraphs 2.1 and 2.2 of the Resolution touch upon the relationship between concepts of income and expense and the timing of income and expense recognition for financial accounting and for tax purposes. This area was not the subject of a proposed amendment, although it was raised in a question from the floor and it was commented upon during the Panel discussion. As the Panel acknowledged, the issues raised are particularly complex because in certain jurisdictions notions of income, expense and net profit for accounting, regulatory and tax purposes have evolved in complete conformity, whereas in other jurisdictions specific tax principles have developed which may, in fact, be more complete and further advanced than those prevailing in the financial accounting arena. Additionally, "profit" is not a necessarily uniform concept: its meaning will almost certainly be coloured by the context – product and unit performance measurement, compensation, incentive programmes and corporate law as well as tax and financial accounting – in which a definition is being sought.

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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 48-52 of the January 1995 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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CARIBBEAN

Cayman Islands

Offshore financial opportunities in the Cayman Islands. An in-depth analysis of the latest opportunities available in one of the world's most popular offshore financial centres. Conference documentation, 16 February 1995, London, Marriott Hotel. Organized by International Business Communications.
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(B. 18.890)

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EUROPE

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London, Financial Times Insurance & Professional Publishing/Pearson Professional Limited, Maple House, 149 Tottenham Court Road, London W1P 9LL, United Kingdom. 1995, pp. 158. ISBN: 1 85334 299 8.
The third edition of this Financial Times Management Report on accounting harmonization in Europe is intended not only to give accountants a better insight into the accounting practices of their European counterparts but also to help them better understand their own system and to predict future developments. An analysis of the causes of different accounting practices – i.e. the different origins of corporate finance, the relationship between taxation and accounting, the choice between civil and common law systems, the relative strength of the accountancy profession and the relative importance of a conceptual infrastructure – helps identify two country groupings: the Anglo-Dutch and the Franco-German. The main practical differences between the European countries' accounting rules and practice are identified and described. The comparative benefits of harmonization are discussed together with the obstacles to be overcome and the potential role of specific countries and the IASC in this process. The final part of the Report is devoted to the harmonization progress within the EU including a detailed discussion of the Second, Fourth and Seventh Directives and future prospects.
(B. 114.774)

Andorra

Hill, W.G.
The Andorra and Gibraltar Report. Undiscovered fiscal paradises of the Iberian Peninsula. 4th Edition.

Hants, Scope International Ltd., Forestside House, Forestside, Rowlands Castle, Hants, PO9 6EE, England. 1995, pp. 148. £ 60.-. ISBN: 0 906619 31 9.
Written in popular style, this book covers a wide range of practical aspects of choosing these locations as a new home, whether for tax or other reasons. A brief history of each location is given with further information covering local taxes, banking secrecy, setting up offshore companies, obtaining a local passport, driving licences and car ownership, healthcare, accommodation, etc. The report concludes with a review of the various attractions of two little known locations, Os and Llivia. There are useful lists of local accountants, lawyers and financial advisers.
(B. 114.766)

Austria

Kohler, Gerhard.
Steuerleitfaden zur Vermietung.
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(B. 114.642)

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Vienna, Linde Verlag Wien GmbH. 1995, pp. 599. 720.- AS. ISBN: 3 85122 491 4.
This book discusses the taxation of individuals and contains the most recent amendments which have been introduced by the 1995 Structural Adjustment Law.
(B. 114.631)

Müller, Eduard.
Steuer Sparbuch. Tips, Tricks und Strategien für 1994/95.
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Booklet containing practical tips on how to save taxes.
(B. 114.238)

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Annuaire fiscal 1995.1.
Diegem, Ced-Samsom. 1995, pp. 821. ISBN: 90 5334 326 1.
Yearbook of tax law. The book contains useful professional information, such as addresses of collectors', inspectors' and directors' services, description of entry into force of recent laws. It describes the regime of income tax, the withholding taxes and the procedures for income tax litigations. It also contains a description of the regime of taxes assimilated to the income tax, registration duties and VAT.
(B. 114.708)

Czech Republic

Weber, Andreas; Baburková, Dietlinde.
Tschechisches Steuerrecht 1995. 2. Auflage.
Cologne, Peter Deubner Verlag GmbH. 1995, pp. 392. 68.- DM. ISBN: 3 88606 160 4.
Book containing the full and amended texts in German as from 1 January 1995 of the following Czech Republic tax laws: Income Tax Act (covering both individual income tax and corporate income tax), VAT, excise tax, real estate tax and road tax.
(B. 114.753)

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Cologne, Peter Deubner Verlag GmbH. 1995, pp. 200. 68.- DM. ISBN: 3 88606 169 8.
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(B. 114.752)

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(B. 114.809)

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(B. 114.810)

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Summaries of current taxation and tax planning strategies for expatriates working in Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic.
(B. 114.780)

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Herne/Berlin, Verlag Neue Wirtschafts Briefe. 1995, pp. 115.
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(B. 114.291)

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Helsinki, Painatuskeskus Oy. 1995, pp. 311. ISBN: 951 37 1684 8.
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(B. 114.775)

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Transfer pricing: European rules and practice.
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This Portfolio contains detailed explanations of the transfer pricing rules and practice in France and the United Kingdom.
(B. 114.831)

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60 DM. ISBN: 3 88606 157 4.
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(B. 114.596)

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(B. 114.705)

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148.- DM. ISBN: 3 504 32477 5.
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(B. 114.575)

Nobes, Christopher.
German accounting explained. Eliminating the barriers to measuring true company performance in Europe's largest economy.
London, Financial Times Insurance & Professional Publishing/Pearson Professional Limited, Maple House, 149 Tottenham Court Road, London W1P 9LL, United Kingdom.
1995, pp. 137. £ 288.-. ISBN: 1 85334 327 7.
The aim of this Financial Times Management Report is straightforward: the facilitation of interpreting German accounts from an international perspective. Use is made throughout of comparisons with other countries' accounting systems, notably the United Kingdom and the United States with illustrations of the significant differences which can arise. Chapter 2 contains a summary of the German corporate culture, including business forms and financing. Causes of differences with other accounting systems are reviewed and possible classification methods considered. A historical perspecive is given by way of an account of the development of, and influences on German accounting (including the EC Directives). The central four chapters describe the main aspects of German accounting from general principles through to group accounting. Chapter 9 concentrates on taxation and the interaction with accounting. Case studies provide illustrations. The final chapter provides an overview of the possibilities for adjusting German accounts to facilitate their interpretation. An explanation of technical terms and general glossary are contained in appendices.
(B. 114.843)

Gibraltar

Hill, W.G.
The Andorra and Gibraltar Report. Undiscovered fiscal paradises of the Iberian Peninsula. 4th Edition.
Hants, Scope International Ltd., Forestside House, Forestside, Rowlands Castle, Hants, PO9 6EE, England. 1995, pp. 148. £ 60.-.
ISBN: 0 906619 31 9.
Written in popular style, this book covers a wide range of practical aspects of choosing these locations as a new home, whether for tax or other reasons. A brief history of each location is given with further information covering local taxes, banking secrecy, setting up offshore companies, obtaining a local passport, driving licences and car ownership, healthcare, accommodation, etc. The report concludes with a review of the various attractions of two little known locations, Os and Llivia. There are useful lists of local accountants, lawyers and financial advisers.
(B. 114.766)

Isle of Man

Statutes in force. Isle of Man companies legislation 1931-1993. Revised to 1 January 1994.
Isle of Man, Government Printer. 1994,
pp. 447.
One loose-leaf binder containing texts of the Isle of Man Companies Acts of 1931, 1961, 1968, 1974, 1982, 1986 and 1992; the Non-Resident Company Duty Act 1986, Single Member Companies Act 1993, and the Companies (Memorandum and Articles of Association) Regulations 1988.
(B. 114.712)

Italy

Alegi, Peter C.
Business operation in Italy.
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Foreign Income Portfolio, No. 968, pp. 125.
An introduction to the Italian business life, including the requirements and principal problems encountered in making investments. This Portfolio includes an analysis of the tax on corporations, tax on individuals, and all taxes which are imposed on business firms and investment.
(B. 114.824)

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Niessen, R.E.C.M.
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32.50 Dfl. ISBN: 90 387 0300 7.
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(B. 114.813)

Sonderen, J.C.M. van.
De fiscale eenheid in de vennootschapsbelasting. Rede in verkorte vorm uitgesproken bij de aanvaarding van het ambt van hoogleraar in het belastingrecht aan de Faculteit der Rechtsgeleerdheid van de Erasmus Universiteit te Rotterdam op 9 juni 1995.
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ISBN: 90 200 1755 1.
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(B. 114.811)

Fiscaal Memo 2, 1995.
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ISBN: 90 200 1693 8.
Booklet containing information on relevant regulations in Dutch tax law as of 1 January 1995.
(B. 114.735)

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ISBN: 90 200 1691 1.
Booklet containing the most important provisions in the Dutch tax law as of 1 July 1995.
(B. 114.776)

Berkhout, T.M.; Bulk, G.C.; Trappen, R. van.
Fiscale hoofdzaken vastgoed.
The Hague, Delwel Uitgeverij B.V. 1994, pp. 180. 32.50 Dfl. ISBN: 90 6155 632 5.
Practical guide treating tax aspects of immovable property within the individual and corporate income taxes, VAT and capital transaction tax. The following subjects are dealt with: depreciation, reserves, valuation and transfer tax.
(B. 114.763)

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The Hague, Delwel Uitgevers B.V. 1994, pp. 155. 32.50 Dfl. ISBN: 90 6155 631 7.
Global overview of tax systems in certain countries as compared with the Dutch tax system. Countries covered: Belgium, Luxembourg, Germany, United Kingdom, USA, France, Spain, Italy, Switzerland, Japan and the Netherlands Antilles.
(B. 114.762)

Mees, L.J.; Bouwman, R.A.L.H.M.; Sodderland, J.W.
Ondernemen in China. Juridische en fiscale aspecten.
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Doing business in China – legal and tax aspects. Information guide for Dutch entrepreneurs intending doing business in the People's Republic of China. The following aspects are covered: foreign trade, foreign investment, representative offices, company law, intellectual property, immovable property, arbitration procedure, tax aspects, and a chapter on Hong Kong.
(B. 114.801)

Soest, A.J. van.
Belastingen. Inkomstenbelasting – Vermogensbelasting – Vennootschapsbelasting – Internationaal belastingrecht. 18th Edition.
Arnhem, Gouda Quint BV. 1995, pp. 690. 120.- Dfl. ISBN: 90 387 0246 9.
Eighteenth edition of handbook considering the individual income tax, corporate income tax, net wealth tax and methods for elimination of double taxation. This edition contains an integral version of the fifth edition of "Internationaal belastingrecht" by R. Romeyn. Legal texts reprinted in respective chapters reflect the situation as of October 1994. A register and a list of selected case laws are appended.
(B. 114.719)

Meijer Timmerman Thijssen, J.; Horzen, F. van; Sint Truiden, M. Ph. van; Zevenboom, G.H.
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Handbook dealing with methods used to finance companies. The authors analyse the subject from the legal, civil, tax and accounting points of view and focus on finance methods with internal or external capital, factoring, leasing or off-balance-sheet financing. Extended case law register and cross reference list are appended.
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Schuttevâer, H.; Zwemmer, J.W.
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Heijmans, E.R.H.; Raaijmakers, J.H.P.M.
Aansprakelijkheden Invorderingswet 1990.
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Fiscale Monografieën, No. 73, pp. 268. 75.- Dfl. ISBN: 90 200 1686 5.
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(B. 114.804)

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(B. 114.683)

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Ellis, M.J.
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(B. 114.812)

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The Hague, SDU Uitgeverij, Koninginnegracht, Den Haag. 1995, pp. 156. 37.38 Dfl. ISBN: 90 12 08207 2.
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(B. 114.679)

United Kingdom

Tolley's taxation of foreign exchange gains and losses. By the Coopers & Lybrand Foreign Exchange Tax Team.
Croydon, Tolley Publishing Company Limited. 1995, pp. 412. £ 49.95.
ISBN: 0 85459 851 0.
The publication includes all relevant legislation as of 23 March 1995, to help the reader to review, plan and structure their foreign currency transactions to avoid potentially major increases in tax liabilities. Illustrated with numerous examples to help prepare for the new rules and to make tax returns under them.
(B. 114.778)

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London, Butterworths. 1995, pp. 429. £ 20.-.
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A comprehensive digest of reported decisions relevant to current legislation from 1875 to 1 January 1995.
(B. 114.777)

Matthews, Janek; Eastaway, Nigel.
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Croydon, Tolley Publishing Company Ltd. 1995, pp. 376. £ 35.95.
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(B. 114.836)

Gravestock, Peter.
Tolley's guide to self-assessment for the self-employed. 2nd Edition.
Croydon, Tolley Publishing Company Ltd. 1995, pp. 117. £ 16.95. ISBN: 1 86012 032 6.
Comprehensive and practical guide offering specialist advice on rules affecting self-employed individuals and partnerships alike. Contains all the latest provisions from the Finance Act 1995, including the new rules on anti-avoidance and partnerships.
(B. 114.837)

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The CSO Blue Book 1995. Editor: Simon Humphries.
London, HMSO. 1995, pp. 175. £ 24.95. ISBN: 0 11 620710 8.
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Rechnungslegung und Grundsätze der Abschlussprüfung in Grossbritannien und Deutschland. Ein Vergleich; Accounting and auditing standards and principles in the United Kingdom and Germany. A comparison.
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IFA Cahiers de Droit Fiscal International, Vol. LXXXB, pp. 841. ISBN: 90 411 0752 5
A summary of national reports on the topic by various contributors in French, English, German and Spanish. The general report by C.T. Plambeck, H.D. Rosenbloom and D.M. Ring is printed in full in the four languages.
(B. 114.742)

International income tax problems of partnerships. 49th Congress of the International Fiscal Association, Cannes 1995.
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IFA Cahiers de Droit Fiscal International, Volume LXXXA, pp. 857.
ISBN: 90 411 0751 1.
A summary of each report in English, French, German and Spanish is appended. The report by the general reporter Jean-Pierre Le Gall is printed in full in the four languages.
(B. 114.741)

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London, Campden Publishing Ltd., Threeways House, 40-44 Clipstone Street, London W1P 8LX, England. 1995, pp. 272. £ 150.
ISBN: 1 898750 09 2.
A leading reference source to the offshore industry. This edition has been fully revised and updated to incorporate the latest details of new and forthcoming legislation, emerging business areas and contemporary issues. The report contains contributions on the topics: companies, banking and investments, trusts, offshore financial centres in 38 countries of the world, including Labuan, Madeira, Nevis, St. Vincent and the Grenadines, the Turks and Caicos Islands and Vanuatu as well as Western Samoa.
(B. 114.793)

Roser, Frank.
Die steuerliche Qualifikation der Finanzierungsinstrumente des Islam.
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Qualification of financial instruments for tax purposes in the Islamic world. The author discusses the fact that the Koran prohibits the charging of interest in respect of financial instruments.
(B. 114.412)

The A-Z guide to offshore centres.
London, The International, Marketing Dept., Greystoke Place, Fetter Lane, London EC4A 1ND; London, Financial Times. 1995.
Outline of 55 countries/principalities and city states in the world, of interest to offshore investments.
(B. 114.717)

The international directory of government 1995.
Ministries, departments, agencies, corporations.
London, Europa Publications Limited. 1994, pp. 830. £ 210.-. ISBN: 1 85743 004 2.
Comprehensive guide to government ministries, departments, agencies and corporations all over the world. This revised edition includes all the countries that have gained independence since 1990. Each country chapter provides details on the Head of State and legislative system, and a full list of ministries. Government organizations and affiliated groups are arranged by subject heading, and include sections on agriculture, banking and the economy, defence, media and transport. Every entry contains, where appropriate, names of principal officials, full address, telephone, telex and fax numbers and an outline of activities undertaken.
(B. 114.713)

Corporate taxes. A worldwide summary.
New York, Price Waterhouse. 1995, pp. 683.
Summary of basic information about corporate taxes in 116 countries and territories. It briefly outlines the corporate tax rates and certain major features of the tax laws that affect corporate operations in the countries covered. The guide reflects the tax rates and rules in effect as of 1 January 1995.
(B. 114.725)

Amsterdam, A.M. van.
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The Hague, Delwel Uitgevers B.V. 1994, pp. 155. 32.50 Dfl. ISBN: 90 6155 631 7.
Global overview of tax systems in certain countries as compared with the Dutch tax system. Countries covered: Belgium, Luxembourg, Germany, the United Kingdom, the United States, France, Spain, Italy, Switzerland, Japan and the Netherlands Antilles.
(B. 114.762)

Langer, Marshall J.
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