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# INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

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## PURPOSE

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

*(art. 2)* The Object of the International Bureau of Fiscal Documentation is the foundation and maintenance of an international documentation bureau, in order to supply information in fiscal legislation and the application of fiscal law, and to stimulate the study of fiscal science.

*(art. 3)* The International Bureau of Fiscal Documentation shall endeavour to realise this object by:

a. founding a library on fiscal legislation, books, periodicals and other publications;

## L'OBJET DU BUREAU

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

*(art. 2)* Le but du Bureau International de Documentation Fiscale est d'établir et de maintenir un bureau international de documentation tendant à fournir des informations concernant la législation fiscale et l'application du droit fiscal, ainsi qu'à stimuler l'étude de la science fiscale.

*(art. 3)* C'est par les moyens suivants que le Bureau se propose d'atteindre ce but:

a. en établissant une bibliothèque fiscale d'ouvrages, revues et autres publications;

b. supplying information;
c. giving any one the opportunity to study all material available in its library;
d. issuing a periodical;
e. any other appropriate measures.

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

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

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

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

A fourth work, *Taxes and Investment in Asia and the Pacific*, is nearing completion. It now comprises six binders, with a seventh to be issued in the near future.

b. en fournissant des informations;
c. en procurant à tous ceux qui s'y intéressent l'occasion de consulter ces ouvrages;
d. en publiant un périodique;
e. en recourant à tout autre moyen adéquat.

Par une coopération étroite avec l'IFA et avec l'aide de correspondants à travers le monde, le Bureau rassemble toutes les données possibles en matière de droit fiscal international et comparé. De cette façon, le Bureau est à même de fournir des renseignements, mais non des avis, concernant des problèmes fiscaux spéciaux. Des honoraires, nécessaires au maintien et à l'expansion du Bureau, sont demandés en fonction du temps nécessaire et du coût. Le Bureau a publié un certain nombre de monographies dont des monographies sur la fiscalité (études réalisées en association avec Harvard Law School, International Tax Program).

Le Bureau publie aussi *European Taxation*, qui est devenu une revue mensuelle sur les systèmes fiscaux européens. *Tax News Service*, publié deux fois par mois, donne une information rapide, à l'échelle mondiale, de tout ce qui touche à la fiscalité. *Supplementary Service to European Taxation* est un ouvrage de référence présentée sous feuilles mobiles.
*Guides to European Taxation*, également une publication sous feuilles mobiles, comprend "L'imposition de Redevances, Dividendes et Intérêts en Europe", "L'imposition des Sociétés de capitaux en Europe", "L'imposition de revenu des investissements privés" et "La Taxe sur la Valeur Ajoutée en Europe". *Tax Treaty Guides*, une autre publication sous feuilles mobiles, comprend le "Manuel relatif à la Convention fiscale Allemagne — Etats Unis" et le "Manuel relatif à la Convention fiscale Pays-Bas — Allemagne" (en langue allemande). Le Bureau a également publié, *Corporate Taxation in Latin America*, *African Tax Systems* et *Taxes and Investment in the Middle East*, ouvrages d'information sous feuilles mobiles.

Un quatrième ouvrage, intitulé *Taxes and Investment in Asia and the Pacific*, est près d'être achevé. A l'heure actuelle cet ouvrage est composé de six volumes; un septiéme volume paraîtra prochainement.

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

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

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

*Plan of Action — Article 3*
The Association shall endeavour by all legal means to realise this aim: a) by scientific research; b) by holding congresses and conferences; c) by publications; d) by cooperation with all data collecting organisations, especially the International Bureau of Fiscal Documentation in Amsterdam; e) by all other appropriate methods.

I.F.A. has branches in 29 countries. Residents in any of these countries (I.F.A. members or candidates for membership) can approach the secretary of the local Branch.

Members who live in countries where IFA has no Branch are registered as direct members of the Association. They can get in touch with the General Secretariat of I.F.A. (this also applies to candidates for membership).
Conditions of direct membership of I.F.A. for 1980 are: individuals US$ 38.— p.a. - corporations US$ 85.— p.a.

# Contents

of the January 1979 issue

In contrast, in the U.K., public companies which are not CLOSE COMPANIES have been required to restrict dividend payments as an anti-inflation measure.

**MINIMUM TAX** — Agreements may be made between the government of a country (or its tax department) and an entrepreneur by which the entrepreneur is given the right, for example, to work mineral deposits, fell timber or engage in some monopoly activity. The agreement may specify special rates of tax and special arrangements for computing tax but occasionally provision will also be made for a minimum payment of tax, regardless of the results of the enterprise in any particular year. Generally speaking, where such minimum payment exceeds the tax liability calculated on the agreed basis, the excess will be carried forward to offset against subsequent tax liabilities; the object of the minimum tax payment requirement is to assure certain minimum fiscal revenue to the government making the agreement. Since, however, the requirement puts additional burden on an enterprise at a time when it may be particularly short of working capital a minimum tax requirement is obviously not a system which could be recommended for general application. Moreover the cash needs of the leasing government may often be met by charging royalties (or export duty) on minerals, etc. extracted, calculated without regard to the profits earned from extraction. In the U.S.A. where income tax reliefs to the (wealthy) individual taxpayer were for a long time considerd too generous, a minimum tax provision now charges 15% tax as a kind of clawback on certain reliefs ("preferences") granted. The 15% charge is not reducible by any credit for foreign tax, but only applies to taxpayers who receive substantial (over $10,000) preferences.

**MINOR, RELIEF FROM INHERITANCE TAX** — A beneficiary who is a minor (i.e., under 18, or 21, etc. depending on the law of his country) and who inherits from the estate of a parent or other person at a time before he has completed his education is granted more relief than would be granted to a more mature person, because of his greater need, in some countries, notably Japan.

**MINORS, TAX LIABILITY OF** — A person under the age of attainment of his majority is regarded as liable to personal taxes even though too young to vote for or against them. While a trustee or executor may be made responsible for assessment and payment of a minor's tax, if there is no such person involved, e.g., in the case of a youthful employee, the tax may be collected directly from the young person even though he may, by law, avoid certain other types of debt. See, however, AGGREGATION, in respect of income settled on a minor by a parent as a tax-avoidance device.

**MOBILISATION OF RESOURCES** — A term often applied to the efforts of a government to raise revenue by various forms of taxation or by loans and other forms of saving by the public.

**MOINS-VALUES** — (Belgium and France) Capital losses.

**MOMS** — (Denmark) Value Added Tax.

**[to be continued]**

# CUMULATIVE INDEX 1979 ~ Nos. 1-5

# Compensation of Expatriates Transferred to Brazil

by Aleksas Juocys*

## I. INTRODUCTION

1. Companies that have Brazilian investments or interests usually send executives or technicians (if technology has been transferred) to the Brazilian companies with which they are associated. Before leaving their country to work on a foreign assignment these employees want an assurance that the salary they will receive abroad will be at least equivalent to the salary they earn in their own country, in addition to their travel expenses and their annual vacations.

2. In order to induce their employees to accept a transfer to another country, foreign companies thus assume the responsibility for all transfer formalities, from the sale or lease of the employee's house abroad and the obtainment of a passport, to the calculation of the expenses that will be reimbursed to him and of the tax he may have to pay in excess of the tax he normally paid in his own country.

3. For the purpose of establishing the entire scheme of compensation of an expatriate employee, foreign companies should have at least a general idea of the income tax implications of the transfer as regards the foreign company itself, the Brazilian company to which the employee is assigned and the employee himself.

## II. PASSPORT AND VISA TO ENTER BRAZIL

4. In view of the possible tax and other implications, the kind of visa with which the expatriate employee will enter Brazil should be carefully examined when planning the transfer. There are various kinds of visas: transit visa, tourist visa, temporary visa, permanent visa, official visa, diplomatic visa. Only the temporary and permanent visas are suitable for an expatriate employee as a tourist visa will not permit him to carry out any remunerated activity in Brazil and the other visas mentioned do not apply to an employee.

### A. The temporary visa

5. A temporary visa is normally granted to a foreigner who intends to spend a limited period of time in Brazil without transferring his residence. The temporary visa is thus suitable for trips made for purposes of education, business or to render technical services either under an agreement or on behalf of the Brazilian government. The temporary visa is usually valid for a period of 180 days, with an option to extend it for an equal period. By providing proper evidence it is, however, possible to obtain a temporary visa for the period of a course, of a service agreement or of an assignment to be carried out in Brazil.

6. Upon applying for a temporary visa, it is necessary to provide the following documents: (a) a passport or the equivalent; (b) a health certificate; (c) an international vaccination certificate; (d) evidence of means of support; (e) a criminal clearance certificate or equivalent at the discretion of the Brazilian consulate. Evidence of means of support can consist of an employment agreement endorsed by the Justice Department of the Brazilian Ministry of Justice, or of a written promise of work previously submitted to the National Labor Department of the Ministry of Labor and Social Security in Brazil.

### B. The permanent visa

7. The permanent visa is granted when a foreigner intends to transfer his residence to Brazil. The documents to be attached to the application are practically the same as required for the temporary visa. In the case of a permanent visa, however, there are certain immigration requirements for all countries except Portugal. These requirements vary according to the needs of Brazil at the time, preference being given to the professions that are not readily available on the Brazilian market. The easiest procedure to obtain a permanent visa, particularly in the case of employees sent by foreign companies to their Brazilian subsidiaries, is to draw up a written promise of work and to have it previously approved by the National Labor Department of the Brazilian Ministry of Labor and Social Security.

8. In some cases the Brazilian Consulate may, as evidence of means of support, accept the deposit of an amount of US$ 25,000 at the local agency of Banco do Brasil S.A. or at another foreign bank which has a Brazilian branch.

9. A foreigner who enters Brazil with a temporary visa can obtain a permanent residence permit without leaving Brazil, provided that he satisfies the conditions for obtaining a permanent visa. The application for such a permanent visa should be made at the Ministry of Justice in Brazil.

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## III. BAGGAGE BROUGHT TO BRAZIL

10. The baggage which the expatriate may bring to Brazil is limited to personal belongings in a quantity and of a quality that is not commercial, according to the values, quantities, conditions and periods established by applicable law. If the quantity or quality of the baggage suggests a commercial intent, import duty and the tax on manufactured products will be due, in addition to the legal sanctions.

11. The baggage which a foreigner may bring when entering Brazil with a temporary visa consists basically of the following. (a) clothing and linen; (b) jewelry and personal articles; (c) books and magazines; (d) other articles of own domestic or professional use. Souvenirs may be brought up to a limit of US$ 100 or the equivalent in another currency. Clearance is not given to any electric or electronic appliances brought in a passenger's luggage.

12. When entering Brazil on a permanent visa, a foreigner may bring immigration baggage without paying taxes. If the foreigner is not immigrating to Brazil for the first time, he will have to prove that he spent at least five years abroad in order to be able to bring immigration baggage. This baggage includes: furniture and other household articles, such as chinaware and kitchen appliances, a limit of one piece applying to objects worth more than US$ 100; animals, seeds and seedlings, professional tools, instruments, appliances and machines, small farming units and one tractor; used jeeps, trucks, bicycles, and motorcycles, limited to one of each per immigrating person or family and provided that they are in the ownership of the immigrant for more than six months prior to the date of departure from the country of origin. During the six months after arrival in Brazil, the immigrant enjoys exemption from the tax on manufactured products to purchase a Brazilian car, boat or aircraft, provided that payment is made with cruzeiro funds resulting from the conversion of foreign currency brought by the immigrant. Import duty exemption is attributed to such baggage only if accompanied by a complete list endorsed by the Brazilian Consulate abroad prior to the shipment. This baggage may not be transferred to other persons for a period of five years unless the other person is equally an immigrant and authorization has been obtained from the proper tax authority.

## IV. LEGAL REQUIREMENTS FOR PERMANENT RESIDENCE IN BRAZIL AND INCOME TAX

13. Upon arriving in Brazil with a temporary or permanent visa, the foreigner has a period of 15 days to go to the Federal Police Department to obtain an Identity Card for Foreigners. The foreigner must also enrol himself with the Individual Taxpayers Register (CPF) if he wants to carry out any transactions, such as buying a car or renting a house in his own name. If the foreigner intends to remain in Brazil for more than twelve months, the first return he files in Brazil to obtain his CPF enrollment should indicate all the property he owns. This return will give him exemption from Brazilian income tax as regards income derived from his personal or real property abroad, this exemption being maintained during the first five fiscal years of permanent residence in Brazil.

### A. Permanent residence in Brazil for less than twelve months

14. A foreigner who comes to Brazil on a temporary visa and who remains in the country for less than twelve months will not be considered a Brazilian resident for income tax purposes. Accordingly, all his foreign income will not be taxed in Brazil and the income he earns from Brazilian sources will be subject to the withholding of Brazilian income tax at the rate of 25 percent unless a lower tax rate is established in a double taxation treaty between Brazil and the foreigner's country of domicile.

### B. Permanent residence in Brazil for more than twelve months

15. A foreigner who remains in Brazil for more than twelve months, either on a temporary or a permanent visa, will be deemed to be a Brazilian resident for income tax purposes as from the twelfth month or permanence in Brazil. Consequently, all the foreigner's income including both that earned abroad (except in the income derived from foreign property as mentioned in paragraph 13 above) and that earned in Brazil will have to be included in the annual income tax return that the foreigner is obliged to file in Brazil. The income received from Brazilian sources will thus be taxed at the normal rate applied to all Brazilian residents. If the foreigner receives Brazilian source employment income, his salary will be subject to the withholding of income tax at the following rates (valid for 1978);

| Net monthly income (in Cr$) | | | | Income tax rate (%) | Deduction (in Cr$) |
|---|---|---|---|---|---|
| up to | | | 5,500 | exempt | — |
| from | 5,501 | to | 6,200 | 5 | 275 |
| from | 6,201 | to | 8,100 | 8 | 461 |
| from | 8,101 | to | 11,500 | 10 | 623 |
| from | 11,501 | to | 15,500 | 12 | 853 |
| from | 15,501 | to | 21,600 | 16 | 1,473 |
| from | 21,601 | to | 33,700 | 20 | 2,337 |
| from | 33,701 | to | 54,000 | 25 | 4,022 |
| above | | | 54,000 | 30 | 6,722 |

The amount of tax to be withheld by the paying agency is determined by multiplying the salary paid by the applicable tax rate and then deducting the amount given under "deduction". For example, if in a given month the employee receives a net monthly salary of Cr$ 25,000 after the deductions permitted by law, the income tax withheld at source will be Cr$ 25,000 x 20% = Cr$ 5,000 — Cr$ 2,337 = Cr$ 2,663. The amount of income tax withheld at source will thus be Cr$ 2,663. The amount of tax thus withheld represents an advance on the income tax due according to the annual income tax return filed by the Brazilian resident, the amount withheld at source enjoying monetary correction.

### C. Permanent visa

16. Foreigners who come to Brazil on a permanent visa are immediately considered resident and domiciled in Brazil for all legal and tax effects. Such foreigners should therefore obtain their CPF (Individual Taxpayers Register) enrollment shortly after arrival, by declaring all the property they own, including their foreign property and pertinent income, so as to qualify for the five-year tax exemption given for their foreign-source income during the first five financial years of permanent residence in Brazil (see last part of paragraph 13 above).

17. The income which the foreigner may receive abroad and which is not derived from real or personal property owned there will, however, have to be included in the annual income tax return filed in Brazil for purposes of Brazilian taxation. The net income reflected in the annual income tax return, after all applicable deductions and abatements for medical, dental and educational expenses and for dependents, is taxed at the following progressive rates (valid for 1978):

| Net annual income bracket (in Cr$) | | | Tax rate (%) | Deduction (in Cr$) |
|---|---|---|---|---|
| up to | | 47,300 | exempt | — |
| from 47,301 | to | 55,500 | 4 | 1,892 |
| from 55,501 | to | 66,400 | 6 | 3,002 |
| from 66,401 | to | 80,100 | 9 | 4,994 |
| from 80,101 | to | 95,500 | 12 | 7,397 |
| from 95,501 | to | 115,600 | 15 | 10,262 |
| from 115,601 | to | 140,100 | 19 | 14,886 |
| from 140,101 | to | 169,300 | 23 | 20,490 |
| from 169,301 | to | 203,800 | 27 | 27,262 |
| from 203,801 | to | 244,800 | 31 | 35,414 |
| from 244,801 | to | 297,600 | 35 | 45,206 |
| from 297,601 | to | 358,500 | 39 | 57,110 |
| from 358,501 | to | 433,200 | 42 | 67,865 |
| from 433,201 | to | 564,200 | 45 | 80,861 |
| from 564,201 | to | 910,000 | 48 | 97,787 |
| above | | 910,000 | 50 | 115,987 |

The amount of tax payable is calculated by miltiplying the net income by the applicable tax rate and deducting the amount indicated under "deduction". Accordingly, if the net annual income is Cr$ 390,000, the income tax due will be Cr$ 390,000 x 42% = Cr$ 163,800 - Cr$ 67,865 = Cr$ 95,935. The income tax due will thus be Cr$ 95,935 with the deduction, if applicable, of the income tax already withheld at source (see last part of paragraph 15).

18. Upon determining the net income that is subject to the withholding of income tax at source (see paragraph 15), the following deductions may generally be made: (a) family support (Cr$ 900 per dependent in the year 1978); (b) contributions to retirement and pension funds; (c) union contributions; (d) alimony paid under a court decision. The following are also excluded from the net income: severance and prior notice pay in cash upon dismissal, within the limits provided by law; sickness allowance and work accident allowance; medical, hospital and dental service maintained by the company; free meals; free transportation, per diem and cost allowances paid to reimburse travel expenses and the expenses of transferring the taxpayer and his family to a place other than that of his former residence.

19. Foreigners who receive income abroad subject to foreign taxation are entitled to credit the foreign tax against the Brazilian income tax they owe according to their income tax return, provided that the foreign country offers the same treatment to Brazilians who live there and receive Brazil-source income. This deduction may, however, not exceed the Brazilian income tax that would be due if the foreign income had not been included.

## V. TAX TREATMENT OF COMPENSATION AND BENEFITS PAID TO THE EXPATRIATE

20. As mentioned, multinational companies seek to compensate the employees they transfer abroad with several fringe benefits in the form of cash, goods, or services, to assure these employees at least the same net earnings that they would have in their own country. In this sense, expatriate employees receive not only full coverage or reimbursement of their moving expenses, but also the travel fares and support in leasing or selling the home or property they may have in their country of origin, payment of courses to learn the language of the country to which they are transferred, the rent of the new home, a car, the school expenses of the children, compensation for taxes, annual vacations with the family, etc. These benefits vary from company to company and depend on the category of employee involved.

### A. Deductibility of costs

21. All these benefits represent an additional cost for the company abroad and the matter should therefore be carefully examined, particularly as regards the deductibility from the income taxable in the foreign country and the tax treatment afforded in the country to which the employee is transferred. The deductibility of the cost abroad probably depends on the nature of the transfer and on how the country of origin treats income derived from a foreign branch or subsidiary. If the legislation of the country in which the company is established provides for consolidated balance sheets of all the companies of the group, both local and abroad, permission may possibly be granted for the deduction of all the transfer expenses. Otherwise, this permission is probably not granted as the employee will be incurring all the expenses to become the employee of another company in another country, this representing an increase of the burden of transferring an employee abroad.

22. In the specific case of Brazil, Brazilian legislation and authorities consider the foreign and the Brazilian company as entirely independent for income tax purposes, even in the case of a Brazilian branch of a foreign company. Consequently, the expenditure made by the foreign company to assign an employee to a Brazilian branch or subsidiary cannot be deducted as an expense of the Brazilian enterprise (not even if it is a branch) and its amount can equally not be remitted abroad. The same will apply to the amounts paid to the employee by the foreign company while he is working for the Brazilian company, except in a few special cases with the authorization of the National Institute of Industrial Prop-

erty and of the Central Bank of Brazil. Therefore, except in these special authorized cases of transfer of technology, the expenses or salaries paid by the foreign company to the employee assigned to the Brazilian company may not be charged to the latter, as the Brazilian company cannot deduct them for income tax purposes nor remit them abroad. It is thus preferable for the expenses to be made directly by the Brazilian company, which will then be able to deduct them provided that they are essential to the transfer of the foreign employee and that such transfer is necessary for the development and maintenance of the source of income of the Brazilian company. Under this procedure, it is possible that some of the payments will not be taxed in the hands of the employee, such as the reimbursement of the moving expenses, travel fares, and some other items.

23. When the expatriate employee begins working in the Brazilian company, the foreign company usually also maintains all the benefits that the employee would enjoy if he had not been transferred, particularly as regards salary differences, incoeme tax, stock option plans, educational allowance, etc. This maintenance also gives rise to serious difficulties in connection with Brazilian income tax, as the Brazilian company cannot pay nor reimburse these expenses to the foreign company nor deduct them from its taxable income. The impossibility of remitting the amount of such expenses abroad is imposed by the Central Bank of Brazil. The situation is delicate since the income tax legislation of the country in which the foreign company is established probably also forbids this deduction on the grounds that the expatriate employee is no longer working directly for the foreign company. The situation becomes even more complicated when consideration is given to the fact that these expenses are usually also taxed in the annual income return that the employee is obliged to file in Brazil.

### B. Labor law

24. Under Brazilian labor law, upon dismissal or otherwise an employee can claim that the benefits he received are a part of his salary. This claim may also include the benefits paid to him by the foreign company as well as the period of service he worked for the foreign company on the grounds that he is the employee of a group of companies to which the Brazilian branch or subsidiary belongs.

### C. Alternatives

25. In spite of all these disadvantages some foreign companies continue to offer all these benefits as a means of inducing their employees to accept a transfer to another country. Other companies, however, seek to pass all these expenses to the Brazilian company where they can be deducted from the taxable income of the Brazilian company if due under a formal employment agreement and where in some cases they are not even taxed in the hands of the employee. In this respect it is important to note that the remuneration of directors and managers of Brazilian companies may be treated as an operational expense only up to the limit of Cr$ 38,500 (in the year 1978) per month per director, up to a maximum of seven directors. The remuneration of employees and directors of Brazilian companies normally includes all fringe benefits, such as rent, educational allowance, vacation travel, etc. Some fringe benefits are not deemed to be a part of the remuneration, such as the use of a company car, membership of a club in the name of the company, free meals, hospital and medical assistance, provided however that such assistance is granted to all employees.

26. Some foreign companies attempt to minimize the burden by deferring the payment of the benefits either directly or through trusts until the expatriate employee returns to his country of origin or through loans granted to the expatriate employee abroad. If the company has a stock option plan, the expatriate employee may acquire shares against future payment or payment after the exercise of the option and sale of the shares.

### D. Stock option plan

27. Stock option plans should be examined as regards the implications of Brazilian legislation. The strict exchange control existing in Brazil does not permit an employee to remit money abroad to contribute to a stock option plan, which can thus only be exercised with funds which the employee already has abroad or with advances or loans or with deferred payment. If the employee acquires stock with funds that he owns abroad, he should indicate in the annual estate return attached to his income tax return that these funds were used for such purpose. If the employee has no funds of his own abroad, the foreign company can either lend or advance the necessary sum to the employee or sell the shares against payment when sold by the employee. The expatriate employee can, however, also not remit the amount of such advance or loan abroad, as determined by the Central Bank of Brazil. Brazilian residents can only remit an amount of US$ 300 per month either to relatives or to support an individual abroad.

In the case of expatriate employees, the most practical manner of implementing a stock option plan is by permitting the employee to sell the shares and thus pay the option price with the proceeds of such sale. Any excess may be either credited or remitted to the expatriate employee in Brazil. The excess will, however, represent a profit and will be subject to 25 percent income tax without any deductions or to progressive taxation in schedule "H" of the employee's annual income tax return. No tax will be levied if the shares are sold through a stock exchange or only five years after the date of their acquisition.

### E. Taxation of an individual's income

28. In Brazil the income of an individual is taxed upon receipt or when legally available to the individual. Accordingly, future income attributed to an expatriate employee while in Brazil is not legally available to him and is thus not taxed in his income tax return. This applies to income that will only be made available to or received by the employee when he returns to his country of origin, even if such payment is made directly by the foreign company or through a trust. A loan does not

represent income and is thus equally not taxed in Brazil, although it is not deductible for taxation purposes. The interest paid on such a loan is deductible if duly evidenced and limited to an amount of Cr$ 10,000 (for the year 1978), as in the case of interest paid for bank or other loans taken in Brazil. This understanding is, however, a point of discussion as the loan granted to the employee abroad is not recognized nor registered by the Central Bank of Brazil and it is thus not possible to remit the principal and interest abroad. The principal and interest of the loan may thus only be paid with funds that the employee owns or receives abroad.

## VI. RETURN OF EXPATRIATE EMPLOYEE TO HIS COUNTRY OF ORIGIN

29. If the expatriate employee came to Brazil on a temporary visa and remained in Brazil for less than twelve months, he will not have any income tax problems upon returning to his country of origin, as Brazilian tax, if due, will already have been withheld at the source by the paying agency.

30. If the expatriate employee came on a temporary visa but stayed in Brazil for more than twelve months and intends to leave the country definitely, he will have to file an income tax return covering the period until the date of his application for the certificate of income tax clearance, in order to obtain the exit visa in his passport.

31. This requirement also applies to foreigners who entered the country with a permanent visa, even if they remained in Brazil for less than twelve months, when they leave the country on a definite basis.

32. When the expatriate employee leaves Brazil definitely, he can obtain Central Bank of Brazil authorization to convert his cruzeiro savings into foreign currency at the official exchange rate, provided that he can prove the origin of his savings, particularly by means of his annual income tax returns.

# THAILAND: Business tax replaces capital gains tax on private share transactions

**(follow-up on Recent Tax Changes in Thailand, Bulletin, November 1978 issue)**

The short term capital gains tax of 10 percent introduced as of May 1, 1978 has been replaced by a new business tax on private share trading transactions as of July 26, 1978. The business tax is levied at a rate of 0.1 percent, plus a municipal surtax of 0.01 percent on the gross proceeds from sales regardless of whether the seller is making a capital gain or not.

The business tax must be deducted at source by Members of the Securities Exchange of Thailand (SET) and they are obliged to remit the amount to the Government on the 15th of the following month. Certain transactions are exempt, i.e. sales of Unit Trust certificates, government bonds and state organization bonds.

The new business tax was introduced under the Act amending the Revenue Code (No. 23) B.E. 2521 (1978) and has been published in the Government Gazette Volume 95, Part 74, dated July 25, 1978.

The volume of shares traded on the Securities Exchange of Thailand took a deep plunge in April 1978 after having reached record heights during 1977, which is illustrated by the accompanying Table.

Turnover of private share trading in the Securities Exchange of Thailand

(Million Baht)

| | 1976 | 1977 | 1978 |
|---|---|---|---|
| January | 69.6 | 167.0 | 3,453.9 |
| February | 63.9 | 198.1 | 3,038.4 |
| March | 104.5 | 471.4 | 2,231.0 |
| April | 106.0 | 1,230.7 | 1,661.1 |
| May | 61.5 | 475.8 | 1,712.8 |
| June | 113.5 | 917.4 | 1,480.6 |
| Sub-Total | 519.0 | 3,460.4 | 13,577.8 |
| July | 63.0 | 1.655.7 | – |
| August | 91.9 | 3,779.7 | – |
| September | 78.7 | 2,721.2 | – |
| October | 79.9 | 5,661.6 | – |
| November | 86.9 | 7,027.2 | – |
| December | 74.3 | 1,975.4 | – |
| Grand Total | 993.7 | 26,281.2 | 13,577.8 |

Source: Securities Exchange of Thailand.

One of the reasons was the Announcement Number 10 of the Revolutionary Party which authorized the Revenue Department to levy a 10 percent capital gains tax on capital gains arising from trading shares between May 1, 1978 and December 31, 1979 if the shares were traded within 6 months of their acquisition.

To make matters worse, the authorities failed to issue clear-cut regulations before and even after the introduction of the short term capital gains tax. In addition, the discovery of fake share certificate receipts, share certificates and transfer forms further rocked the shaky confidence of investors in the early stages of development of a stock market such as the Securities Exchange of Thailand is.

It was expected that the new business tax will improve the stock market condition and provide more confidence to investors who want shares of companies in Thailand.

The news of the passage of the new business tax on stock trading by the National Legislative Assembly on July 14, 1978 might have provided such stimulus in the stock market as turnover jumped from an average 19 million Baht for the first four days (Monday to Thursday) to 62 million Baht on the final day of the 28th week, according to daily reports prepared by the International Trust and Finance Company Limited.

ARTHUR J. MANN*:

# The New Tax Exemption Law in Puerto Rico

## I. INTRODUCTION: HISTORY OF TAX INCENTIVES

*On June 2, 1978 a new Puerto Rico Industrial Incentives Act (Act No. 26) went into effect. This piece of legislation substantially modifies the tax legislation that has underlain Puerto Rico's economic development policy for the past three decades. The principal change deals with the elimination of total tax exemption, offering hereafter partial (and declining) tax exemption for periods of from ten to 25 years.*

Before looking at the major provisions of the new tax exemption law, a brief glance at the history of tax incentives in Puerto Rico may perhaps aid in placing the 1978 law in a more appropriate historical perspective. Industrial tax exemption laws had been passed in 1919, 1925, 1930, and 1936. However, they had little effect in attracting new capital investment since, among other factors, they did not offer exemption from income taxes and applied only to the first established firm in a given industry.

A tax exemption act approved in 1947 gave total exemption from income, property, and municipal taxes for a maximum period of 12 years, with the possibility of obtaining an additional partial three-year exemption. This law was soon replaced by Law 184 of 1948, which extended the 1947 tax exemptions to dividends received from tax exempt enterprises. However, the 1948 law was to expire by 1962, thereby reducing the attractiveness of tax exemption as time passed.

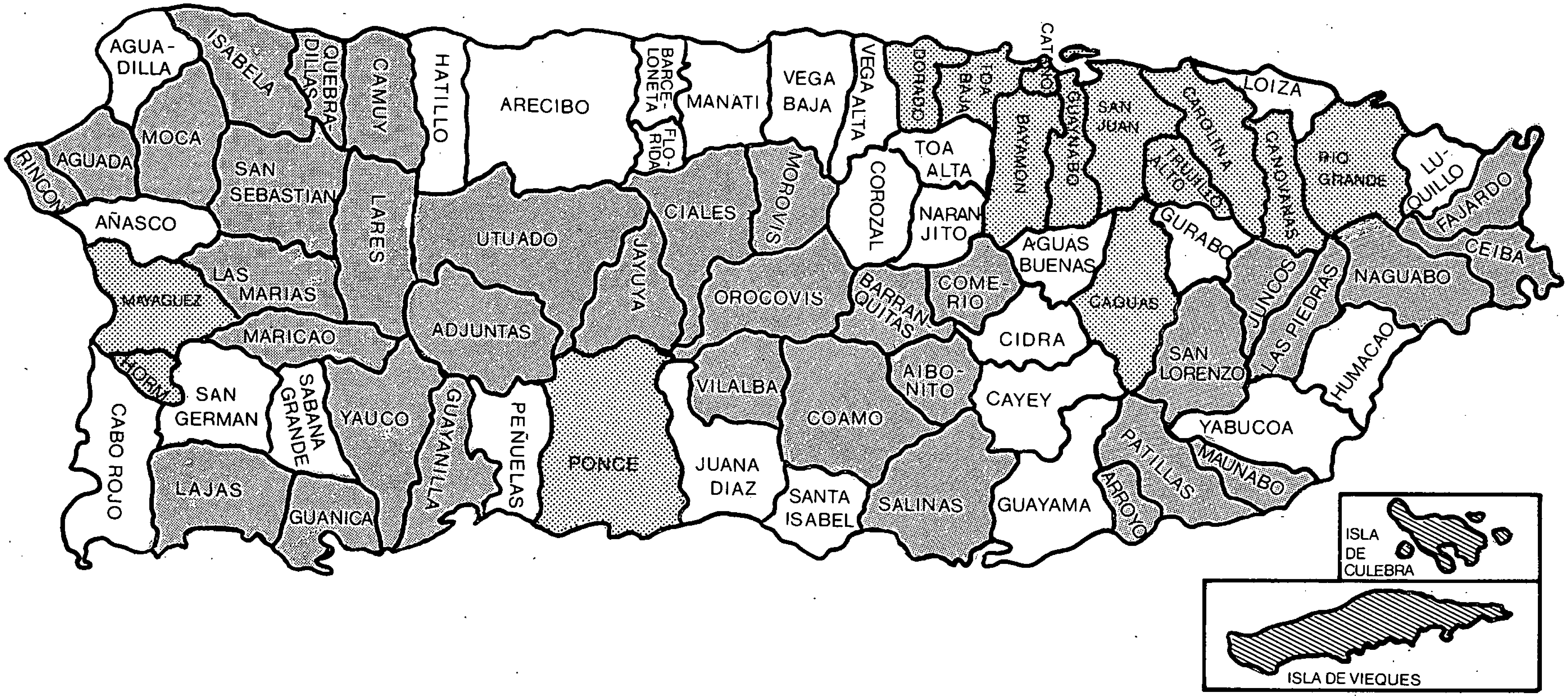
In 1954 legislation was passed which extended total tax exemption for a period of ten years from the date of the beginning of operations of an industrial establishment. Furthermore, dividends from tax exempt firms were exempted from personal income taxes for seven years, and no property taxes were to be paid for five years on machinery and equipment valued at less than $ 1,000,000. Tax exemption as a basis for maintaining high rates of economic growth was extended as official public policy under Law 57 of 1963. In addition to maintaining the fundamental concepts of the 1948 and 1954 laws, the 1963 legislation moved to decentralize industrial development, which had become concentrated around the San Juan metropolitan area (with smaller concentrations around the Mayaguez and Ponce areas). Total tax exemption (from income, property, and municipal levies) for ten years was given if a qualifying firm located in an area of high industrial development, for 12 years if located in a zone of intermediate industrial development, and for 17 years if located in an industrially underdeveloped region.

**Two periods may be distinguished:**
- **legislation adopted from 1919 through 1936 had little effect on economic development since no income tax exemptions were offered;**
- **starting with 1947 income tax exemptions in various forms were introduced which were remarkably successful in furthering Puerto Rico's economic growth.**

Until passage of the 1978 law, which supplants the 1963 legislation, the latter had been subject to 44 legislative amendments. For example, in an effort to further promote industrial decentralization, complete tax exemption by zone had been augmented to periods of 10, 15, 25, and 30 years. But there had always existed a reservoir of doubt regarding both the continued extension of tax exemption and the principle of a 100 percent tax holiday. For instance, the Puerto Rican Treasury Department was unable to collect more than $ 3,426,000,000 in tax revenue between 1948 and 1977 due to the tax holiday clauses. Of course, the massive inflow of new capital attracted by tax exemption may have more than compensated for such "losses" by generating expanded and higher tax bases for other imports. However, over the last decade more capital-intensive industries have been established. Such industries not only require expanded public infrastructure provision, but generate few jobs in an economy where the unemployment rate has, since 1974, hovered around the 20 percent mark. Furthermore, the problem of retaining a firm after its tax exemption period has expired has always been a difficulty facing policy-makers. It is with some of these problems that the new law attempts to grapple.

* Associate Professor of Economics, University of Puerto Rico in Mayaguez.

# PUERTO RICO: INDUSTRIAL TAX EXEMPTION ZONES




Puerto Rico was a Spanish colony for 400 years until it was ceded to the United States in 1898. Puerto Rico is now a self-governing "Commonwealth" associated with the United States but which has its own Constitution. In 1952 it acquired the right to elect its own Governor. The executive power is vested in the Governor and a Cabinet of fourteen Secretaries. There is a bicameral Legislative Assembly consisting of a Senate of 27 members and a House of Representatives of 51 members. Puerto Rico is represented by a Resident Commissioner in the U.S. House of Representatives but he does not possess full voting rights. Citizens of Puerto Rico have the status of U.S. citizens.

10 years — High Industrial Development Zones

15 years — Intermediate Industrial Development Zones

20 years — Low Industrial Development Zones

25 years — Vieques and Culebra

In concluding these introductory remarks, in retrospect the overall policy of tax exemption has been a resounding success in Puerto Rico in terms of the economic growth objective. Between 1947 and 1977 per capita personal income in terms of constant (1954) dollars rose from $ 295 to $ 1,113; constant dollar gross product rose at an annual rate of 5.6 percent; total employment in manufacturing rose from around 50,000 (net of employment in the now defunct home needlework sector) to 144,000, and total employment in all sectors increased from 572,000 to 739,000 (figures which, of course, belie extensive compositional changes in the labor force). Admittedly, the existence of tax holiday provisions represented only one of the many variables in the overall growth equation, and many problems remain (e.g., unemployment).

## II. THE PUERTO RICO INDUSTRIAL INCENTIVES ACT OF 1978:[1] AN OVERVIEW [2]

Total tax exemption has been eliminated. For those firms that qualify, partial exemption grants are offered that cover from ten to 25 years, depending upon the region in which the enterprise is established. The overall exemption periods are divided into five-year subperiods, with declining tax exemption rates of 90 percent, 75 percent, 65 percent, 55 percent, and 50 percent being applied at each five-year interval. As under the 1963 legislation, a partial tax exemption period of ten years applies to firms that locate in High Industrial Development zones, of 15 years to those locating in Intermediate Industrial Development zones, of 20 years to those situating in Low Industrial Development zones, and of 25 years to those establishing operations in the island municipalities of Vieques and Culebra. As previously, all partial exemptions are valid with regard to income and property taxes.

### Small enterprises

In order specifically to aid smaller enterprises and to soften the fiscal impact of partial exemption, total tax exemption is given to the first $ 100,000 of net income of those exempted enterprises whose net income is less than $ 500,000 these same businesses are also exempted from real and personal property taxes for the first $ 100,000 of the assessed property value.

### Service industries

For the first time, certain types of service industries may qualify for partial tax exemption. In the past, exemption had applied only to manufacturing establishments and certain hotels. To be eligible, a service-producing firm (i) must completely market its services outside of Puerto Rico, (ii) 80 percent of its employees must be residents of the island and work more than 20 hours per week, (iii) at least 80 percent of invoice value must be generated domestically, and (iv) the services must not be utilized even indirectly in Puerto Rico. Such a provision has employment-generating objectives (albeit quite limited), as does the provision permitting a tax deduction of five percent of the production payroll to those firms that meet given standards with respect to job creation (and at the same time receive partial tax exemption).

### Conversion to partial tax exemption

An important feature of the new law permits conversion to partial exemption of those tax exemption grants made under the prior 1963 law. By opting for partial exemption instead of full exemption, a firm is able to extend its (partial) tax exemption for up to ten years after the expiration of the original grant period. The firm which selects to convert will then receive 50 percent income tax exemption for the first five years and 35 percent, 40 percent, 45 percent, or 50 percent exemption during the ensuing five-year period according to the industrial development zone in which the enterprise is located. The tax exemption provision applicable to property and municipal taxes is at a 50 percent rate under the conversion clauses. A further benefit acquired under the conversion provisions is that of repatriation of exempt earnings accumulated prior to January 1, 1978, by paying a withholding, or tollgate, tax of 4 percent (which, under certain conditions, generates a carry-forward credit).

Those firms operating in the textile, clothing, leather, and shoe industries whose tax exemption grant expires between 1978 and 1982 are permitted to extend their tax exemption grants for five additional years at 90 percent income tax exemption; their previous exemptions with respect to property and municipal taxes are also extended, subject to the condition that the firm not reduce its annual production or employment by 20 percent or more in comparison to the preceding three-year period. The intent of this provision is to further stimulate those firms which are relatively labor-intensive.

## III. PARTIAL TAX EXEMPTION UNDER THE 1978 ACT

As stated in Part II of this article, 100 percent exemption from certain taxes has been replaced by partial (and declining) tax exemption. With respect to taxes on "industrial development income" (defined below), the proportions of net taxable income exempt from payment of income taxes decrease over subperiods of five years in the following fashion:[3]

---

1. The official Spanish title of the law is "Ley de Incentivos Industriales de Puerto Rico de 1978." Appearing here is the official English title.
2. What is presented at this juncture and in subsequent Parts III—VI is merely a summary view of the principal aspects of the new legislation. This must be the case since the law is a very lengthy document. As a result, many details are necessarily omitted. Subsequent footnotes, which begin with Part III, permit the reader to refer to those sections of the law from which each summary part of this article is drawn.
3. Refer to Section 3(a).

| Subperiods | Exempt portion | Maximum effective tax rate * |
|---|---|---|
| 5 years and less | 90% | 4.5 |
| 6–10 years | 75% | 11.3 |
| 11–15 years | 65% | 15.8 |
| 16–20 years | 55% | 20.3 |
| 21–25 years | 50% | 22.5 |

* Assuming a 45 percent corporate income tax rate, the present maximum.

The first subperiod begins as of the date of commencement of operations and is determined jointly by the Secretary of the Treasury and the Economic Development Administrator. If a firm has already begun operations prior to filing the tax exemption application, the exemption period begins on the date the application was filed.

*Industrial development income* is defined as:[4]

1. An exempted firm's net income from operations declared exempt;
2. Eligible interest, rent, and dividend income derived from:
   a. obligations of the government of Puerto Rico, its instrumentalities, and political subdivisions;
   b. loans made or insured by the Housing Bank of Puerto Rico;
   c. mortgage loans or loans guaranteed by any agency or instrumentality of the governments of Puerto Rico and the United States made to finance housing construction, purchase, or improvement in Puerto Rico;
   d. loans for the construction, expansion, or purchase of land or industrial buildings and for the acquisition of machinery, equipment, and working capital used in the exempted enterprise;
   e. loans for financing the maritime operations of businesses serving Puerto Rico;
   f. loans executed by Puerto Rico's Development Bank, Industrial Development Company, Commercial Development Company, and instrumentalities and subdivisions of the island's government;
   g. loans or participations in such loans made to small businesses operating in Puerto Rico engaged in manufacturing, commerce, and services that are guaranteed by any agency or instrumentality of the governments of Puerto Rico and the United States;
   h. obligations issued by the Conservation Trust of Puerto Rico;
   i. capital notes issued under the Banking Law of Puerto Rico;
   j. real or personal property leased to the government of Puerto Rico or its instrumentalities and subdivisions;
   k. funds invested in non-redeemable preferred stock of banks organized under Puerto Rican laws;
   l. funds deposited for fixed terms by the exempted firm in commercial banks, savings and loan associations, and similar savings institutions doing business in Puerto Rico under determination by the Secretary of the Treasury that these deposits will serve to expand employment and income.
3. Dividends or benefits of a corporation or partnership which is a member of a tax exempt firm if distributed from income made in the two above-cited ways.

Although the new legislation only partially exempts industrial development income from taxes, income from those investments listed above under 2(a-l) remains totally exempt.

**Tax exemption period**

| | |
|---|---|
| High Industrial Development Zones | : 10 years |
| Intermediate Industrial Development Zones | : 15 years |
| Low Industrial Development Zones | : 20 years |
| Vieques and Culebra | : 25 years |

The duration of the partial tax exemption period, from ten to 25 years, depends upon the geographical area of the island in which the business locates.[5] These zones have already been generally defined in Part II above, and are determined by the Governor of Puerto Rico upon the recommendation of several agency heads. If later reclassification of zones is undertaken, the exemptions of firms already established in the area are not affected.

In the calculation of taxable income, those exempt firms engaged in manufacturing whose industrial development income during the taxable year does not exceed $ 500,000 are able to deduct the first $ 100,000 of income in the determination of taxable income under income tax statutes. However, if the firm elects to take the payroll deduction described in the following sentences, it is not permitted to take the $ 100,000 deduction from taxable income.

### Production payroll deduction

The production payroll deduction deals with another part of the new law that seeks to reduce the tax load caused by the elimination of total tax exemption. Under this provision a manufacturing firm may deduct from its pre-tax industrial development income five percent of its production payroll up to an amount not to exceed 50 percent of such income. The production payroll specifically excludes the salaries of executives, supervisors, and administrative personnel, and relates to those employees who receive wage and salary income directly linked to the productive activities of the business.[6]

### Exemption for central and municipal real property taxes

Partial tax exemption applies not only to income taxes but to central and municipal government real and per-

4. Refer to Section 2(a).
5. Refer to Section 3(d).
6. Refer to Section 3(a).

sonal property taxes[7] (income taxes are levied only by the central government). All the property of the exempted firms used in the development, organization, and operation of an enterprise is exempted from property taxes at the same percentages and for the same periods specified above (i.e., 90 percent exemption during the first five years, 75 percent exemption between and including the sixth and tenth years, etc.). Taxation commences upon the start of operations and not upon the beginning of construction, and the duration of partial exemption depends upon the designated industrial zone. Manufacturing enterprises are annually exempted from the payment of taxes on the first $ 100,000 of the assessed value of real and personal property; the duration of this latter provision also depends upon the industrial zone. All intangible personal property in the nature of patents, trademarks, or production licenses used by the exempt firm in its operations is totally exempt from personal property taxes. Finally, with regard to municipal taxes (principally gross receipts levies), total exemption is granted for the periods that vary according to industrial zone.[8]

### Extension to service industries

The 1978 law extends partial tax exemption to service units in such areas as investment banking, insurance, advertising, cinematography, news syndication, computer and consulting services, public relations, repairs, and packaging.[9] The concept of a tax exempt service unit is quite flexible, and additional firms producing services for export may be designated by the Governor upon receipt of a favorable recommendation from the Secretary of the Treasury and the Economic Development Administrator. The principal criteria to be taken into account are external demand for such services, the service firm's domestic job-creating potential, and its total payroll. However, as noted in Part II of this article, the service producing firm must meet rather stiff requirements to obtain tax exempt status, for it must produce exclusively for markets outside Puerto Rico but generate from sources within the island at least four fifths of the value of the services billed.[10]

**Tax exemption period for service units**

| | |
|---|---|
| High Industrial Development Zone | :10 years |
| Intermediate Industrial Development Zone | : 15 years |
| Low Industrial Development Zone | :15 years |
| Vieques and Culebra | :20 years |

Only a maximum of 50 percent of the industrial development income and assessed property value of service units is exempt from income and property levies respectively;[11] the municipal tax exemptions are the same as those authorized to manufacturing concerns. The duration of the partially tax exempt period varies slightly from that granted to manufacturing enterprises. An exempted service unit established in a High Industrial Development zone receives ten years of exemption, but receives only 15 years of exemption if located in both an Intermediate Industrial Development and a Low Industrial Development zone; 20 years of exemption is granted for establishment in Vieques and Culebra. These same rates and periods of partial tax exempt duration are also granted to special, scientific, educational, and recreational facilities.

## IV. THE CONVERSION OPTION TO PARTIAL TAX EXEMPTION [12]

Those business firms that, as of January 1, 1978, were receiving tax exemption grants under previous legislation, are able to exercise the option to convert such grants to the provisions of the new law. The conversion application must be made by December 31, 1978. By accepting partial taxation under this option, the firm receives a partial tax exemption grant extension for ten years (see Part V below). The proportions of industrial development income which are taxable upon conversion vary according to the number of years remaining on the original grant, and are as follows:

| Remaining term of converted grant | Percent of industrial development income exempt | Maximum effective tax rate * |
|---|---|---|
| 4 years or less | 73.3 | 12.0 |
| 4 – 8 years | 77.7 | 10.0 |
| 8 –12 years | 85.5 | 6.5 |
| 12–16 years | 90.0 | 4.5 |
| 16–20 years | 91.0 | 4.1 |
| more than 20 years | 93.3 | 3.0 |

* Assuming a 45 percent corporate income tax rate, the present maximum.

Property and municipal taxes are not affected by the conversion feature, and continue to be paid at the percentages stipulated in the original grant.

If the firm which applies for the conversion option has more than six years remaining on its original grant, it may choose to be partially taxed on only ten percent of its industrial development income. Moreover, it receives a right to carry over as a credit in future tax years an amount equal to two thirds of the net income tax bill it pays under this alternative provision. However, by selecting this alternative the firm loses its vested rights to request the partial tax exemption extension for ten additional years.

### Preferential treatment for accumulated earnings

The firm selecting the conversion option also receives preferential treatment with respect to its accumulated

7. Refer to Section 3(b).
8. Refer to Section 3(c).
9. Refer to Section 2(o).
10. Refer to Section 2(q).
11. Refer to Section 3(o).
12. Refer to Section 3(i).

earnings. Those earnings accumulated *prior to January 1, 1973*, may be distributed over a two-year period (50 percent per year) upon payment of a four percent withholding, or tollgate, tax (as opposed to a maximum ten percent rate). Not less than 50 percent of those distributed earnings (net industrial development income) accumulated *between 1973 and 1978* must be invested in Puerto Rico in specific areas during a five year period in order that the firm may qualify for payment of the reduced four percent tollgate tax. These investment areas include additional structures and equipment of the firm itself, the principal balance of any debt incurred by the firm for the acquisition of equipment or property to be used in industrial development, and in those investments which generate interest, rental, and dividend income as listed in Part III of this article. The remaining earnings can be repatriated in five annual installments (i.e., ten percent per annum). In addition, half of the reinvested earnings accumulated during this latter five-year period may be distributed (or repatriated) after the fifth year upon payment of the four percent tollgate tax.

The firm that selects the conversion option earns the right to carry over as a tax credit in future tax years an amount equal to the sum it pays as the four percent tollgate tax. However, the credit cannot exceed one half of the obligation in a given tax year. Upon liquidation, these firms become exempt from the four percent tollgate tax on earnings accumulated prior to January 1, 1978.

## V. THE EXTENSION OF PARTIAL TAX EXEMPTION [13]

In order to reduce the number of firms that cease operations after their tax exemption grant has terminated, those firms that elect the conversion option automatically receive an extension of their tax exemption grants for an additional ten-year period; grants under the new law may also receive the extension, but in their case there arises no acquired right. Service and special facility firms also qualify for the extension, but only for a span of five years. The percentage exemptions applicable to industrial development income are equal to 50 percent during the first five years and vary according to the industrial development zone in which the firm is located during the latter five years. The following schedule sets out these percentages:

| Zone | Percentage Exemption | |
|---|---|---|
| | Years 1–5 | Years 6–10 |
| High Industrial Development | 50 | 35 |
| Intermediate Industrial Development | 50 | 40 |
| Low Industrial Development | 50 | 45 |
| Vieques and Culebra | 50 | 50 |

During the same ten-year extension period, a 50 percent exemption from property and municipal taxes is also granted. All such extension-related exemptions are contingent upon the condition that the firm not reduce by more than 20 percent its annual production, operations, or employment in comparison with the averages for these variables in the three-year period preceding the date of request for extension. However, such conditions may be waived under extraordinary circumstances.

## VI. ADDITIONAL ASPECTS

Those persons receiving dividends or profits distributed by an exempt firm from its after-tax accumulated net income are exempt from the payment of the individual income tax in the same proportions in which the industrial development income is exempt from taxes. [14] This is contingent upon the accumulated net income having been invested and maintained for at least five years in those areas of investment specified above in Part IV pertinent to earnings accumulated between 1973 and 1978 (so that the firm may qualify for the reduced four percent tollgate tax). Those persons who qualify for such treatment must either be (i) residents of Puerto Rico or (ii) non-residents who bear no tax obligation in their country of residence; non-residents who may *not* take (or only partially take) the Puerto Rican tax as a deduction or tax credit from dividend distributions in their own country also qualify. In the case of a non-Puerto Rican corporate stockholder, such distributions are generally subject to a ten percent tollgate tax. However, these distributions may receive a credit of 50 percent of the tax if the exempted firm meets the criteria of investing and maintaining not less than 50 percent of its net industrial development income for not less than five years in specified investments (again refer to the third paragraph of Part IV of this article).

A tax exemption grant or stock in an exempt firm may be transferred only by written approval of the Governor of Puerto Rico (such approval may be made retroactively under extraordinary circumstances). If such a transfer is made without approval, tax exemption may be forfeited, although certain types of transfers are permitted without prior consent. [15]

That income received by individuals generated by the complete liquidation [16] of a tax exempt firm is not generally subject to Puerto Rican taxes, conditioned upon compliance with the investment criteria set forth in Part IV. Subject to a four percent tax under the new law are liquidating distributions paid to U.S. parent companies (except for pre-1978 accumulations in the case of a conversion).

A successor firm (i.e., a firm that applies for tax exemption to pursue an economic activity similar to that of a predecessor exempted firm) may receive a tax exemption grant provided that: [17]

(a) the predecessor has not ceased operations for more than six consecutive months prior to or after the filing of the application;

13. Refer to Section 3(m).
14. Refer to Section 4.
15. Refer to Section 5.
16. Refer to Section 6.
17. Refer to Section 7.

(b) the predecessor maintains its average annual production and employment for the last three taxable years terminating with the clause of the taxable year preceding the filing of the application;
(c) the average annual employment of the successor is more than 25 percent of that of the predecessor;
(d) the successor does not use the predecessor's physical facilities; additions to physical facilities may be exempt from this clause upon Executive determination.

There is, however, a great deal of flexibility incorporated into this section of the law, and non-compliance with the above-listed provisions does not, under reasonable circumstances, prevent the successor business from gaining tax exempt status.

Applications for tax exemption may be refused on such broad grounds as conflicting with public interest, not benefiting the people of Puerto Rico, or creating "unfair" competition with products of ineligible (for tax exemption) businesses.[18] The principal eligibility criterion continues to be the production on a commercial scale of a manufactured product not produced on a commercial scale in Puerto Rico prior to January 1, 1947. Revocation of a tax exemption grant can be made when the grantee fails to comply with the obligations imposed by the legislation. In the case of a grant obtained through false or fraudulent representation, all previously reported net income (distributed or undistributed) is subject to regular taxation.

As under previous tax exemption legislation, the agency directly in charge of carrying out the provisions of the law is the Puerto Rican Industrial Tax Exemption Office. The Director is appointed by and responsible to the Governor. Applications for and hearings on tax exemption are administered by this Office. Nevertheless, the overall process of grant approval entails analysis of the application and its economic effects by several concerned governmental agencies.[19]

As pointed out in the Introduction to this article, this new piece of legislation took effect on June 2, 1978. Applications for tax exemption grants under the Act are to be received until June 30, 1988.[20]

18. Refer to Section 9.
19. Refer to Section 10.
20. Refer to Section 15.

# UNITED STATES: Survey of the federal income tax rates

## CORPORATIONS

### Income tax

| | |
|---|---|
| On the first $25,000 of profits | 17 percent |
| on the next $25,000 of profits | 20 percent |
| on the next $25,000 of profits | 30 percent |
| on the next $25,000 of profits | 40 percent |
| on profits in excess of $100,000 | 46 percent |

(plus State income tax)

### Minimum tax on tax preferences

(this does not apply to tax option corporations and personal holding companies)

15 percent of the difference between the total of tax preference items (e.g. certain accelerated depreciation rates, depletion etc.) and the regular income tax or — if the regular income tax amounts to less than $10,000 — $10,000.
The minimum tax is levied in addition to the income tax.

## INDIVIDUALS

### Income tax

1. *Married individuals* filing joint returns and surviving spouses:

| On that part of income between | | tax in % |
|---|---|---|
| $ 0 | $ 3,400 | 0 |
| $ 3,400 | $ 5,500 | 14 |
| $ 5,500 | $ 7,600 | 16 |
| $ 7,600 | $ 11,900 | 18 |
| $ 11,900 | $ 16,000 | 21 |
| $ 16,000 | $ 20,200 | 24 |
| $ 20,200 | $ 24,600 | 28 |
| $ 24,600 | $ 29,900 | 32 |
| $ 29,900 | $ 35,200 | 37 |
| $ 35,200 | $ 45,800 | 43 |
| $ 45,800 | $ 60,000 | 49 |
| $ 60,000 | $ 85,600 | 54 |
| $ 85,600 | $109,400 | 59 |
| $109,400 | $162,400 | 64 |
| $162,400 | $215,400 | 68 |
| Over $215,400 | | 60 |

(plus State income tax)

2. *Married individuals* may file separate returns. In this case the income brackets are reduced by half, while the rates remain the same.

[to be continued on p. 33]

Y.C. Jao*:

# Hong Kong's New Tax on Offshore Banking Profits

*A new tax on the net profits arising from offshore transactions of banks and depository institutions that carry on business in Hong Kong, at the standard rate of 17 percent as for incorporated companies, has recently been introduced. The enabling legislation, the Inland Revenue (Amendment) Bill 1978, was passed on August 16, 1978 and took effect retroactively as from April 1, 1978. In view of Hong Kong's growing importance as a financial centre, particularly for the Asian-Pacific region, a short note on the background and significance of the tax is in order.*

## I. BACKGROUND

The tax has its origin in one of the recommendations of a tax reform committee appointed in 1976 and officially known as the Third Inland Revenue Ordinance Review Committee (hereinafter abbreviated as the Review Committee). A discussion of the main recommendations of the Review Committee by the present writer has appeared in a previous issue of this Bulletin. [1] Among the terms of reference of the Review Committee was to consider the territorial ambit of the various schedular taxes. The Review Committee's recommendation regarding the general territorial source principle of taxation, to which Hong Kong adheres, is worth quoting again, not only because of its obvious relevance and importance to the new tax now being discussed, but also for its unequivocal stand on a question that has given rise to much unnecessary misunderstanding and disputation: [2]

> *"In the circumstances, we have come to the conclusion that the broad principle of excluding profits and earnings received in Hong Kong but having their origin elsewhere should continue to operate. Although we have pointed out that the exclusion makes the ambit of the Inland Revenue Ordinance narrower than that of the income tax codes of many other territories, it can also be said that the rule of exempting particular types of income originating outside a country's borders is well recognised as a method of preventing the international double taxation which could otherwise create obstacles to world trade. For instance, France, the Netherlands and Switzerland do not impose tax on the profits earned through foreign branches by firms established in those countries. Again, the Netherlands, Switzerland and, in certain cases, Canada, do not charge resident companies in respect of the dividends they draw from overseas subsidiaries."*

Having reaffirmed the territorial source principle, the Review Committee then considered the detailed application of the principle to the individual categories of taxes in the light of changing commercial practices and case law that have developed during the last three decades. With regard to profits tax, the Review Committee recommended that, while there should be no general extension of the tax to profit made outside Hong Kong, there ought to be legislation taxing what it called the "intermediate category of profit" which accrues in the course of carrying on a trade or business in Hong Kong without the substantial intervention of any branch elsewhere. [3] The same principle of levying tax on such profits should, in the view of the Review Committee, also apply to net interest earned by banks and deposit-taking companies which operate in Hong Kong, collect deposits from the Hong Kong public, and redeposit such proceeds in overseas markets (such as the Euro-dollar market), or on-lend them to overseas borrowers. With regard to the important principle of where the source of any given interest is located, the Review Committee, in contrast to the prevailing tendency of the law courts to give preponderant consideration to the place where the original credit or loan is given (the so-called "provision of credit test"), came to the conclusion that the

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1. Y.C. Jao, Tax Reform and Fiscal Policy in Hong Kong, 32 *Bulletin for International Fiscal Documentation*, 175 (April 1977).
2. *Report of the Third Inland Revenue Ordinance Review Committee*, Hong Kong, 1977, para. 110.
3. The "branch" or "branch organisation" is defined to be identical to the concept of "permanent establishment" normally used in double taxation conventions.

economically valid test should be the place where the credit or loan proceeds are actually employed. In the words of the Review Committee,

> *"the purpose must be to subject to tax under the Inland Revenue Ordinance all significant flows of income which are the result of economic activity carried on in Hong Kong rather than elsewhere".* [4]

The Report of the Review Committee was published in early 1977. The Government of Hong Kong then appointed another working party of officials, chaired by the Financial Secretary, Mr. C.P. Haddon-Cave, to examine the recommendations of the Review Committee with regard to their economic and social implications as well as political and administrative feasibility. The working party eventually decided to reject the proposed general extension of the ambit of profits tax to the "intermediate category of profits" which a business actively carried on in Hong Kong obtains without the substantial intervention of any branch elsewhere. The working party also rejected the Review Committee's recommendation, in respect of interest income generally, that the territorial source criterion should be extended by ascribing a local origin to interest paid by a person carrying on a trade or business in Hong Kong on borrowed money employed or expended to produce assessable profits, not because it disagreed with the underlying rationale of the proposal, but because it thought the administrative problems associated with the proposal would be too complex to be acceptable. However, the working party agreed that the extension of the ambit of the profits tax to include interest earnings which a bank or depository institution actively carried on in Hong Kong obtains without the substantial intervention of a branch elsewhere can be achieved within the framework of the territorial source criterion. In the words of the Financial Secretary,

> *"the Government agrees with the Review Committee that it is a bank's organisation in Hong Kong, and the use to which that organisation is put to collect funds for lending, which are the source of its profits from interest. Thus, where such a business is carried on in Hong Kong, any resulting profits ought to be chargeable to tax here in the same way as commissions, fees and exchange profit dealings are charged at the present time. With the rapid expansion of offshore business, an increasing proportion of the profits of these institutions would otherwise escape tax. There is no justification for this in as much as these profits are, in effect, derived from economic activities carried on in Hong Kong."* [5]

## II. LEGISLATION

The amendments to the existing Inland Revenue Ordinance take the form of inserting definitions of a "bank" and "financial institution" in Section 2(1) and adding a new sub-section to the deeming section 15(1) of the principal Ordinance. The original version of this new sub-section sought to bring into charge: [6]

> *"Sums, not otherwise chargeable under this Part, received by or accrued to a bank or other financial institution by way of interest which arises directly or indirectly through or from the carrying on by the bank or other financial institution of its business in the Colony, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside the Colony."*

The publication of this proposed amendment Bill in March gave rise to strong oppositions from the banking and financial community. Some of the major criticisms of the Bill which were not accepted by the Government may be briefly noted.

The first objection is that the Bill violates the territorial source principle to which Hong Kong has traditionally adhered, under which only income arising in or derived from Hong Kong is chargeable to tax. As explained earlier, the Review Committee reaffirmed this principle, but sought to reinforce it by applying a more stringent test in respect of net profits from offshore transactions earned by banks and financial institutions. In the view of the Review Committee, it is a bank or depository institution's permanent establishment in Hong Kong, which enjoys and exploits the local infrastructure in collecting funds and on-lending them, that constitutes the source of its profits from interest. The allegation that the proposed extension of the profits tax ambit is inconsistent with the source principle is therefore invalid. To assuage the fears of the financial and business community, however, the Financial Secretary felt it necessary to reconfirm the Government's commitment to the territorial source concept. [7] Indeed, as shown earlier, the Review Committee went much further than the Government was prepared to go in extending the territorial source ambit to cover all "intermediate category of profits" and interest earned by non-bank entities.

It has been suggested by the legal profession that the existing loophole arising from sole reliance on the provision of credit test can in fact be plugged without an amending Bill, since the said test need not be the only determining factor influencing the decision of a court. The Government, however, has also rejected this suggestion on the ground that the credit test is well established in case law so that to ignore or challenge it would create an atmosphere of unacceptable uncertainty.

Another complaint by the opponents of the tax is that it is discriminatory against the financial institutions. They point out that when an individual or corporation places surplus funds abroad, the interest earnings therefrom are not taxable. The Government's explanation is that banks and depository financial institutions are uniquely different from other entities in that only they collect deposits from the public as a business. In the words of the Financial Secretary,

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4. *Ibid*, para. 100.
5. *The 1978-79 Budget Speech*, para. 173, March 1, 1978.
6. *Hong Kong Government Gazette*, Legal Supplement No. 3, March 3, 1978.
7. Speech by the Financial Secretary in the Second Reading Debate on the Inland Revenue (Amendment) Bill 1978, August 16, 1978, para. 7.

*"to the extent that the operations involved in their borrowing and lending transactions take place in Hong Kong, it is entirely logical that the profits from such transactions should be liable to Hong Kong tax."* [8]

The Government has long taken the view that banks and depository institutions are in a privileged tax position generally in that they enjoy an effective tax rate well below that paid by other incorporated entities. [9]

The financial community has also warned that imposition of the new tax at 17 percent would adversely affect Hong Kong's status as a financial centre, as banks and financial institutions affected by the tax might migrate to low-rate centres such as Singapore and Manila, where the corresponding rates on offshore banking profits are 10 and 5 percent respectively. The Government's counter-argument is that taxation is only one of the many determinants of a bank's or financial institution's choice of operating base. Hong Kong's other well-known advantages will, it is implied, more than outweigh the slight tax differential resulting from the new tax. The whole question is of course an empirical one, incapable of being proved or disproved on *a priori* grounds. We shall return to this point again later.

Finally, it has been suggested that, since a bank or financial institution is distinguished from other non-financial entities by its deposit-taking activity, the employment of its "shareholders' funds" overseas should be segregated and excluded from the incidence of the tax. This argument has also been rejected by the Government mainly on the ground that it is neither possible nor desirable to draw an artificial distinction between interest income derived from assets which are claimed to represent "shareholders' funds" and those which do not.

The Government did, however, agree to make a few minor concessions to its critics, in order to

*"minimise misunderstanding and reduce apprehension that the Bill is cast wider than was intended".* [10]

Firstly, a "financial institution", originally defined as "any person, other than a bank, who is carrying on in the Colony a business the principal activity, or one of the principal activities, of which is the borrowing and lending of money", has now been amended to mean "a bank licensed under the Banking Ordinance; a deposit-taking company registered under the Deposit-taking Companies Ordinance; and any associated corporation of a bank or deposit-taking company which itself carries on the business of taking deposits". Secondly, the words "directly or indirectly" in the newly added sub-section to the deeming section of the principal Ordinance have been deleted. Thirdly, a new clause has been inserted to ensure that the extension of the charge only affects the profits of licensed banks and registered deposit-taking companies for that part of the year of assessment in which they are so licensed or registered under their respective Ordinances. Finally, a new clause has also been inserted to provide for the deduction from profits brought into charge of any foreign tax already paid on those profits. This relief for double taxation, however, is restricted only to companies managed and controlled in Hong Kong, since companies managed and controlled elsewhere are likely to receive unilateral relief under their own domestic tax legislation.

## III. EVALUATION

In so far as the newly-introduced tax on net profits from offshore interest earnings of banks and financial institutions with permanent establishments in Hong Kong represents a reform measure designed to plug a loophole, the Government in general has a very strong case indeed, particularly as the said reform has been implemented within the framework of the territorial source principle. It has also been shown that the tax is not meant to discriminate against or penalise the financial sector, but rather to correct an anomalous situation whereby banks and financial institutions enjoy a lower effective tax rate than other non-financial concerns.

Most responsible critics would not dispute the principle that banks and depository financial institutions should share a fair and equitable part of the tax burden. Nevertheless, they are still unhappy over the fact that, despite some last-minute revisions, the Inland Revenue (Amendment) Bill of 1978 still leaves room for possible contention and litigation. In particular, they point out that the failure to incorporate the key phrase "without the substantial intervention of a branch elsewhere" used by the Review Committee means that there is still some uncertainty over the exact scope of the tax. [11]

Two important hypothetical situations can be cited to illustrate the general sense of uncertainty. How should offshore loans which are purely "garaged" in Hong Kong, in the sense that they are merely book-entries made in the accounts of a Hong Kong office, without the said office playing any active part, be treated? Again, in the case of those offshore loans where the Hong Kong office has only played a minor part, how should the tax liability be determined? The incorporation of the key phrase "without the intervention of a branch elsewhere" in a statutory form could have removed this uncertainty, or at least provided a tangible basis for argument. However, the Government's adamant refusal to do so means that each case must be judged on its "totality of circumstances" which in the critics' view is a poor substitute for clarity and precision.

The Government was also on less secure ground when it refused to consider the exemption of shareholders' funds from the new tax. Although the Review Committee did not specifically discuss the position of these

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8. *Ibid*, para. 11.
9. This was pointed out, for instance, by the Financial Secretary some five years ago. See *The 1973-74 Budget Speech*, para. 195.
10. Speech by the Financial Secretary in the Second Reading Debate on the Inland Revenue (Amendment) Bill 1978, para. 26.
11. The key phrase does appear in the explanatory memorandum of the Bill which however does not have any statutory force.

funds, it did stress the deposit-taking function of banks and financial institutions. Thus it argued that

> *"the basic situation is one in which the organisation which the bank possesses in Hong Kong is brought into existence and put to work for the purpose of collecting (as deposits) the very funds which are used for the purpose, amongst others, of entering into the transaction which gives rise to the receipt of interest"*

and concluded that

> *"the profits obtained in this way could not have been obtained but for the existence of the organisation through which the deposits are gathered in".* [12]

A strict interpretation of these passages would appear to favour the view that only deposit funds are the source of profits from interest earned on overseas loans or investments. There is some force in the argument that shareholders' funds of banks and depository financial institutions are analogous in principle to the investment overseas of funds by an individual or a corporation, interest on which is not taxable under the amended Ordinance. It is acknowledged that there are legal and accounting difficulties in segregating shareholders' funds from depositors' funds, but some banking experts have claimed that these difficulties are not insurmountable.

It remains to be seen whether the implementation of the tax would drive away business and adversely affect Hong Kong's position as a financial centre. Only the passage of time can enable one to draw up a balance sheet of quantifiable benefits and costs. Certain developments in recent months can be used as proximate indicators of the longer-run trends. Shortly after the Government announced its intention to introduce the new tax from the current fiscal year beginning April 1, it also liberalised its bank licensing policy with respect to foreign banks. [13] These banks will now be allowed to operate a single branch office in Hong Kong provided that they are incorporated in countries whose monetary authorities exercise effective supervision, that they have total assets, net of contra items, of not less than US $ 3,000 million, and that some form of reciprocity is available in their countries of incorporation to Hong Kong banks. Since the new banking policy was announced on March 15, 1978, twenty-one foreign banks have been issued full licences. This swift response on the part of foreign banks would seem to lend strong support to the claim that foreign banks are not too concerned with the implications of the new tax, and that Hong Kong's well-known advantages — low standard tax rate, liberal governmental policy towards private enterprise, absence of exchange control, stable social conditions, rapid economic growth, and, last but not least, proximity to China, a country which is embarking on a huge industrialisation programme and is reported to be willing to tap the credit facilities of foreign banks — easily outweigh any disadvantages that might arise from the new tax. On the other hand, outstanding offshore loans of the banking system, which had been growing rapidly before the announcement of the tax, appear to have peaked. Thus, after reaching a record high of HK$ 19,634 million in February, they began to level off and by the end of June had fallen to HK$ 16,749 million. It is not yet clear whether this reversal of trend represents only a temporary consolidation after years of phenomenal growth — about 72 percent per annum from December 1969 to February 1978 — or a calculated reaction to the new tax. However, the possibility that the tax has influenced, at least to some extent, the reshuffling of banks' overseas loan portfolios cannot be ruled out. If this is the case, then the Government's original estimate that the new tax will yield about HK$ 145 million in fiscal year 1979-80 and HK$ 80 million annually thereafter may have erred on the optimistic side. [14]

Finally, it is to be noted that the tax on offshore banking profits is only one of the tax reform measures recommended by the 1976 Review Committee. Some have already been rejected by the Government, while others are still being considered. A discussion of these issues must be left to another occasion.

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12. *Report of the Third Inland Revenue Ordinance Review Committee*, Hong Kong, 1977, para. 131-133.
13. The ban on new bank licences was imposed in 1966 after a serious banking crisis erupted in 1965.
14. Another factor that may reduce the estimated yield is the fact that the spreads between borrowing and lending rates in offshore syndicated loans, normally expressed in terms of percentage points over the London Inter-bank Offer Rate (LIBOR), had steadily narrowed in recent years. The lowest spreads for prime borrowers, for example, declined from about 1.25 percent in 1976 to about 0.5 percent in mid-1978.

# USA

# The Foreign Earned Income Act of 1978: The Taxation of U.S. Citizens Overseas

by Richard P. Casna*

*The recently enacted Foreign Earned Income Act of 1978 (H.R. 9251) dramatically affects the taxation of Americans living and working abroad. Significant changes in the assessment of income tax on foreign earnings by non-resident Americans will result from this new legislation.*

*The following article presents an overview of the provisions of the new law and how they will be applied to the taxation of American citizens living abroad.*

## I. INTRODUCTION

On Sunday, October 15, 1978, the United States Congress enacted H.R. 9251, the Foreign Earned Income Act of 1978 (F.E.I.A.) which represents the long-awaited legislation regarding the taxation of non-resident American citizens. The new law, signed by President Carter on November 9, 1978, significantly establishes sweeping and profound changes in the manner of this taxation. Basically, this new legislation replaces the earned income exclusions from gross income available under Sec. 911 of the Internal Revenue Code with a series of special deductions under a new Sec. 913. The new law, effective for taxable years beginning after December 31, 1977, delays the effective date of the changes made by the Tax Reform Act of 1976 (T.R.A.) until after 1977 and, in addition, provides an optional transitional rule for use by taxpayers in 1978. [1] In effect, this means that the more liberal pre-1976 T.R.A. rules apply to taxable years beginning in 1977 while taxpayers may choose between applying the 1976 T.R.A. rules or the new rules under the F.E.I.A. to taxable years beginning in 1978 only. For taxable years beginning after 1978, the rules as provided in the new legislation are to be the sole basis of taxation of non-resident Americans

This article, therefore, will review the new legislation and analyze the application of its provisions in respect to taxable years beginning in 1977, 1978 and thereafter. [2]

## II. TAX YEARS BEGINNING IN 1977

Since the new legislation delays the application of the 1976 T.R.A. provisions effecting the Sec. 911 exclusions until after 1977, the pre-1976 T.R.A. exclusion rules apply to income earned abroad in 1977. [3]

It is therefore appropriate to briefly discuss the effect of these pre-1976 T.R.A. rules in respect to the treatment of foreign earned income. In addition, it is pointed out that the Internal Revenue Service has recently granted 1977 overseas taxpayers who were out of the country on April 15, 1977 a filing date extension until February 15, 1979 for their 1977 tax returns. Therefore, those taxpayers who have already filed their 1977 returns based on the 1976 T.R.A. provisions should review their return to determine if a lower tax liability would result under application of the more liberal pre-1976 T.R.A. provisions and, thus, obtain any refund of tax which may be due the taxpayer by filing an amended return.

Under the rules prior to enactment of the 1976 Tax Reform Act, a U.S. citizen who met either the "bona fide resident" test [4] or the "physical presence" test [5] was entitled to exclude $ 20,000 of earned income derived from sources outside the United States from his or her gross income. Furthermore, if the U.S. citizen was a bona fide resident of a foreign country for three consecutive years or more, he or she was entitled to a $ 25,000 earned income exclusion.

This income exclusion is limited to sums received as wages, salaries, professional fees or compensation for personal services actually rendered. Moreover, the non-excludable income is taxed, under the rules prior to enactment of the 1976 T.R.A., on the basis as if it were the only income, i.e., it is taxed at the rate which would apply if there were no other income.

Furthermore, unilateral relief is granted in the form of a tax credit for foreign taxes paid or accrued which were allocable to the excluded income. [6] Individuals not entitled to the exclusion may claim both the foreign tax credit and the zero-bracket amount. [7] For taxable years

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1. F.E.I.A. Sec. 209(c)(1).
2. Appreciation is expressed to Mr. Charles M. Bruce, Counsel to the Committee on Finance of the United States Senate, who generously provided the author copies of the Conference Report and legislative text from which the article is drawn and to the staff of the International Bureau of Fiscal Documentation for their assistance in the preparation of this article.
3. Tax Reform Act of 1976, Sec. 1011(d), as amended by the Tax Treatment Extension Act of 1977 Sec. 1(a).
4. Any U.S. citizen who was a bona fide resident of a foreign country for an uninterrupted period including an entire taxable year.
5. Any U.S. citizen who was present in a foreign country for 17 out of 18 consecutive months.
6. I.R.C. Sec. 901.
7. The "zero bracket amount" refers to the income bracket amounts in the tax rate schedules and tax tables on which no or "zero" tax is imposed.

beginning in 1977, if an individual who is entitled to the earned income exclusion claims the foreign tax credit, he or she is required to make an unused zero-bracket amount computation in accordance with Code Sec. 63. This computation is the zero-bracket amount in excess of the taxpayer's itemized deductions and is added to the taxpayer's adjusted gross income. No credit, however, is available for foreign taxes paid on U.S.-source income.

## III. SPECIAL ELECTION PROVISION FOR 1978

For tax years beginning in 1978 only, taxpayers are given the option of applying the law as amended by the 1976 T.R.A. or applying the new provisions of the F.E.I.A. of 1978. [8] This option is provided in order to prevent any provision of the new law, which is effective as of January 1, 1978, from having a mandatory retroactive effect. Therefore, before discussing the provisions of the new legislation, a brief review of the rules of the 1976 T.R.A. as they effected the taxation of non-resident American citizens is in order.

The basic effects of the 1976 T.R.A. rules upon the International Revenue Code sections relating to the taxation of overseas Americans were restrictive in nature. A reduction in the amount of the earned income exclusion and less liberal use of the foreign tax credit were the two primary changes effected as a result of this legislation.

If a taxpayer elects this option — to be taxed in 1978 under the provisions of the 1976 T.R.A. — the "bona fide resident" test or "physical presence" test must still be met, however, the increased exclusion for those taxpayers resident overseas three years or more is eliminated. The earned income exclusion from gross income is reduced to $ 15,000 and, moreover, the taxpayer is subject to the following three 1976 T.R.A. rules modifying the exclusion rules: 1) the foreign income taxes paid on amounts attributable to earned income which is excluded from U.S. tax are not creditable or deductible against U.S. tax, 2) any income (including U.S.-source income) not sheltered by the exclusion is subject to U.S. tax at the rate bracket that would apply if none of the foreign earned income was excluded, and 3) any income earned abroad that is received outside the country in which it is earned is ineligible for the exclusion if one of the purposes of receiving this income outside the country was to avoid that country's tax. As the net effect under this option reduces the income exclusion, limits the foreign tax credit and taxes the non-excluded income at higher rates, it would appear that this choice particularly benefits those taxpayers in the lowest income brackets, and especially benefits those taxpayers who fail to have the type of expenses which fall under any of the special deductions provided by the new law and which is the other alternative available to taxpayers for determining their 1978 income tax liability.

## IV. TAX YEARS BEGINNING AFTER 1978 (and, if elected, for 1978)

The sole basis for the determination of the tax liability of overseas Americans for tax years beginning after 1978 and, if elected, the alternative basis for tax years beginning in 1978, is provided by the new provisions of the F.E.I.A. of 1978. The basic net effect of these provisions is to allow an overall deduction for excess foreign living costs rather than an earned income exclusion from gross income. [9]

The new law provides that this overall deduction shall be comprised of five elements:

1) Cost-of-living differential,
2) Housing expenses,
3) Schooling expenses,
4) Home leave travel expenses,
5) Hardship area deduction.

Furthermore, it should be noted that the total amount of the deduction cannot exceed the individual's "net foreign source earned income", i.e., the individual's foreign earned income [10] for the portion of the taxable year in which his or her tax home [11] is in a foreign country reduced by the value of employer-furnished meals and lodging which is excluded from income and other deductions allocable to the foreign earned income such as, for example, foreign real property taxes. [12]

Moreover, the "bona fide resident" and "physical presence" tests are retained, however, the new law now stipulates that resident aliens, including those aliens not covered by treaties containing non-discrimination clauses, can, if otherwise qualified, avail themselves of the "physical presence" test. Under prior law, only U.S. citizens could avail themselves of this test. Still, only U.S. citizens can avail themselves of the "bona fide resident" test.

### A. The qualified cost-of-living differential

This element of the special overall deduction provided by the new Sec. 913 represents the amount by which the general cost of living in the foreign place in which the taxpayer's tax home is located exceeds the general cost of living for the metropolitan area in the continental U.S. (excluding Alaska) having the highest general cost of living (currently New York City). [13] This amount will be determined in accordance with tables to be provided by the Internal Revenue Service which are to be revised at least once during each calendar year in order to reflect changing economic conditions. The

8. F.E.I.A. Sec. 209(c)(1).
9. Since the deduction is taken in arriving at adjusted gross income, individuals may claim the deduction even though they do not itemize other deductions.
10. "Earned income" refers to sums received as wages, salaries, professional fees or compensation for personal services actually rendered, excluding amounts paid by the United States or any agency thereof. F.E.I.A. Sec. 913(j)(1)(A).
11. "Tax home" means, with respect to any individual, such individual's home for purposes of section 162(a)(2) (relating to travelling expenses while away from home). An individual shall not be treated as having a tax home in a foreign country for any period for which his or her abode is within the United States. F.E.I.A. Sec. 913(j)(1)(B).
12. F.E.I.A. Sec. 913(c).
13. F.E.I.A. Sec. 913(d).

I.R.S. is allowed to take into account, in preparing these tables, the State Department's Local Index of Living Costs Abroad relating to such foreign places. 14 The cost-of-living differential will reflect the daily reasonable living expenses (excluding housing and schooling expenses) and will vary depending on the composition of the taxpayer's family residing either with him or or at a qualified second household. In addition, in making the comparison, the tables will assume that the family income equals the salary of a U.S. Government employee paid at the level of Step 1, grade GS—14, 15 regardless of the taxpayer's actual taxable income.

Moreover, the cost-of-living differential will be denied the taxpayer who receives meals and lodging furnished by the employer where these are excluded from gross income under Code Sec. 119. 16

### B. Qualified housing expenses

This deduction represents the excess of the individual's housing expenses over his "base housing amount". 17 Housing expenses include the reasonable expenses paid or incurred during the taxable year for housing in a foreign country such as utilities and insurance, but do not include expenses for mortgage interest, real estate taxes or other expenses which are otherwise deductible under other provisions of the Code. Expenses which are considered "lavish" or "extravagant" under the circumstances will not be treated as reasonable and, hence, not allowable as deductible. 18 The "base housing amount" represents one-sixth (1/6) of the taxpayer's net earned income and is equal to twenty percent (20%) of the excess of the individual's earned income (from whatever source reduced by such trade or business expenses properly allocable thereto) over the sum of his housing expenses, cost-of-living differential, schooling expenses, home leave travel expenses and any qualified hardship area deduction. 19

If an individual's tax home is in a hardship area and he maintains a second household for his spouse and dependents at a foreign place other than his tax home, the base housing amount for the household maintained at his tax home will be zero. 20

In addition, the new law further provides that, except in cases of a qualified second household (described below), housing expenses of only one house can be deducted at a given time and that house must be the one which bears the closest relationship to the individual's tax home. 21

Again, as with the cost-of-living differential, the deduction for housing expenses will be denied where the employee receives employer-furnished meals and lodging the value of which is excluded under Code Sec. 119.

### C. Qualified schooling expenses

This deduction allows the taxpayer to deduct the reasonable schooling expenses paid or incurred during the taxable year for the education of each dependent of the taxpayer at the elementary or secondary level. 22 Elementary or secondary level is defined as the equivalent of education from the kindergarten through the twelfth (12th) grade in a U.S.-type school.

The reasonable education expenses include the cost of tuition, fees, books, and local transportation, in addition to any other expenses required by the school. 23 Expenses for room and board and for transportation other than local transportation are allowed only in the situation where an adequate U.S.-type school is not available within a reasonable commuting distance of the taxpayer's tax home. Where this is the case, room and board expenses in addition to the transportation expense of the dependent each school year between the taxpayer's tax home and the location of the school will be treated as allowable schooling expenses. 24

In the situation where there is an adequate U.S.-type school available within a reasonable commuting distance of the taxpayer's tax home but the dependent attends some other school (including in the U.S.) the allowable schooling expenses may not exceed the amount which would have been charged had the dependent attended the school located within a reasonable commuting distance of the tax home. 25

Furthermore, the allowable schooling expenses attributable to education will only be taken into account for the period during which the individual's tax home is in a foreign country. 26

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14. F.E.I.A. Sec. 913(d)(2)(D). Some examples of cost-of-living differentials, for a family of four persons, are:

| Living in: | Cost-of-living differential $ | Living in: | Cost-of-living differential $ |
|---|---|---|---|
| Argentina | none | Italy | 300 |
| Australia | 1,700 | Japan | 7,000 |
| Austria | 5,700 | Mexico | none |
| Belgium | 7,000 | Netherlands | 3,700 |
| Brazil | 1,000 | Saudi Arabia | 3,700 |
| Canada | none | Spain | 300 |
| China | none | Switzerland | 7,000 |
| France | 4,600 | United Kingdom | none |
| German Fed. Rep. | 5,700 | Venezuela | 4,600 |
| Indonesia | 2,300 | | |

These cost-of-living deductions are based on figures of April 1, 1978. It is reported that the Treasury will soon publish figures reflecting the situation as per July 1, 1978, to reflect the decline in value of the dollar.

15. Step 1, GS-14 salary is currently $ 32,442 annually.
16. F.E.I.A. Sec. 913(d)(2)(E). Code Sec. 119 entitles a taxpayer to exclude the value of employer-furnished meals and lodging from gross income when furnished for the convenience of the employer.
17. F.E.I.A. Sec. 913(e).
18. F.E.I.A. Sec. 913(e)(2)(B).
19. F.E.I.A. Sec. 913(e)(3)(A).
20. F.E.I.A. Sec. 913(e)(3)(B).
21. F.E.I.A. Sec. 913(5).
22. F.E.I.A. Sec. 913(f).
23. F.E.I.A. Sec. 913(f)(2).
24. F.E.I.A. Sec. 913(f)(3).
25. F.E.I.A. Sec. 913(t)(4).
26. F.E.I.A. Sec. 913(t)(5).

### D. Qualified home leave travel expenses

This deduction permits the taxpayer to deduct the reasonable amounts paid or incurred for the transportation of the taxpayer, his or her spouse and each dependent from the location of their tax home outside the United States to either the individual's present (or, if none, most recent) principal residence in the U.S. or (if never having resided in the U.S.) to the nearest port of entry in the continental United States (excluding Alaska). [27]

The amount of the deduction is limited to the cost of an economy or coach roundtrip fare per person and also to one such trip for each continuous period of 12 months for which the taxpayer's tax home is in a foreign country. In order to so qualify, the spouse and dependents, except in the case of a qualifying second household, must reside with the taxpayer.

### E. Qualified hardship area deduction

The new law uniquely distinguishes taxpayers working and residing in so-called "hardship areas". These areas are defined by the F.E.I.A. as being those areas designated by the Department of State where extraordinarily difficult living conditions, notably unhealthful conditions, or excessive physical hardships exist and for which a post differential of fifteen percent (15%) or more is provided U.S. Government personnel present there, or if none present, would be provided if there were. [28] A deduction computed on a daily basis at an annual rate of $ 5,000 is allowed for days during which a taxpayer's tax home is in a hardship area. [29]

## V. SPECIAL RULES FOR TAXPAYERS MAINTAINING SEPARATE HOUSEHOLDS

In addition to the above described provisions relating to the five particular deductions, the new law provides special rules for taxpayers who, because of adverse living conditions [30] at their tax homes, maintain separate households for spouses and dependents. [31] Basically, the general effect of these rules is that the computation of the five various elements of the special deduction shall be based on the second qualified household rather than on the taxpayer's tax home. These special rules are summarized below.

### A. Cost-of-living differential

Here, the computation to determine the cost-of-living differential is to be based with reference to the foreign place where the qualified second household is located and not on the place of the taxpayer's tax home. In addition, although the taxpayer receives no separate cost-of-living deduction for his or her tax home, the deduction is not disallowed for days during which the taxpayer excludes the value of meals and lodging provided by his or her employer under Sec. 119. [32]

### B. Qualified housing expenses

In addition to deducting the full cost of housing at his or her tax home, a taxpayer maintaining a qualified second household may deduct the excess of the expenses of maintaining the second household over his or her base housing amount. [33] For this purpose, the base housing amount of the qualified second household is determined by reducing earned income by the full housing costs at both the tax home and the qualified second household.

Furthermore, the deduction for excess housing costs at the qualified second household is not disallowed for days during which the taxpayer excludes the value of meals and lodging at his or her tax home under Sec. 119, and the rule permitting the taxpayer to deduct only those costs with respect to the household having the closest relationship to his or her tax home is modified so as to permit the deduction of excess housing costs at the qualified second household.

### C. Schooling and home leave travel expenses

For purposes of determining the amounts of these deductions for the expenses of spouses and dependents in the case where a qualified second household is maintained, the determinations will be made with reference to the location of the qualified second household rather than to the location of the tax home. [34]

## VI. INDIVIDUALS RESIDING IN CERTAIN CAMPS

The new legislation makes available special provisions covering those citizens and residents who, because of their employment, reside in camps set up by employers in hardship areas. These provisions provide that such taxpayers may elect a $ 20,000 annual exclusion (computed on a daily basis) in lieu of the special deduction for excess foreign living costs created by Sec. 913. [35]

If this election is made the taxpayer is still entitled to claim the Sec. 119 exclusion for employer-furnished meals and lodging. However, they will not be permitted to take a foreign tax credit for amounts excluded from income. The camps must meet three requirements in order to qualify as such for these purposes.

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27. F.E.I.A. Sec. 913(g).
28. A list of areas to which U.S. government personnel are presently assigned which qualify as "hardship areas" is provided in the Appendix. Other areas or countries may be classified as hardship areas, however, to which no U.S. government personnel are currently assigned.
29. F.E.I.A. Sec. 913(h). A special provision of the new law pertaining to those individuals residing in "labor camps" within a hardship area is discussed *infra* at Section VI.
30. "Adverse living conditions" mean living conditions which are dangerous, unhealthful, or otherwise adverse. F.E.I.A. Sec. 913(j)(1)(D).
31. There is no requirement that such taxpayer's tax home be located in a hardship area.
32. F.E.I.A. Sec. 913(i)(l)(A)(ii).
33. F.E.I.A. Sec. 913(i)(l)(B).
34. F.E.I.A. Sec. 913(i)(C).
35. F.E.I.A. Sec. 202.

1) The camp must constitute substandard housing which is provided by or on behalf of the employer for the convenience of the employer because the place at which the taxpayer works is in a remote area where satisfactory housing is not available on the open market.
2) The camp must be located, as near as practicable, in the vicinity of the place where the taxpayer works.
3) The lodging must be furnished in a common area (or enclave) which is not available to the public and which normally accommodates ten (10) or more employees. [36]

Moreover, where the taxpayer elects this exclusion, the camp will be considered part of the employer's business premises for purposes of excluding the value of meals and lodging from gross income under Sec. 119.

## VII. MISCELLANEOUS RULES

In addition to the provisions amending Sec. 911 and adding Sec. 913, the Foreign Earned Income Act of 1978 provides significant new rules concerning other miscellaneous areas which effect the taxation of non-resident Americans. These provisions are briefly discussed below.

### A. Moving expenses

Under Sec. 217 of the Internal Revenue Code when a taxpayer moves his or her residence because of employment reasons he or she is entitled to a deduction of various costs incurred as a result of the move. The new legislation in respect of foreign moves makes several changes to these regulations.

It should be noted that "foreign move" is defined as a move in connection with the commencement of work by the taxpayer at a new principal place of work located outside the United States. [37] Thus, a move from the U.S. to a foreign country or from one foreign country to another is a foreign move, but a move from a foreign country to the U.S. is not a foreign move. However, moves to the U.S. from a foreign country when carried out by an individual who is returning to the U.S. as a result of the bona fide retirement of the individual from employment where the principal place of work and former residence were outside the U.S. or who is returning as the survivor of any decedent who (as of the time of his death) had a principal place of work outside the U.S. and the moving costs are incurred in connection with a move which began within six (6) months after the death of that decedent, shall be treated as foreign moves. [38] The changes made by the new law to the determination of the deduction for moving expenses are: 1) The deduction for pre-move house searching costs, temporary living expenses and residence-related sale or lease expenses is increased to an overall limit of $ 6,000 (the former limit was $ 3,000). 2) The expenses relating to house-hunting trips and temporary living expenses at the new job location are deductible to a maximum of $ 4,500 (formerly $ 1,500) of the overall $ 6,000 limit. 3) The period of time during which temporary living expenses would be deductible as moving expenses is increased from 30 to 90 days. In addition, deductible moving expenses include the reasonable costs (without any dollar limitation) of moving household goods and personal effects to and from storage and of storing the goods and effects for part or all of the period during which the taxpayer's new place of work abroad continues to be his principal place of work. [39]

### B. Meals or lodging furnished to employees under certain conditions

Under Sec. 119 of the Code taxpayers are allowed to exclude from gross income the value of meals and lodging furnished them by their employer for the convenience of the employer.

The new legislation expands this exclusion to include the value of meals and lodging furnished by or on behalf of the employer to the taxpayer, his or her spouse, or any dependents for the convenience of the employer.[40] By way of illustration, the housing provided by the prime contractor on a construction job to an employee of a subcontractor for the convenience of the sub-contractor would meet this requirement.

### C. Suspension of running of the period under Section 1034 for purchasing a new principal residence

Section 1034 of the Code grants the taxpayer who sells his or her home an eighteen to twenty-four month period during which he or she can replace the residence and postpone payment of the capital gains tax on the sale of the first residence. The new law extends this period for four years during such time that the taxpayer has a tax home outside the United States. [41] However, no period of time so suspended may be extended beyond the date four years after the date of the sale of the old residence.

### D. Wage withholding

Following the date of enactment of the new legislation foreign earned income is not to be subject to withholding to the extent that the employer reasonably believes the employee will have deductions under Code Sec. 913 relating to certain expenses of living abroad. [42]

## VIII. CONCLUSION

It is worth noting in conclusion that the changes made in respect to Sec. 911 by the new legislation have been estimated to reduce fiscal 1979 revenues by $ 255 mil-

36. F.E.I.A. Sec. 202(b).
37. F.E.I.A. Sec. 204(a).
38. F.E.I.A. Sec. 204.
39. F.E.I.A. Sec. 204(2).
40. F.E.I.A. Sec. 205.
41. F.E.I.A. Sec. 206.
42. F.E.I.A. Sec. 207.

lion. Furthermore, Sec. 208 of the new law directs the Secretary of the Treasury to transmit, as soon as practicable after the close of the calendar year 1979 and after the close of each second calendar year thereafter, a report to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate setting forth with respect to the preceding two calendar years the following information:

1) the number, country of residence, and other pertinent characteristics of persons claiming the benefits of sections 911, 912 and 913 of the Internal Revenue Code of 1954,
2) the revenue cost and economic effects of the provisions of such sections 911, 912, and 913 and
3) a detailed description of the manner in which the provisions of such sections 911, 912, and 913 have been administered during the preceding 2 calendar years.

# APPENDIX

The list below contains those foreign locations to which U.S. Government personnel are presently assigned and which qualify as hardship areas. Note that other foreign locations to which no U.S. Government personnel are currently assigned may also qualify as hardship areas

Afghanistan
Algeria
Angola
— Luanda
Antarctic & Artic regions: Posts or areas south or north of the 60 degree latitudes
Ascension Island
Bahrain
Bangladesh
Belize
Benin
Bolivia
— exept Cocha-bamba and Santa Cruz
Brazil
— Acre
Amapa
Amazonas
Cuiaba
Goias
Guapore
Haranhao
Hato Grosso
Para
Piaui
Rio Branco
Bulgaria
— except Sofia
Burma
Burundi
Cameroon
Canada
— North West Territories
Cape Verde
Central African Empire
Chad
Chagos Archipelago
China (Taiwan)
— except Koahsiung (incl. Tsoying) & Taichung (incl. Ching Chuan Kang and Ching), Tainan, and Taipei
Congo
Cook Islands
Costa Rica
— except San Jose
Cuba
— Havana
Djibouti
Dominican Republic
— except Santo Domingo
Ecuador
Egypt
— except Alexandria & Cairo
Ethiopia
Falkland Islands
French West Indies
Gabon
Ghana
Greenland
Guatemala
— except Guatemala City
Guinea
Guinea-Bissau
Guyana
Haiti
Honduras
India
Indonesia
Iran
— except Isfahan, Shiraz, Tabriz, Tehran
Iraq
Ivory Coast
Jordan
— except Amman
Kenya
— Garissa, Kitale, Hgomeni, Hajir
Korea (South)
— except Osan AB (incl. Pyongtaek), Pusan and Seoul (incl. Ascom, Suwon, Kimpo Airfield), Camps Eiler, Mercer & Thompson
Kuwait
Laos
Lebanon
— Beirut
Liberia
Libya
Madagascar
Malaysia
— except Kuala Lumpur & Penang
Mali
Mauritania
Midway Islands
Mozambique
— Maputo
Nepal
Nicaragua
Niger
Nigeria
Oman
Pakistan
Panama
— except Panama City & Santiago
Paraguay
— except Asuncion
Peru
— except Arequipa & Lima
Philippines
— except Baguio City, Cagayan de Oro, Cebu, Los Banoz, Manila (incl. Cavite), San Fernando, La Union, San Miguel Zambales, and San Pablo
Qatar
Romania
— except Bucharest
Rwanda
Saudi Arabia
Senegal
Sierra Leone
Sinai Field Mission
Somalia
Sri Lanka
Sudan
Surinam
— except Paramaribo
Syria
Tanzania
Thailand
— except Bangkok
Togo
Trust Territory of the Pacific Islands
Tunisia
— Makthar
Turkey
— Prininclik
United Arab Emirates
United Kingdom
— Belfast and Londonderry
Upper Volta
USSR
Yemen Arab Republic
Zaire
Zambia
— Lusaka
Other Foreign Locations
— US Government civilian employees assigned to locations not shown above receive no post (hardship) differential or less than 15 percent.

# EGYPT: New Tax Measures*

The text of Law no. 46 of 1978 published in Official Journal No. 29 Bis (a) of July 20, 1978, has been received by the International Bureau of Fiscal Documentation. The Law which amends Laws Nos. 14 of 1939 and 99 of 1949 and other laws relating to income taxation contains, inter alia, the following provisions:

### (1) Tax on industrial and commercial profits

The tax on industrial and commercial activities is extended to:

(i) Profits from single transactions.

(ii) Profits from disposal of built property or lands in urban areas. The creation of usufruct on property or a lease for a period exceeding 50 years will be regarded as a disposal. Only amounts in excess of L.E. 10,000 will be subject to the tax. The rate of tax will be the same as the proportional duty prescribed by Law no. 70 of 1964 concerning publicity and notarisation fees. Where, however, there is more than one disposal within a period of 10 years then the profits from such disposals will be subject to the normal rate of tax on industrial and commercial profits (39.7 percent).
Exemption is provided for:

1. disposal by an heir of property, in the condition as inherited from the legator, where the amount thereof does not exceed L.E. 20,000. Where it exceeds this amount tax will be levied on the excess;
2. property contributed as capital to investment projects under Laws no. 43 of 1974 as amended and no. 86 of 1964, or as contributions to the capital of establishments subject to the provisions of Laws no. 60 of 1976 and no. 111 of 1973, being the law on general organisations and public sector companies.

(iii) Profits from the division of building land and disposal thereof.

(iv) Profits from the letting of furnished premises to persons subject to the tax on profits from non-commercial activities whether for purposes of lodging or exercising their activities. The tax will vary according to the rental value per room (for the basis of property taxes) and will be between L.E. 1 per month (where rental does not exceed L.E. 3 per room) and L.E. 8 per month (where rental value exceeds L.E. 10 per room). 50 percent of the rental value may be deducted for costs where more than one furnished unit in non-tourist places is rented and where any part of a furnished unit in a tourist district is rented.
The tax on basis of profits may not be less than the value of the fixed rates referred to above for units rented in non-tourist places and three-fold that valued for units rented in tourist districts.
This provision is an addition to that allowing for the taxation of profits from leases of furnished commercial or industrial premises.

(v) Profits from fruit crops of orchards exceeding 3 feddans in area, crops of decorative, medicinal and aromatic plants where area exceeds 1 feddan and crops of plant nurseries, irrespective of cultivated area (unless solely for the owner's personal use).

(vi) Profit from automated poultry raising and hatching and livestock breeding. New projects set up after the commencement of the law will, however, be exempt for five years from the financial year following the date on which activities commence.

### (2) Tax on income from movable capital

Interest on deposits with banks and postal savings funds and banks is exempted from the tax on income from movable capital as an encouragement to savings.

### (3) Tax on wages and salaries

The following is provided:

(i) Exemption for taxpayers whose annual income does not exceed L.E. 600 (or L.E. 680 in the case of married persons with children). Taxpayers with income exceeding these limits will only be taxed on the excess.

(ii) Tax at the rate of 10 percent will be imposed, without any reduction, on amounts paid to foreign experts whose employment does not exceed six continuous months.

### (4) General income tax

The following is provided:

(i) The exemption limit is raised from L.E. 1,000 to L.E. 1,200. In addition, a family burden exemption amount will be allowed from net annual income of L.E. 75 for each dependent child and for the taxpayer's wife with a maximum of L.E. 300 (previously L.E. 50 with a maximum of L.E. 200). Where income exceeds L.E. 3,000 the family burden exemption will not be granted.

(ii) The deduction from taxable income for life assurance premiums is raised to 10 percent of net total annual income or L.E. 400, whichever is lower.

(iii) A new deduction from taxable income is provided with respect to amounts contributed by a taxpayer in the form of securities toward new investment projects, amounts paid for government development bonds or amounts deposited in an Egyptian bank for a continuous period of at least five years, up to a maximum of L.E. 3,000. Such securities must be deposited in an Egyptian bank and may not be disposed of for a period of five years.

(iv) The rates of the tax are now as follows:

| | more than L.E. | up to L.E.- | at the rate (%) |
|---|---|---|---|
| First bracket up to | 1,200 | exempted | |
| Second bracket | 1,200 | 2,000 | 8 |
| Third bracket | 2,000 | 3,000 | 9 |
| Fourth bracket | 3,000 | 4,000 | 10 |
| Fifth bracket | 4,000 | 5,000 | 11 |
| Sixth bracket | 5,000 | 6,000 | 12 |
| Seventh bracket | 6,000 | 7,000 | 15 |
| Eighth bracket | 7,000 | 8,000 | 20 |
| Ninth bracket | 8,000 | 9,000 | 25 |
| Tenth bracket | 9,000 | 10,000 | 30 |
| Eleventh bracket | 10,000 | 15,000 | 35 |
| Twelfth bracket | 15,000 | 20,000 | 40 |
| Thirteenth bracket | 20,000 | 30,000 | 45 |
| Fourteenth bracket | 30,000 | 40,000 | 50 |
| Fifteenth bracket | 40,000 | 50,000 | 55 |
| Sixteenth bracket | 50,000 | 60,000 | 60 |
| Seventeenth bracket | 60,000 | 70,000 | 65 |
| Eighteenth bracket | 70,000 | 100,000 | 70 |
| Nineteenth bracket | 100,000 | | 80 |

### (5) Miscellaneous

(i) A tax is to be imposed on work permits issued for Egyptians applying for work abroad or for any foreign project in Egypt at the rate of L.E. 50 for highly qualified personnel and L.E. 25 for others for every authorised year.

* Note submitted by Ms. E.A. de Brauw-Hay, Senior Staff Member of the International Bureau of Fiscal Documentation.

(ii) A tax to be imposed on entertainment consumptions, e.g. on entertainment parties at hotels and public tourist places, tax will be imposed at the rate of 20 percent of the amount paid, and on tickets for travel abroad paid for in local currency at the rate of 10 percent of the price of the ticket.

(iii) Introduction of the wealth return: any taxpayer whose net annual income exceeds L.E. 1,200 must submit once every five years a declaration of all sources of wealth with respect to himself, his wife and his minor sons.

(iv) Deduction of tax at source: it is provided that the government, local authorities, public sector companies, trade unions, private joint stock companies and branches of foreign companies, hotels and other establishments whose capital exceeds L.E. 5,000 will deduct a certain percentage from amounts exceeding L.E. 10 representing commission, amounts paid for supplies, contracting operations or services etc. to private sector individuals to the account of the industrial and commercial profits tax due by such individuals.
It is also provided that the customs department will collect from private sector individuals a percentage of the value of their commodity imports authorised for supply to the country for trading purposes or for processing to the account of the industrial and commercial profits tax due by them. The percentage due will be laid down by the Minister of Finance.

(v) Introduction of tax cards: in order for a taxpayer to obtain a new licence or renew an old one to exercise a trade or industry he must be the holder of a tax card. In the same article it is also provided that owners of properties being constructed, restored or demolished must inform the Taxation Department of the contractor etc. carrying out the work.

# SRI LANKA: Budget 1978/79 ~ Tax Proposals*

A new Inland Revenue Act effective from 1979/80, designed to rationalize the tax structure, will be introduced.

### Tax amnesty

Tax amnesty covering all taxes and levies will be given to persons who make investments in specified development projects, utilizing undeclared profits of any period prior to 31 March 1977. A tax of 30 percent will be imposed. The amnesty period begins 1 December 1978 and will end 31 March 1979. The amnesty will be administered by the National Savings Bank and not by the Inland Revenue Department.

The undeclared monies must be deposited in special accounts in the National Savings Bank and may be withdrawn after the amnesty period for investment in specified areas; otherwise they must be kept in such a special account until 31 March 1983. Monies lying in the National Savings Bank and awaiting investment will earn interest at the savings deposit rate of 8.4 percent.

The approved areas in which investments may be made under this scheme will include companies with which the Greater Colombo Economic Commission has entered into agreements, approved investments in industries, agriculture, horticulture, fisheries, tourism, housing (including projects approved by the Urban Development Authority, etc.), donations to the Government and expenditure incurred by the private sector on approved projects included in the Government Development Plan. Such investments will not qualify for other incentive available under the Inland Revenue Act. The amnesty will not apply to cases already under investigation.

### Income tax

The company tax will be reduced to 50 percent (previously 60 percent). Foreign companies will pay, in addition, a tax of 5 percent (previously 6 percent) in lieu of estate duty. The refundable tax of 33 1/3 percent on dividends will continue to be paid while the rate of tax on religious and charitable institutions will be reduced from the present rate of 23 to 20 percent. The present marginal rate of personal income tax will continue to be 70 percent. The rate schedule applicable to residents will also apply to non-residents. However, the 12,000 Rs. exemption will not apply.

Husband and wife will be separately assessed. The income of children under 18 years of age will be added to that of their father during the duration of the marriage. Where the marriage ceases to exist the income of the child will be added to that of the parent who in fact maintains the child. Income up to 12,000 Rs. will be exempt. The present system of allowances will be abolished.

Public servants will be fully exempt from income tax on their employment income.

* Note submitted by M.P. Dominic, Attorney at law, Sri Lanka, Drs. in de rechtswetenschappen (Netherlands).

From the year of assessment 1979/80, assessment will be made on a current year basis.

### Income tax incentives

The scope of the tax holiday for small and medium industries will be enlarged. Industrial undertakings with capital up to 1,000,000 Rs. (earlier only 500,000 Rs.) will qualify. The exemption limit is increased to 200,000 Rs. (earlier 100,000 Rs.). The entirety of the dividends declared by such companies will be exempt.

New export-oriented companies manufacturing non-traditional products for export, if incorporated on or after 15 November 1978, will be eligible for the 8-year tax holiday if they are approved by the Minister of finance for such purposes. This is not a new tax holiday. A similar tax holiday was already available, however, the scheme was not in operation.

Depreciation allowances — At present, 100 percent depreciation is allowed in the first year in respect of plant, machinery and fixtures. This scheme will apply until 31 March 1980.

Currently, certain buildings qualify for 50 percent once-and-for-all depreciation in the first year. Commercial buildings do not, in general, qualify. It is proposed to extend the once-and-for-all 50 percent depreciation allowance to commercial buildings constructed by any company for its own use or for letting; any company which takes meaningful and positive steps to construct commercial buildings prior to 31 March 1980 will be able to claim the depreciation.

However, it is proposed, with effect from 1 April 1980, to introduce a new scheme of capital allowances. A fixed percentage of the cost of construction of buildings and of the cost of the acquisition of plant, machinery and fixtures, depending on the life of such assets, will be written off annually over a period of years under this scheme. This scheme will then be in conformity with the present accounting and commercial practice in other countries.

The maximum limit imposed on the investment allowance will be raised from 20 percent to $33^1/3$ percent of the assessable income of a taxpayer. Premia for medical insurance will also qualify for investment allowance. An individual who constructs a house using his own financial resources may claim investment allowance, as at present, subject to the maximum limit. It is proposed to allow the taxpayer to carry forward and deduct the balance of the construction cost over the subsequent years. The same will apply to the purchase of one house or one site for the construction of a house.

The maximum limit on investment allowances will not apply to donations to Government and local Government institutions and expenditure on approved Government projects. Any amount which cannot be deducted in one year can be carried forward and deducted in subsequent years.

Withdrawal of the investment allowance in respect of realization of investment within 5 years will not apply if the proceeds are reinvested in shares in other approved investments. No investment allowance will be given on such reinvestment.

Housing reliefs will be standardised. The present exemption of the capital gains on the first sale of a house constructed by an individual is subject to restrictions relating to floor area and extent of land. These restrictions will be removed. Further, the exemption will apply to the first sale of a house irrespective of whether it is constructed, purchased or inherited.

Company formation expenses will be allowed to be deducted, as will research and development expenditures incurred by any business.

In the case of savings in the National Savings Bank, one third of the interest earned up to 2,000 Rs. will be exempt. The partial exemptions given in respect of medium and long term capital gains arising from transfer of immovable property will be extended to movable properties, including shares in public and private companies. The purpose of granting partial exemption is to take inflation into account.

Limited income tax exemptions will be granted to sportsclubs.

### Wealth tax

Owner-occupied houses will be exempt from wealth tax. Separate wealth tax assessments will be made on husband and wife.

### Estate duty

The exemption limit for estate duty purposes will be increased from 50,000 Rs. to 100,000 Rs. The value of one house owned by the testator will be exempt for estate duty purposes; this will be subject to a maximum limit of 300,000 Rs. That part of the life insurance policy payments which is required to pay the estate duty will be exempt from estate duty.

In addition, the following exemptions will be granted:

(a) the value of a single annuity up to 10,000 Rs.;
(b) legacies to bona fide employees up to 10,000 Rs. if they take effect within a period of 2 years of death;
(c) bequests made to an approved charity up to 100,000 Rs. if they take effect within a period of 2 years of death;
(d) household and personal effects including jewellery up to 25,000 Rs.; and
(e) the value of a life interest passing on death relating to property given to the Government.

### Others

Stamp duty on issue of shares will be reduced from 1 to 0.05 percent. The existing high rate band for transfer of shares will be replaced by a flat rate of 1 percent.

Export duty on block rubber is increased to 75 percent.

Export duties on minor export crops have been reduced:

| | |
|---|---|
| Cinnamon chips | — 5 percent |
| Cinnamon quills | — 10 percent |
| Citronella oil | — 5 percent |
| Cocoa | — 12.5 percent |

Bank debits tax will be repealed.

Interest will be paid at 1 percent per month on tax refunds which are overdue.

The subsidy for rubber replanting will be increased from 3,000 Rs. to 4,000 Rs. per acre.

# Tax Levels and Structures in OECD Member Countries

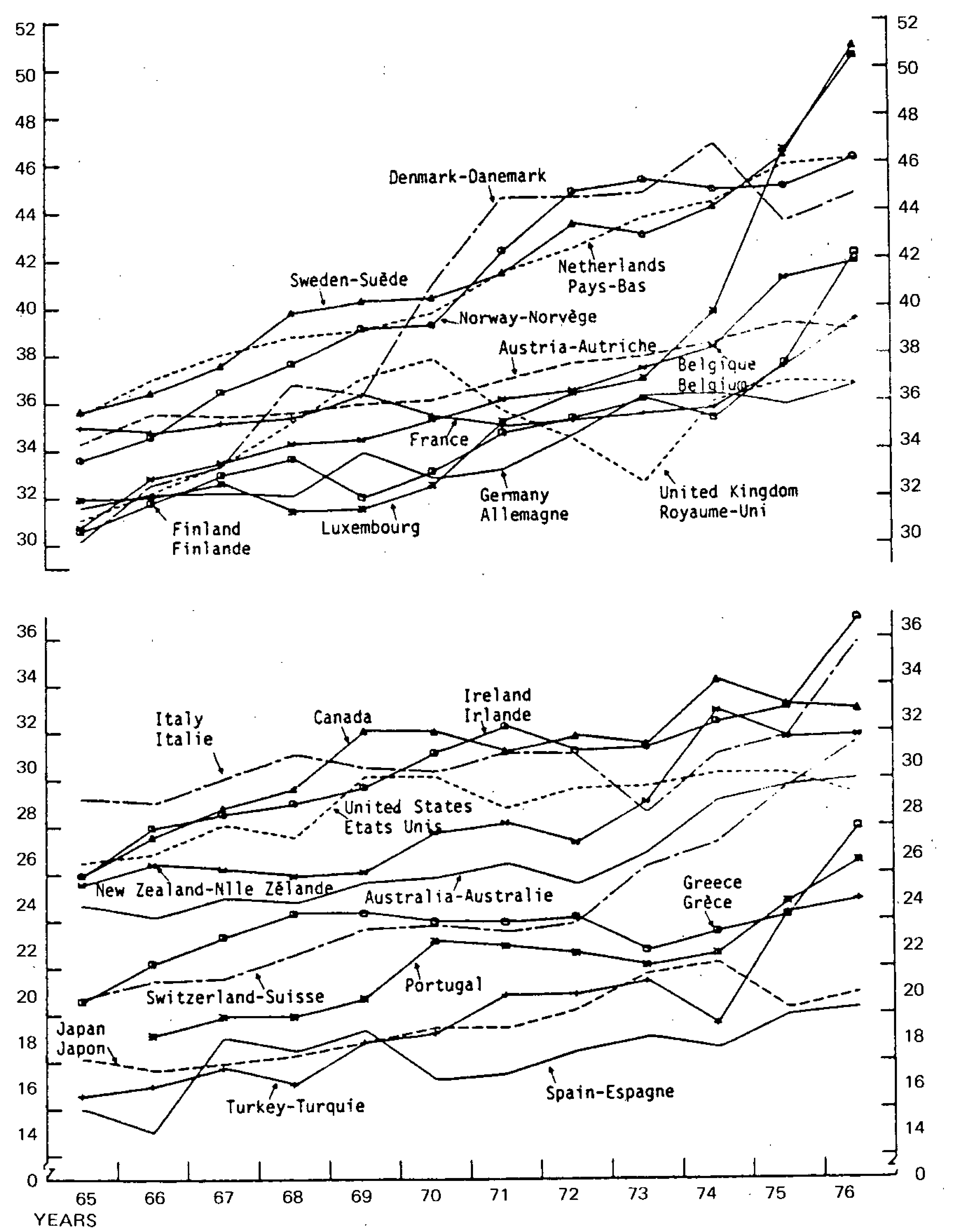
The OECD has just published its annual statistical bulletin on tax levels and structures in OECD Member countries. [1] The bulletin contains the most comprehensive information that is at present available on an internationally comparable basis, concerning the amounts of receipts collected by OECD Member countries and the varying ways in which these receipts are raised.

The 35 comparative tables contained in the report, as well as the numerous country tables, show how countries differ in the proportion of their Gross Domestic Product taken in taxes and the different reliance that they place on the various kinds of taxes: income taxes, social security contributions, consumption taxes, etc. The commentary which accompanies the tables draws attention to how the level and composition of tax revenues have changed between 1965 and 1976. In all countries the ratio of tax-to-GDP has increased during this period and in the Nordic countries, Belgium, Ireland, Luxembourg and the Netherlands, this increase has been very large. This increasing trend also remains true for most countries between 1970 and 1976, but during this period, the ratio of total taxes to GDP remained more or less stable in Canada and Japan and even slightly declined in the United Kingdom and the United States. Most countries have tended to place more reliance on personal income taxes and/or social security contributions as well as value-added taxes, while corporation taxes, property taxes and taxes on tobacco and alcoholic drinks have somewhat declined.

Data on the allocation of tax revenues by levels of government during 1975 are provided in an annex to the publication. The annex highlights the wide differences in the proportion of tax revenues accruing to each level of government and the varying methods that are used to finance local government.

A second annex to the edition provides, for most OECD countries, [2] provisional esti-

**TOTAL TAX REVENUE AS PERCENTAGE OF GDP 1965 – 1976**




| TOTAL TAX REVENUE AS PERCENTAGE OF GDP-1976 | |
|---|---|
| SWEDEN | 50.89 |
| LUXEMBOURG | 50.45 |
| NORWAY | 46.18 |
| NETHERLANDS | 46.16 |
| DENMARK | 44.70 |
| FINLAND | 42.19 |
| BELGIUM | 41.87 |
| FRANCE | 39.45 |
| AUSTRIA | 38.91 |
| IRELAND | 36.81 |
| UNITED KINGDOM | 36.70 |
| GERMANY | 36.70 |
| ITALY | 35.82 |
| CANADA | 32.89 |
| NEW ZEALAND | 31.83 |
| SWITZERLAND | 31.59 |
| AUSTRALIA | 29.98 |
| UNITED STATES | 29.29 |
| GREECE | 27.94 |
| PORTUGAL | 26.51 |
| TURKEY | 24.87 |
| JAPAN | 20.91 |
| SPAIN | 20.27 |

1. "Revenue Statistics of OECD Member Countries 1965-1976 — A Standardized Classification".
291 pages, OECD, Paris, 1978.
$ 15.50 — £ 7.60 — F 62.
Available from OECD Sales Agents.
2. All OECD countries except, Australia, Greece, Portugal and Spain.

mates of tax receipts for the main categories of tax for the previous calendar year (in this case 1977). Even though these estimates are subject to revision, and for this reason are reproduced in an annex in order not to confuse them with the more definitive data in the main body of the publication, some interesting tentative results emerge as to what has been happening to tax levels and structures in the most recent period.

In Germany, Italy, Sweden and Turkey, there appears to have been a large increase in the tax-to-GDP ratio between 1976 and 1977. This contrasts with the situation in Finland, Ireland and United Kingdom, where this ratio declined somewhat. In the remaining countries for which information is available, there was a small increase in this ratio. These differences may to some extent reflect short term economic policy changes and some of them may indeed disappear when the data are eventually revised.

Countries' relative reliance on the three main groups of taxes — taxes on income and profits, social security contributions and taxes on goods and services — has remained more or less unchanged. There has, however, been a tendency to place somewhat greater emphasis on employers' social security contributions, in comparison with taxes on goods and services. Personal income taxes continue to be the most important source of revenue for most countries.

This edition contains two special features. The first describes the use of sample surveys and tax models to estimate the effects of changes in the income tax legislation on tax yields and describes the measures of the elasticity of the income tax systems that are used in some OECD Member countries. The second updates to 1977, data on the amount of income taxes and social security contributions paid and family cash benefits received by a typical worker in various family circumstances in the different OECD countries.

The attached table compares the total taxes in OECD Member countries, as a ratio of GDP, in 1976 and a graph indicates how this ratio has changed since 1965.

# United States:

## THE ZENITH CASE: Countervailing Duties and a Strengthening of the GATT Principles*

In the case of *Zenith Radio Corp. v. The United States*, the U.S. Supreme Court, by a unanimous decision on June 21, 1978, upheld the reversal of a decision of the U.S. Customs Court requiring the United States to impose a countervailing duty on Japanese electronic products which had received an exemption from an indirect tax. The U.S. Customs Court decision had far-reaching implications as it represented a major departure from the GATT principles as well as from a long-standing practice in international trade. [1] The decision of the U.S. Supreme Court, while affirming the prior rule of practice, will continue to have meaningful significance when viewed in the light of the current MTN and GATT negotiations. In view of this, a large portion of the report of the Supreme Court's decision is provided below followed by an explanation and analysis.

Mr. J. MARSHALL delivered the opinion of the Court.

Under s. 303(a) of the Tariff Act of 1930, 46 Stat. 687, as amended, 19 U.S.C. s. 1303(a) (Supp. V, 1975), whenever a foreign country pays a "bounty or grant" upon the exportation of a product from that country, the Secretary of the Treasury is required to levy a countervailing duty, "equal to the net amount of such bounty or grant," upon importation of the product into the United States. The issue in this case is whether Japan confers a "bounty" or "grant" on certain consumer electronic products by failing to impose a commodity tax on those products when they are exported, while imposing the tax on the products when they are sold in Japan.

I

Under the Commodity Tax Law of Japan, Law No. 48 of 1962, see App. 44-48, a variety of consumer goods, including the electronic products at issue here, are subject to an "indirect" tax — a tax levied on the goods themselves, and computed as a percentage of the manufacturer's sales price rather than the income or wealth of the purchaser or seller. The Japanese tax applies both to products manufactured in Japan and to those imported into Japan. On goods manufactured in Japan, the tax is levied upon shipment from the factory; imported products are taxed when they are withdrawn from the customs warehouse. Only goods destined for consumption in Japan are subject to the tax, however. Products shipped for export are exempt, and any tax paid upon the shipment of a product is refunded if the product is subsequently exported. Thus the tax is "remitted" on exports. [2]

In April 1970 petitioner, an American manufacturer of consumer electronic products, filed a petition with the Commissioner of Customs, requesting assessment of countervailing duties on a number of consumer electronic products exported from Japan to this country. Petitioner alleged that Japan had bestowed a "bounty or grant" upon exportation of these products by, inter alia, remitting the Japanese Commodity Tax that would have been imposed had the products been sold within Japan. In January 1976, after soliciting the views of interested parties and conducting an investigation pursuant to Treasury Department regulations, the Acting Commissioner of Customs published a notice of final determination, rejecting petitioner's request. 41 Fed. Reg. 1298 (1976).

Petitioner then filed suit in the Customs Court, claiming that the Treasury Department had erred in concluding that remission of the Japanese Commodity Tax was not a bounty or grant within the purview of the countervailing duty statute. The Department defended on the ground that, since the remission of indirect taxes was "nonexcessive", the statute did not require assessment of a countervailing duty. In the Department's terminology, a remission of taxes is "nonexcessive" if it does not exceed the amount of tax paid or otherwise due; thus, for example, if a tax of $ 5 is levied on goods at the factory, the return of the $ 5 upon exportation would be "nonexcessive", whereas a payment of $ 8 from the government to the manufacturer upon exportation would be "excessive" by $ 3. The Department pointed out that the current version of s. 303 is in all relevant respects unchanged from the countervailing duty statute enacted by Congress in 1897, and that the Secretary — in decisions dating back to 1898 — has always taken the position that the nonexcessive remission of an indirect tax is not a bounty or grant within the meaning of the statute.

On cross-motions for summary judgement, the Customs Court ruled in favor of petitioner and ordered the Secretary to assess countervailing duties on all Japanese consumer electronic products specified in petitioner's complaint. 430 F.Supp. 242 (1977). The court acknowledged the Secretary's longstanding interpretation of the statute. It concluded, however, that this administrative practice could not be sustained in light of this Court's decision in *Downs v. United States*, 187 U.S. 496 (1903), which held that an export bounty had been conferred by a complicated Russian scheme for the regulation of sugar production and sale, involving, among other elements, remission of excise taxes in the event of exportation.

On appeal by the Government, the Court of Customs and Patent Appeals, dividing 3-2,[3] reversed the judgment of the Customs Court and remanded for entry of summary judgment in favor of the United States. 562 F. 2d 1209 (1977). The majority opinion distinguished *Downs* on the ground that it did not decide the question of whether nonexcessive remission of an indirect tax, standing alone, constitutes a bounty or grant upon exportation. The court then examined the language of s. 303 and the legislative history of the 1897 provision and concluded that, "in determining whether a bounty or grant has been conferred, it is the economic result of the foreign government's action which controls." 562 F.2d, at 1216. Relying primarily on the "long-continued" and "uniform" administrative practice, id., at 1218-1219, 1222-1223, and secondarily on congressional "acquiescence" in this practice through repeated re-enactment of the controlling statutory language, id., at 1220, the court held that interpretation of "bounty or grant" so as not to include a nonexcessive remission of an indirect tax is "a lawfully permissible interpretation of s. 303." 562 F.2d, at 1223.

We granted certiorari, and we now affirm.

II

It is undisputed that the Treasury Department adopted the statutory interpretation at issue here less than a year after passage of the basic countervailing duty statute in 1897, see T.D. 19321, 1 Synopsis of (Treasury) Decisions 696 (1898), and that the Department has uniformly maintained this position for over 80 years. This longstanding and consistent administrative interpretation is entitled to considerable weight.

* Note submitted by Richard P. Casna, J.D., Southwestern Univ., 1978 Intern. — Mc George European Program.

1. A report of the Customs Court decision appeared in the June 1977 issue of the *Bulletin*, at p. 276.

2. For purposes of this opinion, the Court adopts the convention followed by the parties and uses the term "remission" to ecompass both the exemption of exports from initial taxation and the refund to the exporter of any taxes already paid.

3. Of the five judges of the Appellate Court, three voted to reverse the decision of the lower court and two voted to affirm the decision. (Note by ed.)

Moreover, an administrative "practice has peculiar weight when it involves a contemporaneous construction of a statute by the (persons) charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new." *Norwegian Nitrogen Products Co. v. United States*, 288 U.S. 294, 315 (1933); see, e.g., *Power Reactor Co. v. Electricians*, 367 U.S. 396, 408 (1961).

The question is thus whether, in light of the normal aids to statutory construction, the Department's interpretation is "sufficiently reasonable" to be accepted by a reviewing court. *Train v. Natural Resources Defense Council*, 421 U.S. 60, 75 (1975). Our examination of the language, the legislative history, and the overall purpose of the 1897 provision persuades us that the Department's initial construction of the statute was far from unreasonable; and we are unable to find anything in the events subsequent to that time that convinces us that the Department was required to abandon this interpretation.

A

The language of the 1897 statute evolved out of two earlier countervailing duty provisions that had been applicable only to sugar imports. The first provision was enacted in 1890, apparently for the purpose of protecting domestic sugar refiners from unfair foreign competition; it provided for a fixed countervailing duty on refined sugar imported from countries that "pay. . ., directly or indirectly, a (greater) bounty on the exportation of" refined sugar than on raw sugar. Tariff Act of 1890, s. 237, 26 Stat. 584. Although the congressional debates did not focus sharply on the meaning of the word "bounty", what evidence there is suggests that the term was not intended to encompass the nonexcessive remission of an indirect tax. . . the "bounties" consisted of the amounts by which government payments exceeded the excise taxes that had been paid upon the beets from which the sugar was produced.

This concept of a "net" bounty — that is, a remission in excess of taxes paid or otherwise due — as the trigger for a countervailing duty requirement emerged more clearly in the second sugar provision, enacted in 1894. Tariff Act of 1894, s. 182½, 28 Stat. 521. The 1894 statute extended the countervailing duty requirement to all imported sugar, raw as well as refined, and provided for payment of a fixed duty on all sugar coming from a country which "pays, directly or indirectly, a bounty on the export thereof." A proviso to the statute made clear, however, that no duties were to be assessed in the event that the "bounty" did not exceed the amount of taxes already paid.

The 1897 statute greatly expanded upon the coverage of the 1894 provision by making the countervailing duty requirement applicable to all imported products. Tariff Act of 1897, s. 5, 30 Stat. 205. There are strong indications, however, that Congress intended to retain the "net bounty" concept of the 1894 provision as the criterion for determining when a countervailing duty was to be imposed. Although the proviso in the 1894 law was deleted, the 1897 statute did provide for levying of duties equal to the "net amount" of any export bounty or grant. And the legislative history suggests that this language, in addition to establishing a responsive mechanism for determining the appropriate amount of countervailing duty, was intended to incorporate the prior rule that nonexcessive remission of indirect taxes would not trigger the countervailing requirement at all.

B

Regardless of whether this legislative history absolutely compelled the Secretary to interpret "bounty or grant" so as not to encompass any nonexcessive remission of an indirect tax, there can be no doubt that such a construction was reasonable in light of the statutory purpose.

This purpose is relatively clear from the face of the statute and is confirmed by the congressional debates: the countervailing duty was intended to offset the unfair competitive advantage that foreign producers would otherwise enjoy from export subsidies paid by their governments.

In deciding in 1898 that a nonexcessive remission of indirect taxes did not result in the type of competitive advantage that Congress intended to counteract, the Department was clearly acting in accordance with the shared assumptions of the day as to the fairness and economic effect of that practice. The theory underlying the Department's position was that a foreign country's remission of indirect taxes did not constitute subsidization of that country's exports. Rather, such remission was viewed as a reasonable measure for avoiding double taxation of exports — once by the foreign country and once upon sale in this country. As explained in a recent study prepared by the Department for the Senate Committee on Finance,

*"(the Department's construction was) based on the principle that, since exports are not consumed in the country of production, they should not be subject to consumption taxes in that country. The theory has been that the application of countervailing duties to the rebate of consumption (and other indirect) taxes would have the effect of double taxation of the product, since the United States would not only impose its own indirect taxes, such as Federal and state excise taxes and state and local sales taxes, but would also collect, through the use of the countervailing duty, the indirect tax imposed by the exporting country on domestically consumed goods." Executive Branch GATT Studies, Senate Committee on Finance, 93d Cong., 2d Sess., 17-18 (1974).*

This intuitively appealing principle regarding double taxation had been widely accepted both in this country and abroad for many years prior to enactment of the 1897 statute.

The Secretary's interpretation of the countervailing duty statute is as permissible today as it was in 1898. The statute has been reenacted five times by Congress without any modification of the relevant language, and, whether or not Congress can be said to have "acquiesced" in the administrative practice, it certainly has not acted to change it. At the same time, the Secretary's position has been incorporated in the General Agreement on Tariffs and Trade (GATT), which is followed by every major trading nation in the world; foreign tax systems as well as private expectations thus have been built on the assumption that countervailing duties would not be imposed on nonexcessive remissions of indirect taxes. In light of these substantial reliance interests, the longstanding administrative construction of the statute should "not be disturbed except for cogent reasons." *McLaren v. Fleischer*, 256 U.S. 477, 481 (1921); see *Udall v. Tallman*, 380 U.S. 18.

Aside from the contention . . . that the Department's construction is inconsistent with this Court's decisions, petitioner's sole argument is that the Department's position is premised on false economic assumptions that should be rejected by the courts. In particular petitioner points to "modern" economic theory suggesting that remission of indirect taxes may create an incentive to export in some circumstances, and to recent criticism of the GATT rules as favoring producers in countries that rely more heavily on indirect than on direct taxes. But, even assuming that these arguments are at all relevant in view of the legislative history of the 1897 provision and the longstanding administrative construction of the statute, they do not demonstrate the unreasonableness of the Secretary's current position. Even "modern" economists do not agree on the ultimate economic effect of remitting indirect taxes, and — given the present state of economic knowledge — it may be difficult, if not impossible, to measure the precise effect in any particular case.

More fundamentally, as the Senate Committee with responsibility in this area recently stated, "the issues involved in applying the countervailing duty law are complex, and . . . internationally, there is (a) lack of any satisfactory agreement on what constitutes a fair, as opposed to an 'unfair' subsidy." S. Rep. No. 93-1298, p. 183 (1974). In this situation, it is not the task of the judiciary to substitute its views as to fairness and economic effect for those of the Secretary.

III

Notwithstanding all of the foregoing considerations, this would be a very different case if, as petitioner contends, the Secretary's practice were contrary to this Court's decision in *Downs v. United States*, 187 U.S. 496 (1903). Upon close examination of the admittedly opaque opinion in that case, however, we do not believe that *Downs* is controlling on the question presented here.

The Russian sugar laws at issue in *Downs* were, as the Court noted, "very complicated." Much of the Court's opinion was devoted to an exposition of these provisions, but for present purposes only two features are relevant: (1) excise taxes imposed on sugar sales within Russia were remitted on exports; and (2) the exporter received, in addition, a certificate entitling its bearer to sell an amount of sugar in Russia, equal to the quantity exported, without paying the full excise tax otherwise due. This certificate was transferable and had a substantial market value related to the amount of tax forgiveness that it carried with it.

The Secretary, following the same interpretation of the statute that he followed here, imposed a countervailing duty based on the value of the certificates alone, and not on the excise taxes remitted on the exports themselves. Downs, the importer, sought review, claiming that the Russian system did not confer any countervailable bounty or grant within the meaning of the 1897 statute. He did not otherwise challenge the amount of the duty assessed by the Secretary.

The issue as it came before this Court, therefore, was whether a nonexcessive remission of an indirect tax, together with the granting of an additional benefit represented by the value of the certificate, constituted a "bounty or grant". Since the amount of the bounty was not in question, neither the parties nor this Court focused carefully on the distinction between remission of the excise tax and conferral of the certificate. Petitioner argues, however, that certain broad language in the Court's opinion suggests that mere remission of a tax, even if nonexcessive, must be considered a bounty or grant within the meaning of the statute. Petitioner relies in particular on the following language:

*"The details of this elaborate procedure for the production, sale, taxation and exportation of Russian sugar are of much less importance than the two facts which appear clearly through this maze of regulations, viz.: that no sugar is permitted to be sold in Russia that does not pay an excise tax of R. 1.75 per pound, and that sugar exported pays no tax at all ... When a tax is imposed upon all sugar produced, but is remitted upon all sugar exported, then, by whatever process, or in whatever manner, or under whatever name it is disguised, it is a bounty upon exportation."*

This passage is inconsistent with both preceding and subsequent language which suggests that the Court understood the "bounty" to reside in the value of the certificates.

In our view the passage does no more than establish the proposition that an *excessive* remission of taxes — there, the combination of the exemption with the certificates — is an export bounty within the meaning of the statute.

No one argued in *Downs* that a nonexcessive remission of taxes, standing alone, would have constituted a bounty on exportation, and indeed that issue was not presented on the facts of the case. It must also be remembered, of course, that the Court did affirm the Secretary's decision, and that decision rested on the conclusion that a bounty had been paid only to the extent that the remission exceeded the taxes otherwise due. In light of all these circumstances, the isolated statement in *Downs* relied upon by petitioner cannot be dispositive here.

The judgment of the Court of Customs and Patent Appeals is, accordingly, affirmed.

# ANALYSIS

By this opinion, the sweeping effects anticipated as a result of the lower court's decision are seen to be rather short-lived. The *Zenith* decision, however, represents a significant statement by the Court and contains several points which should be noted.

First of all, the Court was unanimous in stating that a nonexcessive remission of an indirect tax, standing alone, will not be sufficient to trigger the countervailing duty provisions of the U.S. Tariff Act, and that a remission is nonexcessive whenever it does not exceed the amount of tax paid or that would be otherwise due. The tax considered in the *Zenith* case — the Japanese Commodity Tax Law — is an example of such a tax. Therefore, similar types of taxes such as value added taxes, in the sense that they do not provide for excessive remission of taxes, would likewise be considered as not countervailable under the *Zenith* decision. The Court was careful to point out, however, that excessive remissions, i.e., those which exceed the amount of tax paid or due, would be considered as subject to imposition of the countervailing duties.

A second significant aspect of the decision concerns the Court's discussion of the process of determining whether or not a 'bounty' has, in fact, been conferred. The Court reiterated language of the appellate court to the effect that the controlling factor in this determination is the 'economic result' of the foreign government's action. In reaching its decision, the Court gave considerable weight and recognition to the legislative history of the statute and to the administrative manner in which it has been enforced. The fact that no consensus exists in economic thought as to the effects of remissions of indirect taxes, coupled with the fact that it may well be impossible to determine any particular effect, led the Court to conclude that the application of the statute to only those cases of excessive remissions was a reasonable method of enforcement. The foundation of this premise was grounded in the theory that such application of countervailing duties was recognized as one method of avoiding double taxation of exports. In this same vein, the Court noted the lack of any agreement, internationally, as to what constitutes a fair, as opposed to an 'unfair' subsidy. This aspect of the decision is particularly significant coming as it does at a time when the United States government is calling for a reduction of trade barriers and for the reaching of an international agreement on the content of subsidized exports. In these circumstances the Court was inclined to state that the role of the judiciary does not include the re-fashioning of legislative and administrative action in these matters.

A third and final aspect of this case which deserves comment involves a procedural matter, and, though not addressed directly in the opinion, resulted from the action in this proceeding. When the case went to the Supreme Court for consideration, the Government of Japan and the Delegation of the Commission of the European Communities sought to present their views on the issues of the case to the Court. This was accomplished by way of diplomatic notes via the U.S. Department of State and the Solicitor General. However, in a letter to the Solicitor General the Clerk of the U.S. Supreme Court pointed out that the transmission of diplomatic notes to the Court was not authorized by the Court's rules and suggested that, in the future, foreign governments seeking to present their views to the Court in a particular case, do so by filing a brief as *amicus curiae*. Under Rule 42 of the Rules of the Supreme Court *amicus curiae* briefs are permitted with the consent of the parties to the case, or by motion in the absence of consent. The Clerk, in his letter to the Solicitor General, noted that in the unlikely event that any other party should decline to consent, the Supreme Court would almost certainly grant a foreign government's motion for leave to file as *amicus curiae*. This type of brief is in liberal use in all jurisdictions and provides a convenient and efficient way of communicating particular views to a court by outside parties. The Solicitor General has suggested to the Department of State, as a result of this, that the Department of State communicate to foreign governments this preferred manner of communicating with the Supreme Court.

In light of current trade negotiations, the *Zenith* case can be viewed as a definitional step along the path toward clearer focus on the content of export subsidies. Additional significance of the decision stems from the fact that one item on the agenda of the next U.S. Congress is trade legislation. At a time when the principles of GATT are being carefully examined, the *Zenith* case appears to strengthen those principles.

## UNITED STATES: SURVEY OF THE FEDERAL INCOME TAX RATES [continued from p. 14]

3. *Single individuals*

| | On that part of income between | | tax in % |
|---|---|---|---|
| | $ 0 | $ 2,300 | 0 |
| | $ 2,300 | $ 3,400 | 14 |
| | $ 3,400 | $ 4,400 | 16 |
| | $ 4,400 | $ 6,500 | 18 |
| | $ 6,500 | $ 8,500 | 19 |
| | $ 8,500 | $ 10,800 | 21 |
| | $ 10,800 | $ 12,900 | 24 |
| | $ 12,900 | $ 15,000 | 26 |
| | $ 15,000 | $ 18,200 | 30 |
| | $ 18,200 | $ 23,500 | 34 |
| | $ 23,500 | $ 28,800 | 39 |
| | $ 28,800 | $ 34,100 | 44 |
| | $ 34,100 | $ 41,500 | 49 |
| | $ 41,500 | $ 55,300 | 55 |
| | $ 55,300 | $ 81,800 | 63 |
| | $ 81,800 | $108,300 | 68 |
| Over | $108,300 | | 70 |

(plus State income tax)

4. There is another table for "heads of households" (e.g. a divorced person with a child). The rates are about the average of the rates of single persons and married persons filing joint returns.

### Exemption from taxable income

Personal exemption for the taxpayer, his spouse and each dependent: $1,000.

| *Maximum tax rate:* | |
|---|---|
| on earned income | 50 percent |
| on unearned income — e.g. dividends, interest, rent | 70 percent |

### Minimum tax on tax preferences

15 percent of the difference between the total of tax preference items and half of the regular income tax or — if this amounts to less than $10,000 — $10,000.
The minimum tax is levied in addition to the income tax.

### Alternative tax

If the alternative tax exceeds the regular income tax and the minimum tax on tax preferences, the excess must be paid in addition to the regular income tax and the minimum tax on tax preferences. The alternative tax is calculated on gross income, less deductions allowed and increased by the sum of tax preferences for adjusted itemized deductions and for the capital gains deduction.
The rates of that tax are:
- 10 percent on the alternative minimum income above $20,000 through $60,000
- 20 percent on such income above $60,000 through $100,000
- 25 percent of such income above $100,000.

## SOCIAL SECURITY AND UNEMPLOYMENT TAXES

### Old age benefit tax

Employer and employee must pay 6.13 percent each of the employee's employment income through $22,900 for social security and hospital insurance (Medicare).

### Unemployment tax

The employer must pay 3.4 percent of the first $6,000 paid to a covered employee for unemployment benefits.

### Self-employment tax

Self-employed persons must pay 8.1 percent of their income through $22,900 for unemployment benefits.

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# TAX GLOSSARY

by H.W.T. PEPPER *

**GROSS PRODUCT TAX** — A tax on the gross product or gross profit of a firm, a principle now embodied in VAT (q.v.) which taxes the "added value" at each stage of production and distribution. Added value is the gross amount charged by each entrepreneur for his efforts before deducting his expenses, and variously also described as his gross profit or gross product.

**GROSS PROFIT** — The profit computed by deducting purchases from sales, with due adjustment for increases or decreases in stock in trade or inventory, but without taking account of other expenses is referred to as the "gross profit". The figure computed is of significance in computing the GROSS PROFIT RATIO (q.v.) and is also equivalent to "added value", which is the tax base for VAT (q.v.).

**GROSS PROFIT RATIO** — The ratio of the GROSS PROFIT (q.v.) to the sales of a business or, alternatively, to the adjusted purchases, or "goods consumed", during the accounting period.

**GROSS RECEIPTS TAX** — A tax, usually at a low rate, upon the gross receipts of a business which usually takes the form of a CASCADE TAX (q.v.) (or TRANSACTIONS TAX) on the transactions of traders at all levels of production and distribution.
The levying of tax on the RECEIPTS of a business may, however, be allowed as an option to traders (instead of taxing them on *sales*) as a feature, e.g., of a retail sales tax, where the trader's accounts are kept in such a way as to make it easier to extract details of cash receipts in the taxable period than of sales effected therein.

**GROSSING UP** — Where income is subject to deduction of income tax at the source or where foreign income is brought into the country after the payment of foreign income tax thereon, the taxpayer receives a net sum after tax and is usually entitled to relief for the tax deducted or paid. The restoration or credit of the tax referred to in a sense can only be logically done in the context of a computation of tax in the home country on the gross income before deduction of tax.
Relief or credit for the tax deducted abroad is usually done in the computation of tax in the home country by taxing the foreign income on the gross amount before deduction of foreign tax and charging local tax less a credit for the foreign tax, the amount of the credit being fixed in the country's own tax laws as modified by any provisions in a DOUBLE TAXATION TREATY (q.v.) between the two countries involved.

**GROUND ANNUALS** — See GROUND RENTS.

**GROUND RENTS** — Rents receivable by the "ground landlord" for a site on which, usually, buildings have been erected by the lessee, the latter holding the land on a lease, which may be for as long as 99 or even 999 years, but nowadays tends to be for shorter periods. The system of separate ownership of land and buildings assists development in that the developer (who may be merely erecting a residence for himself on the land) does not have to find the capital to buy the land as well as to finance the building. Both "owners" have an interest in the land and may be liable to income and capital gains taxes, as well as, perhaps, to taxes on development.

**GROUPING NOTICE** — An application to the tax authorities for associated companies to receive GROUP TREATMENT (q.v.).

**GROUP OF TEN** — The group consists of Belgium, Canada, France, Germany, Holland, Italy, Japan, Sweden, the U.K. and the U.S.A., and its purpose is to endeavour to exert a stabilising effect on currencies by making funds available for support in certain special circumstances.

**GROUP RELIEF** — Relief may be claimed, e.g., under the U.K. corporation tax law, where one company within a group (or consortium) applies to surrender all or part of a tax-deductible loss for the benefit of another company within the group. (See also GROUP TREATMENT.)

**GROUP TREATMENT** — The term used to describe the tax treatment whereby the profits and losses of associated companies may be grouped together and, in effect, treated as the aggregated profits of a single enterprise. The treatment has particular relevance to such situations as (a) excess profit taxes where comparison is made between current profit and those of an earlier year or years. Some companies in the group may attract substantial tax liability while others show deficits compared with earlier results and greater equity is likely to result when a "global" comparison is made; and (b) as an anti-avoidance provision where a graduated scale of rates is applied to companies or corporations which encourages the fragmentation of a single large enterprise into a large number of small companies in order to obtain multiple benefit from the lower rates in the schedule. (See also ORGANSCHAFT and GROUP RELIEF.)

**GROUPS OF COMPANIES** — Two or more companies may be held to constitute a "group" where one is a subsidiary of the other or both are subsidiaries of a third. The precise degree of shareholding, etc. which constitutes control is usually defined in tax legislation.

**GROWTH IN VALUE** — As an extension of the ordinary application of income tax to accrued income, liability exists in some instances on unrealised gains. One example is the tax treatment of shares acquired by a director or employee from his company under a share option scheme. Under the U.K. tax provisions, tax liability exists on the growth in value of shares thus acquired for a period of 7 years after acquisition, or at the date of disposal, or upon the date there cease to be any restrictions on the shares held, whichever of the three dates occurs earliest. The ending of restrictions on shares held by directors or employees is technically known as their "unclogging". (See FIRST LETTING TAX for another example of tax liability on unrealised gains.)

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

**GRUBSTAKER** — (Canadian) See PROSPECTORS AND GRUBSTAKERS.

**GRUNDSTEUER** — (Austria, Germany) Land tax.

**GRUNDERWERBSTEUER** — (Austria, Germany) Tax on the transfer of land.

**GUIDELINE LIVES** — The estimated useful life of plant, machinery, etc. for the purposes of computing depreciation for U.S.A. tax purposes. The guideline figures may be changed from time to time in the light of actual experience.

# H

**HALF–INCOME RULE** — Certain capital gains tax regimes (U.K., U.S.A.) provide that an individual instead of paying tax at the normal CGT rate on his gains may have one-half the total gains added to his income and pay income tax at the appropriate basis on this reduced figure instead of CGT on the total gain. This provision is sometimes known as the "half-income rule".

**HANDLING CHARGES** — See CUSTOMS HANDLING CHARGES.

**HARDHEIDSCLAUSULE** — (Holland) Discretionary power of the tax administration in Holland to mitigate any harsh results of the tax law.

**HARDSHIP** — Hardship is often taken into account, not in the computation of taxes, such as income tax or property tax (local rates), but as a factor in either abating or cancelling the tax computed as due. Relief for hardship may be given either because the taxpayer has by misfortune or improvidence inadequate means to pay, or because the incidence of the tax has worked inequitably in his particular circumstances. Sometimes hardship may merely be taken into account as a factor justifying an extension of the period of time in which the tax has to be paid. In the case of property taxes in some countries, and the equivalent levying of local rates in Britain, where the tax charge is based not on actual ability to pay but by reference to the value of property owned or occupied, and to the quantum of local government expenditure which has to be apportioned among the owners and occupiers within the government's jurisdiction, there are various schemes for hardship relief. Abatements of property tax, or rates rebates, may be given to persons in the lowest income groups, the abatement being graded according to the income of the taxpayer or of the family unit. Some American states allow relief against property tax for low-income families in respect of the sales levied by the state of food. (See also, FAMILY INCOME SUPPLEMENT, NEGATIVE INCOME TAX.)

**HARMONISATION OF TAX, E.E.C. DIRECTIVES** — The Commission of the council of the European Communities have submitted a number of Directives on the harmonisation of taxes among the 9 members of the E.E.C. (agreed upon in general principles). Among these was the adoption of value added tax, the harmonisation of income tax rates and structures regarding companies, capital and other taxes on registration of companies, purchase and sale of securities, and so on. The directives are partly intended to assist in removing obstacles and difficulties in the way of the movement of investment capital between the member countries so as to facilitate economic development.

**HEALTH TAX** — The term applied to an extra tax (of 7 pence per 20 cigarettes) introduced by the April 1978 Budget in Britain to apply (from September 1978) to cigarettes with a tobacco tar content above 20 milligrams. The tax is in addition to ordinary fiscal levies. Research had shown that the health danger from smoking increased along with the ratio of the tar content in the tobacco. (See also, NATIONAL HEALTH CONTRIBUTIONS, PAYROLL TAXATION.)

**HEARTH TAX** — A form of poll tax payable on the basis of the household unit rather than by, e.g., each adult person.

**HEIGHT, OF TAX SYSTEM** — Term invented by Dr. J.B. Bracewell-Milnes (in his "Measurement of Fiscal Policy") to refer to a method of comparing the varying incidence of different tax systems at the "top", using coefficients compiled by adding the maximum tax rates for 8 taxes, namely, those on earned income, investment income, expenditure out of each of these, legacies and gifts received and transmitted, capital gains, and wealth.

**HERD BASIS** — A method of computing income tax in the case of farmers or livestock rearers, whereby a breeding herd or flock is regarded as a capital asset. Income tax is chargeable on the profits from the sale of progeny less the cost of replacement of units in the herd, but not upon the sale of the herd as a whole or of sections of it in the event of the herd being sold or being reduced in size.

**HIDDEN TAXATION** — See TAXE OCCULTE.

**HOBBY FARMING** — The term applied to agricultural activities, often conducted not on strictly commercial lines, by a "gentleman" or "dog and gun" farmer, where the farm is usually not the main activity of the taxpayer and is owned for prestige or recreational purposes rather than as a business proposition. Because farming losses are normally available for offset against other income when computing income tax, individuals who are subjected to very high marginal rates of income tax (and/or surtax) may find that farming losses are very largely offset by the income tax relief allowable in respect of the losses, and hence consider it worthwhile to run a hobby farm. Anti-avoidance measures taken to restrict or deny relief for hobby farm losses usually take the form of endeavouring to show by an analysis of the transactions and activities of the farm that there has been no serious attempt to make it profitable and, therefore, that no trade or business has, in fact, been carried on.

**HOBBY TRADING** — Where a trade, profession, or vocation is carried on as a hobby, rather than as a serious attempt to make commercial profits, relief for losses incurred is normally denied.

**HOLDING COMPANY** — When one company owns shares in another the possibility of double or dual taxation arises. Most tax systems take account of this factor, which is also recognised in double taxation treaties. Where the holding is significant, e.g., 10% or more, relief is usually given in respect of tax withheld from dividends payable to the holding company and/or from the tax charged on that company. Where the holding is large enough to give control other factors arise. (See CONTROL, etc.)

**HOME CONSUMPTION** — In computing the taxable profits of a business, account is usually taken of any goods or services provided by the businessman for his own home and family. To make this adjustment is in any case the only correct method in accountancy terms of computing accurately the results of his business activities.

On the other hand, a suitable debit has to be made for work done in the business by members of the family who are remunerated by payment in kind which is duly credited to sales. (See also, INTERNAL USE, CONTRA ACCOUNTS.)

**HOTEL TAX** — Taxation may be levied upon hotels in several ways, the most important being an occupancy or ROOM TAX (q.v.), and sales tax on gross receipts from room-letting and selected other services such as restaurant and bar, laundry, and, finally, the modern trend to levy VAT on total receipts. Apart from these levies there may be licensing duties on the hotel and its bars and restaurants, imposed more for control purposes than for revenue, although where as an incentive to the development of tourism hotels are exempted from income tax on profits, sales and licensing levies assume more importance as the manner in which a government may secure *some* revenue to help finance development.

**HOUSEKEEPER** — Although income tax reliefs to individual taxpayers are mainly given in respect of the cost of maintaining dependents who are related to the claimant, it is fairly common practice to grant relief where a bereaved spouse has to employ someone to act as housekeeper, especially where there are dependent children, and the taxpayer has to go out to work, and especially where the housekeeper (who need not be a relative) lives with the family.

**HOUSE PURCHASE** — It is the practice in some countries to allow special tax relief to persons, particularly employees, who are buying residences. In Britain and France interest payable on mortgages relating to a residence is tax-deductible. Germany allows a special deduction for residents of West Berlin of 50% of the cost of constructing their own houses.

**HOUSING ASSOCIATIONS** — (U.K.) Housing Associations are non-profit-making organisations, the function of which is to provide housing accommodation for its members, often by rehabilitating old property. Such associations are encouraged by being charged at a more favourable tax rate than ordinary commercial concerns.

**HOUSING FOR EMPLOYEES** — In general the value of free living accommodation provided by an employer for his employee and family is regarded as a taxable PERQUISITE (q.v.). Where the employee is *required* to live in a particular residence, e.g., to be near a factory or other work-place, however, it is not usual to tax the value of the accommodation. (See also, REPRESENTATIVE OCCUPATION.)

**HUSBANDRY** — The term husbandry is more or less synonymous with "farming". "Husbandry" has, however, been defined in U.K. tax law to cover activities such as the intensive rearing of hens in batteries, calves in stalls, and other so-called "factory" methods of "farming", where no farm in the traditional sense is required and the work may be done in places remote from farming areas.

**HUT TAX** — A form of poll tax levied on inhabited dwellings or huts usually at an early stage of development of an economy when it is necessary to raise funds for administration but not possible to introduce an income tax. Such taxes are usually levied at a fixed rate per hut and are, therefore, regressive, although it has been argued that there is a degree of graduation where a more affluent taxpayer in a polygamic society owns several huts, installing a different wife or family in each. Such taxes have, in general, been replaced by graduated poll taxes, income taxes and other forms of taxation.

**HYPOTHECATION OF REVENUE** — See EARMARKING OF REVENUE.

# I

**IDLE LANDS, TAX ON** — The theory that economic development may be promoted by taxing "idle" land, on the grounds that the owner will then either develop the land or sell out to someone else who will, has sometimes been advocated as a means of producing revenue as well as stimulating development. In practice, where lands have not been developed because they are not ripe for development, or because they are too remote from roads, population centres, etc., to make development feasible, taxes have not been successful in generating development since if the owner is forced to sell his lands for the payment of taxes he is unlikely to find a buyer to take on the lands, which now have the added disadvantage of a tax burden as well as being not ripe for development. Taxes on vacant sites or lots in developed areas have, on the other hand, something to recommend them and are, in fact, a feature of site value taxation and other forms of urban property taxation which take into account the market value of land, whether occupied or not.

**IF YOU CAN'T BAN THEM, TAX THEM** — Certain human activities are regarded by sections of public and religious opinion with some degree of disfavour. Governments, not usually anxious to incur unpopularity with *any* section of society, can sometimes gain public support when *taxing* the undesirable, though they might incur serious hostility if they tried to *ban* the activity.
"Prohibition" of alcohol in the U.S.A. was very unpopular, and its repeal enabled the Government to turn a negative revenue (the cost of trying to enforce Prohibition and deal with the attendant crime wave) into a positive revenue from licences, duties, and taxes on the commodity.
After failing to eliminate completely the activities of illegal "street bookies" taking off-course bets on horse races, Britain finally legalised betting shops in towns far from the race tracks, and collected tax revenue therefrom.
In France, efforts to ban pornographic and violent films were recently abandoned in favour of levying a special tax of 20% on the profits of production, distribution, and exhibition fo such films in addition to the ordinary 50% corporation tax.
Britain has (1978) introduced a special extra tax on cigarettes with a high tobacco tar content (See HEALTH TAX) instead of banning the use of such cigarettes, or smoking altogether.
In the U.S.A., more and more states are now running their own State lotteries, which may be more effective than police efforts in stamping out illegal "Street" lotteries (sometimes known as the "numbers racket"). (See also GAMING DUTIES, LOTTERY TAX, POOLS BETTINGS DUTY.)

**IMMIGRANT** — There is often special tax treatment of someone coming to reside in the taxing country, particularly in the year of entry when there is most danger to the newcomer of double taxation (in the old as well as the new country). In Britain, for example, there is a rule that where a source of income ceases before arrival, no tax liability will arise on remittances of income from the old sources, after arrival of the immigrant.

**IMMOBILISATIONS** — (France) Fixed assets.

**IMPACT OF TAX** — The impact of a tax may be distinguished from its "incidence", the impact being usually regarded as the effect on the person who has to pay the tax in the first place, while where he is able to pass the burden on to someone else the true incidence will be upon the latter person. Some writers, however, use the terms "impact" and "incidence" interchangeably in relation to the person who ultimately bears the tax.

**IMPORT DEPOSITS** — Import deposits are deposits usually expressed as a percentage of the value of goods imported imposed upon importers in an attempt to reduce imports, while at the same time providing a certain extra cash flow to the government from the surviving imports, usually in a period when there is a balance of payments problem. Import deposits have been used at different times in these circumstances, for example, in Italy and more recently in Britain and the Dominican Republic. Since they have a restrictive and unequal effect on trade, import deposits are usually highly unpopular with a country's trading partners, and may have a disproportionately large effect in inflating local prices.

**IMPORT DUTIES** — See CUSTOMS DUTIES.

**IMPORT QUOTAS** — The introduction of import quotas is usually regarded internationally as an inferior method of limiting imports, although, from the importing country's viewpoint, it has a much more predictable effect than the raising of tariffs. Since the actual imports may be quantified under a quota scheme, the importing country is able to plan its trade with some precision. In the exporting country, however, the effect may be that some traders may be more fortunate than others in obtaining portions of the quota available to the exporting country as a whole, with resulting inequity between different traders.

**IMPORT SURCHARGE** — In recent years the import surchage has been used as a means of restricting imports, which at the same time garners some extra revenue, in Britain and the U.S.A., in each case in an attempt to tackle a large balance of payments deficit. The device is usually regarded as temporarily expedient and on that footing is sometimes more acceptable to exporting countries than a quota scheme or a more permanent raising of tariff barriers. The surcharge is normally levied as a percentage addition to ordinary customs duties. (See also CUSTOMS REGULATOR.)

**IMPOST TAX** — The term is used for levies on imports made in Guernsey.

**IMPOSTA SUL REDDITO DELLE PERSONE FISICHE (IRPEF)** — (Italy) National personal income tax.

**IMPOSTA SUL REDDITO DELLE PERSONE GIURIDICHE (IRPEG)** — (Italy) National corporate income tax.

**IMPOSTA SUL VALORE AGGIUNTO (IVA)** — (Italy) Value Added Tax.

**IMPOT** — (Belgium, France, Switzerland) Tax.

**IMPOT ANTICIPE** — Withholding tax, such as the Federal tax on income from capital in Switzerland.

**IMPOT DES PERSONNES PHYSIQUES** — (Belgium) Individual income tax.

**IMPOT DES SOCIETES** — (Belgium) Corporate income tax.

**IMPOT SUR LA FORTUNE** — (France) Wealth tax.

**IMPOT SUR LE REVENU** — (France) Individual income tax.

**IMPOT SUR LES REVENUS DES COLLECTIVITES** — (Luxembourg) Corporate income tax.

**IMPOT SUR LES SOCIETES** — (France) Corporate income tax.

**IMPUTATION** — (Belgium, France) Credit.

**IMPUTATION SYSTEM** — The imputation system, in the context of the taxation of corporate income and dividends, is the system whereby:
(a) all corporate income, whether distributed or not, would be liable to corporate income tax at the same rate, but
(b) part or all of the corporate tax on the income distributed would be available to be set as a credit against the shareholder's tax liability on the dividends received or be wholly or partly repaid to him if the tax thus credited exceeded his personal tax liability.

**INCAPACITATED PERSON** — An individual, regarded by the law as incapable of looking after his or her own affairs, which are thus to be handled by trustees or executors. For tax purposes, recourse has to be to the trustees, etc., with the exception mentioned below. The group includes persons declared mentally unfit, infants (persons below the age of majority, usually 18 or 21) and sometimes married women, who though mentally capable were at one time barred from some transactions, mainly as a protection from being imposed upon by tricksters. In the case of infants, the protection of the law is mainly concerned with money, etc. coming to the child from external sources (and directed to be held in trust), but an "infant" has been held to be properly taxable in his own right on money he earns himself.

**INCENTIVES** — In the context of taxation the term "incentive" is generally used to refer to the situation where either no tax is charged upon certain types of income, or less tax than would usually be levied is charged, so that the taxpayer is encouraged to produce or earn a particular kind of income or carry on a particular kind of activity. Briefly, incentives may either take the form of EXEMPTIONS or TAX HOLIDAYS ( q.v.) or of special deductions being made which are either deductions which are not normally given or which are allowed at a higher rate than normal. (See also DEPRECIATION, FREE and INVESTMENT ALLOWANCES.) In the case of SELECTIVE EMPLOYMENT TAX (q.v.), in Britain, incentives in the shape of REGIONAL EMPLOYMENT PREMIUMS (q.v.) were paid to employers in sums exceeding the amounts of tax paid.

**INCIDENCE OF TAX** — The incidence of a tax is the amount of tax which an individual has ultimately to bear (which may be contrasted with his ability to pay or taxable capacity). (See also IMPACT OF TAX.)

**INCOME SPLITTING** — In the U.S. Federal Income Tax system an individual is liable to tax such that successive slabs of his income are liable to gradually increasing rates of tax. When the individual marries he may opt to have his own and his wife's income aggregated and then have the joint income taxed in accordance with a graduated scale in which the slabs of income chargeable at each rate are double in size. The term "income-splitting" derives from the relevant provision in the tax law which enacts: "In the case of a joint return of a husband and wife. . . . the tax imposed shall be twice the tax which would be imposed if the taxable income were cut in half . . . . . " (Section 2, U.S. Internal Revenue Code).

**INCOME TAX** — The term "income tax" is usually applied to a graduated annual tax on the aggregated income of all types received by a person, which in the case of an individual may include the income of his spouse or, in some tax systems, also that of his minor children. In practice, SCHEDULAR TAXES (q.v.), which charge taxes at different rates and sometimes according to different rules on different types of income, may also be regarded as income taxes since each "schedule" imposes tax on a particular type of income even though there is no aggregation.

**INCOME TAX, NEGATIVE** — The term "negative income tax" has been applied to systems of welfare payments which are calculated on the basis of the actual income, usually of a family group, compared with what are taken to be the minimum income levels for survival. The FAMILY INCOME SUPPLEMENT (q.v.) in Britain is a type of negative income tax and a proposal for such a "tax" is currently being processed in the U.S.A.

**INDEX-LINKED ADJUSTMENTS** — Some systems of capital gains taxation seek to eliminate from the tax computation that part of the gain which is attributable to currency depreciation and thus allow the original cost of the asset, disposed of at a profit in money terms, to be written-up by an adjustment based, for example, on changes in the cost of living index over the period of ownership. Since the value of personal and other reliefs from income tax which are expressed in money terms lose part of their value when money depreciates, it is usual to increase income tax reliefs from time to time in order to compensate. Some countries, notably Belgium and Britain, have now formally undertaken to index personal reliefs so that falls in their money value are automatically adjusted from year to year.

**INDICIA, EXTERNAL, OF WEALTH** — See EXTERNAL EVIDENCE OF MEANS.

**INDIRECT TAXATION** — This term relates to taxes which are borne by someone other than the person responsible for paying them initially (see also DIRECT TAXES). Broadly, indirect taxation is that levied on goods and services, including customs and excise duties and sales taxation, but the term would also cover payroll taxation levied upon an employer's wage bill without reference to the circumstances of individual employees and not intended to be passed on the employees.

**INDKOMSTSKAT** — (Denmark) Income tax.

**INDKOMSTÅR** — (Denmark) Income year.

[to be continued]

# Conference Diary

## FEBRUARY 1979

*British Branch of I.F.A.:* The taxation implications of the Hofstra Report, London (U.K.), February 22 (English).

## MARCH 1979

*Business International Institute:* Doing Business in the U.S.A. (including The U.S. Tax System), Mont Pélerin-sur-Vevey (Switzerland), March 4-7 (English).

*Conventions — Kopel Tours Ltd.:* Jubilee Convention of Accountancy and Taxation, Jerusalem (Israel), March 11-15 (Hebrew, English and German).

*British Branch of I.F.A.:* Self Assessment, London (U.K.), March 15 (English).

*International Bureau of Fiscal Documentation:* Tax, Investment and Trade Prospects in the Middle East, London (U.K.), March 19-21 (English).

*British Branch of I.F.A.:* The work of the OECD Fiscal Committee, London (U.K.), March 29 (English).

## APRIL 1979

*Management Centre Europe:* International Taxation (a working conference), Vienna (Austria), April 18-20 (English, French and German).

*Institute for International Research:* 1979 Corporate Tax Conference, London (U.K.), April 25-27 (English).

*Business International Institute:* International Seminar (including International Taxation), Port Chester, New York (U.S.A.), April 30 - May 11 (English).

## MAY 1979

*Investment and Property Studies:* The Vienna Conference (including international tax planning), Vienna (Austria), May 16-18 (English).

## JUNE 1979

*The Taxation Institute of Australia:* First International Convention (including Fundamental Concept in Double Taxation Treaties, Guide to Estate Planning Far East locations), Hong Kong, June 10-16 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The taxation of transfers of family-held enterprises on death and inter-vivos; II. The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities. For the seminars the following subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark), September 4-8 (English, French, German, Spanish).

## FEBRUARY 1980

*Business Perspectives:* 6th International Tax Conference. Singapore, February 4-8 (English).

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: Secretariat, c/o Williams & Clyn's Bank Ltd., P.O. Box 448, 20 Birchin Lane, London EC3P 3DP (U.K.).

Business International Institute, 12-14 chemin Rieu, 1208 Geneva 17 (Switzerland).

Business Perspectives: 11 Alexander Place, London SW7 2SG. Tel. 01-589-3197. Telex: 917036.

Conventions — Kopel Tours Ltd., 122 Hayarkon Street, P.O. Box 3054, Tel Aviv (Israel).

Institute for International Research, 70 Warren Street, London W1P 5PA (U.K.).

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

International Bureau of Fiscal Documentation, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam (Holland).

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4A 1AB (U.K.).

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

The Taxation Institute of Australia, 19th Floor, C.A.G.A. Building, 8 Bent Street, Sydney, 2000, Australia.

# Bibliography

# Books

*The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.*

## ALGERIA

### GUIDE DES ENTREPRISES ETRANGERES EN ALGERIE

5me Edition, février 1978. Algiers, Chambre Française de Commerce et d'Industrie en Algérie, 1978. 160 pp.
Guide providing information to foreign enterprises doing business with or investing in Algeria. Company law, business law, labour law and taxation aspects are considered. (B. 10.952)

## ARGENTINA

### FINANZAS PUBLICAS

Esbozo de una teoría general. By Dino Jarach. Buenos Aires, Editorial Cangallo, 1978. 650 pp.
Outline of a general theory on public finance. (B. 15.818)

## ASIA

### GLOSSARY OF TAX TERMS IN MEMBER-COUNTRIES OF THE STUDY GROUP ON ASIAN TAX ADMINISTRATION AND RESEARCH

(A SGATAR Project). Manila, National Tax Research Center, 1978. 109 pp.
Tax glossary explaining in Part I tax terms commonly used by two or more countries and in Part II tax terms as defined in the internal laws of the respective participating countries: Australia, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore and Thailand. (B. 51.142)

## AUSTRALIA

### 1978 AUSTRALIAN MASTER TAX GUIDE

North Ryde, CCH Australia, Ltd., 1978. 672 pp.
Annual guide providing explanation of the corporate and individual income tax for the 1978 income year. (B. 51.141)

### AUSTRALIEN: RECHTSBESTIMMUNGEN UND RICHTLINIEN FUR AUSLÄNDISCHE INVESTITIONEN

Cologne, Bundesstelle für Aussenhandelsinformation, 1978. Berichte und Dokumente zum ausländischen Wirtschafts- und Steuerrecht, No. 109/109A. 70 pp., 6 DM.
Legislation and related information concerning foreign investments in Australia. (B. 101.474)

### BUSINESS STUDY: AUSTRALIA

London, Touche Ross International, 1977. 135 pp.
Monograph on Australia which is part of a series, Business Study, prepared by Touche Ross International for the use of the firm and interested clients. The contents deal with investment factors, financial institutions and business regulations, forms of business entities, accounting and auditing and taxation in Australia. (B. 51.150)

### INVESTMENT IN AUSTRALIA

Canberra, Australian Government Publishing Service, 1976. 105 pp.
Information book setting out foreign investment in Australia and how to comply with the foreign investment guidelines; relevant statutes thereto are appended. (B. 51.147)

### CCH BUSINESS GUIDE TO BELGIUM

By Jean-Pierre de Bandt. With accounting and auditing chapter by Arthur Andersen & Co., Brussels. Chicago, Commerce Clearing House, Inc., 1978. 303 pp.
General presentation of information on doing business in Belgium, banking and finance, labour law and social security, taxation, accounting and auditing and other relevant subjects. (B. 101.463)

### LA FISCALITE IMMOBILIERE LIEE A LA POLITIQUE D'URBANISATION

By Jean van Houtte. Brussels, Etablissements Emile Bruylant, 1978. 9 pp.
Extract of Belgian report on real estate taxation and policy of city development delivered at the 10th International Congress of Comparative Law, held in Budapest, August 23-28, 1978. (B. 101.403)

## CANADA

### CORPORATE MANAGEMENT TAX CONFERENCE 1978

Toronto, Canadian Tax Foundation, 1978. 253 pp.
The two subjects discussed at the 1978 Corporate Management Tax Conference printed herein are: Tax Planning for Corporate Distributions before 1979 and New Strategies for Corporate Acquisitions. (B. 101.484)

### ESSAYS ON CANADIAN TAXATION

Editors Brian G. Hansen, Vern Krishna, James A. Rendall and contributors. Toronto, Richard de Boo, Ltd., 1978. 760 pp.
Collection of essays discussing various taxation topics intended as a useful source of readings for students or teachers in Canadian tax law. (B. 101.456)

### INCOME TAX ACT

Annotated. 9th Tax Reform Edition 1978 consolidated with amendments to July 1978 with related tax legislation and the income tax regulations. Editor-in-Chief H. Heward Stikeman. Toronto, Richard de Boo, Ltd., 1978. 1172 pp.
Annotated text of the Canadian Income Tax Act updated to July

1978 with related tax regulations. The full texts of the double taxation treaties with USA and U.K. are included. (B. 101.455)

## COMMON MARKET (EEC)

### BUSINESS STUDY: COMMON MARKET

London, Touche Ross International, 1976. 115 pp.
Monograph on the Common Market which is part of a series, Business Study, prepared by Touche Ross International for the use of the firm and interested clients. The present study deals with the individual countries of the Common Market with respect to exchange controls, investment factors, business entities and taxation. A description is given of the EEC — what it is and how it works (12 pages). (B. 101.537)

### FINANCIELE HULPVERLENING DOOR DE EUROPESE GEMEENSCHAP

Luxembourg, Bureau voor Officiële Publikaties der Europese Gemeenschappen, 1976. 27 pp.
Information on the financial aids provided by institutions of the Community to interested parties. (B. 101.427)

## GERMANY (FED. REP.)

### AUSSENSTEUERRECHT

Grundriss für Studium und Praxis. By Wolfgang Lipps. Bonn, Stollfuss Verlag, 1978. Schriftenreihe Recht und Praxis, Band 6. 303 pp., 29.80 DM.
Explanation of general aspects of German taxation in the case of international business relations (German taxation of foreign source income, tax treaties, the Foreign Investment Law, the Developing Countries Tax Law, and, in particular, the Foreign Tax Law). Texts of relevant statutes are appended. (B. 101.402)

### BESTEUERUNG DER PERSONEN- UND KAPITAL-GESELLSCHAFTEN

3., neubearbeitete und erweiterte Auflage 1978. By Hugo von Wallis and Wolfgang Heinicke. Heidelberg, Verlagsgesellschaft Recht und Wirtschaft, 1978. 264 pp., 54 DM.
Explanation of the taxation of the most common forms of partnerships, corporations, etc. (B. 101.434)

### BUSINESS STUDY: FEDERAL REPUBLIC OF GERMANY

London, Touche Ross International, 1976. 165 pp.
Monograph on the German Federal Republic which is part of a series, Business Study, prepared by Touche Ross International for the use of the firm and interested clients. The contents deal with investment factors, business practices, forms of business entities, accounting and auditing as well as taxation (46 pages). (B. 101.534)

### DAS EINKOMMENSTEUERRECHT

Kommentar zum Einkommensteuergesetz. 12. verbesserte und erweiterte Auflage. Band I. By Eberhard Littmann. Stuttgart, Fachverlag für Wirtschafts- und Steuerrecht Schäffer & Co., 1978. 1668 pp., 175 DM.
Comprehensive commentary on the West German Individual Income Tax Law, Sections 1-12. (B. 101.435)

### GRUNDZÜGE UND BEISPIELE ZUM ANRECHNUNGSVERFAHREN NACH DEM KÖRPERSCHAFTSTEUERGESETZ 1977

By Georg Renner and Jürgen Scheider-Ludorff. Ludwigshafen (Rhein), Friedrich Kiehl Verlag, 1978. 148 pp., 22 DM.
Monograph presenting the principles of the West German Corporate Income Tax System as enacted in 1977 with practical examples. (B. 101.436)

### HANDBUCH DER FINANZWISSENSCHAFT

Dritte, gänzlich neubearbeitete Auflage under Mitwirkung von Norbert Andel und Heinz Haller. Herausgegeben von Fritz Neumark. Lieferung 16, Band II, Tübingen, J.C.B. Mohr (Paul Siebeck), 1978. 80 pp., 16.80 DM.
Third revised edition of a handbook on public finance.
This supplement deals especially with the structural development of public finance and general tax theory. (B. 101.432)

### HANDBUCH ZUR LOHNSTEUER 1978

Stand: 1. Juli 1978. Munich, Verlag C.H. Beck, 1978. Schriften des Deutschen Wissenschaftlichen Steuerinstituts der Steuerberater und Steuerbevollmächtigten E.V. 581 pp., 45 DM.
Monograph containing all provisions, executive orders, rulings, etc. relevant to the West German wage tax. (B. 101.437)

### HÖCHSTRICHTERLICHE RECHTSPRECHUNG ZU INTERNATIONALEN DOPPELBESTEUERUNGSABKOMMEN

By Rudolf Weber-Fas. 2 Volumes. Tübingen, J.C.B. Mohr (Paul Siebeck), 1978. 410 + 420 pp., 74 DM per volume.
Collection of those decisions of the Supreme Tax Court (Bundesfinanzhof) and the Constitutional Court (Bundesverfassungsgericht) which are concerned with conventions for the avoidance of double taxation. (B. 101.414)

### KÖRPERSCHAFTSTEUERGESETZ 1977

Mit einschlägigen Vorschriften des EStG und UmwStG 1977. Handkommentar. By Kay D. Kläschen. Bonn, Stollfuss Verlag, 1977. 746 pp., 48 DM.
Loose-leaf publication commenting on the provisions of the West German Corporate Income Tax Law 1977. (B. 101.433)

### RECHNUNGSLEGUNG UND PRÜFUNG DER VERSICHERUNGSUNTERNEHMEN

Herausgegeben vom Institut der Wirtschaftsprüfer in Deutschland e.V. Düsseldorf, IdW-Verlag, 1978. 488 pp., 76 DM.
Comprehensive description of all the details of the accounting, auditing and taxation of insurance companies in West Germany. (B. 101.438)

## GREECE

### TAX PROFILE: GREECE

Prepared by Touche Ross International, Athens, July 1978. London, Tax Planning International, Finax Publications, 1978. 16 pp. (B. 101.488)

## HONG KONG

### BUSINESS STUDY: HONG KONG

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## ICELAND

### TAXES IN ICELAND 1978

Short description of the taxation of individuals and companies in Iceland 1978. (Assessment year 1978; Tax Year (Income year) 1977). Prepared by S. Thorbjörnsson. Reykjavik, Government Printer, 1978. 17 pp. (B. 101.466)

## INDONESIA

### PAJAK KEKAYAAN

Jakarta, Berita Pajak, 1976. 75 pp.
Consolidated text in the Indonesian language of the Net Wealth Tax Law of 1932 as amended. Implementing provisions are appended. (B. 51.119)

## INTERNATIONAL

### CONVENTIONS FISCALES ENTRE PAYS DEVELOPPES ET PAYS EN DEVELOPPEMENT

Septième rapport. Rapport du Groupe d'experts des conventions fiscales entre pays développés et pays en développement sur les travaux de sa septième réunion. New York, United Nations, 1978. 72 pp.
Seventh report on tax treaties between developed and developing countries (in French). An English edition of the same is available. (B. 101.473)

### INTERNATIONAL CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE FOR THE PREVENTION, INVESTIGATION AND REPRESSION OF CUSTOMS OFFENCES

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A study by the Rotterdam Institute for Fiscal Studies.
Volume B: Counry Reports. Deventer, Kluwer, 1978. 344 pp.
Study in two volumes analyzing the policy of six western European countries towards international tax avoidance from the statutory as well as economic points of view. Volume B contains country reports as of January 1, 1978 for Belgium, France, Germany, the Netherlands, United Kingdom and the U.S.A. (B. 101.416)

### THE INTERNATIONAL TAX TREATIES SERVICE

Editor Michael Edwardes-Ker. Dublin, In-Depth Publishing, Ltd., 1977.
Loose-leaf publication service which analyses the OECD 1977 Model Tax Convention on an article by article basis. The text of each article is quoted, followed by the Commentary, and then by Editorial comments. Then each court decision or ruling in any State relating to that particular article is analysed. Supplements will update the material. (B. 101.460)

## IRAN

### INDIVIDUAL AND CORPORATE TAX IN IRAN

Prepared by Bruce A. Miller of Touche Ross International, Tehran, August 1978. London, Tax Planning International, Finax Publications, 1978. 36 pp. (B. 51.138)

## ISRAEL

### THE ENCOURAGEMENT OF CAPITAL INVESTMENTS LAW 5719-1959

Incorporating all amendments to that Law, up to and including Amendment No. 17. Jerusalem, A.G. Publications, Ltd., 1978. 32 pp.
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Monograph on Japan which is part of a series, Business Study, prepared by Touche Ross International for the use of the firm and interested clients. The contents deal with investment factors, labour and business practices, forms of business entities, accounting and auditing, as well as taxation in Japan (33 pages).
(B. 51.148)

### GUIDE TO JAPANESE TAXES 1978-79

By Taizo Hayashi. Tokyo, Zaikei Shoho Sha, 1978. 234 pp.
Annual updated information on Japanese taxes levied as of April 1, 1978. (B. 51.140)

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### AN INTRODUCTION TO TAXATION IN KENYA

By Safdar Ali Butt and Amirali Sokwala. London, Cassell & Company, Ltd., 1978. 176 pp.
Guide explaining income tax, corporation tax and capital gains tax in Kenya. It is designed as a textbook for students with worked examples, questions and examination papers appended. The text is based on the Income Tax Act (Cap. 470) as of January 1, 1978. (B. 10.951)

## LATIN AMERICA

### ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA

1977 Report. Washington, Inter-American Development Bank, 1977. 450 pp.
Report presenting a detailed review of developments in Latin America viewed from two principal aspects: economic and social. Statistical summary is appended. (B. 15.820)

### ESTUDIOS DE DERECHO TRIBUTARIO INTERNACIONAL

By Ramón Valdés Costa. Montevideo, Rosgal S.A., 1978. 225 pp.
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Reglamento y disposiciones complementarias. Trigésimoquinta edición. Mexico, Editorial Porrúa, 1978. 629 pp.
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By Jean Lamodière. Aix-Marseille, Centre National de la Recherche Scientifique, 1977. Les Cahiers du C.R.E.S.M. (Centre

de Recherches et d'études sur les Sociétés Méditerranéennes, No. 6. 175 pp.
Study of the development of foreign investment law in Morocco. (B. 10.950)

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Enkele randvakken bij de studie van het belastingrecht.
By J. Reugebrink. Deventer, FED, 1978. 163 pp.
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Preliminary report prepared by C. van Raad concerning international fiscal non-discrimination under the Netherlands' direct taxes (e.g. corporate and individual income tax). Part 2 contains the report on the debates, answer and closing remarks. (B. 101.498)

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English translation of the text of the corporate income tax law in the Netherlands Antilles followed by an explanation of each article. (B. 15.821)

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### INVESTMENT IN SINGAPORE

Company law, taxation and related matters. Second edition. Singapore, Peat, Marwick, Mitchell & Co., 1977. 75 pp.
Guide designed to inform non-resident companies who contemplate investment or business activity in Singapore through the establishment of a Singapore company or a branch about the investment opportunities. Company law, taxation and related matters are included. (B. 51.122)

### INVESTOR'S GUIDE TO THE ECONOMIC CLIMATE OF SINGAPORE

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### MANUAL DEL IMPUSTO GENERAL SOBRE EL TRAFICO DE LAS EMPRESAS

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### BOTSCHAFT ZUR BUNDESFINANZREFORM 1978 VOM 15. MÄRZ 1978

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Setting out the amendment text of the Acts relating to capital transfer tax, development land tax, stamp duties and value added tax (including VAT Statutory Instruments) as operative on 6 August 1978. Editors Moiz Sadikali and David Roberts. London, Butterworths, 1978. 1196 pp., £ 7.95. (B. 101.454)

### BUTTERWORTHS YELLOW TAX HANDBOOK

Seventeenth edition. Setting out the amended text of the Taxes Acts relating to income tax, corporation tax and capital gains tax as operative for 1978-79. Editors David Roberts and Moiz Sadikali. London, Butterworths, 1978. 1100 pp., £ 9.95.
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Booklet explaining the provisions of the Development Land Tax Act 1976 as amended by the Finance Act. 1977. (B. 101.339)

### EXCHANGE CONTROL

An introductory guide to exchange control in the United Kingdom. By Halmer Hudson. Croydon, Tolley Publishing Co., 1978. 56 pp., £ 3.50. (B. 101.415)

### A GUIDE TO DIRECT FOREIGN INVESTMENT INTO THE UNITED KINGDOM

By Peter M. Barclay and John R. Poole. London, Finax Publications, 1978. 174 pp.
The law and practice outlined herein are as of March 1978. The taxes levied in the U.K. are described and U.K. anti-avoidance legislation is dealt with. (B. 101.450)

### THE HAMBRO TAX GUIDE 1978-79

By A.S. Silke and W.I. Sinclair. Consulting editor G.S.A. Wheatcroft. London, Macdonald and Jane's, 1978. 238 pp., £ 5.50.
This seventh edition deals with the tax system for the 1978-79 fiscal year and covers capital transfer tax, individual income tax, capital gains tax, the imputation system of corporation tax, development land tax and the value added tax. (B. 101.452)

### KEY TO INCOME TAX

Finance Act 1978 edition. By J.M. Cooper and Percy F. Hughes. London, Taxation Publishing Company, Ltd., 1978. 265 pp., £ 4.75.
Annual reference guide explaining the individual income tax changes effected by the 1978 Finance Act. (B. 101.449)

### PUBLIC SECTOR ECONOMICS

By. C.V. Brown and P.M. Jackson. Oxford, Martin Robertson & Company, Ltd., 1978. 452 pp., £ 16.—.
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Report of a Committee chaired by Professor J.E. Meade for the Institute for Fiscal Studies. London, George Allen & Unwin, 1978. 18 pp. (B. 101.244)

### TAX PHILOSOPHERS

Two hundred years of thought in Great Britain and the United States. By Harold M. Groves. Edited by Donald J. Curran.

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Study classifying the thoughts of major English-speaking tax philosophers as they apply to public finance, with emphasis on the philosophical rather than the economic aspects of taxation. (B. 101. 445)

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### INTERNAL REVENUE CUMULATIVE BULLETIN 1977-2, JULY—DECEMBER

Washington, Government Printer, 1978. 604 pp.
Consolidation of all official rulings, decisions, executive orders, tax treaties and other items of a permanent nature, published in the weekly Bulletin in the second half of 1977. (B. 101.462)

### RECOMMENDED TAX LAW CHANGES

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### STATE TAX HANDBOOK AS OF OCTOBER 1, 1978

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General guide to inform business enterprises planning to operate in one of the countries in Western Europe. It deals with investment incentives, exchange control, finance and taxation in the following countries: Austria, Belgium, Channel Islands, Denmark, Finland, France, Germany, Gibraltar, Ireland, Italy, Liechtenstein, Luxembourg, Monaco, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. (B. 101.536)

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Continuation of *H.W.T. Pepper's* Tax Glossary

# Contents

of the February 1979 issue

# TAX REFORM IN ND A

## An Evaluation of the Report of the Indirect Taxation Enquiry Committee (1977-78)

by G. Thimmaiah*

### 1. INTRODUCTION

Tax reform is supposed to set right any inconsistency between the prevailing design of tax structure and the policy objectives of the government. Such inconsistency may be the result of failure to design the tax structure appropriately or the result of changed circumstances which make the old design of the tax structure out-of-date. Periodical reforms are, therefore, necessary to adapt the tax structure designed in the past to the same objective in a changed socio-economic situation, or to serve changed objectives with the same socio-economic situation, or both. For this purpose, recommendations for tax reform should be based on empirical findings of the actual effects of the existing tax structure and a thorough examination of the sources of inconsistency between the policy objectives and tax levers.

Indian tax structure, which was designed by the British rulers mainly for raising revenue and remotely for reducing inequalities of income, was found inadequate for meeting the challenges of planned development which was ushered in by the government-sponsored Five-Year Plans. Therefore, the need arose early in the fifties for tax reform and, accordingly, the *Taxation Enquiry Commission* [1] *(TEC)*, was appointed in 1953 to suggest required changes in the tax structure to support the objectives of the Five-Year Plans. The TEC outlined the changed objectives of economic policy, and recommended required reforms for the purpose of achieving new economic policy objectives in a changed socio-political situation. The suggested reforms were based on theoretical arguments, survey of the then existing tax structure of the Central, state and local governments, and also empirical results on the incidence of taxation. The Committee's recommendations were by and large accepted and implemented by the Government of India.

**Large scale tax evasion**

Soon after, it was found that there was large scale evasion of income tax; as a result the objective of reducing inequalities of income and wealth required certain reforms in the direct tax structure. The Government of India invited Nicholas Kaldor [2] to suggest ways and means of redesigning and adapting the direct tax structure for achieving the objective of reducing inequalities of income and wealth. He suggested an "integrated direct tax structure", consisting of income tax (at a moderate rate), wealth tax, gifts tax, capital gains tax and expenditure tax. The Government of India accepted his recommendations and implemented them with a difference, i.e., as against the suggested moderate rates of income tax, the Government of India introduced high marginal rates of income tax, and also levied other direct taxes suggested by Kaldor.

Subsequently, the economic structure of the country changed so fast and became so much more sophisticated that the other policies of the government started off-setting the effects of direct taxation in reducing inequalities

**Contents**



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1. *Report of the Taxation Enquiry Commission*, Vols. I, II, III (Chairman: John Mathai) Ministry of Finance, Government of India, New Delhi, 1954.

2. *Indian Tax Reform: Report of a Survey*, Ministry of Finance, Government of India, New Delhi, 1965.

Further, there was a plethora of hurdles in tax laws and procedures. The Government of India, therefore, appointed a one-man Committee [3] to examine these complications and to recommend measures for rationalisation and simplification of the structure of direct as well as indirect taxes. The Government of India, however, did not accept all the recommendations of this one-man Committee. But the problem of tax evasion was further accentuated by the high marginal rates of income tax and widespread corruption. Hence in 1970 the *Direct Taxes Enquiry Committee* [4] was appointed to go into the matter thoroughly and suggest appropriate measures. The Committee suggested reducing marginal rates to encourage honesty in reporting income for taxation and this was implemented in 1975.

**The JHA committee**

However, by this time the relative importance of indirect taxes had increased and as a consequence their adverse economic effects were felt all over the economy. The economic distortions created by indirect taxes were only recognised towards the end of the Fifth Plan period. The Government of India realised that while the reform of direct taxation was overemphasised, required reform in indirect taxation was delayed for too long. Hence, a Committee [5] was constituted in July 1976 to examine the required reforms within the whole structure of indirect taxes including those levied by Central, state and local governments. The Committee submitted an Interim Report in April 1977, Part I of the Report in October 1977, and Part II of the Report in January 1978. The terms of reference of this Committee were far-reaching as were its recommendations; however, the Report has not received the public attention it deserves.

### INDIAN INDIRECT TAX SYSTEM

In India indirect taxes include Union excise duties, customs duties, state excise duties, Central sales tax, state sales tax, tax on passengers and goods, entertainment tax, *octroi* and cesses.

The Central Government levies six types of Union excise duties which are levied on manufactured goods (other than intoxicating liquors) at the point of production. These duties resemble the manufacturers' sales tax. Though the Central Government levies additional Union excise duties (one of the six types) in place of the former states' sales tax on six commodities, the net yield is distributed among the states on the advice of the Finance Commission. In addition, the Central Government levies Central sales tax on inter-state sales, but the revenue is collected and appropriated by the state governments. The Central Government is the sole authority to levy customs duties (taxes on exports and imports) as in other countries.

The state governments levy excise duties on the production of liquors, sales tax on the sale of all types of commodities for consumption. States' sales tax has been levied mostly at single point, though double-point and multiple point sales taxes are still in operation in some states. The state governments also levy entertainment tax and a tax on the value of the passenger fare and goods freight carried by motor vehicles. However, they have delegated the power to levy *octroi* and cesses to urban local bodies. *Octroi* is levied on the quantity of goods brought into the municipal area either for sale or for consumption. Cesses are levied in the form of surcharges by the urban local bodies, mostly on property tax, and the revenue from them is earmarked for specific purposes, e.g. education, public library, health, etc.

## 2. APPROACH TO TAX REFORM

The Committee has recognised that the industrial output has grown in volume and diversity, that the foreign exchange constraint has lost its importance in view of increased foreign exchange reserves, and that tax administration has reached a high degree of sophistication and experience. Furthermore, new lines of production have been established and the pattern of consumption has changed in the sense that products which were once considered luxuries have become commodities of widespread consumption because of their cheapness. In the light of these structural changes in the Indian economy, the Committee has observed that

> *"one of the basic tasks of reform of the system of indirect taxation is to reconcile the revenue objectives with the objectives of establishing a structure of taxation which would meet the ends of equity, growth and efficiency, keeping in view the structural changes in the economy which have been accruing as a result of the development process".* [6]

For the purpose of its deliberations, the Committee has defined indirect taxes

> *"in the conventional sense of covering those taxes which are expected or intended to be passed on, whether or not they are passed on, to someone else",* [7]

and has based its analysis of the existing structure of such indirect taxes on empirical studies commissioned by the Committee and, furthermore, has recommended the required reforms to achieve the main objectives of a more desirable tax structure. The Committee has maintained that a sound tax system should satisfy at least four criteria:

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3. *Final Report on Rationalisation and Simplification of the Tax Structure* (Chairman: S. Bhoothalingam), Ministry of Finance, Government of India, New Delhi, 1967.
4. *Final Report of the Direct taxes Enquiry Committee* (Chairman: K.N. Wanchoo), Ministry of Finance, Government of India, New Delhi, 1971.
5. *Indirect Taxation Enquiry Committee:* Part II (Chairman: L.K. Jha), Ministry of Finance, Government of India, New Delhi, January 1978.
6. *Interim Report of the Indirect Taxation Enquiry Committee* (Chairman: L.K. Jha), Ministry of Finance (Department of Revenue and Banking), Government of India, New Delhi, April 1977, p.iv.
7. *Ibid.*, p. 10.

(1) built-in-elasticity of yield;
(2) progressivity in its overall incidence;
(3) planned non-neutrality in its effect on production, employment, investment and relative costs; and,
(4) simplicity in tax administration.

These characteristics of a sound tax system are too well-known to need any elaboration. Starting from these premises, the Committee has examined the structure of Union excise duties, import and export duties entirely levied and collected by the Central government, sales taxes levied and collected by the state governments, and octroi [8] which is levied and collected mostly by urban local governments. Of these, it has given more importance in its enquiry to the Union excise duties and sales taxes because of their revenue importance (see Table 1) and their significant distortion effects in the economy.

**TABLE 1**

**THE RELATIVE IMPORTANCE OF DIRECT AND INDIRECT TAXES IN THE INDIAN TAX SYSTEM, 1976-77**

| Category | Percentage contribution to total tax revenue of the country | |
|---|---|---|
| 1. Indirect taxes, of which | | 79.3 |
| (a) Union excise | 34.6 | |
| (b) Customs | 12.3 | |
| (c) Sales tax | 19.0 | |
| (d) Other indirect taxes | 13.4 | |
| 2. Direct taxes, of which | | 20.7 |
| (a) Income tax | 8.0 | |
| (b) Corporation tax | 9.2 | |
| (c) Other direct taxes | 3.5 | |
| 3. All taxes | | 100.0 |

*Source:*
*Report of the Indirect Taxation Enquiry Committee,* Part II, January, 1978, pp. 6-7.

**Built-in elasticity is lacking**

The Committee has found that whereas the yield from sales tax satisfies the built-in elasticity criterion, other indirect taxes do not. This is so with Union excise duties and is mainly attributed to the reliance on the "specific rates". But it has been pointed out that,

> *"A basic factor which has been ignored by the Committee which is responsible for this inelasticity of tax revenue is the widespread exemptions provided for the small sector which accounts for 40 percent of industrial production."* [9]

**Progressivity of indirect taxes**

However, the Committee has found that all these indirect taxes are progressive in their incidence in relation to consumer expenditure. This finding is based on the incidence of tax measured with reference to per capita consumer expenditure. In other words, for measuring the "actual incidence" the actual per capita yield from indirect taxes is allocated in proportion to the per capita consumer expenditure of different classes of consumers. This gives a progressive incidence which is a necessary condition for progressivity (see Table 2), but this is merely a *necessary* condition and not a *sufficient* condition. The sufficient condition is that its incidence on the nature of commodities taxed should also be progressive. That is, it should be progressive by nature of commodities in the sense that the proportion of tax paid by different expenditure groups should be low on necessities like foodgrains, higher on comforts and highest on luxuries. This is not borne out from the Committee's study which may be observed in Table 3. Even then, the Committee has tried to suggest reforms to make indirect taxes more progressive which implies that the Committee is not confident about the results it has obtained. Further, the Committee has not specified what kind of progression the indirect taxes should have in India nor how to reconcile it with incentives to save, invest and work. Probably the Committee thought that these are relevant for direct taxes only.

**Planned non-neutrality**

As regards planned non-neutrality, almost all indirect taxes are found to be distorting in their effect on relative costs and prices mainly because of the haphazard way the rates of indirect taxes are fixed for different commodities without making distinctions between inputs, raw materials and final products. In this context, the Committee has maintained that

> *"a considerable divergence (exists) between the 'nominal' rate of tax of which the consumer is aware when he buys a product, and . . . the 'cumulative levy' which would represent the sum total of all the indirect taxes levied by different authorities at various stages before the final product reaches the consumer."* [10]

The Committee has observed that,

> *"seen from the purely theoretical point of view, it is important to remember that neutrality is a desirable attribute only in so far [as] taxation is looked upon as purely a means of raising revenue".* [11]

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8. This is a tax levied mostly by the urban local bodies in India on the goods entering into their municipal boundaries intended either for consumption or for sale within the municipal boundaries. The word *octroi* is not mentioned in the Indian Constitution. But it is used to refer to the tax powers of the state governments under the entry 52 of the State List in the Constitution which reads as "taxes on entry of goods into a local area for consumption, use or sale therein". The state governments have delegated the power to levy these taxes to the local bodies and the urban local bodies are levying *octroi* under such delegated power.
9. A Bagchi, "Central Budget 1978—79; A Symposium", *Margin: A Quarterly Journal of NCAER,* April 1978, p. 54.
10. *Interim Report,* p. 27.
11. *Interim Report,* p. 19.

## TABLE 2

**INDIRECT TAXES AS PERCENT OF TOTAL EXPENDITURE AND TOTAL CASH EXPENDITURE BY PER CAPITA EXPENDITURE GROUPS (1973-74)**

| Monthly per capita expenditure group (in Rs.) | Rural | | Urban | | All India | |
|---|---|---|---|---|---|---|
| | Tax as percent of total expen-diture | Tax as percent of total cash ex-penditure | Tax as percent of total expen-diture | Tax as percent of total cash ex-penditure | Tax as percent of total expen-diture | Tax as percent of total cash ex-penditure |
| 0 - 15 | 2.91 | 4.55 | 3.63 | 4.44 | 2.96 | 4.56 |
| 15 - 28 | 3.33 | 5.25 | 6.31 | 6.79 | 3.63 | 5.46 |
| 28 - 43 | 4.45 | 7.27 | 7.36 | 7.93 | 4.89 | 7.41 |
| 43 - 55 | 6.18 | 10.32 | 9.66 | 10.31 | 6.85 | 10.31 |
| 55 - 75 | 6.71 | 11.40 | 11.86 | 12.70 | 7.92 | 11.82 |
| 75 - 100 | 10.02 | 16.43 | 14.80 | 15.85 | 11.40 | 16.21 |
| 100 & above | 16.17 | 22.46 | 30.19 | 31.35 | 21.96 | 26.77 |
| All house-holds | 8.03 | 12.87 | 17.96 | 19.03 | 10.54 | 14.96 |

*Source: Op.cit.*, p.90.

But, the Committee has pointed out,

*"In India, where investment and production are to be carried on according to planned priorities and reduction of inequalities is an accepted objective, indirect taxation will have to be used, where necessary, in a non-neutral way for bringing about reallocation of resources as between different consumer products and for introducing progression in the distribution of the tax burden."* [12]

### Preservation of resources through indirect taxation

Further, the Committee has argued that:

*"The market price of a resource may not reflect its true scarcity value to society, in such a case indirect taxation can be used as a tool to conserve that resource and to encourage the utilisation of substitute resources which may be less valuable from the long-term interests of society."* [13]

The Committee has further maintained that such intervention by the government to influence prices through indirect taxes may cause a short-term welfare loss through the traditional "excess burden", but will be offset by long-term wélfare gains to society. Here, the Committee has raised a point without proving it convincingly. It would have been more acceptable if the Committee had justified the case for progressive structure of indirect taxes on the basis of the political decision of the Party in power instead of taking shelter under long-term social gain to the society — *which is only a mirage!*

The administration of any tax is never satisfactory and, hence, it deserves periodical scrutiny. But it is surprising to know from the Committee's findings that the administrative procedures are as complicated as they ever were, notwithstanding the appointment of several Committees [14] which were asked to examine them and to suggest measures to simplify them.

## 3. REFORM OF UNION EXCISE DUTIES

The TEC judged the suitability of a commodity for the levy of excise on the basis of the extent to which indigenous production had grown under the umbrella of protection, whereas the Committee has judged it on the basis of the nature of the commodity, i.e., whether it is a necessity or luxury, and the uses to which it is put, for example, whether as an input [15] or the final product. Further, the Committee has found a plethora of rates on similar commodities arbitrarily fixed mainly for revenue purpose. And even these rates have been varied in response to pressures brought upon the government by vested interests on various grounds. The result has been an anarchy of rates. For instance, the *Venkatappaiah Committee* [16] has pointed out that there were three hundred statutory basic rates of excise duties on all excisable commodities which were increased to *two thousand* effective rates through administrative notifications. On textile items alone there were about two hundred effective rates. Even after implementing the *Venkatappaiah Committee* recommendations there are still fifty effective rates on textiles. Furthermore, specific duties dominated the excise duty structure, thereby making it less progressive and less revenue-elastic. This will be evident from Table 4. Therefore, the Committee has recommended a speedy switch-over to *ad valorem* duties to make their yield elastic and their incidence progressive.

The Committee has suggested the following guidelines for reforming excise duties:

(i) the rates of duties on raw materials should be lowered and the revenue loss, if any, made good by devising an upward adjustment of rates on final products;
(ii) the rates of duties on substitute raw materials should be the same except in cases where their use is to be economised,

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12. *Ibid.*
13. *Interim Report*, p. 20.
14. They are: *Customs Reorganisation Committee* (1958), *Central Excise Administrative Reorganisation Committee (1963), Committee on Rationalisation and Simplification of the Tax Structure (1967), Working Group of the Administrative Reforms Commission on Customs and Central Excise Administration* (1968), and (Central Excise (Self Removal Procedure) Review Committee *(1975)*.
15. The term input has been used by the Committee to refer to "raw materials, semi-finished goods and intermediate goods".
16. *Central Excise (Self Removal Procedure) Review Committee* (Chairman: B. Venkatappaiah), Government of India, New Delhi, 1975.

## TABLE 3

### DISTRIBUTION OF THE BURDEN OF INDIRECT TAXES AS PERCENT OF TOTAL CONSUMPTION EXPENDITURE (1973-74)

| Commodities | Monthly per capita expenditure groups (in Rs.) 0-15 | 15-28 | 28-43 | 43-55 | 55-75 | 75-100 | 100 & above | All urban house-holds |
|---|---|---|---|---|---|---|---|---|
| Foodgrains and atta (wheat flour)* | 0.30 | 0.37 | 0.36 | 0.33 | 0.28 | 0.24 | 0.18 | 0.26 |
| Sugar | 0.61 | 0.46 | 0.60 | 0.55 | 0.54 | 0.51 | 0.38 | 0.47 |
| Tea & Coffee | 0.00 | 0.05 | 0.14 | 0.15 | 0.22 | 0.33 | 0.28 | 0.23 |
| Vegetable products, oil & fats | 0.00 | 0.33 | 0.46 | 0.52 | 0.50 | 0.50 | 0.40 | 0.47 |
| Kerosene oil | 0.00 | 0.48 | 0.51 | 0.54 | 0.51 | 0.50 | 0.45 | 0.50 |
| Drugs and medicines | 0.00 | 0.09 | 0.17 | 0.23 | 0.28 | 0.36 | 0.52 | 0.36 |
| Tobacco products | 0.00 | 0.34 | 0.57 | 1.03 | 1.16 | 1.55 | 3.12 | 1.80 |
| Liquor* | 0.00 | 0.13 | 0.02 | 0.20 | 0.16 | 0.74 | 2.46 | 1.03 |
| Cotton fabrics* | 0.00 | 0.12 | 0.01 | 0.18 | 0.51 | 0.59 | 1.68 | 0.81 |
| Art and rayon silk | 0.00 | 0.00 | 0.00 | 0.02 | 0.15 | 0.25 | 1.31 | 0.52 |
| Matches | 0.00 | 0.05 | 0.07 | 0.10 | 0.09 | 0.06 | 0.05 | 0.07 |
| Soap and detergents | 0.00 | 0.08 | 0.11 | 0.11 | 0.12 | 0.12 | 0.11 | 0.11 |
| Paper & paper products | 0.00 | 0.03 | 0.03 | 0.09 | 0.21 | 0.20 | 0.31 | 0.22 |
| Motor spirit | 0.00 | 0.18 | 0.21 | 0.26 | 0.28 | 0.29 | 4.45 | 1.66 |
| Refined diesel oil | 0.00 | 0.33 | 0.35 | 0.52 | 0.73 | 0.79 | 1.36 | 0.88 |
| Tyres & tubes | 0.61 | 0.10 | 0.10 | 0.13 | 0.16 | 0.17 | 0.39 | 0.23 |
| Iron & steel | 0.00 | 0.48 | 0.54 | 0.68 | 0.76 | 0.80 | 1.30 | 0.91 |
| Total for 17 items | 1.52 | 3.62 | 4.25 | 5.64 | 6.66 | 8.00 | 18.75 | 10.53 |
| Total incidence for all indirect taxes | 3.63 | 6.31 | 7.36 | 9.66 | 11.86 | 14.80 | 30.19 | 17.96 |

*Note:* *Taxes on these commodities are levied only by the states.
*Source: Op.cit.,* pp. 102-103.

The last column is only a summary of the per capita tax paid on different commodities. In order to know whether an indirect tax is progressive or not, we have to read the per capita tax paid on different commodities by the consumers belonging to different levels of consumption expenditure. For instance, the per capita incidence of indirect taxes on foodgrains and *atta*, sugar, kerosene oil, and matches is regressive if we compare the per capita tax paid at different levels of monthly per capita expenditure. Except sugar, the remaining three commodities are necessities in India. Therefore, though the incidence of indirect taxes is progressive in terms of aggregate consumer expenditure as indicated in Table 2, it is regressive when we consider it both by consumer expenditure groups and by commodities like necessities and luxuries.

(iii) the rates of duty on components as well as on final goods may be the same; and
(iv) packing materials used in essential goods may be taxed moderately.

If an unforeseen revenue contingency arises, a surcharge on all commodities may be levied on a short term basis, but if it becomes permanent, then appropriate upward adjustments in rates should be carried out.

**Committee recommends introduction of a small number of basic rates**

The Committee has recommended that there should be a minimum of four or five basic rates such as 10, 20, 30, and 40 percent *ad valorem* and that the highest need not be a ceiling rate. Some products like foodgrains, handloom textiles, etc. may be exempted for the purpose of making the incidence of indirect taxes progressive. Products of widespread consumption like vanaspati (hydrogenated edible oil) and refined vegetable oil may be taxed between five and ten percent *ad valorem*. The twenty percent rate may be applied to the generality of the products for mass consumption and the thirty to forty percent rates may be applied to products in the nature of comforts and luxuries. The exceptions to these would be the products on which outlay is small (e.g., matches) which may be taxed at high rates even though they are not luxuries. At present, foodgrains and salt are exempted from union excise duties even though foodgrains are covered by a single-point sales tax. Textiles are taxed at low rates, but synthetic fabrics are taxed at higher rates on the assumption that they are used mostly by the wealthy. The Committee has recommended lower rates on artificial fabrics because of their widespread use and in view of a changed pattern of consumption. Raw materials are recommended to be taxed at low rates, because,

> *"Apart from reducing unjustified discrimination between computing raw materials, changes in the excise duty on raw materials should aim at lowering the costs of those consumer goods on which we are anxious to avoid having too high a cumulative levy."*[17]

17. *Interim Report,* p. 69.

## TABLE 4

### THE RELATIVE IMPORTANCE OF AD VALOREM AND SPECIFIC EXCISE DUTIES IN 1976-77

| Commodity group | Revenue (1976-77) (Rs. in million) | Percentage of total excise revenue |
|---|---|---|
| 1. Subject to specific duty | 21,278.7 | 50.7 |
| 2. Subject to *ad valorem* duty | 190,008.4 | 45.3 |
| 3. Others: | | |
| a) *Ad valorem* component | 976.9 | 2.3 |
| b) Specific component | 703.1 | 1.7 |
| 4. Total | 41,967.1* | |

*Notes:* (i) The item "others" above includes commodities subject to *ad valorem*-cum-*specific* rates such as aluminium.

(ii) Some commodities are subvidided in a number of sub-headings of which some are subject to *specific* rates while the others are subject to *ad valorem* rates, e.g. copper and copper alloys.

* Gross revenue excluding cesses and miscellaneous receipts. These "cesses" refer to surcharges levied by the Central Government on the commodities subject to Union excise duties. The revenue from these cesses is earmarked for the handloom industry. These "cesses" are one of the six types of Union excise duties levied by the Central Government.

*Source: Report of the Indirect Taxation Enquiry Committee,* Part II, January 1978, p. 23.

The Committee has specifically suggested a reduction of rates on packaging materials such as aluminium foils which are used in the packaging of essential drugs. However, the Committee has failed to recognise the administrative difficulty in distinguishing its use for packaging of essential drugs from its use for packaging of non-essential drugs. The Committee has also suggested freer and more liberal use of the present relief from taxation for inputs under section 56A of the Central Excise Rules, 1944. The Committee has felt that the present rate of 28.5 percent duty on grey cement is high and, hence, it deserves reduction. Regarding the taxation of capital goods, the Committee has maintained that

> *"capital goods in the nature of plant and machinery should not be subject to a cumulative excise levy higher than 5 percent, unless there are good and identifiable reasons for a higher imposition"*.[18]

In regard to the excise duty concessions which are intended for both the administrative reason of identifying the producers and for the economic reason of protecting small producers, the criteria used for providing concession, such as (a) the value or quantity of production in a year, (b) the number of workers employed, (c) the use of power, and (d) the value of the plant and machinery installed, are considered to be complicated. Hence, the Committee has suggested the use of one criterion, viz., the value of production, on a slab basis. Thus, the industries whose annual output is below Rs.0.25 million may be exempted, and those whose annual output is above this amount up to Rs. 1 million, and between Rs. 1 million and Rs. 1.5 million, may be taxed at concessional rates. Above this limit (turnover of over Rs.1.5 million), normal rates may be made applicable. It is noteworthy that the Committee has cautioned that its suggestions are solely in the nature of model guidelines notwithstanding specific recommendations relating to several commodities.

The Committee has maintained in one instance that,

> *"Fiscal concessions should be an adjunct to rather than a substitute for a positive well-thought-out policy for developing decentralised production."*[19]

However, later the Committee observed

> *"that the situation is not one which can be viewed as presenting a choice between fiscal concessions on the one hand and alternative ways of helping the small scale sector on the other. The question is one of evolving an appropriate mix of policy measure to ensure that smaller industrial units derive and retain adequate dynamism."* [20]

How this should be done is not outlined by the Committee, with the exception of vague statements such as,

> *"tax concessions to small producers should be so devised that they do not inhibit the natural growth of the concerned units or encourage undesirable practices of one kind or another."* [21]

Quite apart from such generalisations, the Commitee has made no attempt to integrate tax concessions to small industries into the social objectives they are intended to serve, such as, the requirement to provide minimum wages and workman's accident benefits, etc. Otherwise, if tax concessions are given mainly on the basis of the value of the output, such small producers may reap a "tax-subsidy" in addition to the exploitation of helpless labourers without payment of minimum wages. This integrated approach is overlooked by the Committee.

## 4. REFORM OF IMPORT DUTIES

The Committee has found that import duties have been used to provide protection to domestic industries and to conserve foreign exchange, and therefore, has pointed out that the classification of imported goods into capital goods, raw materials, intermediaries and consumer goods has not resulted in a uniform levy on each of these categories, nor in a rising scale of levies on these different categories of goods. This is mainly due to the charging of countervailing duties in addition to import

18. *Report of the Indirect Taxation Enquiry Committee,* Part I, Government of India, October 1977, pp. 74-75.
19. *Interim Report,* p. 171.
20. *Interim Report,* p. 177.
21. *Interim Report,* p. 179.

duties. Countervailing duties on imported goods are intended to equalise the landed price of imported goods with the price of those produced in the country. For instance, 120 percent import duties plus countervailing duties on consumer goods makes no distinction between necessities and luxuries. Though import of capital goods is taxed at lower rates, raw materials are heavily taxed at 45 percent, thereby adding to the cascading effect. The Committee has opined that,

> *"In so far as taxation is looked upon as an instrument of mobilising savings for investment, the tax on capital goods is not to be commended as it is likely to be met out of the country's savings at least in the short-run."* 22

**The Committee recommends the reduction of import duties**

Therefore, the Committee has felt that

> *"the level of existing import duties on capital goods as a class is higher than necessary. So is the severity of import restrictions."* 23

Hence, the Committee has suggested the present rate of 40 percent be reduced. In regard to raw materials, it has been recommended to reduce the duty except in the case of raw materials which have to be restricted for want of foreign exchange. Any revenue loss may be recovered by pushing up the rates on final products. According to the Committee, details of such modifications may be based on an industry-to-industry study entrusted to the Bureau of Industrial Costs and Prices. In the case of intermediate and semi-processed goods, the present rate of 75 percent is considered too high and, hence, reduction to a level necessary for protection is recommended. The Committee has observed that,

> *"The high level of import duties has undoubtedly contributed to the development of a high cost structure."* 24

The Committee has maintained that,

> *"in the altered foreign exchange context and without concern for the augmentation of revenues, we would urge that special study should be undertaken to see what class of consumer goods can be allowed to be imported in a longer measure without entailing a wasteful use of foreign exchange. Imports of some of the luxuries of the rich may well continue to be banned. After a careful review, it should be possible to allow imports, on a more liberal basis, of articles already being allowed for import as well as of new ones which will satisfy the needs of various consumer groups as well as professional classes like doctors, photographers and even students and sportsmen."* 25

Regarding the import of inputs (raw materials, semi-finished goods and intermediate goods), the Committee has recommended that the import duty should be sufficient to equalise the landed price with the domestic price. In certain cases, in lieu of levying prohibitive duties, it is better to provide subsidy to the domestic producers or to arrange for price-pooling arrangements. The Committee has recommended abolition of auxiliary duties which have been levied only for revenue purposes. However, the Committee has recommended the retention of countervailing duties in disagreement with the Bhoothalingam Committee's suggestion of abolishing them. The Committee has, however, recommended its abolition on goods which are not produced in the country. The Committee has particularly recommended lowering of import duties on fine raw wool imported to produce garments which are considered necessities during the winter season in some parts of India. The Committee has felt that the danger of loss of revenue is exaggerated and protection may still be provided domestic producers through alternative means. The import duties on capital goods may be considered sufficient to protect domestic producers. The Committee has opined that the principle behind the countervailing duties (protection of domestic producers) is sound, and that such duties should be maintained, but the rates may be scaled down to equate the landed price with the domestic price. The Committee has ruled out the case for specific duties and instead has justified *ad valorem* duties even in the case of import duties.

**Economic role of export duties**

Regarding export duties, the Committee has ruled out the case for the specific nature of the duties and has maintained that their future role is mainly economic, viz.,

> *"driving a wedge between high overseas prices and low domestic prices so that export demand does not unduly raise internal prices."* 26

While the Union excise duties and import duties are levied by the Central government, sales taxes are levied by the state governments and octroi is levied by urban local bodies. Therefore, the Committee has rightly maintained that,

> *"In our federal system, the total burden on the consumer is the result of the interaction of taxes levied by the Centre, the States and the Local Bodies; and obviously no final answers can emerge until an acceptable and visible solution, possibly through appropriate Constitutional amendment, has been found to the problems created by the overlapping of jurisdiction."* 27

## 5. REFORM OF SALES TAX

The Committee has found that state sales taxes cover many commodities not covered by Union excise duties. In the words of the Committee,

> *"primary agricultural products as a class are not subject to excise duties. For administrative reasons small and scattered producers have to be left out*

22. *Interim Report*, p. 194.
23. *Interim Report*, p. 197.
24. *Interim Report*, p. 208.
25. *Interim Report*, p. 92.
26. *Interim Report*, p. 105.
27. *Interim Report*, p. vi.

*of the excise net. Then again the value added to the product after manufacturing stage, at wholesale and retail levels, does not come within the purview of excise taxation. To the extent that sales taxes affect these areas, not only is there no overlapping or duplication but they serve some legitimate economic and fiscal purpose. They achieve a widening of the tax base."* [28]

The Committee, however, has found certain disadvantages in the presently operating sales tax. They include:

(i) legal, administrative and procedural complexities which afflict trade and industry,

(ii) unhealthy trends generated by the existence of different rates of sales tax on the same commodity in different states.

(iii) ways in which sales taxes imposed by one state affect other states; and

(iv) the problem of cascading of and distortions in factor prices.

The Committee has maintained that,

*"From the economic point of view there is no difference between an ad valorem excise duty and a single point sales tax at the manufacturing stage."* [29]

The Committee, therefore, has felt that sales tax rates, particularly multipoint sales tax, have created a cascading effect and that high Central sales tax rates have resulted in resource transfers from the poorer states to the richer states.

**The Committee urges more uniform sales taxes and reduction of their rates**

In its Interim Report, the Committee suggested the first alternative of replacing sales taxes with Union excise duties. [30] But because of the constitutional and political implications of this alternative, the second alternative suggested is to use Central government powers to curb heavy taxation on certain Essential Declared Goods and to reduce Central sales tax rates from the present four percent to one percent. The Committee has also suggested that sales taxes should not be levied on inputs (raw materials, semi-finished goods and intermediate goods), but only on finished products and that the states should switch over to single-point, etc. The Committee has furthermore stressed the need for extending additional Union excise duties to cement, medicines, vanaspati and petroleum producers. Over and above these recommendations, the Committee has recommended that,

*"It would . . . be advantageous both to state governments and to business and industry, if uniformity in sales tax legislation and procedures was achieved in all states, either through Central legislation or by the drafting of a model law by a Central Agency like the Law Commission which each state could adopt. The former could be achieved by getting the consent of the states under Article 252 of the Constitution. Alternatively, a small group of representatives from different states could be set up who could jointly evolve the draft of such law after agreement. Such standardisation on the legal and procedural plane would be desirable and need not touch upon the rate structure which each state would be free to determine acting within its own legislative powers."* [31]

## 6. REFORM OF OCTROI

The Committee, after narrating the adverse effects of *octroi* levied by urban local bodies, has recommended its abolition and subsequent replacement by alternative sources of revenue. In this connection, the Committee has drawn the attention of the Central, state and local governments to similar recommendations of several earlier official Committees. After examining the relative merits of alternative sources of revenue suggested by these earlier Committees to replace octroi, the Committee has, however, recommended

*"a small turnover tax for various reasons including the fact that at least two competent Committees looking at the problem from the states' point of view have recommended it . . ."* [32]

The Committee has also examined the advisability of

(i) extending sales taxes to the sale of services, as it is a residuary power vested in the Central government,

(ii) raising the Constitutional limit imposed on the amount of profession tax that can be levied by the state governments, and

(iii) abolishing the separate levy of electricity duty.

The Committee has recommended that it would be better to levy a Central sales tax on the sale of services even if the revenue is transferred to the states, and to persuade the state governments to abolish electricity duty by making appropriate adjustments in electricity tariffs.

**The introduction of VAT as a long-term measure**

After making all these recommendations for immediate reform of indirect taxes, the Committee has also suggested, as a long-term reform measure, the introduction of value added tax in the nature of manufacturer's turnover tax *manvat* in place of Union excise duties on factory production. This long-term reform is reported to be supported by the Federation of Indian Chambers of Commerce and Industry. The Committee is not certain about the revenue implications of this long-term measure. Therefore, the Committee has suggested that

28. *Interim Report*, p. 212.
29. *Interim Report*, p. 209.
30. The Interim Report of the Committee was circulated among the state governments for eliciting their opinion. Most of the state governments opposed the first alternative. Therefore, in Part II of the Report, the Committee totally dropped the proposal to centralise sales tax.
31. *Report of the Indirect Taxation Enquiry Committee*, Part II, January 1978, p. 228.
32. *Ibid.*, pp. 244-245.

*"It would be prudent to make a start with 3 or 4 industries which produce final products (such as automobiles and diesel engines). Such a pilot project would enable Tax Administration to test out procedures and study the reaction of taxpayers."* 33

The Committee has felt that prior to introduction of *manvat*

*"it would be necessary, as one of the preparatory steps, to rationalise the excise duty structure so as to have only 4 or 5 rates."* 34

Finally, the Committee has recommended certain procedural changes to make the administration of indirect taxes as simple as possible. In addition, the Committee has reiterated the need for establishing an independent machinery to resolve disputes under Customs and Central excise laws, at present in the hands of Departmental bureaucrats. This was first suggested by TEC in 1954, and endorsed by the Supreme Court but has remained unfulfilled. The Committee has suggested adopting a law similar to one in operation in Gujarat state to prevent excess collection of excise duties by the dealers.

## 7. AN OVERALL ASSESSMENT

The Committee has no doubt begun with rational criteria which the suggested reforms should inject into the Indian indirect tax structure. But the Committee has totally ignored the problem of conflict between these criteria and the need for the ordering of these criteria in terms of priorities to resolve the conflict. Besides, the Committee has overlooked the need for broad guidelines for trade-off in cases of a tie between two criteria even in their ordered arrangement. Thus, the Committee has overemphasised the theory of tax reform but overlooked the practical guidelines based on compromises needed for actual implementation.

The Committee has commissioned some empirical studies relating to income elasticity of revenue and incidence of indirect taxation, the cascading effect of many indirect taxes, and a feasibility study of value added tax. Thus, the homework done by the Committee is adequate for the enormous task it was called upon to undertake. But these empirical studies are presented against the background of sophisticated theoretical concepts to give an impression that the empirical methods and results have comprehended complicated economic phenomena. For instance, the Committee has maintained that

*"the incidence of taxation should accordingly be defined as the change in the distribution of real income available for private use"*, 35

following Richard A. Musgrave. But they have measured the incidence of indirect taxes in terms of per capita monetary consumer expenditure at current prices while there is no reference to change in the distribution of such monetary consumer expenditure in the interpretation of the result. In effect, what is measured is the traditional final burden of indirect taxation.

Second, the Committee was asked to suggest ways and means of procedural simplification. But recommendations to simplify the administrative procedures and the required administrative reorganisation to implement the Committee's recommendations have not been contemplated or integrated. Perhaps this part of the Committee's report is very pedestrian.

In regard to its recommendation of replacing octroi by a turnover tax, the Committee has failed to make an in-depth all-India study. While the adverse effects of octroi, such as regressivity in incidence, inelasticity, administrative corruption and hindrance to the smooth flow of trade and transport, do justify its abolition, the alternative source of revenue to replace it does not necessarily appear to be the same for all the states. Hence, the Jha Committee, by referring to the recommendations of other Official Committees, has only shifted its responsibility.

## 8. GOVERNMENT'S ACTION ON THE RECOMMENDATIONS

Before we turn to the action taken by the Government of India on the recommendations of the Committee, it is necessary to mention briefly the history of the Committee. It was appointed by the Government of India headed by Mrs. Indira Gandhi during an emergency period. It appeared as though it were another step to meet the demands of the organised private sector in order to obtain its support for the state of emergency. Most of the members and the Chairman were sympathisers of Mrs. Gandhi.

However, within less than one year from the date of appointment of the Committee, the Indira Gandhi government lost power in the 1977 General Elections and the Janatha Party government assumed power. However, being more democratic in its outlook, it did not dissolve this Committee. 36 In fact, the new government asked the Committee to submit an Interim Report and a summary of their findings for consideration for implementation, which the Committee did. However, the Prebudget Economic Survey for 1977-78 maintained that these recommendations could be implemented, subject to administrative feasibility. But, the Finance Minister, instead of accepting any of the recommendations of the Committee, introduced changes in indirect taxes which

33. *Interim Report*, pp. 146-147.
34. *Interim Report*, p. 148.
35. *Report of the Indirect Taxation Enquiry Committee*, Part II January 1978, p. 108.
36. It may be mentioned here that in Australia, where the Commonwealth Government headed by McMahon appointed *The Commonwealth of Australia Taxation Review Committee* under the Chairmanship of Mr. Justice Asprey, in 1972, which was confirmed by the Whitlam Government; after the report was submitted in 1975, the Fraser Government considered it for implementation in 1977. See for details, Ross Parsons, "A View of Tax Reform", *Bulletin for International Fiscal Documentation*, March 1977, pp. 107-114.

went against the main theme of the Committee's recommendations. For instance, he imposed a blanket five percent surcharge on all the rates of excise duties of the existing system. And he levied a two percent excise duty on two inputs, viz., electricity generated and coal produced, which was contrary to the recommendations of the Committee. Dr. R.J. Chelliah, one of the members of the Committee, observed in the course of his comments on the budget that

> "... *on the ground of administrative non-feasibility, reluctance to take innovative action could always be justified. I must say I am disappointed. Instead of not merely not implementing any of the basic recommendations of the Jha Committee, the task of rationalisation has been made very difficult by intensifying and compounding the evil effects of the existing system.*" [37]

He has further maintained that,

> "*In particular, I disapprove of the tax that has been levied on coal and electricity. This goes directly counter to the suggestion made by the Committee that since taxation of inputs leads to cascading, and many other undesirable effects and increases the cost of production, only to the extent that we are able to provide for relief in respect of input taxation that input should be taxed. The tax on coal and electricity, in addition to being economically undesirable, partly also encroaches upon the sphere of the state governments because state governments are specifically empowered to levy an electricity duty... No attempt at coordination has been made.*" [38]

However, Dr. R.M. Honavar, the Chief Economic Adviser to the Ministry of Finance, has defended these levies in the following way:

> "... *the considerations which went into levying such a tax was the fact that not enough was being realised from these two sources in which fairly large amounts of investment have been made over the years. In the case of electricity, for instance, since the state governments were not either willing or in a position to raise the price of electricity, it was felt that we could sort of bear the odium and levy an excise duty on electricity generated. Similarly, it has been felt for a fairly long time that the price of coal should be raised because the current price is uneconomic.*" [39]

On the question of the future of the Committee's recommendations, he has maintained that:

> "*It is not a sort of bureaucratic device not to do anything but really readjusting the tax structure along the lines suggested by the Jha Committee is a time consuming affair, and therefore I think we did not undertake the task without the careful thought which the Jha Committees proposals deserved.*" [40]

It is learned that the Government of India is bringing an indirect taxes reform bill before the Parliament in the winter session. Therefore, we have to wait and see what specific measures will be introduced by the government to implement the well-intended recommendations of the Committee.

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37. "Central-Budget 1977-78: A Symposium", *Margin: A Quarterly Journal of NCAER*, April 1978, pp. 40-41.
38. *Ibid.*, p. 42.
39. *Ibid.*, p. 49.
40. *Ibid.*, p. 51.

German Democratic Republic (GDR)*:

# The Promotion of Housing Construction in GDR Towns and Communities by the State Financial System

By Prof. Dr. Hans Spiller**

1. The Constitutional principle of the management and planning of all social development processes also determines the GDR's policy in the fields of housing construction and urban planning. The economic and sociopolitical targets of urban planning and housing construction are directed and promoted in multiple ways by means of the state financial system. Here, all categories of the financial system are integrated. In this way the direct financing from the state budget, the temporary, long-term financing from the state credit funds, the protective and risk financing from the state insurance fund, and also the differentiated taxation serve as instruments for achieving the aims of urban planning and residential building.

"Urbanization" in a number of capitalist states sometimes leads to uncontrolled building because housing construction is only orientated toward profit, to so-called "dormitories" (disintegrated satellite suburbs), and, in connection with unemployment and underemployment, to the emergence of "slums". These negative phenomena are prevented in the socialist countries by a systematic, harmonious development of towns and communities.

The socialist order of society, which is based on the principle of management and planning of the national economy, not only brings about a systematic increase in the material and cultural living standards of the people, but at the same time solves a number of further problems related to social and regional development. The socialist economic policy safeguards the continuous realization of the basic right to work. Moreover, in view of the high growth rates in production, a very careful disposition of the potential labour forces is called for. This systematic structural policy with regard to the national economy renders it possible to set up, on the basis of state investments, single industrial enterprises and whole industrial complexes in what were industrially less developed regions. The development of agricultural production cooperatives, prevalent in GDR agriculture, tends to ever greater units and specialized associations with industrial production methods, together with own or state-owned cultural, social and medical centres. It takes the course of gradually eliminating the social and cultural differences between towns and country. The continuing mechanization and industrialization of agriculture require highly qualified labour forces with technical and university qualifications, such as qualified agricultural economists engineers for agricultural machines, physicians for centralized outpatient departments and doctor's surgeries, veterinarians for catte-breeding — which to a large degree is done along industrial lines — agricultural chemists, and pilots of special airplanes to spray pesticides and fertilizers. This, in turn, creates corresponding cultural, social and accommodation requirements.

These and other factors, due to the systematic promotion of qualified working and living conditions, prevent a migration from country to town and can be regarded as the essential reasons for avoiding an uncontrolled "urbanization". GDR housing policy, in respect of its aims, is not confined to the problems of a planned, harmonious development of the towns; rather, it is directed toward a housing policy corresponding to the social requirements of town and country.

The obligation imposed on smaller towns and rural communities to provide for sufficient flats satisfying modern standards of accommodation while taking into account present and future demands — for example, when establishing large agro-industrial complexes in the country — represents the necessary correlate of town planning. In this way, and by means of numerous other socio-political measures, a well-balanced development of town and country is secured.

2. The housing programm adopted by the Central Committee of the Socialist Unity Party of Germany (SED) and the GDR government in 1973 stipulates that the housing question as a social problem will be completely solved by 1990. Until that time, the social and territorial differences which have developed as a result of the historical situation concerning housing conditions are to be qualitatively abolished, and further essential prerequisites of the socialist way of life and personal development in town and country are to be provided for. This implies the construction of a sufficient number of modern flats so that each family will have a self-contained flat with a number of rooms corresponding to the number of family members, the necessary sanitary facilities and modern heating. To achieve this aim there is a plan to set up residential complexes and, simultaneously, the necessary cultural

* English version of a paper which was prepared in the German language for the Xth International Congress for Comparative Law (Budapest 1978) in particular for the discussion held in Section IV.E. which dealt with the subject of taxation of land and town planning.

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and social facilities, including kindergartens, schools, outpatient departments, shops and public services such as restaurants, cinemas, and theatres, parks, sports grounds and further facilities for recreation.

The state is responsible for fulfilling the tasks of urban planning and housing construction in their entirety.

It directs central planning activities in accordance with the national economy's development, regional policy, environmental protection, etc., and safeguards financing. Here, the differentiated application and the stimulating effect of the various financial instruments are of great significance.

As to the individual regions, the local state bodies (i.e., the counties, districts, towns and communities) are responsible for putting into practice the political measures of urban planning and housing construction.[1] The scope of competence of the local state bodies stretches over all forms of property, i.e., both state housing construction as well as cooperative and individual housing construction, but at the same time comprises all kinds of extensions to and maintenance of buildings. This implies in detail:

— the construction of new blocks of flats;
— the modernization, re-building and extension of flats;
— the repair of flats and dwelling houses;
— the construction of new community facilities (schools, hospitals, kindergartens, etc.) and their repair.

These are tremendous tasks as far as material and financial expenditure are concerned. So in the period from 1976 to 1980, at an expense of 55,000 million Marks, 75,000 flats will be provided by building new houses or modernizing old ones. The extension of the capacity of schools and kindergartens, which are financed from budgetary means, requires special expenditure for the additional reason that general compulsory education has been extended to 10 years, and the percentage of children who attend a kindergarten or a nursery — presently amounting to more than 80 percent shall be raised.

3. From the total volume of residential construction in the GDR, about 45 percent is construction, 45 percent cooperative construction and 10 percent private construction (owner-occupied houses).

Within the framework of the state plan, the local state bodies decide on the territorial building conception, the creation of material prerequisites, the allocation of building capacities, and the location of the buildings themselves. Furthermore, they are responsible for development activities. State building ground is placed at the disposal of social-legal entities to be used for dwelling houses, without return and for an unlimited period of time.

In order to prevent arable land from being used in a way which was not intended, in addition to cases of using arable land as building land for such purposes as, for instance, industrial buildings, a non-recurring land-use charge is imposed. Based on the quality of the soil, it amounts to as much as 400,000 Marks per hectare and the revenue goes to the state budget.[2]

State construction of housing and community facilities is financed from the budget of the local bodies with the state banking system granting considerable credits.[3] While the lender takes a minimum interest of 10 percent, the state banking system grants credits for financing further expenditures on the planned building projects. These credits are strictly tied to that purpose and have to be repaid annually in the form of a fixed amount of 5 percent of the credit granted (with included interest of 4 percent per annum).

The credits raised are repaid from budgetary means by the local state bodies or the institutions acting on their behalf (nationally — owned enterprises, housing administration), in accordance with legally stipulated interest and repayment rates and other terms concerning credit agreements. Like the central budget, the budgets of the local state bodies are established on the principle that receipts and expenditures have to be well-balanced and the credit obligations are included on the side of expenditures. When the revenues of the local state bodies do not suffice to cover the planned expenditures, such bodies are assigned a legally stipulated share of the receipts of the central budget within the framework of the GDR's state budget annually adopted by the People's Chamber.

The state banking system fulfils its credit tasks in the framework of an over-all credit plan adopted by the government. This credit plan is coordinated with the budget, the plan of note circulation and the major development indexes of the national economy. In connection with price stability, the credit plan to an essential degree decides upon the systematic character of note circulation and thus represents a prerequisite for the stability of the GDR's currency. The crediting of housing construction is considered to be a part of the over-all credit plan. Fulfilling the function of a creditor, the banking system simultaneously takes over important tasks in controlling the purposeful use of credits, the systematic realization of building projects and the repayment of credits in due time. These data can always be made available at short notice. This fact, just as in the situation of the development of territorial building becoming obvious from credit development, enables clear analyses to be made concerning the systematic development and financing of buildings, and thus fulfils the signalizing function for state management required by the financial system.

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1. Law on the Local Popular Representations and their Bodies in the GDR, of July 12, 1973, Gesetzblatt (GDR Law Gazette, in the following GBl.), part 1, p. 313, paras 26, 40, 58.
2. Decree on the Land-Use Charge of June 15, 1967, GBl. part II, page 487 and following.
3. Decree on the Financing of National Housebuilding and the Construction of State Facilities of December 12, 1970 (GBl. part II, P. 764 and following).

Besides state housing construction, the construction of entire industrial complexes on a cooperative basis is of growing significance. Interested parties can unite on a cooperative basis for setting up dwelling houses and are given state support on a large scale. In the majority of cases, the financial and material assistance of nationally-owned enterprises is extended in the interest of employees who are members of building cooperatives temporarily offering them means of transport and other technical assistance.

The members of a cooperative have to purchase shares for the flats to be built, these shares being calculated in accordance with the size of the flat.

To ease the tight manpower situation in the GDR, in addition to the low payable share, 400 to 450 working hours (according to the size of the flat) must be performed and only exceptionally may be paid for.

The workers' housing construction cooperatives are required to raise 15 percent of the overall building costs from their own fund; the building costs exceeding this sum are offered to them in the form of bank credits on a contractual basis with terms similar to those of state housing construction projects. In order to promote these cooperatives, the budgets of the local state bodies pay an annual 4 percent interest rate for the bank credits raised by these cooperatives, while the cooperatives themselves pay from their rental income an annual redemption rate of 1 percent of the credit sum.[4]

In addition to the previously mentioned promotional measures of the state, all socialist workers' housing construction cooperatives are exempted from taxation.

The far-reaching promotional activities of the state, together with the modern arrangement and outfitting of residential areas built on a cooperative basis, have caused a rapid development of this form of building. Thus, the members' initiatives and participation in cooperative management bodies and building activities become effective factors of rationalization. For this reason, growing importance is attached to this form of building and the quantitative proportion of it in the GDR's total building volume will continue to increase.

The direct state-financing aid received from the local bodies' budgets and from the state crediting system presupposes that all these building projects do not exceed the framework established by overall planning, the stipulations of urban planning adopted by the local popular representations, and the state standards of environmental protection. The linking of state plans for urban planning and housing construction on the one hand and financial means on the other facilitates housing construction more immediately than would real estate and other taxes.

The individual construction of owner-occupied houses, being a further form of housing construction is encouraged in the GDR. For social reasons the promotional measures are in the first place directed at workers' families, large families and families of cooperative farmers living in the country.[5] Also, the building permit of the competent local state bodies, which is given only if the territorial provisions of housing construction are observed, forms the prerequisite for all promotional measures.

As to financial assistance, people who want to build their own houses receive credits from the local banks and the Banks for Agriculture and Food Economy of up to 75 percent of the overall building costs. Moreover the local state bodies grant numerous additional benefits to workers' families and larger families, as, for instance, rebates of interest, partial repayment of credits, the right to use national building ground offered without charge, and exemptions from licence fees. Nationally-owned enterprises employing the builders of owner-occupied houses can grant additional redemption allowances up to an amount of 10,000 Marks, provided that the workers commit themselves to work in these enterprises for a longer time. Young married couples who build their own houses, as a rule, receive credits without interest, and, moreover, they are partly exempted from repaying a credit upon the birth of any children.[6]

Private ownership of an owner-occupied house is exclusively confined to the accommodation requirements of a single family.

In addition, there is private ownership of larger dwelling houses the flats of which, in general, are rented. These flats are registered by the state housing allotment bodies and given to people who are seeking a flat.

According to the principle of steadiness of prices and inadmissibility of price increases, which has been valid in the GDR for decades, rent increases are not allowed.

The owners of such tenant houses mentioned above are required to meet the general obligation to pay taxes. This is particularly so in the payment of the income tax and property tax (when exceeding the exemption limit) and of the land tax.[7]

The rental income of the owners of tenant houses, after payment of the taxes for the state budget (which are of small significance), is used for repairs or extension of the dwelling houses. If this income does not suffice for carrying out the necessary repairs or extensions, the

4. Decree on Workers' Housing Construction Cooperatives of February 23, 1973, GBl. part I, p. 389, and Regulation on the Planning, Financing and Accounting of State Grants for Socialist Workers' Housing Construction Cooperatives in the Budgets of the Local State Bodies of June 19, 1974, GBl. part I, p. 323.

5. Decree on the Promotion of the Construction of owner-occupied Houses of November 24, 1971, GBl. part I, p. 709 and following.

6. Decree on the Granting of Credits on More Favourable Terms to Young Married Couples, of May 10, 1972, GB1. part II, p. 316.

7. Law on the Income Tax of September 18, 1970, separate print of the Gesetzblatt no. 670; Law on the Property Tax of September 18, 1970, separate print of the Gesetzblatt no. 675; Law on the Land Tax of September 18, 1970, separate print of the Gesetzblatt no. 676.

owners can apply for credits from the local bank on favourable interest terms.[8]

As a further incentive for maintaining and enlarging this housing volume, exemption from taxation is granted for a period of ten years following the compliance with these measures, regarding the enlargement or improvement of accommodations.[9]
The remaining taxes from private tenant houses form the general budgetary receipts for all expense items of the state budget. Due to their volume they only cover a small portion of state expenditures for financing of housing construction, whereas the major part is financed by means of the state income from the national economy.

In summation, it can be stated that under the conditions of the planned socialist economy, the financial system, with its multiple legal instruments (budget, credit, interest, taxes), also serves the promotion of housing construction in the towns and communities of the GDR in a differentiated and effective way. Through dialectical interrelations between the material and financial development, the financial instruments, in addition to the direct financing task, fulfil coordinated functions in the fields of stimulation, signalization and control which aim at the optimum realization of the targets of social development.

As to urban planning and housing construction, budgetary and credit instruments dominate the financial side, whereas the obligatory payments of the national economy to the state budget as well as taxes are of a greater significance with regard to other development processes.

Here, the purposeful utilization of financial instruments is directed at the harmonious development of comprehensive housing construction which comprises, apart from the construction and modernization of flats, the setting up of a sufficient number of schools, nurseries and kindergartens, facilities of the health service, shops and public services, homes for aged people, as well as cultural and sports centres. Rents of flats are so low that, as a rule, they do not cover the costs and, therefore, are backed by the state.

The state's broad financing of comprehensive housing construction, resting on a legal basis, allows the setting up of socialist residential areas in towns and communities which through their functional and architectural arrangement solve fundamental questions of the material basis of the socialist way of life.

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8. Decree on the Financing of Private Building Measures for Creating and Maintaining Private Housing, of April 28, 1960, GBl. part I, p. 351 and following.
9. Compare the legal provisions in the previous footnote and in the 3rd Decree on Amending and Supplementing the Rules on the Imposition of the Land Tax of June 5, 1968, GBl. part II, p. 340.

# Convention de double imposition entre la Belgique et la Suisse

# Double taxation treaty between Belgium and Switzerland

**Readers who are interested in the Belgian-Swiss tax treaty are also referred to an article appearing in EUROPEAN TAXATION 1/1979 entitled: "Belgium and Switzerland conclude tax treaty; Deviations from the OECD Model Convention 1977"**

## VUE D'ENSEMBLE

*La Belgique est le seul pays important d'Europe occidentale avec lequel la Suisse ne soit pas liée par une convention de double imposition. Le présent accord comble donc une lacune considérable dans le réseau des conventions suisses de double imposition, lacune due essentiellement aux conceptions diamétralement opposées défendues jusqu'à tout récemment par les deux pays, notamment en matière d'imposition des revenus de capitaux.*

*La convention conclue le 28 août 1978 est fidèle au modèle de convention de 1977 de l'Organisation de coopération et de développement économiques (OCDE) et correspond à la pratique suisse en la matière. Vivement souhaitée par l'économie suisse, elle respecte dans une large mesure les voeux exprimés par les cantons lors des procédures de consultation. Les redevances de licences, en particulier, sont exclusivement imposables dans l'Etat de domicile de leur bénéficiaire. Les intérêts sont certes grevés, en principe, d'un impôt de 10 pour cent dans l'Etat de leur provenance; cette règle comporte toutefois des larges exceptions dans le domaine du financement à l'exportation où seul l'Etat du domicile du bénéficiaire est habilité à percevoir l'impôt. Enfin, la réglementation concernant les dividendes est également satisfaisante dans la mesure où le taux généralement applicable dans l'Etat de la source (15%) correspond à la solution adoptée dans plusieurs conventions suisses, et le taux relatif aux dividendes de filiales (10% ) représente un compromis raisonnable entre les propositions suisses (5%) et la pratique belge (15%).*

## MESSAGE

### 1. Genèse

La convention du 28 août 1978 est le fruit de plus de 25 ans de laborieuses négociations. C'est en effet en 1952 que les premiers pourparlers techniques ont eu lieu. Après deux ans, force fut de constater que les systèmes fiscaux et les principes communément admis de part et d'autre étaient trop différents pour permettre une harmonisation des points de vue.

Les négociations furent relancées à la suite d'un voyage d'information entrepris en novembre 1967 par une délégation gouvernementale belge en vue de stimuler les investissements suisses en Belgique. La Belgique avait entre-temps procédé à une profonde réforme de sa législation fiscale, qui lui avait permis de conclure plusieurs conventions inspirées du projet de convention de l'OCDE de 1963. Ces éléments laissaient mieux augurer des négociations à venir. Le Conseil fédéral décida donc d'accepter la proposition belge et de reprendre les pourparlers enlisés depuis 1954.

**THE BELGIAN – SWISS TAX TREATY FINALLY CONCLUDED**

*On August 25, 1978 Belgim and Switzerland, after 25 years of negotiation, signed a treaty for the avoidance of double taxation with respect to taxes on income and net worth. The major stumbling blocks to the agreement have been the distinctions between the Belgian and Swiss tax systems, the taxation of dividends (especially between parent and subsidiary companies) and interest. As is to be expected, the treaty basically follows the OECD Draft Convention of 1977. The following are some of its main features:*

- *The treaty applies to taxes on income and net worth, but excludes withholding tax on gains realized on lotteries, games and bettings. It is noted that only Switzerland levies a tax on net worth.*
- *Business income will be subject to tax in the country where the permanent establishment (branch office) is located through which the income is derived.*
- *Dividends are in principle taxed in the country where the recipient is resident. The country of origin (i.e. where the distributing company is situated) may levy a withholding tax of 15 percent, which is reduced to 10 percent, if the recipient is a company owning at least 25 percent of the distributing company. Belgium will not extend its imputation system to Swiss residents.*
- *Similarly, interest is also taxed in the country where the recipient is resident but the country of origin (i.e. where the debtor resides) may levy a withholding tax of 10 percent. An exemption from withholding tax applies where the interest is paid in connection with the sale on credit of goods and merchandise from one enterprise to another or where it is paid in connection with a sale on credit of industrial, commercial or scientific equipment. In addition no withholding tax is due where the interest is paid from any loan - not evidenced by bearer securities - granted by a bank.*
- *Royalties are only taxable in the country where the payee (licensor) is resident. The country of origin (i.e. the country where the payor or licensee resides) may not levy any tax on royalties paid to the recipient in the other country.*
- *Now becoming common in treaties concluded by Switzerland, the treaty contains detailed rules directed against abusive use of its provisions.*
- *The treaty also contains non-discrimination provisions which, inter alia, result in a reduced rate of Belgian corporate income tax (48 percent) on income derived by a Swiss corporation through a Belgian branch.*
- *The treaty is not yet in effect, but shall apply to income of the year during which the instruments of ratification are exchanged.*

Les négociations de 1968, 1969 et 1972 conduisirent malheureusement à la constatation que les divergences entre les deux délégations étaient encore trop nombreuses et importantes pour aboutir à un accord. La principale pierre d'achoppement était constituée par le droit d'imposition des intérêts et dividendes; la Belgique souhaitait en effet accorder à l'Etat de la source un droit de 15 pour cent dans les deux cas, taux que la Suisse jugeait inacceptable puisque contraire à sa pratique; la délégation suisse souhaitait obtenir l'exonération des intérêts et un taux réduit pour les dividendes de filiales. Ces négociations permirent néanmoins de s'entendre sur plusieurs autres points, notamment sur les redevances de licences.

La Belgique s'était en effet déclarée d'accord avec l'imposition exclusive de ces revenus dans l'Etat du domicile de leur bénéficiaire.

Les négociations reprirent en 1977, sur la base des résultats acquis en 1972, et aboutirent rapidement à un accord, la Belgique ayant ramené ses prétentions relatives à l'imposition à la source des intérêts et dividendes à un niveau acceptable pour la Suisse. Consultés en décembre 1977, cantons et groupements économiques intéressés ont à nouveau exprimé l'intérêt qu'ils avaient à une réglementation des relations fiscales entre la Suisse et la Belgique et approuvé dans un très large mesure les solutions envisagées.

## 2. Commentaires des dispositions de la convention

Dans le message du 13 juillet 1965 concernant la convention avec la Suède du 7 mai 1965, le Conseil fédéral a commenté en détail les dispositions du projet de convention de l'OCDE de 1963 (FF *1965* II 732), dont la Suisse s'est inspirée pour négocier ses conventions de double imposition. Ce modèle a été remanié depuis lors; la version revisée a été publiée en avril 1977 par le Conseil de l'OCDE, accompagnée d'une nouvelle recommandation. Les innovations ont déjà pu être prises en considération lors des négociations avec la Grande-Bretagne et ont fait l'objet de remarques particulières dans notre message du 11 janvier 1978 relatif à la nouvelle convention conclue avec ce pays le 8 décembre 1977 (FF *1978* I 193). Les commentaires qui suivent s'attachent dès lors essentiellement à dégager les particularités de la convention avec la Belgique.

*Article 2* (Impôts visés)

La convention s'applique aux impôts sur le revenu et sur la fortune, à l'exclusion des impôts perçus à la source sur les gains réalisés dans les loteries, jeux et paris.

*Article 4* (Résidents)

A l'article correspondant du modèle de convention de 1977 ont été apportés les compléments suivants.

Les sociétés en nom collectif et en commandite de droit suisse ainsi que les sociétés de personnes de droit belge qui ne sont pas traitées comme des personnes morales en droit fiscal, sont considérées comme des résidents des Etats contractants, ce qui leur permet de demander en leur nom d'être mis au bénéfice de la convention (par. 1).

Le paragraphe 4, chiffre 1°, précise, comme le font quelques autres conventions suisses, que la convention ne peut être invoquée par des ayants-droits effectifs et non pas par des fiduciaires intercalées; en outre, les personnes physiques qui n'acquittent pas dans leur Etat de domicile des impôts complets sur les revenus provenant de l'autre Etat contractant sont exclues, en vertu du paragraphe 4, chiffre 2°, des avantages de la convention (cf. message du Conseil fédéral du 5 mai 1976 concernant la convention de double imposition avec l'Italie, FF *1976* II 653).

*Article 5* (Etablissement stable)

La définition de l'établissement stable donnée par le modèle de convention de 1977 a été intégralement reprise dans la convention.

Le paragraphe 6, relatif aux agents indépendants a été complété par une disposition selon laquelle on considère qu'une entreprise d'assurance possède un établissement stable lorsqu'un intermédiaire a le pouvoir de conclure des contrats en son nom et qu'il l'exerce habituellement. Cette disposition correspond à la pratique belge; elle est motivée par le fait qu'il est particulièrement difficile, de l'avis des autorités belges, de déterminer si un agent d'assurance jouit d'un statut dépendant ou indépendant.

Il est entendu que les bénéfices de cet établissement stable ne comprennent pas les revenus provenant d'opérations d'assurance ou de réassurance conclues par le siège de l'entreprise.

*Article 7* (Bénéfice des entreprises)

Cet article est également conforme au modèle de convention de 1977. Il contient au surplus une disposition selon laquelle les Etats contractants sont autorisés, à défaut de comptabilité régulière ou d'autres éléments probants, à calculer le bénéfice imposable d'un établissement stable au moyen de comparaisons établies avec d'autres entreprises de même genre exerçant le même type d'activités (par. 4, let. a).

*Article 9* (Entreprises associées)

Cet article correspond au paragraphe 1 de l'article 9 du modèle de convention de 1977; un Etat peut corriger sur le plan fiscal les bénéfices d'une entreprise lorsque certains d'entre eux ont été transférés au détriment de cette entreprise dans une autre entreprise du même groupe.

Le nouveau paragraphe 2 proposé par l'OCDE n'a pas été repris; la Suisse rejette un engagement pris dans un traité international de rectifier dans la même proportion ses propres impôts lors de contestations de prix de transfert par l'autre Etat (cf. message du 11 janvier 1978 concernant une convention de double imposation avec le Grande-Bretagne; FF *1978* I 199).

*Article 10* (Dividendes)

La convention limite à 10 pour cent l'impôt qui peut être perçu par l'Etat de la source sur les dividendes de filiales détenant au moins 25 pour cent du capital de la société servant les dividendes, et à 15 pour cent dans les autres cas. Le taux de 15 pour cent est conforme au modèle de convention de 1977 et à la solution adoptée par plusieurs conventions suisses, alors que le taux de 10 pour cent constitue un compromis entre la recommendation de l'OCDE, préconisée par la Suisse (5%), et la pratique belge (15%).

Le paragraphe 3, relatif à la définition des dividendes, a été complétée à la demande de la Belgique, qui assimile les revenus de capitaux investis dans des sociétés de personnes belges à des dividendes, quel que soit le statut fiscal de ces sociétés.

Par ailleurs, la Belgique a institué en faveur des actionnaires de sociétés de capitaux belges le système dit du crédit d'impôt. Les actionnaires résidant en Belgique peuvent imputer sur leurs propres impôts sur le revenu afférents aux dividendes reçus de sociétés de capitaux belges, une part de l'impôt prélevé sur la société qui les a distribués. La délégation belge a refusé d'accorder aux actionnaires suisses un avantage correspondant au crédit d'impôt; elle s'est cependant engagée à revoir ultérieurement la question si la Belgique venait à accorder aux actionnaires de sociétés belges résidant dans un Etat tiers un avantage qui tienne compte du crédit d'impôt et si l'octroi de cet avantage n'était pas motivé par des considérations particulières à cet Etat.

*Article 11* (Intérêts)

La Suisse n'a pas pu obtenir de la Belgique que le taux de l'impôt réservé à l'Etat de la source soit inférieur, en règle générale, aux 10 pour cent recommandés par le modèle de convention de 1977. Le paragraphe 3 dispose toutefois que les intérêts liés à la vente à crédit d'équipements industriels, commerciaux ou scientifiques, à la vente à crédit de marchandises livrées par une entreprise à une autre, ou payés sur un prêt bancaire, ne sont imposables que dans l'Etat du domicile de leur bénéficiaire.

Le paragraphe 7 prévoit que le taux réservé par l'article 10 (Dividendes) à l'Etat de la source est également applicable aux intérêts excédant le montant normal dont seraient convenus deux partenaires indépendants.

*Article 12* (Redevances de licences)

L'article 12 accorde le droit exclusif d'imposer les redevances de licences à l'Etat du domicile de leur bénéficiaire. Le paragraphe 4 prévoit que le taux d'impôt réservé par l'article 10 (Dividendes) à l'Etat de la source est également applicable aux redevances de licences excédant le montant normal dont seraient convenus deux partenaires indépendants.

*Article 17* (Artistes et sportifs)

L'article correspond au modèle de convention de 1977 et à la pratique suisse. L'imposition a lieu à l'endroit où est exercée l'activité artistique ou sportive, même lorsque les revenus de cette activité sont attribués à une autre personne que l'artiste ou le sportif (par. 1 et 2). Cette imposition est toutefois exclue lorsque l'activité de la personne est subventionnée dans une large part par des fonds publics (par. 3).

*Article 18* (Pensions)

En dérogation au principe de l'imposition des pensions dans l'Etat du domicile de leur bénéficiaire (par. 1), l'imposition des prestations accordées aux victimes de guerre, militaires ou civiles, a été réservée à l'Etat débiteur de ces rentes (par. 2).

*Article 22* (Prévention de l'usage abusif de la convention)

Les dispositions visant à lutter contre les utilisations abusives de la convention correspondent à celles que contiennent les conventions avec l'Allemagne (art. 23), la France (art. 14) et l'Italie (art. 23).

*Article 24* (Méthodes pour éliminer les doubles impositions)

La Belgique et la Suisse évitent la double imposition par la méthode de l'exonération. La détermination du taux global (par. 1, ch. 1°, et par. 2, ch. 1°) est réservée.

Pour les dividendes, intérêts et redevances excédentaires, la Belgique accorde l'imputation d'impôt prévue par sa législation interne (par. 1, ch. 2°) et la Suisse l'imputation forfaitaire d'impôt (par. 2, ch. 2°).

Les sociétés domiciliées dans un Etat contractant peuvent bénéficier des mêmes avantages fiscaux, pour des dividendes provenant de l'autre Etat contractant, que pour les dividendes payés par une entreprise du premier Etat (par. 1, ch. 3°, et par. 2, ch. 4°).

La Belgique a demandé l'insertion d'une disposition spéciale pour éviter les doubles déductions de dettes (par. 1, ch. 4). Une entreprise belge qui a subi des pertes dans son établissement stable suisse et a pu déduire ces pertes des bénéfices imposables en Belgique ne peut bénéficier, en Belgique, au cours d'une autre période fiscale, de l'exonération de ses bénéfices suisses lorsque ceux-ci ne sont pas imposés en Suisse parce qu'ils sont compensés avec les pertes subies.

Le paragraphe 2, chiffres 2° et 3°, précise, pour la Suisse, que c'est l'imposition des montants nets des dividendes, intérêts et redevances qui s'applique en lieu et place de l'imputation forfaitaire d'impôt, lorsque le bénéficiaire suisse des revenus n'a pas droit au dégrèvement des impôts belges, en vertu des dispositions sur l'utilisation abusive des conventions.

*Article 25* (Non-discrimination)

L'article correspondant du modèle de convention de 1977 a été complété par une disposition particulière relative au taux applicable aux établissements stables belges des sociétés suisses (par. 6). D'après la législation belge, les établissements stables de sociétés étrangères sont imposés à un taux plus élevé que celui qui est applicable aus sociétés belges (actuellement 54% au lieu de 48%). Grâce à la convention, les établissements stables de sociétés suisses seront traités de la même manière que les sociétés belges et leur taux d'imposition ne devra pas excéder celui qui est généralement applicable aux sociétés belges (actuellement 48%).

*Article 26* (Procédure amiable)

Les dispositions relatives à la procédure amiable correspondent à quelques exceptions près au modèle de convention de 1977. La disposition selon laquelle un accord amiable doit être exécuté sans égard aux délais du droit interne n'a pas été reprise. A la demande de la Belgique, la possibilité de s'entretenir des cas non visés par la convention et de procéder à un échange de vues au sein d'une commission mixte a dû être écartée. En revanche, la possibilité qu'ont les autorités compétentes de délibérer en commun des mesures permettant de faire échec à un usage abusif de la convention constitue une innovation (par. 3). Enfin ce n'est pas en vertu de cet article mais de l'article 29, paragraphe 3, que les autorités compétentes sont habilitées à communiquer directement entre elles.

*Article 27* (Echange d'informations)

La Belgique a insisté pour qu'une clause en matière d'échanges d'informations soit insérée dans la convention. L'article 27 correspond aux dispositions contenues dans les conventions conclues avec l'Allemagne, l'Autriche, le Danemark, la France et l'Italie (cf. message du Conseil fédéral du 5 mai 1976 concernant la convention de double imposition avec l'Italie; FF *1976* II 653).

*Article 29* (Divers)

Le paragraphe 1er réserve à la Belgique le droit d'imposer les rachats d'actions et les liquidations de sociétés belges conformément à sa seule législation. Cette réserve, qui correspond à une pratique belge constante, a pour conséquence que les opérations visées ci-dessus ne sont pas assimilées à des distributions de dividendes auxquelles s'applique l'article 10. La Belgique considère en effet que les impôts prélevés à ces occasions représentent une charge grevant la société elle-même et non les actionnaires.

Le paragraphe 2 précise que la Belgique peut prélever son précompte mobilier sur les revenus de valeurs mobilières étrangères lors de leur encaissement en Belgique. Cet impôt ne peut toutefois pas être perçu à la charge des résidents de la Suisse.

*Article 30* (Entrée en vigueur)

La convention s'appliquera pour la première fois aux impôts de l'année au cours de laquelle les instruments de ratifications auront été échangés.

*Article 31* (Dénonciation)

La convention est conclue pour une durée indéterminée mais peut être dénoncée moyennant un préavis de six mois, pour la fin de chaque année, à partir de la troisième année suivant l'échange des instruments de ratification.

## 3. Conséquences financières

Comme toute convention de double imposition, la présente convention entraîne un abandon de recettes fiscales de la part des deux Etats. Pour la Suisse, cet abandon se présente sous deux aspects. D'une part, la partie de l'impôt anticipé qui excède les taux limites d'imposition des dividendes (10 et 15%) et des intérêts (10%) devra être remboursée aux résidents de Belgique (personnes physiques et sociétés) qui en feront la demande. Faute de données statistiques ou d'estimations sur le volume des titres suisses détenus par des résidents de Belgique, il est pratiquement impossible d'indiquer l'ampleur que prendra ce remboursement. Cette perte sera essentiellement à la charge de la Confédération. L'autre forme de pertes de ressources fiscales est constituée par l'imputation forfaitaire d'impôt pour les dividendes et intérêts échéant à des résidents de Suisse. Là également, nous sommes hors d'état de fournir des chiffres, même approximatifs, concernant l'ampleur du coût de l'imputation forfaitaire. Selon la clé de répartition fixée en 1967 et toujours en vigueur, la Confédération prend à sa charge le tiers du coût de cette imputation forfaitaire, le solde étant à la charge des cantons (et des communes).

En contrepartie de ces pertes de ressources fiscales, certains avantages financiers pourront résulter de la convention pour les fiscs suisses. Les montants bruts des revenus provenant de Belgique seront imposables en Suisse, alors que jusqu'ici on devait admettre à titre de déduction le montant de l'impôt belge à la source (20% pour les dividendes p.ex.), d'où une augmentation générale des revenus imposables. Au surplus, il convient de rappeler que les conventions de double impositions ne sont pas conclues dans l'intérêt des fiscs, mais bien dans celui des contribuables et de la libéralisation des échanges, pierre de touche de toute la politique suisse en matière de commerce extérieur.

## 4. Constitutionnalité

La convention est conclue conformément à l'article 8 de la constitution. L'Assemblée fédérale est compétente pour approuver la convention en vertu de l'article 85, chiffre 5, de la constitution. La convention est conclue pour une durée ferme de trois ans, mais elle est dénonçable dès lors pour la fin de chaque année civile; elle ne prévoit pas l'adhésion à une organisation internationale et n'entraîne pas une unification multilatérale du droit; l'arrêté fédéral n'est donc pas soumis au référendum facultatif en vertu de l'article 89, 3e alinéa, de la constitution. La portée matérielle et territoriale restreinte de la convention ne justifie pas, en outre, qu'elle soit soumise au référendum facultatif par une décision des deux Chambres prise en application de l'article 89, 4e alinéa, de la constitution.

## 5. Conclusions

La convention complète utilement le réseau des conventions suisses de double imposition puisque la Belgique est le seul Etat important d'Europe occidentale avec lequel notre pays n'a pas conclu d'accord de ce genre. La convention facilitera le développement des échanges commerciaux entre les deux pays et mettra les entreprises suisses au bénéfice des mêmes avantages que celles des nombreux Etats tiers déjè liés à la Belgique par un traité fiscal. Les solutions convenues s'inscrivent dans la pratique suisse et ont reçu l'approbation des cantons et des milieux économiques intéressés.

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# Convention entre la Confédération suisse et le Royaume de Belgique en vue d'éviter les doubles impositions en matière d'impôts sur le revenu et sur la fortune

*Texte original*

Le Conseil fédéral suisse
et
Sa Majesté le roi des belges,

Désireux d'éviter les doubles impositions en matière d'impôts sur le revenu et sur la fortune, ont décidé de conclure une Convention et ont nommé à cet effet comme Plénipotentiaires, savoir:

Le Conseil fédéral suisse:
Monsieur Pierre Aubert, Conseiller fédéral, Chef du Département politique fédéral

Sa Majesté le roi des belges:
Son Excellence Monsieur Georges Puttevils, Ambassadeur de Belgique à Berne

Lesquels, après s'être communiqué leurs pleins pouvoirs, reconnus en bonne et due forme, sont convenus des dispositions suivantes:

### Chapitre I: Champ d'application de la Convention

**Article 1er** Personnes visées

La présente Convention s'applique aux personnes qui sont des résidents d'un Etat contractant ou des deux Etats contractants.

**Article 2** Impôts visés

§ 1er. La présente Convention s'applique aux impôts sur le revenu et sur la fortune perçus pour le compte d'un Etat contractant, de ses subdivisions politiques ou de ses collectivités locales, quel que soit le système de perception.

§ 2. Sont considérés comme impôts sur le revenu et sur la fortune les impôts ordinaires et extraordinaires perçus sur le revenu total, sur la fortune totale, ou sur des éléments du revenu ou de la fortune, y compris les impôts sur les gains provenant de l'aliénation de biens mobiliers ou immobiliers, les impôts sur le montant global des salaires payés par les entreprises, ainsi que les impôts sur les plus-values.

§ 3. Les impôts actuels auxquels s'applique la Convention sont notamment:
1° en Belgique:
a) l'impôt des personnes physiques;
b) l'impôt des sociétés;
c) l'impôt des personnes morales;
d) l'impôt des non-résidents;
e) la participation exceptionnelle et temporaire de solidarité,
y compris les précomptes, les décimes et centimes additionnels à ces impôts et précomptes ainsi que les taxes additionnelles à l'impôt des personnes physiques,
(ci-après dénommés "l'impôt belge");

2° en Suisse:
les impôts fédéraux, cantonaux et communaux
a) sur le revenu (revenu total, produit du travail, rendement de la fortune, bénéfices industriels et commerciaux, gains en capital et autres revenus),
et
b) sur la fortune (fortune totale, fortune mobilière et immobilière, fortune industrielle et commerciale, capital et réserves et autres éléments de la fortune),
(ci-après dénommés "l'impôt suisse").

§ 4. La Convention ne s'applique pas aux impôts percus à la source sur les gains faits dans les loteries, jeux et paris.

§ 5. La Convention s'applique aussi aux impôts de nature identique ou analogue qui seraient établis après la date de signature de la Convention et qui s'ajouteraient aux impôts actuels ou qui les remplaceraient. Les autorités compétentes des Etats contractants se communiquent les modifications apportées à leurs législations fiscales respectives.

## Chapitre II: Définitions

### Article 3 Définitions générales

§ 1er. Au sens de la présente Convention, à moins que le contexte n'exige une interprétation différente:

1°a) le terme "Belgique" désigne le Royaume de Belgique et, employé dans un sens géographique, il désigne le territoire national ainsi que les zones de juridiction nationale en mer du Royaume de Belgique;

b) le terme "Suisse" désigne la Confédération suisse;

2° les expressions "un Etat contractant" et "l'autre Etat contractant" désignent, suivant le contexte, la Belgique ou la Suisse;

3° le terme "personne" comprend les personnes physiques, les sociétés et tous autres groupements de personnes;

4° le terme "société" désigne toute personne morale ou toute entité qui est considérée comme une personne morale aux fins d'imposition dans l'Etat dont elle est un résident;

5° les expressions "entreprise d'un Etat contractant" et "entreprise de l'autre Etat contractant" désignent respectivement une entreprise exploitée par un résident d'un Etat contractant et une entreprise exploitée par un résident de l'autre Etat contractant;

6° l'expression "trafic international" désigne tout transport effectué par un navire ou un aéronef exploité par une entreprise dont le siège de direction effective est situé dans un Etat contractant, sauf lorsque le navire ou l'aéronef n'est exploité qu'entre des points situés dans l'autre Etat contractant;

7° l'expression "autorité compétente" désigne:

a) en Belgique, le Directeur général des contributions directes, et

b) en Suisse, le Directeur de l'administration fédérale des contributions.

§ 2. Pour l'application de la Convention par un Etat contractant, toute expression qui n'y est pas définie a le sens qui lui attribue le droit de cet Etat concernant les impôts auxquels s'applique la Convention, à moins que le contexte n'exige une interprétation différente.

### Article 4 Résident

§ 1er. Au sens de la présente Convention, l'expression "résident d'un Etat contractant" désigne toute personne qui, en vertu de la législation de cet Etat, est assujettie à l'impôt dans cet Etat, en raison de son domicile, de sa résidence, de son siège de direction ou de tout autre critère de nature analogue; elle désigne également les sociétés de droit belge, autres que les sociétés par actions, qui ont opté pour l'assujettissement de leurs bénéfices à l'impôt des personnes physiques dans le chef de leurs associés ainsi que les sociétés en nom collectif et en commandite simple de droit suisse ayant leur siège de direction effective en Suisse. Toutefois, cette expression ne comprend pas les personnes qui ne sont assujetties à l'impôt dans cet Etat que pour les revenus de sources situées dans cet Etat ou pour la fortune qui y est située.

§ 2. Lorsque, selon les dispositions du paragraphe 1er, une personne physique est un résident des deux Etats contractants, sa situation est réglée de la manière suivante:

a) cette personne est considérée comme un résident de l'Etat où elle dispose d'un foyer d'habitation permanent; si elle dispose d'un foyer d'habitation permanent dans les deux Etats, elle est considérée comme un résident de l'Etat avec lequel ses liens personnels et économiques sont les plus étroits (centre des intérêts vitaux);

b) si l'Etat où cette personne a le centre de ses intérêts vitaux ne peut pas être déterminé, ou si elle ne dispose d'un foyer d'habitation permanent dans aucun des Etats, elle est considérée comme un résident de l'Etat où elle séjourne de façon habituelle;

c) si cette personne séjourne de façon habituelle dans les deux Etats ou si elle ne séjourne de façon habituelle dans aucun d'eux, elle est considérée comme un résident de l'Etat dont elle possède la nationalité;

d) si cette personne possède la nationalité des deux Etats ou si elle ne possède la nationalité d'aucun d'eux, les autorités compétentes des Etats contractants tranchent la question d'un commun accord.

§ 3. Lorsque, selon les dispositions du paragraphe 1er, une personne autre qu'une personne physique est un résident des deux Etats contractants, elle est considérée comme un résident de l'Etat où son siège de direction effective est situé.

§ 4. N'est pas considérée comme un résident d'un Etat contractant au sens du présent article:

1° une personne qui, bien que répondant à la définition des paragraphes 1er à 3 ci-dessus, n'est que le bénéficiaire apparent des revenus, ces revenus bénéficiant en réalité — soit directement, soit indirectement par l'intermédiaire d'autres personnes physiques ou morales — à une personne qui ne peut être regardée elle-même comme un résident de cet Etat au sens du présent article;

2° une personne physique qui n'est pas assujettie aux impôts généralement perçus dans l'Etat contractant dont elle serait un résident selon les dispositions des paragraphes précédents, pour tous les revenus généralement imposables selon la législation fiscale de cet Etat et provenant de l'autre Etat contractant.

### Article 5 Etablissement stable

§ 1er. Au sens de la présente Convention, l'expression "établissement stable" désigne une installation fixe d'affaires par l'intermédiaire de laquelle une entreprise exerce tout ou partie de son activité.

§ 2. L'expression "établissement stable" comprend notamment:

a) un siège de direction,
b) une succursale,
c) un bureau,
d) une usine,
e) un atelier et
f) une mine, un puits de pétrole ou de gaz, une carrière ou tout autre lieu d'extraction de ressources naturelles.

§ 3. Un chantier de construction ou de montage ne constitue un établissement stable que si sa durée dépasse douze mois.

§ 4. Nonobstant les dispositions précédentes du présent article, on considère qu'il n'y a pas "établissement stable" si:

a) il est fait usage d'installations aux seules fins de stockage, d'exposition ou de livraison de marchandises appartenant à l'entreprise;
b) des marchandises appartenant à l'entreprise sont entreposées aux seules fins de stockage, d'exposition ou de livraison;
c) des marchandises appartenant à l'entreprise sont entreposées aux seules fins de transformation par une autre entreprise;
d) une installation fixe d'affaires est utilisée aux seules fins d'acheter des marchandises ou de réunir des informations, pour l'entreprise;
e) une installation fixe d'affaires est utilisée aux seules fins d'exercer, pour l'entreprise, toute autre activité de caractère préparatoire ou auxiliaire;
f) une installation fixe d'affaires est utilisée aux seules fins de l'exercice cumulé d'activités mentionnées aux alinéas a) à e), à condition que l'activité d'ensemble de l'installation fixe d'affaires résultant de ce cumul garde un caractère préparatoire ou auxiliaire.

§ 5. Nonobstant les dispositions des paragraphes 1er et 2, lorsqu'une personne — autre qu'un agent jouissant d'un statut indépendant auquel s'applique le paragraphe 6 — agit pour le compte d'une entreprise et dispose dans un Etat contractant de pouvoirs qu'elle y exerce habituellement lui permettant de conclure des contrats au nom de l'entreprise, cette entreprise est considérée comme ayant un établissement stable dans cet Etat pour toutes les activités que cette personne exerce pour l'entreprise, à moins que les activités de cette personne ne soient limitées à celles qui sont mentionnées au paragraphe 4 et qui, si elles étaient exercées par l'intermédiaire d'une installation fixe d'affaires, ne permettraient pas de considérer cette installation comme un établissement stable selon les dispositions de ce paragraphe.

§ 6. Une entreprise n'est pas considerée comme ayant un établissement stable dans un Etat contractant du seul fait qu'elle y exerce son activité par l'entremise d'un courtier, d'un commissionnaire général ou de tout autre agent jouissant d'un statut independant, à condition que ces personnes agissent dans le cadre ordinaire de leur activité.

Toutefois, lorsqu'un intermédiaire agit pour le compte d'une entreprise d'assurance et dispose dans un Etat contractant de pouvoirs qu'il y exerce habituellement lui permettant de conclure des contrats au nom de cette entreprise, celle-ci est considérée comme ayant un établissement stable dans cet Etat.

§ 7. Le fait qu'une société qui est un résident d'un Etat contractant contrôle ou est contrôlée par une société qui est un résident de l'autre Etat contractant ou qui y exerce son activité (que ce soit par l'intermédiaire d'un établissement stable ou non) ne suffit pas, en lui-même, à faire de l'une quelconque de ces sociétés un établissement stable de l'autre.

## Chapitre III: Imposition des revenus

**Article 6** Revenus immobiliers

§ 1er. Les revenus qu'un résident d'un Etat contractant tire de biens immobiliers (y compris les revenus des exploitations agricoles ou forestières) situés dans l'autre Etat contractant, sont imposables dans cet autre Etat.

§ 2. L'expression "biens immobiliers" a le sens que lui attribue le droit de l'Etat contractant où les biens considérés sont situés. L'expression comprend en tous cas les accessoires, le cheptel mort ou vif des exploitations agricoles et forestières, les droits auxquels s'appliquent les dispositions du droit privé concernant la propriété foncière, l'usufruit des biens immobiliers et les droits à des paiements variables ou fixes pour l'exploitation ou la concession de l'exploitation de gisements minéraux, sources et autres ressources naturelles; les navires, bateaux et aéronefs ne sont pas considérés comme des biens immobiliers.

§ 3. Les dispositions du paragraphe 1er s'appliquent aux revenus provenant de l'exploitation ou de la jouissance directes, de la location ou de l'affermage, ainsi que de toute autre forme d'exploitation de biens immobiliers.

§ 4. Les dispositions des paragraphes 1er et 3 s'appliquent également aux revenus provenant des biens immobiliers d'une entreprise ainsi qu'aux revenus des biens immobiliers servant à l'exercice d'une profession indépendante.

**Article 7** Bénéfices des entreprises

§ 1er. Les bénéfices d'une entreprise d'un Etat contractant ne sont imposables que dans cet Etat, à moins que l'entreprise n'exerce son activité dans l'autre Etat contractant par l'intermédiaire d'un établissement stable qui y est situé. Si l'entreprise exerce son activité d'une telle façon, les bénéfices de l'entreprise sont imposables dans l'autre Etat mais uniquement dans la mesure où ils sont imputables à cet établissement stable.

§ 2. Sous réserve des dispositions du paragraphe 3, lorsqu'une entreprise d'un Etat contractant exerce son activité dans l'autre Etat contractant par l'intermédiaire d'un établissement stable qui y est situé, il est imputé, dans chaque Etat contractant, à cet établissement stable les bénéfices qu'il aurait pu réaliser s'il avait constitué une entreprise distincte exerçant des activités identiques ou analogues dans des conditions identiques ou analogues et agissant en toute indépendance.

§ 3. Pour déterminer les bénéfices d'un établissement stable, sont admises en déduction les dépenses exposées aux fins poursuivies par cet établissement stable, y compris les dépenses de direction et les frais généraux d'administration ainsi exposés, soit dans l'Etat où est situé cet établissement, soit ailleurs.

§ 4. a) A défaut de comptabilité régulière ou d'autres éléments probants permettant de déterminer le montant des bénéfices d'une entreprise d'un Etat contractant, qui est imputable à son établissement stable situé dans l'autre Etat, l'impôt peut notamment être établi dans cet autre Etat conformément à sa propre législation, compte tenu des bénéfices normaux d'entreprises analogues du même Etat, se livrant à la même activité ou à des activités analogues dans des conditions identiques ou analogues.
b) S'il est d'usage, dans un Etat contractant, de déterminer les bénéfices imputables à un établissement stable sur la base d'une répartition des bénéfices totaux de l'entreprise entre ses diverses parties, aucune disposition du paragraphe 2 n'empêche cet Etat contractant de déterminer les bénéfices imposables selon la répartition en usage; la méthode de répartition adoptée doit cependant être telle que le résultat obtenu soit conforme aux principes contenus dans le présent article.

§ 5 Aucun bénéfice n'est imputé à un établissement stable du fait qu'il a simplement acheté des marchandises pour l'entreprise.

§ 6. Aux fins des paragraphes précédents, les bénéfices à imputer à l'établissement stable sont déterminés chaque année selon la même méthode, à moins qu'il n'existe des motifs valables et suffisants de procéder autrement.

§ 7. Lorsque les bénéfices comprennent des éléments de revenus traités séparément dans d'autre articles de la présente Convention, les dispositions de ces articles ne sont pas affectées par les dispositions du présent article.

**Article 8** Navigation maritime, intérieure et aérienne

§ 1er. Les bénéfices provenant de l'exploitation, en trafic international, de navires ou d'aéronefs ne sont imposables que dans l'Etat contractant où le siège de direction effective de l'entreprise est situé.

§ 2. Les bénéfices provenant de l'exploitation de bateaux servant à la navigation intérieure ne sont imposables que dans l'Etat contractant où le siège de direction effective de l'entreprise est situé.

§ 3. Si le siège de direction effective d'une entreprise de navigation maritime ou intérieure est à bord d'un navire ou d'un bateau, ce siège est considéré comme situé dans l'Etat contractant où se trouve le port d'attache de ce navire ou de ce bateau, ou à défaut de port d'attache, dans l'Etat contractant dont l'exploitant du navire ou du bateau est un résident.

§ 4. Les dispositions du paragraphe 1er s'appliquent aussi aux bénéfices provenant de la participation à un pool, une exploitation en commun ou un organisme international d'exploitation.

**Article 9** Entreprises associées

Lorsque
a) une entreprise d'un Etat contractant participe directement ou indirectement à la direction, au contrôle ou au capital d'une entreprise de l'autre Etat contractant, ou que
b) les mêmes personnes participent directement ou indirectement à la direction, au contrôle ou au capital d'une entreprise d'un Etat contractant et d'une entreprise de l'autre Etat contractant,

et que, dans l'un et l'autre cas, les deux entreprises sont, dans leurs relations commerciales ou financières, liées par des conditions convenues ou imposées, qui diffèrent de celles qui seraient convenues entre des entreprises indépendantes, les bénéfices qui, sans ces conditions, auraient été réalisés par l'une des entreprises mais n'ont pu l'être en fait à cause de ces conditions, peuvent être inclus dans les bénéfices de cette entreprise et imposés en conséquence.

**Article 10** Dividendes

§ 1er. Les dividendes payés par une société qui est un résident d'un Etat contractant à un résident de l'autre Etat contractant sont imposables dans cet autre Etat.

§ 2. Toutefois, ces dividendes sont aussi imposables dans l'Etat contractant dont la société qui paie les dividendes est un résident, et selon la législation de cet Etat, mais si le bénéficiaire effectif des dividendes est un résident de l'autre Etat, l'impôt ainsi établi ne peut excéder:
a) 10 pour cent du montant brut des dividendes si le bénéficiaire effectif est une société (autre qu'une société de personnes de droit belge ayant opté pour l'assujettissement de ses bénéfices à l'impôt des personnes physiques) qui détient directement au moins 25 pour cent du capital de la société qui paie les dividendes;
b) 15 pour cent du montant brut des dividendes, dans tous les autre cas.
Le présent paragraphe n'affecte pas l'imposition de la société au titre des bénéfices qui servent au paiement des dividendes.

§ 3. Le terme "dividendes" employé dans le présent article désigne les revenus provenant d'actions, actions ou bons de jouissance, parts de mine, parts de fondateur ou autres parts bénéficiaires à l'exception des créances, ainsi que les revenus d'autres parts sociales soumis au même régime fiscal que les revenus d'actions par la législation de l'Etat dont la société distributrice est un résident. Ce terme désigne également les revenus — même attribués sous la forme d'intérêts — imposables au titre de revenus de capitaux investis par les associés dans les sociétés autres que les sociétés par actions qui sont des résidents de la Belgique.

§ 4. Les dispositions des paragraphes 1er et 2 ne s'appliquent pas lorsque le bénéficiaire effectif des dividendes, résident d'un Etat contractant, exerce dans l'autre Etat contractant dont la société qui paie les dividendes est un résident, soit une activité industrielle ou commerciale par l'intermédiaire d'un établissement stable qui y est situé, soit une profession indépendante au moyen d'une base fixe qui y est située, et que la participation génératrice des dividendes s'y rattache effectivement. Dans ce cas, les dispositions de l'article 7 ou de l'article 14, suivant les cas, sont applicables.

§ 5. Lorsqu'une société qui est un résident d'un Etat cintractant tire des bénéfices ou des revenus de l'autre Etat contractant, cet autre Etat ne peut percevoir aucun impôt sur les dividendes payés par la société, sauf dans la mesure où des dividendes sont payés à un résident de cet autre

Etat ou dans la mesure où la participation génératrice des dividendes se rattache effectivement à un établissement stable ou à une base fixe situés dans cet autre Etat, ni prélever aucun impôt, au titre de l'imposition des bénéfices non distribués, sur les bénéfices non distribués de la société, même si les dividendes payés ou les bénéfices non distribués consistent en tout ou en partie en bénéfices ou revenus provenant de cet autre Etat.

**Article 11** Intérêts

§ 1$^{er}$. Les intérêts provenant d'un Etat contractant et payés à un résident de l'autre Etat contractant sont imposables dans cet autre Etat.

§ 2. Toutefois, ces intérêts sont aussi imposables dans l'Etat contractant d'où ils proviennent et selon la législation de cet Etat, mais si le bénéficiaire effectif des intérêts est un résident de l'autre Etat, l'impôt ainsi établi ne peut excéder 10 pour cent du montant brut des intérêts.

§ 3. Nonobstant les dispositions du paragraphe 2, les intérêts mentionnés au paragraphe 1$^{er}$ ne sont imposables que dans l'Etat contractant dont le bénéficiaire effectif est un résident, si ces intérêts sont payés:
a) en liaison avec la vente à crédit d'un équipement industriel, commercial ou scientifique,
b) en liaison avec la vente à crédit de marchandises livrées par une entreprise à une autre entreprise, ou
c) sur un prêt de n'importe quelle nature, non représenté par des titres au porteur, consenti par un établissement bancaire.

§ 4. Le terme "intérêts" employé dans le présent article désigne les revenus des créances de toute nature, assorties ou non de garanties hypothécaires ou d'une clause de participation aux bénéfices du débiteur, et notamment les revenus des fonds publics et des obligations d'emprunts, y compris les primes et lots attachés à ces titres. Ce terme ne comprend pas les pénalisations pour paiement tardif ni les intérêts assimilés à des dividendes par l'article 10, paragraphe 3, deuxième phrase.

§ 5. Les dispositions des paragraphes 1$^{er}$, 2 et 3 ne s'appliquent pas lorsque le bénéficiaire effectif des intérêts, résident d'un Etat contractant, exerce dans l'autre Etat contractant d'où proviennent les intérêts, soit une activité industrielle ou commerciale par l'intermédiaire d'un établissement stable qui y est situé, soit une profession indépendante au moyen d'une base fixe qui y est située, et que la créance génératrice des intérêts s'y rattache effectivement. Dans ce cas, les dispositions de l'article 7 ou de l'article 14, suivant les cas, sont applicables.

§ 6. Les intérêts sont considérés comme provenant d'un Etat contractant lorsque le débiteur est cet Etat lui-même, une subdivision politique, une collectivité locale ou un résident de cet Etat. Toutefois, lorsque le débiteur des intérêts, qu'il soit ou non un résident d'un Etat contractant, a dans un Etat contractant un établissement stable, ou une base fixe, pour lequel la dette donnant lieu au paiement des intérêts a été contractée et qui supporte la charge de ces intérêts, ceux-ci sont considérés comme provenant de l'Etat où l'établissement stable, ou la base fixe, est situé.

§ 7. Lorsque, en raison de relations spéciales existant entre le débiteur et le bénéficiaire effectif ou que l'un et l'autre entretiennent avec de tierces personnes, le montant des intérêts, compte tenu de la créance pour laquelle ils sont payés, excède celui dont seraient convenus le débiteur et le bénéficiaire effectif en l'absence de pareilles relations, les dispositions du présent article ne s'appliquent qu'à ce dernier montant. Dans ce cas, la partie excédentaire des paiements reste imposable selon la législation de chaque Etat contractant, mais lorsque la partie excédentaire des intérêts est comprise dans le revenu imposable du débiteur et que celui-ci est une société, l'impôt prélevé sur cette partie excédentaire dans l'Etat contractant d'où les intérêts proviennent ne peut excéder celui qui serait applicable si les intérêts étaient des dividendes auxquels s'applique l'article 10.

**Article 12** Redevances

§ 1$^{er}$. Les redevances provenant d'un Etat contractant et payées à un résident de l'autre Etat contractant ne sont imposables que dans cet autre Etat, si ce résident en est le bénéficiaire effectif.

§ 2. Le terme "redevances" employé dans le présent article désigne les rémunérations de toute nature payées pour l'usage ou la concession de l'usage d'un droit d'auteur sur une oeuvre littéraire, artistique ou scientifique, y compris les films cinématographiques et les films ou les enregistrements conçus pour la radio et la télévision, d'un brevet, d'une marque de fabrique ou de commerce, d'un dessin ou d'un modèle, d'un plan, d'une formule ou d'un procédé secrets, ainsi que pour l'usage ou la concession de l'usage d'un équipement industriel, commercial ou scientifique ne constituant pas un bien immobilier visé à l'article 6 et pour des informations ayant trait à une expérience acquise dans le domaine industriel, commercial ou scientifique.

§ 3. Les dispositions du paragraphe 1$^{er}$ ne s'appliquent pas lorsque le bénéficiaire effectif des redevances, résident d'un Etat contractant, exerce dans l'autre Etat contractant d'où proviennent les redevances, soit une activité industrielle ou commerciale par l'intermédiaire d'un établissement stable qui y est situé, soit une profession indépendante au moyen d'une base fixe qui y est située, et que le droit ou le bien générateur des redevances s'y rattache effectivement. Dans ce cas, les dispositions de l'article 7 ou de l'article 14, suivant les cas, sont applicables.

§ 4. Lorsque, en raison de relations spéciales existant entre le débiteur et le bénéficiaire effectif ou que l'un et l'autre entretiennent avec de tierces personnes, le montant des redevances, compte tenu de la prestation pour laquelle elles sont payées, excède celui dont seraient convenus le débiteur et le bénéficiare effectif en l'absence de pareilles relations, les dispositions du présent article ne s'appliquent qu'à ce dernier montant. Dans ce cas, la partie excédentaire des paiements reste imposable selon la législation de chaque Etat contractant, mais lorsque la partie excédentaire des redevances est comprise dans le revenu imposable du débiteur et que celui-ci est une société, l'impôt relevé sur cette partie excédentaire dans l'Etat contractant d'où les redevances proviennent ne peut excéder celui qui serait applicable si les redevances étaient des dividendes auxquels s'applique l'article 10.

**Article 13** Gains en capital

§ 1$^{er}$. Les gains qu'un résident d'un Etat contractant tire de l'aliénation de biens immobiliers visés à l'article 6 et situés dans l'autre Etat contractant, sont imposables dans cet autre Etat.

§ 2. Les gains provenant de l'aliénation de biens mobiliers qui font partie de l'actif d'un établissement stable qu'une entreprise d'un Etat contractant a dans l'autre Etat contractant, ou de biens mobiliers qui appartiennent à une base fixe dont un résident d'un Etat contractant dispose dans l'autre Etat contractant pour l'exercice d'une profession indépendante, y compris de tels gains provenant de l'aliénation de cet établissement stable (seul ou avec l'ensemble de l'entreprise) ou de cette base fixe, sont imposables dans cet autre Etat.

§ 3. Les gains provenant de l'aliénation de navires ou aéronefs exploités en trafic international, de bateaux servant à la navigation intérieure ou de biens mobiliers affectés à l'exploitation de ces navires, aéronefs ou bateaux, ne sont imposables que dans l'Etat contractant où le siège de direction effective de l'entreprise est situé.

§ 4. Les gains provenant de l'aliénation de tous biens autres que ceux visés aux paragraphes 1$^{er}$, 2 et 3 ne sont imposables que dans l'Etat contractant dont le cédant est un résident.

**Article 14** Professions indépendantes

§ 1$^{er}$. Les revenus qu'un résident d'un Etat contractant tire d'une profession libérale ou d'autres activités de caractère indépendant ne sont imposables que dans cet Etat, à moins que ce résident ne dispose de façon habituelle dans l'autre Etat contractant d'une base fixe pour l'exercice de ses activités. S'il dispose d'une telle base fixe, les revenus sont imposables dans l'autre Etat mais uniquement dans la mesure où ils sont imputables à cette base fixe.

§ 2. L'expression "profession libérale" comprend notamment les activités indépendantes d'ordre scientifique, littéraire, artistique, éducatif ou pédagogique, ainsi que les activités indépendantes des médecins, avocats, ingénieurs, architects, dentistes et comptables.

**Article 15** Professions dépendantes

§ 1$^{er}$. Sous réserve des dispositions des articles 16, 18 et 19, les salaires, traitements et autres rémunérations similaires qu'un résident d'un Etat contractant reçoit au titre d'un emploi salarié ne sont imposables que dans cet Etat, à moins que l'emploi ne soit exercé dans l'autre Etat contractant. Si l'emploi y est exercé, les rémunérations reçues à ce titre sont imposables dans cet autre Etat.

§ 2. Nonobstant les dispositions du paragraphe 1er, les rémunérations qu'un résident d'un Etat contractant reçoit au titre d'un emploi salarié exercé dans l'autre Etat contractant ne sont imposables que dans le premier Etat si:
a) le bénéficiaire séjourne dans l'autre Etat pendant une période ou des périodes n'excédant pas au total 183 jours au cours de l'année civile, et
b) les rémunérations sont payées par un employeur ou pour le compte d'un employeur qui n'est pas un résident de l'autre Etat, et
c) la charge des rémunérations n'est pas supportée par un établissement stable ou une base fixe que l'employeur a dans l'autre Etat.

§ 3. Nonobstant les dispositions précédentes du présent article, les rémunérations reçues au titre d'un emploi salarié exercé à bord d'un navire ou d'un aéronef exploité en trafic international, ou à bord d'un bateau servant à la navigation intérieure, sont imposables dans l'Etat contractant où le siège de direction effective de l'entreprise est situé.

**Article 16** Tantièmes

§ 1er. Les tantièmes, jetons de présence et autres rétributions similaires qu'un résident d'un Etat contractant reçoit en sa qualité de membre du conseil d'administration ou de surveillance d'une société qui est un résident de l'autre Etat contractant sont imposables dans cet autre Etat. Il en est même des rémunérations d'un associé commandité d'une société en commandite par actions qui est un résident de la Belgique.

§ 2. Toutefois, les rémunérations que les personnes visées au paragraphe 1er reçoivent de cette société en une autre qualité sont imposables, suivant les cas, conformément aux dispositions de l'article 14 ou de l'article 15, paragraphe 1er.

**Article 17** Artistes et sportifs

§ 1er. Nonobstant les dispositions des articles 14 et 15, les revenus qu'un résident d'un Etat contractant tire de ses activités personnelles exercées dans l'autre Etat contractant en tant qu'artiste du spectacle, tel qu'un artiste de théâtre, de cinéma, de la radio ou de la télévision, ou qu'un musicien, ou en tant que sportif, sont imposables dans cet autre Etat.

§ 2. Lorsque les revenus d'activités qu'un artist du spectacle ou un sportif exerce personnellement et en cette qualité sont attribués non pas à l'artiste ou au sportif lui-même mais à une autre personne, ces revenus sont imposables, nonobstant les dispositions des articles 7, 14 et 15, dans l'Etat contractant où les activités de l'artiste ou du sportif sont exercées.

§ 3. Les dispositions des paragraphes 1er et 2 ne sont pas applicables aux revenus provenant des activités d'artistes du spectacle qui sont subventionnées, directement ou indirectement, pour une part importante par des allocations provenant de fonds publics.

**Article 18** Pensions

§ 1er. Sous réserve des dispositions de l'article 19, paragraphe 2, les pensions et autres rémunérations similaires, payées à un résident d'un Etat contractant au titre d'un emploi antérieur, ne sont imposables que dans cet Etat.

§ 2. Les pensions, rentes et autres allocations, périodiques ou non, payées par un Etat contractant — autrement qu'au titre d'un emploi antérieur — aux victimes de guerre, militaires ou civiles, aux victimes militaires du temps de paix ainsi qu'aux ayants droit des victimes précitées ne sont imposables que dans cet Etat.

**Article 19** Fonctions publiques

§ 1er. a) Les rémunérations, autres que les pensions, payées par un Etat contractant ou l'une de ses subdivisions politiques, collectivités locales ou personnes morales de droit public à une personne physique, au titre de services rendus à cet Etat ou à cette subdivision, collectivité ou personne morale, ne sont imposables que dans cet Etat.
b) Toutefois, ces rémunérations ne sont imposables que dans l'autre Etat contractant si les services sont rendus dans cet Etat et si la personne physique est un résident de cet Etat qui:
(i) possède la nationalité de cet Etat, ou
(ii) n'est pas devenu un résident de cet Etat à seule fin de rendre les services.

§ 2.a) Les pensions payées par un Etat contractant ou l'une de ses subdivisions politiques, collectivités locales ou personnes morales de droit public, soit directement sout par prélèvement sur des fonds qu'ils ont constitués, à une personne physique, au titre de services rendus à cet Etat ou à cette subdivision, collectivité ou personne morale, ne sont imposables que dans cet Etat.
b) Toutefois, ces pensions ne sont imposables que dans l'autre Etat contractant si la personne physique est un résident de cet Etat et en possède la nationalité.

§ 3. Les dispositions des articles 15, 16 et 18 s'appliquent aux rémunérations et pensions payées au titre de services rendus dans le cadre d'une activité industrielle ou commerciale exercée par un Etat contractant ou l'une de ses subdivisions politiques, collectivités locales ou personnes morales de droit public.
Toutefois, les dispositions des paragraphes 1er et 2 du présent article s'appliquent aux rémunérations et pensions payées, au titre de services rendus, par les organismes suivants:
a) en Belgique:
— la Société nationale des chemins de fer belges;
— la Régie des télégraphes et des téléphones;
— la Régie des postes;
b) en Suises:
— les Chemins de fer fédéraux suisses;
— l'Entreprise suisse des postes, téléphones et télégraphes;
— l'Office national suisse du tourisme.

**Article 20** Etudiants

Les sommes qu'un étudiant, un apprenti ou un stagiaire qui est, ou qui était immédiatement avant de se rendre dans un Etat contractant, un résident de l'autre Etat contractant et qui séjourne dans le premier Etat à seule fin d'y poursuivre ses études ou sa formation, reçoit pour couvrir ses frais d'entretien, d'études ou de formation ne sont pas imposables dans cet Etat, à condition qu'elles proviennent de sources situées en dehors de cet Etat.

**Articles 21** Autres revenus

§ 1er. Les éléments du revenu d'un résident d'un Etat contractant, d'où qu'ils proviennent, qui ne sont pas traités dans les articles précédents de la présente Convention ne sont imposables que dans cet Etat.

§ 2. Les dispositions du paragraphe 1er ne s'appliquent pas aux revenus autres que les revenus provenant de biens immobiliers tels qu'ils sont définis à l'article 6, paragraphe 2, lorsque le bénéficiaire de tels revenus, résident d'un Etat contractant, exerce dans l'autre Etat contractant, soit une activité industrielle ou commerciale par l'intermédiaire d'un établissement stable qui y est situé, soit une profession indépendante au moyen d'une base fixe qui y est située, et que le droit ou le bien générateur des revenus s'y rattache effectivement. Dans ce cas, les dispositions de l'article 7 ou de l'article 14, suivant les cas, sont applicables.

**Articles 22** Prévention de l'usage abusif de la Convention

§ 1er. Une société qui est un résident d'un Etat contractant et dans laquelle des personnes qui ne sont pas des résidents de cet Etat ont un intérêt prépondérant direct ou indirect sous forme d'une participation ou d'une autre manière, ne peut bénéficier d'un dégrèvement des impôts de l'autre Etat contractant perçus sur les dividendes, intérêts et redevances, provenant de cet autre Etat, conformément aux dispositions des articles 10, 11 et 12, que si:
1° les comptes créditeurs portant intérêt ouverts au nom de personnes qui ne sont pas des résidents du premier Etat ne s'élèvent pas à plus de six fois le total formé par le capital-actions (ou le capital social) et les réserves apparentes; cette disposition ne s'applique pas aux banques des deux Etats contractants;
2° les dettes contractées envers les mêmes personnes ne portent pas intérêt à un taux excédant le taux normal; est considéré comme taux normal:
a) pour la Belgique, le taux des intérêts admissibles au titre de charges professionnelles en vertu de la législation belge;
b) pour la Suisse, le taux du rendement moyen des obligations émises par la Confédération suisse majoré de deux points;
3° 50 pour cent au plus des revenus en question provenant de l'autre Etat contractant sont utilisés à servir des engagements (intérêts débiteurs, redevances de licences, frais de développement, de réclame, de première installation, de voyage, amortissements de biens de toute nature y compris les biens incorporels, procédés, etc.) envers des personnes qui ne sont pas des résidents du premier Etat;
4° les dépenses en relation avec les revenus en question provenant de l'autre Etat

contractant sont exclusivement couvertes à l'aide de ces revenus;
5° la société distribue 25 pour cent au moins des revenus en question provenant de l'autre Etat contractant.

Les mesures plus étendues qui ont été ou seront prises par l'un des Etats contractants et qui visent à empêcher des prétentions abusives à un dégrèvement d'impôt perçu à la source par l'autre Etat contractant restent applicables.

§ 2. Une société qui est un résident de la Suisse et dans laquelle des personnes qui ne sont pas des résidents de la Suisse ont un intérêt prépondérant direct ou indirect sous forme d'une participation ou d'une autre manière, ne peut prétendre, même si elle remplit les conditions posées au paragraphe 1er, au dégrèvement des impôts perçus par la Belgique sur les intérêts ou les redevances provenant de la Belgique qui lui sont payés que si, dans le canton où cette société a son siège, ces intérêts ou redevances sont soumis à l'impôt cantonal sur le revenu dans des conditions identiques ou similaires à celles prévues par les dispositions concernant l'impôt fédéral pour la défense nationale.

Une fondation de famille qui est un résident de la Suisse ne peut prétendre au dégrèvement des impôts perçus en Belgique sur les dividendes, intérêts et redevances provenant de la Belgique qui lui sont payés, si le fondateur ou la majorité des bénéficiaires sont des personnes qui ne sont pas des résidents de la Suisse et que les revenus en question profitent ou doivent profiter pour plus d'un tiers à des personnes qui ne sont pas des résidents de la Suisse.

§ 3. La surveillance, les enquêtes et les attestations qu'implique l'application des paragraphes 1er et 2 sont du ressort des autorités compétentes de l'Etat contractant dont le bénéficiaire des revenus en question est un résident.
Si les autorités compétentes de l'autre Etat contractant d'où proviennent ces revenus ont des indications valables pour mettre en doute des déclarations fournies par le bénéficiaire de ces revenus dans la demande de dégrèvement et attestées par les autorités compétentes du premier Etat, elles transmettent ces indications aux autorités compétentes du premier Etat; celles-ci procèdent à une nouvelle enquête et informent les autorités compétentes de l'autre Etat du résultat. En cas de divergences de vues persistantes entre les autorités compétentes des deux Etats, les dispositions de l'article 26 trouvent leur application.

## Chapitre IV: Imposition de la fortune

### Article 23 Fortune

§ 1er. La fortune constituée par des biens immobiliers visés à l'article 6, que possède un résident d'un Etat contractant et qui sont situés dans l'autre Etat contractant, est imposable dans cet autre Etat.

§ 2. La fortune constituée par des biens mobiliers qui font partie de l'actif d'un établissement stable qu'une entreprise d'un Etat contractant a dans l'autre Etat contractant ou par des biens mobiliers qui appartiennent à une base fixe dont un résident d'un Etat contractant dispose dans l'autre Etat contractant pour l'exercice d'une profession indépendante est imposable dans cet autre Etat.

§ 3. La fortune constituée par des navires et des aéronefs exploités en trafic international, par des bateaux servant à la navigation intérieure ainsi que par des biens mobiliers affectés à leur exploitation n'est imposable que dans l'Etat contractant où le siège de direction effective de l'entreprise est situé.

§ 4. Tous les autres éléments de la fortune d'un résident d'un Etat contractant ne sont imposables que dans cet Etat.

## Chapitre V: Méthodes pour éliminer les doubles impositions

### Article 24

§ 1er. En ce qui concerne la Belgique, la double imposition est évitée de la manière suivante:
1° Lorsqu'un résident de la Belgique reçoit des revenus ou possède de la fortune, non visés aux 2° et 3° ci-après, qui sont imposables en Suisse conformément aux dispositions de la présente Convention, la Belgique exempte de l'impôt ces revenus ou cette fortune, mais elle peut, pour calculer le montant de ses impôts sur le reste du revenu ou de la fortune de ce résident, appliquer le même taux que si les revenus ou la fortune en question n'avaient pas été exemptés.
2° En ce qui concerne les dividendes imposables conformément à l'article 10, paragraphe 2, et non exemptés d'impôt belge en vertu du 3° ci-après, les intérêts imposables conformément à l'article 11, paragraphes 2 ou 7, et les redevances imposables conformément à l'article 12, paragraphe 4, la quotité forfaitaire d'impôt étranger prévue par la législation belge est imputée, dans les conditions et aux taux prévus par cette législation, sur l'impôt belge afférent à ces revenus.
3° Lorsqu'une société qui est un résident de la Belgique a la propriété d'actions ou parts d'une société qui est un résident de la Suisse et y est soumise à l'impôt sur le revenu des sociétés, les dividendes qui lui sont payés par cette dernière société et qui sont imposables en Suisse conformément à l'article 10, paragraphe 2, sont exemptés de l'impôt des sociétés en Belgique, dans la mesure où cette exemption serait accordée si les deux sociétés étaient des résidents de la Belgique.
4° Lorsque, conformément à la législation belge, des pertes subies par une entreprise belge dans un établissement stable situé en Suisse ont été effectivement déduites des bénéfices de cette entreprise pour son imposition en Belgique, l'exemption prévue au 1° ne s'applique pas en Belgique aux bénéfices d'autres périodes imposables qui sont imputables à cet établissement, dans la mesure où ces bénéfices ont aussi été exemptés d'impôt en Suisse en raison de leur compensation avec lesdites pertes.

§ 2 En ce qui concerne la Suisse, la double imposition est évitée de la manière suivante:
1° Lorsqu'un résident de la Suisse reçoit des revenus ou possède de la fortune, non visés aux 2°, 3° et 4° ci-après, qui sont imposables en Belgique conformément aux dispositions de la présente Convention, la Suisse exempte de l'impôt ces revenus ou cette fortune, mais elle peut, pour calculer le montant de ses impôts sur le reste du revenu ou de la fortune de ce résident, appliquer le même taux que si les revenus ou la fortune en question n'avaient pas été exemptés.
2° Lorsqu'un résident de la Suisse reçoit des revenus qui, conformément aux dispositions des articles 10 et 11, sont imposables en Belgique, la Suisse accorde un dégrèvement à ce résident, à sa demande. Ce dégrèvement consiste:
a) en l'imputation de l'impôt payé en Belgique conformément aux dispositions des articles 10 et 11 sur l'impôt suisse qui frappe les revenus de ce résident, la somme ainsi imputée ne pouvant toutefois excéder la fraction de l'impôt suisse, calculé avant l'imputation, correspondant aux revenus qui sont imposés en Belgique, ou
b) en une réduction forfaitaire de l'impôt suisse, ou
c) en une exemption partielle des revenus en question de l'impôt suisse, mais au moins en une déduction de l'impôt payé en Belgique du montant brut des revenus reçus de Belgique.

Toutefois, ce dégrèvement consiste en une déduction de l'impôt payé en Belgique du montant brut des revenus en question reçus de Belgique, lorsque le bénéficiaire résident de la Suisse ne peut, en vertu des dispositions de l'article 22, bénéficier du dégrèvement prévu aux articles 10 et 11 de l'impôt belge frappant les dividendes et les intérêts.
La Suisse déterminera le genre de dégrèvement et règlera la procédure selon les prescriptions concernant l'exécution des conventions internationales conclues par la Confédération en vue d'éviter les doubles impositions.
3° Lorsqu'un résident de la Suisse reçoit des redevances et ne peut, en vertu des dispositions de l'article 22, bénéficier du dégrèvement, prévu à l'article 12, de l'impôt belge frappant ces redevances, la Suisse accorde une déduction de l'impôt payé en Belgique du montant brut des redevances.
4° Lorsqu'une société qui est un résident de la Suisse reçoit des dividendes d'une société qui est un résident de la Belgique, elle bénéficie en ce qui concerne l'impôt suisse afférent à ces dividendes, des mêmes avantages que ceux dont elle bénéficierait si la société qui paie les dividendes était un résident de la Suisse.

## Chapitre VI: Dispositions spéciales

### Article 25 Non-discrimination

§ 1er. Les nationaux d'un Etat contractant ne sont soumis dans l'autre Etat contractant à aucune imposition ou obligation y relative, qui est autre ou plus lourde que celles auxquelles sont ou pourront être assujettis les nationaux de cet autre Etat qui se trouvent dans la même situation. La présente disposition s'applique aussi nonobstant les dispositions de l'article 1er, aux personnes qui ne sont pas des résidents d'un Etat contractant ou des deux Etats contractants.

§ 2. Le terme "nationaux" désigne:

a) toutes les personnes physiques qui possèdent la nationalité d'un Etat contractant;
b) toutes les personnes morales, sociétés de personnes et associations constituées conformément à la législation en vigueur dans un Etat contractant.

§ 3. L'imposition d'un établissement stable qu'une entreprise d'un Etat contractant a dans l'autre Etat contractant n'est pas établie dans cet autre Etat d'une façon moins favorable que l'imposition des entreprises de cet autre Etat qui exercent la même activité. La présente disposition ne peut être interprétée comme obligeant un Etat contractant à accorder aux résidents de l'autre Etat contractant les déductions personnelles, abattements et réductions d'impôt en fonction de la situation ou des charges de famille qu'il accorde à ses propres résidents.

§ 4. A moins que les dispositions de l'article 9, de l'article 11, paragraphe 7, ou de l'article 12, paragraphe 4, ne soient applicables, les intérêts, redevances et autres dépenses payés par une entreprise d'un Etat contractant à un résident de l'autre Etat contractant sont déductibles, pour la détermination des bénéfices imposables de cette entreprise, dans les mêmes conditions que s'ils avaient été payés à un résident du premier Etat. De même, les dettes d'une entreprise d'un Etat contractant envers un résident de l'autre Etat contractant sont déductibles, pour la détermination de la fortune imposable de cette entreprise, dans les mêmes conditions que si elles avaient été contractées envers un résident du premier Etat.

§ 5. Les entreprises d'un Etat contractant, dont le capital est en totalité ou en partie, directement ou indirectement, détenu ou contrôlé par un ou plusieurs résidents de l'autre Etat contractant, ne sont soumises dans le premier Etat à aucune imposition ou obligation y relative, qui est autre ou plus lourde que celles auxquelles sont ou pourront être assujetties les autres entreprises similaires du premier Etat.

§ 6. Aucune disposition du présent article ne peut être interprétée comme empêchant la Belgique d'imposer au taux prévu par la législation belge le montant total des bénéfices d'un établissement stable belge d'une société qui est un résident de la Suisse ou d'une association ayant son siège de direction effective en Suisse, pourvu que le taux précité n'excède pas le taux généralement applicable aux bénéfices des sociétés qui sont des résidents de la Belgique.

§ 7. Les dispositions du présent article s'appliquent, nonobstant les dispositions de l'article 2, aux impôts de toute nature ou dénomination.

**Article 26** Procédure amiable

§ 1er. Lorsqu'une personne estime que les mesures prises par un Etat contractant ou par les deux Etats contractants entraînent ou entraîneront pour elle une imposition non conforme aux dispositions de la présente Convention, elle peut, indépendamment des recours prévus par le droit interne de ces Etats, soumettre son cas à l'autorité compétente de l'Etat contractant dont elle est un résident ou, si son cas relève de l'article 25, paragraphe 1er, à celle de l'Etat contractant dont elle possède la nationalité. Le cas doit être soumis dans les trois ans qui suivent la première notification de la mesure qui entraîne une imposition non conforme aux dispositions de la Convention.

§ 2. Cette autorité compétente s'efforce, si la réclamation lui paraît fondée et si elle n'est pas elle-même en mesure d'y apporter une solution satisfaisante, de résoudre le cas par voie d'accord amiable avec l'autorité compétente de l'autre Etat contractant, en vue d'éviter une imposition non conforme à la Convention.

§ 3. Les autorités compétentes des Etats contractants s'efforcent, par voie d'accord amiable, de résoudre les difficultés ou de dissiper les doutes auxquels peuvent donner lieu l'interprétation ou l'application de la Convention. Elles peuvent également se concerter pour envisager des mesures en vue de faire échec à un usage abusif de la Convention.

**Article 27** Echange de renseignements

§ 1er. Les autorités compétentes des Etats contractants échangent les renseignements (que les législations fiscales des deux Etats permettent d'obtenir dans le cadre de la pratique administrative normale) nécessaires pour une application régulière de la présente Convention. Tout renseignement échangé de cette manière doit être tenu secret et ne peut être révélé qu'aux personnes qui s'occupent de la fixation, de la perception, de la juridiction ou des poursuites pénales des impôts auxquels se rapporte la Convention. Il n'est pas échangé de renseignements qui dévoileraient un secret commercial, bancaire, industriel ou professionnal ou un procédé commercial.

§ 2. Les dispositions du présent article ne peuvent en aucun cas être interprétées comme imposant à l'un des Etats contractants l'obligation de prendre des mesures administratives dérogeant à sa propre réglementation ou à sa pratique administrative, ou contraires à sa souveraineté, à sa sécurité, à ses intérêts généraux ou a l'ordre public, ou de transmettre des indications qui ne peuvent être obtenues sur la base de sa propre législation et de celle de l'Etat qui les demande.

**Article 28** Agents diplomatiques et fonctionnaires consulaires

§ 1er. Les dispositions de la présente Convention ne portent pas atteinte aux privilèges fiscaux dont bénéficient les membres des missions diplomatiques et des postes consulaires en vertu soit des règles générales du droit des gens, soit des dispositions d'accords particuliers.

§ 2. Aux fins de la Convention, les membres d'une mission diplomatique ou d'un poste consulaire d'un Etat contractant accrédités dans l'autre Etat contractant ou dans un Etat tiers, qui ont la nationalité de l'Etat accréditant, sont réputés être des résidents dudit Etat s'ils y sont soumis aux mêmes obligations, en matière d'impôts sur le revenu et sur la fortune, que les résidents de cet Etat.

§ 3. La Convention ne s'applique pas aux organisations internationales, à leurs organes ou à leurs fonctionnaires, ni aux personnes qui sont membres d'une mission diplomatique ou d'un poste consulaire d'un Etat tiers, lorsqu'ils se trouvent sur le territoire d'un Etat contractant et ne sont pas traités comme des résidents de l'un ou de l'autre Etat contractant en matière d'impôts sur le revenu et sur la fortune.

**Article 29** Divers

§ 1er. Les dispositions de la présente Convention ne limitent pas l'imposition d'une société qui est un résident de la Belgique, conformément à la législation belge, en cas de rachat de ses propres actions ou parts ou à l'occasion du partage de son avoir social.

§ 2. Aucune disposition de la Convention ne peut être interprétée comme empêchant la Belgique de percevoir, à charge de personnes autres que des résidents de la Suisse, le précompte mobilier dû conformément aux dispositions de sa législation interne en raison de l'encaissement sur son territoire de revenus de valeurs mobilières étrangères.

§ 3. Les autorités compétentes des Etats contractants communiquent directement entre elles pour l'application de la Convention.

§ 4. Les autorités compétentes des Etats contractants se concertent au sujet des mesures administratives nécessaires à l'exécution des dispositions de la Convention et notamment au sujet des justifications à fournir par les résidents de chaque Etat pour bénéficier dans l'autre Etat des exemptions ou réductions d'impôts prévues à cette Convention.

## Chapitre VII: Dispositions finales

**Article 30** Entrée en viguer

§ 1er. La présente Convention sera ratifiée et les instruments de ratification seront échangés à Bruxelles aussitôt que possible.

§ 2. La Convention entrera en vigueur le quinzième jour suivant celui de l'échange des instruments de ratification et elle s'appliquera:

1° en Belgique:

a) aux impôts perçus par voie de retenue à la source, sur les revenus attribués ou mis en paiement à partir du 1er janvier de l'année au cours de laquelle les instruments de ratification auront été échangés;
b) aux autres impôts établis sur des revenus de périodes imposables prenant fin à partir du 31 décembre de

l'année au cours de laquelle les instruments de ratification auront été échangés;

2° en Suisse:

a) aux impôts perçus par voie de retenue à la source, sur les revenus dont la mise en paiement intervient à partir du 1er janvier de l'année au cours de laquelle les instruments de ratification auront été échangés;

b) aux autres impôts perçus pour les années fiscales commençant le 1er janvier de l'année au cours de laquelle les instruments de ratification auront été échangés et après cette date.

§ 3. L'accord conclu par échange de notes du 5 décembre 1957 entre le Conseil fédéral suisse et le Gouvernement belge tendant à éviter la double imposition des entreprises de navigation maritime ou aérienne est abrogé et cesse ses effets pour les impôts auxquels la présente Convention est applicable conformément au paragraphe 2.

**Article 31** Dénonciation

La présente Convention restera indéfiniment en vigueur; mais chacun des Etats contractants pourra, jusqu'au 30 juin inclus de toute année civile à partir de la troisième année à dater de celle de l'échange des instruments de ratification, la dénoncer, par écrit et par la voie diplomatique, à l'autre Etat contractant. En cas de dénonciation avant le 1er juillet d'une telle année, la Convention s'appliquera pour la dernière fois:

1° en Belgique:

a) aux impôts perçus par voie de retenue à la source sur les revenus attribués ou mis en paiement au plus tard le 31 décembre de l'année de la dénonciation;

b) aux autres impôts établis sur des revenus de périodes imposables prenant fin avant le 31 décembre de l'année qui suit immédiatement l'année de la dénonciation.

2° en Suisse:

a) aux impôts perçus par voie de retenue à la source sur les revenus dont la mise en paiement intervient au plus tard le 31 décembre de l'année de la dénonciation;

b) aux autres impôts perçus pour les années fiscales prenant fin avant le 31 décembre de l'année qui suit immédiatement l'année de la dénonciation.

*En foi de quoi*, les Plénipotentiaires des deux Etats ont signé la présente Convention et y ont apposé leurs sceaux.

Fait à Berne le 28 août 1978 en double exemplaire, en langue française et en langue néerlandaise, les deux textes faisant également foi.

Pour le Conseil fédéral suisse:
Pierre Aubert

Pour Sa Majesté le roi des belges:
Georges Puttevils

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Continuation of *H.W.T. Pepper's* Tax Glossary

# MALAYSIA: Tax Changes for 1979

**Extract from the Malaysian budget for the fiscal year 1979 presented by Finance Minister Tengku Razaleigh Hamzah on October 20, 1978**

**THE 1979 BUDGET PACKAGE OF TAX MEASURES WITHIN THE CONTEXT OF ITS BUDGET STRATEGY**

I would now like to *outline* the *specific major measures* that would constitute the Budgetary Package that has been prepared to realise the objectives of my Budget Strategy.

## REINVESTMENT ALLOWANCE

Existing incentives under the Investment Incentives Act in the form of pioneer status, investment tax credit, labour utilisation relief, etc. cater almost exclusively for new business enterprises. In recognition of the potential contribution that existing industries could make to national development, I am therefore proposing to grant a Reinvestment Allowance amounting to 25 percent of the expenditure on plant, machinery and industrial buildings incurred for expansion during the next three years. All existing companies engaged in manufacturing and processing which are not enjoying any form of incentives under the Investment Incentives Act including those which have ceased to benefit from such incentives for at least 3 years, would be eligible for this reinvestment allowance. This incentive will be administered directly by the Income Tax Department but before companies could avail themselves of this incentive, their expansion programme must first have been approved by the Ministry of Trade and Industry unless they are exempted under the Industrial Coordination Act.

Hon'ble Members are aware that there have been complaints of some red tape in the implementation of our industrial policies. In order to meet these complaints and to overcome these problems, the Government recently established the One Stop Agency or the Central Unit within FIDA to further streamline administrative procedure and to expedite the implementation of our industrial policies.

Even though we have adequate agricultural land for cultivation of food, the agricultural potential of such land is often underexploited. Since greater and better utilisation of agricultural land benefits the nation in terms of savings in foreign exchange and lower domestic prices of food as supplies increase, it is proposed to offer *Incentives under the Investment Incentives Act 1968*, in the form of investment tax credit amounting to 50 percent of qualifying capital expenditure on food production. However, because capital expenditure in the case of agriculture is generally smaller than in the case of manufacture, there is a need to adopt a different concept of "qualifying development expenditure" for agriculture, if the incentive is to be really beneficial to those engaged in the commercial cultivation of food crops and the rearing of livestocks. The concept to be used would be made known together with other specific details on this incentive when the Minister of Trade and Industry tables a Bill on this matter for debate in this House shortly. I would like to add that this incentive is available only to companies and cooperatives. For the general information of the Hon'ble Members, only the production of the following food items will be eligible for the incentive for a start, and these are:

(i) cultivation of food crops and fruits.
(ii) cultivation of vegetables.
(iii) rearing of fresh water fish and prawns and marine culture.
(iv) rearing of livestock for meat and dairy products.

Additions to the list would be announced by the Minister of Trade and Industry from time to time.

(See Appendix I.)

## EXPORT DUTY ON COPRA AND FRESH COCONUTS

In order to discourage exports so as to ensure increased supply of copra to the domestic oil mills which would in turn be beneficial to consumers, I am proposing to raise the export duty on copra and fresh coconuts from 10 percent to 15 percent. This should not affect coconut farmers because there is sufficient domestic demand from oil mills as well as households.

The palm oil industry in Sabah and Sarawak which developed later than in Peninsular Malaysia has requested assistance in the form of partial export duty relief in view of higher cost of production. Although therefore the export duty on palm oil was restructured only last year, I propose to provide duty exemption of 30 percent in respect of palm oil produced and exported from Sabah and Sarawak. The temporary assistance in the form of 50 percent export duty exemption which was granted in the last few years only to the Sabah and Sarawak Land Development Boards for the benefit of settlers and small farmers is at the same time withdrawn so that the 30 percent duty relief will now be enjoyed by all producers alike in Sabah and Sarawak.

I would like to inform Hon'ble Members that I do not intend to revise the export duty structure on commodities this year especially after the major revision that I introduced in my Budget last year. However, I wish to assure Hon'ble Members that this matter is under constant review and that even now it is being studied.

(See Appendix II.)

## TIMBER ROYALTY AND TIN PROFITS TAX

There are two adjustments that I wish to make this year and these relate to royalty on timber and tin profits tax. In regard to payment of timber royalty, existing income tax law provides that only payments to State Governments are allowed as deductions in computing taxable income, the intention being to discourage Ali Baba operations. However, because the practice in some states is the SEDCs (State Economic Development Corporations) to whom forest concessions are alienated, in turn realienate to private loggers who actually engage in the timber extraction, the present tax provision operates to the disadvantage of such people who are in fact not Ali Babas. It is thus proposed to amend the Act so as to make royalty payments to SEDCs and other State authorities allowable for deduction. In regard to the tin profits tax, Hon'ble Members may recall the amendment made last year to provide inducement for increased tin production particularly by gravel pump mines and other small tin mining operations. I now propose to reduce the top marginal rate of tax from 15 percent to 12½ percent. With this relief, I hope the tin industry would be in a better position to expand production particularly in the context of current market conditions.

(See Appendix I.)

## EXEMPTION FROM WITHHOLDING TAX ON INTEREST

Withholding tax of 15 percent on interest payable to non-residents discourages commercial banks in Malaysia as well as those abroad from making an international market for the ringgit mainly because in order to do so effectively, banks abroad need to maintain ringgit balances in Malaysia while Malaysian banks have to borrow abroad to fund their foreign exchange operations. Since such balances and loans are basically short-term in nature, the interest thereon attracts withholding tax, thereby adding to the cost of foreign exchange transactions. This additional cost is, in turn, passed on by the commercial banks to exporters making them less competitive. It also means that the ringgit rates of exchange quoted in Malaysia and abroad could not be as fine as it could otherwise have been. This situation has serious implications on the promotion of Kuala Lumpur as an attractive international centre for the trading of commodities. In addition, the burden of the withholding tax discourages Malaysian banks and merchant banks from engaging actively in foreign currency loans for Malaysian institutions, since such loans are normally funded abroad on a short-term basis. Foreign banks, however, do not have this disadvantage. In view of the factors which I have mentioned, I propose to exempt Malaysian commercial banks, including the merchant banks, from having to withhold tax on interest payable to non-resident banks.

(See Appendix I.)

## TAX INCENTIVES FOR SHIPPING

I would like now to touch on shipping in regard to which, Hon'ble Members may recall the anouncement which I made in last year's Budget that a study will be undertaken on the possibilities of providing incentives for the shipping industry. This scheme has now been framed and I would like to mention only its main features. The incentive to be offered to Malaysian shipping enterprises is in the form of full relief from income tax for a period of 12 years beginning from the year of initial operation. In addition, dividends declared up to a maximum of 10 percent of the paid-up capital would be tax exempt in the hands of shareholders. However, shipping companies are required to credit the balance of the net profit, after allowing for dividend distribution, to a fleet expansion reserve to be utilised for the acquisition of additional vessels. Shipping enterprises which have already been in existence may find themselves ineligible because of the conditions stipulated. In this case they could apply separately to My Ministry so that an appropriate application of the incentive could be determined on the merits of each case.

(See Appendix I.)

## FISCAL INCENTIVES FOR SAVINGS

Currently, only savings with the National Savings Bank benefit from tax exemption in respect of interest earned on deposit not exceeding $20,000. It is now proposed that savings with commercial banks and other approved institutions such as cooperatives, finance companies, Bank Pertanian and the Pilgrims Management and Fund Boards should also qualify for this incentive, but subject to a lower tax exempt limit, so that the competitive position of the National Savings Bank is not weakened. I am suggesting a ceiling in terms of interest amounting to $600 against a limit of $1,400 allowed in the case of the National Savings Bank. The maximum interest which a saver could benefit is therefore $2,000 which would represent interest earnings from total savings deposits of about $33,400 at an interest rate of 6 percent. This is higher than the tax exemption provided currently on interest from savings not exceeding $20,000 deposited with the National Savings Bank. I would like, however, to clarify that only deposits in savings accounts would qualify for tax exemption.

(See Appendix I.)

## INCREASE IN RELIEF FOR INSURANCE AND EMPLOYEES PROVIDENT FUND CONTRIBUTIONS

I have also reviewed the present position regarding savings in the form of contributions to provident funds and insurance premia in regard to which a maximum deduction of $3,000 is allowed for income tax purposes. The present limit of $3,000 has been in effect for many years and needs to be revised considering that rates of contributions to provident fund schemes have increased over time and so have the premium rates on insurance policies. At the same time, it is felt that the level of allowance should not be such as to benefit largely those in the high income groups who could in any case take out large insurance policies and provide for other forms of retirement funds. Accordingly, I am raising the total allowable deduction in respect of provident funds contributions and insurance premia to $3,500.

(See Appendix I.)

## TAX ON BUSES

Public transport, particularly in the urban areas, has been the target of criticism in respect of the standard and efficiency of service. The public transport industry is generally operating under difficult conditions because of increased operating costs and the large amount of capital expenditure required for purchase of buses. The fares of bus companies on the other hand could be raised only if approved by the Government. Thus their net earnings are often inadequate to enable them to improve their services by replacing at the appropriate time used buses or adding to the existing fleet of vehicles. With a view to assisting them to improve their services I propose to reduce the excise duty on buses from 15 to 5 percent. The engine tax on buses is also reduced by 25 percent. At the same time, the passenger seat tax which according to earlier plan is to be abolished by the end of 1979 is now completely withdrawn. With this substantial tax relief to operators of public transport I look forward to much more improvement in our public transport services.

(See Appendix V.)

## IMPORT DUTY

As a continuing exercise aimed at alleviating the burden of inflation and at the same time generating more trading activity for the business community, action is taken to reduce import duties on a range of consumer items. The most significant is the reduction in import duty on fruits by 50 percent. These fruits include durians, apples and oranges. There is justification for the reduction because fruit dealers have been taking advantage of the high import duty and the short supply of domestic fruits to raise to unreasonable levels the prices of even the domestic fruits. The farmers, on the other hand, have not been benefitting as much from the higher prices while consumers are being made to pay excessive prices. This situation needs to be rectified through import duty reduction which would have the effect of bringing down prices of domestic fruits with greater competition provided by imported fruits. Even though the rates are reduced by 50 percent, the tariff level after the tax change, is still adequate to provide protection to our fruit farmers. I would certainly like to see that the reduction of duty by 50 percent is passed on to consumers in the form of lower prices on fruits. At the same time the investment tax credit which I have proposed for the production of food crops including fruits should encourage the production of more local fruits on a commercial scale and thereby benefitting farmers as well as consumers.

Radio and TV sets provide a popular channel of communication and as such should be made accessible to a wide section of the population. With the proposed introduction of colour TV service, as many people as possible should be able to enjoy colour transmission. As the bulk of the population could only afford to purchase smaller colour TV sets, it is proposed to lower the import duty on colour as well as black and white TV sets of 16 inches or less from 45 percent to 25 percent while on sets of more than 16 inches the duty would be lowered to 35 percent only. Excise duty on locally assembled sets would at the same time be reduced from 10 percent to 5 percent for sets of 16 inches or less while for larger sets, the present excise of 10 percent remains. In respect of radios, the import duty rates are reduced from 30 percent or 25 percent, depending on type, to 20 percent or 15 percent respectively.

I have also withdrawn the import duty on printing and writing paper. The import duties on musical instruments are reduced from 45 percent generally to 25 percent and on cosmetics and perfumery from the high level of 60 percent to 45 percent. Other changes in import duties have been undertaken for various purposes including rationalisation and harmonisation.

(See Appendixes III and IV.)

## SALES TAX

The collection of sales tax from tailors is causing problem as there are numerous small tailors. Due to lack of book-keeping knowledge and the generally small business nature of tailoring establishments, tailors could not be expected to act as effective agents for the collection of sales tax on behalf of the Government. In order to overcome this problem, it is proposed to exempt tailors from the requirement of having to be licenced under the Sales Tax Act. This exemption does not however cover garment manufacturers.

## ESTATE DUTY

The legal process entailed in the settlement of estate duty is the subject of numerous complaints and I am aware of the hardship which beneficiaries have to go through. Pending a comprehensive review of the Estate Duty Enactment, I have decided that instead of interest penalty being leviable from the date of death, no interest shall be charged for the period from the date of death to the expiration of 30 days from the date of issue of assessment. I am also taking action to exempt from estate duty the payment of additional death benefits to an EPF (Employees Provident Fund) contributor's next of kin on his or her death before the age of 60. This exemption has retrospective effect to August 1, 1977 when the EPF death benefit scheme came into operation.

(See Appendix I.)

## CHILD ALLOWANCES

I do not propose to amend personal relief at the moment as tax payers are already getting a tax rebate of $60 each as well as a rebate of $30 for the wife. However, in regard to allowances for children, it is felt that the present level has become inadequate in view of the heavier financial commitment required for bringing up children. Accordingly, I am revising the level of allowances to $800 for the first child, $700 for the second child, $600 for the third child, $500 for the fourth child, and $ 400 for the fifth child thereby giving a maximum relief of $3,000 or $650 more than the present maximum. Opportunity is also taken to raise the deduction which would be allowed in respect of handicapped children from $300 to $400.

(See Appendix I.)

## APPENDIX I

### SUMMARY OF DIRECT TAX MEASURES

**1. Reinvestment Allowance**

Scope: The incentive is open to manufacturing and processing industries undertaking expansion approved by the Ministry of Trade and Industry.

Nature of incentive: 25% of expenditure on plant, machinery and industrial building will be allowed to be deducted from adjusted income (similar to reinvestment tax credit).

Effective date: Year of assessments 1980, 1981 and 1982 for respective basis years 1979, 1980, 1981.

**2. Tax Incentives for Shipping**

Scope: The incentives are open to shipping operations.

Nature of incentives:
a) Statutory income of a shipping company for a period of 12 years from the date of commencement of business.
b) Payment of tax-free dividends up to 10% of paid up capital is allowed.

Effective date: Year of assessment 1979.

**3. Incentives for Food Industry**

Scope: The incentives are open for the cultivation of food crops, fruits, vegetables, rearing of fresh water fish, prawns, marine culture and rearing of livestocks for meat and dairy.

Nature of incentives: An investment tax credit of 50% of expenditure incurred in the process of establishing an approved project is allowed.

Effective date: Year of assessment 1979.

**4. Exemption of Withholding Tax on Interest**

Scope: The exemption is to be extended to domestic commercial and merchant banks.

Nature of exemption: The withholding tax of 15% on interest paid to non-residents abroad by domestic commercial and merchant banks is to be abolished.

Effective date: Year of assessment 1979.

**5. Tin Profits Tax**

Present provision: Tin profits tax is charged at scale rates on taxable tin profits in excess of $10,000 at the following rates:

| | |
|---|---|
| First $200,000 | 5% |
| Next $200,000 | 10% |
| Exceeding $400,000 | 15% |

Proposed change: The top rate of tax is to be reduced from 15% to 12½%

Effective date: Year of assessment 1979.

**6. Fiscal Incentives for Savings**

Present provision: Interest earned on savings deposits are taxable except for interest earned with the Bank Simpanan Nasional on savings deposits up to $20,000.

Proposed change:
(a) Interest up to $600 earned on savings deposits either in commercial banks, Tabung Haji, Cooperatives, Bank Pertanian and licensed borrowing companies is to be exempted.
(b) For the Bank Simpanan Nasional instead of defining the exemption level in terms of the existing $20,000 worth of savings with the bank, an exemption on interest up to $1,400 earned from such savings is given.

Effective date: Year of assessment 1979.

**7. Children Relief**

Scope: The increase in child relief is for the benefit of resident taxpayers.

Nature of relief: The proposed increase in relief is as follows:

| | Present Relief | Proposed Relief |
|---|---|---|
| 1st child | $750 | $800 |
| 2nd child | $500 | $700 |
| 3rd child | $500 | $600 |
| 4th child | $300 | $500 |
| 5th child | $300 | $400 |
| | $2350 | $3000 |

For handicapped children the relief is revised from $300 to $400 each.

Effective date: Year of assessment 1979.

## 8. Increase in Relief for Insurance and EPF Contributions

| | |
|---|---|
| Present provision: | The present relief allowed as deduction for income tax purpose for insurance premiums and Employees Provident Fund Contributions is $3000. |
| Proposed measure: | The allowance is to be increased from $3000 to $3500. |
| Effective date: | Year of assessment 1979. |

## 9. Estate Duty

| | |
|---|---|
| Present provision: | (a) The Employees Provident Fund has introduced a new scheme called the Death Benefit Scheme under which payments are made to the beneficiaries of a deceased member who dies before the age of 60. Such payments are liable to estate duty.<br>(b) Interest is imposed on estate duty payable from the time of death at 3% for the first 6 months, 6% for the next 6 months and 12% after that. |
| Proposed Changes: | (a) Payments made to beneficiaries under the Death Benefit Scheme will be exempted from estate duty.<br>(b) Any interest on estate duty payable from the date of death will be exempted up to a period of 30 days from the date of service of assessment. |
| Effective date: | 1st August 1977. |

# APPENDIX II

## CHANGES IN EXPORT DUTIES

| BTN No. | Items | Existing Rate | Proposed Rate |
|---|---|---|---|
| 08.01.110 | Fresh Coconuts | 10% | 15% |
| 12.01. 200 | Copra | 10% | 15% |
| 15.07. 180 | Palm oil | Rate as specified in Appendix E of Customs Duties Order, 1978. | Producers in Sabah and Sarawak will only pay 70% of the existing rate. |

# APPENDIX III

## CHANGES IN IMPORT DUTIES

| BTN No. | Items | Unit of Quantity | Existing Rate | Proposed Rate |
|---|---|---|---|---|
| 08.01 | Avocados, mangoes, guavas and mangosteens. | tonne | $881.85 | $440.90 |
| 08.02 | Citrus fruits, fresh or dried Oranges | | | |
| 110 | fresh | tonne | $1322.77 | $661.40 |
| 120 | dried | kg. | 1.32 | 0.66 sen |
| 08.03 | Figs, fresh or dried | tonne | $1322.77 | $661.40 |
| 08.04 | Grapes, fresh or dried | tonne | $1322.77 | $661.40 |
| 08.05 | Nuts (e.g. almonds, hazelnuts) | kg. | 44 sen | 22 sen |
| 08.06 | Apples, pears and quinces, fresh | tonne | $1322.77 | $661.40 |
| 08.07 | Stone fruit, fresh (peaches, plums) | tonne | $1322.77 | $661.40 |
| 08.08 | Berries, fresh | tonne | $1322.77 | $661.40 |
| 08.09 | Other fruit, fresh Tropical fruit (like rambutan, papaya, durian langsat, water-melon) | tonne | $1322.77 | $661.40 |
| 08.10 000 | Fruit, preserved by freezing | tonne | $1654.46 | $826.70 |
| 08.11 | Fruits provisionally preserved but unsuitable for immediate consumption; in airtight container | tonne | $1653.46 | $826.70 |
| 08.12 000 | Fruits other than the above headings | tonne | $1322.77 | $661.40 |
| 08.13 000 | Peels of fruits | tonne | $330.69 | $165.35 |
| 85.15 | Colour television receivers | | | |
| 210 | mains operated, with screen of 41.6cm and below | No. | 45% | 25% |
| 220 | mains operated, other | No. | 45% | 35% whichever is the higher |
| 230 | battery operated, with screen of 41.4cm and below | No. | 45% | 25% |
| 231 (new) | battery operated, other | No. | 45% | 35% |
| | Monochrome television receivers | | | |
| 250 | mains operated, with screen of 41:6cm and below | No. | 45% | 25% |
| 260 | mains operated, other | No. | 45% or $250 each. | 35% |
| 270 | battery operated, with screens of 41.6cm and below | No. | 45% | 25% |
| 271 (new) | battery operated, other | No. | 45% or $250 each. | 35% |
| 85.15 311 | Radio broadcast receivers fitted | | | |
| 319 | to motor vehicles with recorders or reproducer | No. | 30% | 20% |
| 391 | Car radios without recorders or | | | |
| 399 | reproducer | No. | 25% | 15% |
| 411 | Portable radio receivers with | | | |
| 419 | recorders and reproducers | No. | 30% | 20% |
| 491 | Portable radio without recorders | | | |
| 499 | or reproducers. | No. | 25% | 15% |
| 511 | Other radios, mains operated with recorders or reproducers | No. | 30% | 20% |
| 521 | Radios, battery operated with recorders and reproducers | No. | 30% | 20% |
| 531 | Radios without recorders or reproducers, mains operated. | No. | 25% | 15% |
| 541 | Radios without recorders or reproducers, battery operated. | No. | 25% | 15% |
| 92.01 | Pianos (including automatic pianos, whether or not with keyboards): harpsichords and other keyboard stringed instruments; harps but not including seolian harps: | No. | 45% | 25% |
| 92.02 | Other string musical instruments: Box instruments and Plucked string instruments | No. | 45% | 25% |

| BTN No. | Items | Unit of Quantity | Existing Rate | Proposed Rate |
|---|---|---|---|---|
| 92.03 000 | Pipe and reed organs, including harmoniums and the like | No. | 45% | 25% |
| 92.04. 000 | Accordions, concertinas and similar musical instruments; mouth organs | No. | 45% | 25% |
| 92.05 000 | Other wind musical instruments | No. | 45% | 25% |
| 92.06 000 | Percussion musical instruments (for example, drums, xylophones, cymbals, castanets) | No. | 45% | 25% |
| 92.07 000 | Electro-magnetic, electrostatic, electronic and similar musical instruments (for example, pianos, organs, accordians) | No. | 45% | 25% |
| 92.08 000 | Musical instruments not falling within any other heading of this Chapter (for example, fairground organs, mechanical street organs; musical boxes, musical saws); mechanical singing birds; decoy calls and effects of all kinds; mouth-blown sound signalling instruments (for example, whistles and boatswains' pipes) | No. | 45% | 25% |
| 92.10 | Parts and accessories of musical instruments, including perforated music rolls and mechanisms for musical boxes; metronomes, tuning forks and pitch pipes of all kinds | No. | 45% | 25% |
| 33.0 | Perfumery, cosmetics and toilet preparations: aqueous distillates and aqueous solutions of essential oils, including such products suitable for medicinal uses. | Value | 60% | 45% |
| 48.01 | Paper and paper board: Printing paper and writing paper Uncoated printing paper in rolls: | | | |
| 211 | not exceeding 25 cm in width | Tonne | 30% | nil |
| 33.01 | Essential oils, like citronella oil eucalyptus oil patchouli oil of pepper | L | 30% | nil |
| 39.07 620 | Fluorescent lamp fittings | Value | 30% | 20% |
| 690 | other | Value | 15% | 20% |
| 70.14 110 | Illuminating glassware designed or fitted with electricity | Value | 45% | 20% |
| 71.09 | Platinum and other metal of platinum group | kg. | 15% | 5% |
| 71.10 000 | Rolled Platinum | kg. | 15% | 5% |
| 83.07 | Lamps and lighting fittings etc. of other base metals: | Value | 30% | 20% |
| 84.12 990 | Air conditioning (New) Parts | No. | — | 45% |
| 87.02 | Motor vehicles for the transport of both goods and passengers Dual purpose vehicle | | | |
| 102 | completely built up | No. | 60% to 100% | 30% |
| 94.01 100 | Chairs and other seats | No. | 25% | 50% |
| 94.01 900 | Parts | Value | 25% | 50% |

## APPENDIX IV

### CHANGES IN EXCISE DUTIES

| Item Code | Item | Existing Rate | Proposed Rate |
|---|---|---|---|
| 14.14.1 | Colour T.V. - with screen of 41.6cm and below | 10% or $60 each whichever is the higher | 5% |
| 14.14.2 | Colour T.V. - with screen of more than 41.6cm | 10% or $60 each whichever is the higher | 10% |
| 14.15.1 | Black/white T.V.-with screen of 41.6cm and below | 10% or $60 each whichever is the highest | 5% |
| 14.15.2 | Black/white T.V. - with screen of more than 41.6cm | 10% or $60 each whichever is the highest | 10% |
| 15.3.1 | Dual Purpose Vehicles | 25% — 60% | 15% |
| 15.2 | Motor buses, being vehicles with seats for more than 6 persons | 15% | 5% |

## APPENDIX V

### CHANGES OF TAXES ON BUSES

| Items | Existing Rate | Proposed Rate |
|---|---|---|
| | Petrol | Petrol |
| 1. Engine Tax on buses | Less than 2000c.c. ...$10/- per month<br>More than 2000c.c. ...$15/- per month | Less than 2000c.c. ...$7.50 per month<br>More than 2000c.c. ...$12.75 per month |
| | **Diesel** | **Diesel** |
| | Less than 1500c.c. $80/- per month<br>1500c.c. — 2500c.c. $100/- per month<br>2500c.c. — 3500c.c. $120/- per month<br>Exceeding 3500c.c. $220/- per month | Less than 1500c.c. $60/- per month<br>1500c.c. — 2500c.c. $75/- per month<br>2500c.c. —3500c.c. $90/- per month<br>Exceeding 3500c.c. $165/- per month |
| 2. Seat Tax | $4 per seat per month or 4% of gross collection per month. | Seat tax to be abolished. |

# Conference Diary

## MARCH 1979

*Business International Institute:* Doing Business in the U.S.A. (including The U.S. Tax System), Mont Pélerin-sur-Vevey (Switzerland), March 4-7 (English).

*Conventions — Kopel Tours Ltd.:* Jubilee Convention of Accountancy and Taxation, Jerusalem (Israel), March 11-15 (Hebrew, English and German).

*British Branch of I.F.A.:* Self Assessment, London (U.K.), March 15 (English).

*International Bureau of Fiscal Documentation:* Tax, Investment and Trade Prospects in the Middle East, London (U.K.), March 19-21 (English).

*Institute for International Research:* How to diversify and acquire successfully (including Tax and financial planning for diversification and acquisition). London (U.K.), March 20-21 (English).

*British Branch of I.F.A.:* The work of the OECD Fiscal Committee, London (U.K.), March 29 (English).

## APRIL 1979

*AMR International:* Project Financing (including tax implications of project financing), London (U.K.), April 2-3 (English).

*Management Centre Europe:* International Taxation (a working conference), Vienna (Austria), April 18-20 (English, French and German).

*Institute for International Research:* 1979 Corporate Tax Conference, London (U.K.), April 25-27 (English).

*Business International Institute:* International Seminar (including International Taxation), Port Chester, New York (U.S.A.), April 30 - May 11 (English).

## MAY 1979

*Investment and Property Studies:* The Vienna Conference (including international tax planning), Vienna (Austria), May 16-18 (English).

## JUNE 1979

*The Taxation Institute of Australia:* First International Convention (including Fundamental Concept in Double Taxation Treaties, Guide to Estate Planning Far East locations), Hong Kong, June 10-16 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The taxation of transfers of family-held enterprises on death and inter-vivos; II. The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities. For the seminars the following subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark), September 4-8 (English, French, German, Spanish).

## FEBRUARY 1980

*Business Perspectives:* 6th International Tax Conference. Singapore, February 4-8 (English).

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

AMR International, 6-10 Frederick Close, Stanhope Place, London W2 2HD (U.K.)

British Branch of I.F.A.: Secretariat, c/o Williams & Clyn's Bank Ltd., P.O. Box 448, 20 Birchin Lane, London EC3P 3DP (U.K.).

Business International Institute, 12-14 chemin Rieu, 1208 Geneva 17 (Switzerland).

Business Perspectives: 11 Alexander Place, London SW7 2SG. Tel. 01-589-3197. Telex: 917036.

Conventions — Kopel Tours Ltd., 122 Hayarkon Street, P.O. Box 3054, Tel Aviv (Israel).

Institute for International Research, 70 Warren Street, London W1P 5PA (U.K.).

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

International Bureau of Fiscal Documentation, Sarphatistraat 124, P.O. Box 20237, 1000 HE Amsterdam (Holland).

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4A 1AB (U.K.).

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

The Taxation Institute of Australia, 19th Floor, C.A.G.A. Building, 8 Bent Street, Sydney, 2000, Australia.

# nd'a:

# DEPRECIATION ON DESIGNS AND BLUEPRINTS PERMITTED

## Extract of a decision of the Karnataka High Court of July 13, 1978[1]

*Under the Indian income tax law the computation of taxable business income is based on the surplus by which the gross receipts of a business exceed the expenditure incurred on land, labour, capital, managerial skill and all other tangible or intangible assets used for the purpose of the business. Ordinarily, any expenditure which is not of capital nature incurred in the course of business or trade is treated as revenue expenditure, but so far as the fixed assets, which are utilised for the purpose of business, are concerned, a certain percentage of their value, popularly known as "depreciation", is deducted periodically in the course of computation of the profits made. Without taking into account such depreciation, it would not be possible to arrive at the true profits. That is why the Income Tax Act has provided for depreciation allowance being allowed under s. 32 of the Act in respect of buildings, machinery, plant or furniture owned by the assessee and used for the purpose of the business, subject to certain conditions.*

*S. 43(3) of the Act states that "plant" includes ships, vehicles, books, scientific apparatus and surgical equipment used for the purpose of the business. The definition is not an exhaustive one. As time passes it is not only tangible assets that depreciate but also intangible assets like technical knowledge that become obsolete as progress is made in scientific research. Moreover, when technical know-how necessary for the business is acquired by incurring expenditure, there is no justification in denying appropriate deduction in respect of its cost while computing taxable profits if it can be brought under the heading "Plant". Hence, the word "plant", when it is construed liberally, includes within its meaning such designs and blue-prints also.*

*Where the assessee-company had used the designs, drawings, plants, and technical data which it acquired for valuable consideration from a foreign company in the course of its business, and the cost thereof was not treated as revenue expenditure, if no depreciation was allowed in the case of these items, it would not be possible to ascertain the true profits of the assessee. The assessee-company could not have erected the factory for carrying on the manufacturing process without the expenditure incurred on the acquisition of these items which could be compendiously included in the expression "technical know-how" necessary for the purpose of carrying on the business. Therefore, the designs and blue-prints constitute "plant" for the purpose of allowing depreciation under s. 32 of the Act.*

### I. THE FACTS[2]

The assessee is a company in which the public are not substantially interested. It was incorporated on June 12, 1967. One Mr. M.S. Nagappa is its managing director. Prior to the incorporation of the company, Mr. Nagappa entered into an agreement with M/s. Nippon Communication Industrial Company Ltd., Japan, on December 27, 1966. The agreement was for collaboration in the erection of a manufacturing plant for production of capacitors. Under art. 3(b)(i) of that agreement the said Japanese company agreed to provide designs, plans, drawings, specifications and engineering know-how to enable the licensee to construct a manufacturing plant and to commence production of the capacitors. The Japanese company also agreed to assist the assessee in other ways such as furnishing information with regard to specifications and procurement sources of the machinery and equipment required for the production of capacitors and rendering assistance in the testing of material procured by the assessee in accordance with the recommendations and specifications furnished as stated above. Under art. 6 of the agreement in consideration of the services and assistance to be rendered in accordance with the agreement and disclosure to the assessee of the Japanese company's proprietary information and technical know-how in accordance with the provisions of art. 3(b) referred to above, the assessee agreed to pay 20,000 U.S. dollars. After its incorporation, the assessee entered into an agreement dated October 12, 1967, with another Japanese company known as M/s. Sansei Denki Kabushiki Kaisha, known in English as M/s. Sansei Electric Company Ltd., Japan, in connection with the manufacture of switches. Under that agreement the said Japanese company undertook to provide the assessee with its designs, plans, drawings, specifications and engineering know-how, to enable the assessee to construct a manufacturing plant and to commence production of switches and in consideration thereof the assessee agreed to pay 2,500 sterling pounds. The construction of the buildings was started in August, 1967. Installation of machinery was taken up during June/July, 1968, and was completed by September, 1968. Two Japanese experts arrived and assisted the assessee in the erection of machinery and trial runs. Commercial production of capacitors was started in January, 1969, and of switches in May, 1969. In the books of account of the assessee, there was a capitalisation of a total sum of Rs. 4,62,000 as on June 30, 1968. This sum included the sum of Rs. 1,95,300 paid to the Japanese companies towards technical assistance and some other expenses. During the Assessment year 1970-71 (relating to the accounting period ending June 30, 1969) the assessee claimed that the sum of Rs. 1,95,300 which had been paid by it to the Japanese

1. Re: Nippon Electronics (P.) Ltd v. Commissioner of Income Tax, Karnataka. Reported in Income Tax Reporter, Madras (1979) 116 I.T.R. at 231.
2. As found by the High Court.

companies under the agreements referred to above had been paid for the purpose of acquiring the necessary drawings, designs and technical data for the purpose of construction of the plant for manufacturing capacitors and switches and that the said drawings, designs and technical data constituted "plant" referred to in s. 32(1) of the Act and that it was entitled to depreciation allowance in respect of it. The Income Tax Officer disallowed the claim of the assessee obeving:

"The assessee has capitalised expenditure incurred up to 30th June, 1968. This figure includes technical assistance fee paid to the foreign collaborator amounting to Rs. 1,95,300. The technical assistance fee paid is for technical information passed on by the foreign collaborator and the assessee can use the information passed on even after the expiry of the period of agreement. Thus, admittedly it is a capital asset. But the assessee has allocated this expenditure on buildings and plant and machinery. This procedure is irregular for the reason that the value of the land, building, has not been increased by the assessee possessing certain technical information. Thus, the procedure of capitalising this payment to plant and building is not correct. It is an item of capital expenditure on which no depreciation can be claimed. Hence, the claim for depreciation on this is not allowed. In the revised working this amount has been excluded for the purposes of depreciation and depreciation has been allowed only on the net figures."

In the appeal filed by the assessee, the Appelate Assistant Commissioner did not deal with this issue at all though he allowed some relief in other respects. On further appeal, the Tribuanl held: "We find it difficult to hold that designs and blueprints constitute plant for the purpose of depreciation. In any case, on the basis of the agreement the payments are not for designs and blue-prints as such but for diverse considerations, the major one of which appears to be know-how", and dismissed the appeal.

## II. THE ISSUE

At the instance of the assesse The Tribunal referred the two following questions to the High Court:

"(i) Whether, on the facts and in the circumstances of the case and on a proper interpretation of the two agreements dated 27th December, 1966, and 12th October, 1967, the Tribunal was right in holding that the payments of Rs. 1,95,300 were not for designs and blue-prints as such but for diverse considerations ?

(ii) If the answer to the first question is in the negative, whether on the facts and in the circumstances of the case, the designs and blue-prints constituted plant for purpose of allowance of depreciation under the I.T. Act, 1961 ?"

## III. JUDGMENT

At the instance of the assessee, the Tribunal has referred the two questions extracted above. The first question relates to the latter part of the finding recorded by the Tribunal, and the second question relates to the earlier part.

It is clear from the terms of the two agreements which are referred to above that the assessee paid the amounts payable under the agreements in consideration of the Japanese companies furnishing necessary designs, drawings, technical data and other information necessary for the erection of the factory for manufacturing capacitors and switches, and also in consideration of other assistance rendered to it by them.

We are of the view that part of the amounts so paid must be treated as having been paid in consideration of the Japanese companies providing designs, drawings, plans and technical data. The Tribunal was, therefore, in error in holding that the payments were not in regard to these items. It should have held that the payments had been made partly for these items and partly for other assistance rendered by the Japanese companies. The answer to the first question has, therefore, to be in the negative.

The answer to the next question depends upon the construction to be placed on s. 32 of the Act. S. 32(1) of the Act provides for allowing depreciation in respect of buildings, machinery, plant or furniture owned by the assessee and used for the purpose of business or profession in accordance with the prescribed rates, in the course of the computation of the profits arising out of the business carried on by the assessee for purposes of determination of the tax payable under the Act.

Whereas the contention of the assessee before the authorities under the Act was that the designs, drawings, plans and technical data which were necessary for the erection of the factory for manufacturing goods fell within the meaning of the expression "plant" found in s. 32 of the Act, the contention of the department was that they did not.

It is well known in the world of commerce that the income of a businessman is always the surplus by which the gross receipts from his busines exceed the expenditure incurred on land, labour, capital and managerial skill and all other tangible and intangible assets used for the purpose of the business. The capital contributed by a businessman in the course of his business may be in the form of fixed assets or circulating capital. Ordinarily, any expenditure which is not of capital nature incurred in the course of business or trade is treated as revenue expenditure, but so far as the fixed assets which are utilised for the purpose of business are concerned, a certain percentage of their value is deducted periodically in the course of computation of the profits made by him. The amount so deducted is popularly know as "depreciation". Without taking into account such depreciation, it would not be possible to arrive at the true profits. It is only on account of this the statute has provided for depreciation allowance being allowed in certain repects under s. 32 of the Act subject to certain conditions. That section specifically refers to four items on which depreciation can be allowed, namely, buildings, machinery, plant or furniture owned by the assessee and used for the purpose of the business. There is no dispute that the items with which we are concerned, namely, designs, drawings, plans and technical data do not come within the category of buildings, machinery and furniture. Under s. 43(3) of the Act an inclusive definition of the "plant" is given. It states that "plant" includes ships, vehicles, books, scientific apparatus and surgical equipment used for the purpose of business or profession. The definition is not an exhaustive one. There is no dispute in this case that the assessee has used the designs, drawings, plans and technical data which it acquired for valuable consideration from the Japanese companies in the course of its business. The expenditure incurred by the assessee in that connection is not treated by the department as revenue expenditure. As mentioned earlier, if no depreciation is allowed in the case of these items, it would not be possible in this case also to ascertain the true profits. The principal argument urged on behalf of the department before the appellate authorities to deny the depreciation allowance was that these items did not come within either the traditional meaning of the expression "plant" or within the extended meaning of that expression in s. 43(3) of the Act.

In *Commissioner of Income Tax v. Elecon Engineering Co. Ltd.* [3] the High Court of Gujarat after considering several cases including *Rolls Royce's* [4] case, where some doubts have been expressed about the true nature of technical know-how, came to the conclusion that items such as drawings, patterns and technical information necessary for the carrying on of business came within the meaning of the expression "plant" under s. 32 of the Act and the assessee was entitled to claim depreciation allowance in respect of them in accordance with the rules governing it. After reviewing several authorities the Gujarat High Court observed (at p. 698):

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3. Income Tax Reports, (1974) 96 at 672.
4. Income Tax Reports, (1965) 56 at 580.

"On reviewing these authorities, a broad consensus emerges from which the essential characteristics of plant can be clearly gleaned. The word 'plant', in its ordinary meaning, is a word of wide import and in the context of s. 32 it must be broadly contrued. It includes any article or object, fixed or movable, live or dead, used by a businessman for carrying on his business. It is not necessarily confined to an apparatus which is used for mechanical operations or processes or is employed in mechanical or industrial business. It would not, however, cover the stock-in-trade, that is, goods bought or made for sale by a businessman. It would also not include an article which is merely a part of the premises in which the business is carried on as distinguished from a part of the plant with which the business is carried on. An article to qualify as plant must furthermore have some degree of durability and that which is quickly consumed or worn out in the course of a few operations or within a short time cannot properly be called 'plant'. But an article would not be any the less plant because it is small in size or cheap in value or a large quantity thereof is consumed while being employed in carrying on business. In the ultimate analysis the inquiry which must be made is as to what operation the apparatus performs in the assessee's business. The relevant test to be applied is: Does it fulfil the function of plant in the assessee's trading activity? Is it the tool of the taxpayer's trade? If it is, then it is plant no matter that it is not very long-lasting or does not contain working parts such as a machine does and plays a merely passive role in the accomplishment of the trading purpose."

We respectfully agree with the view taken by the High Court of Gujarat. The time has now come when we may have to revise our views in some respects regarding the distinction which is being observed so far between tangible assets and intangible assets while considering the question of depreciation allowance. We cannot forget that as time passes, it is not only that tangible assets that depreciate but also intangible assets like technical knowledge become obsolete as progress is made in scientific research. Moreover, when technical know-how is acquired by incurring expenditure, there is no justification in denying appropriate deduction in respect of its cost while computing taxable profits if it can be brought under the heading "plant". In view of the foregoing we would not be committing an error in taking the view that the word "plant" when it is construed liberally as required by the Supreme Court in *Taj Mahal Hotel's* case [5], includes within its meaning designs and blue-prints also. We, therefore, hold that the designs and blue-prints referred to in question No. 2 do constitute "plant" for purposes of allowing depreciation under s. 32 of the Act.

In the result, the first question is answered in the negative and the second question in the affirmative.

The parties shall bear their own costs.

5. Income Tax Reports, (1971) 82 at 44.

# CUMULATIVE INDEX 1979 ~ No. 1

# TAX GLOSSARY

*by H.W.T. PEPPER **

**INDUSTRIAL BUILDINGS ALLOWANCE** — See CAPITAL ALLOWANCES.

**INDUSTRIAL PURPOSE** — A concept used in the U.K. DEVELOPMENT LAND TAX (q.v.); the tax which would be payable on development is deferred on buildings and land used in manufacture, mining, and certain other trades, i.e., where put to "industrial" use.

**INFANT** — See INCAPACITATED PERSON.

**INFANT INDUSTRY** — An industry which is new to the country or region in which it is set up, especially such an industry which is encouraged by tariff protection, customs duty exemption on imported materials, income tax exemption, sub-economic site or factory rents, etc., payroll tax or other concessions. Care has to be taken not to overdo the concessions to new industry in case those lead to the setting up of industries which are not really viable, thus causing the indefinite prolongation of concessions and justifying the jibe that "Infant industries never grow up". (See also PIONEER INDUSTRIES.)

**INFLATION FACTOR** — A decline in the value of money through currency inflation is taken account of by some countries in computing capital gains expressed in money terms, usually by writing up the cost of the asset disposed of by a factor representing the currency inflation which has taken place over the period the asset has been held. In some tax systems, the cost of assets which may be depreciated for tax purposes is also permitted to be written up by reference to an inflation factor. (See also INDEX-LINKED ADJUSTMENT.)

**INGREDIENT, PHYSICAL** — A term used in connection with sales taxation, particularly where commodities which form part of a finished product have suffered some form of indirect tax such that there is a danger of "double taxation" where the finished product is also subjected to sales tax. A physical ingredient may be a raw material which is processed or it may be a component which has been assembled in the course of producing the finished product.

**INHABITED HOUSE DUTY** — A tax on the occupation of residential property introduced in 1978 which preceded the introduction of income tax under SCHEDULE A (q.v.) in Britain.

**INHERITANCE TAX** — A tax levied on the transmission of assets on death. (See also CAPITAL TRANSFER TAX, DEATH DUTIES, SUCCESSION DUTY.)

**INITIAL ALLOWANCES** — Initial allowances are allowances made under CAPITAL ALLOWANCES (q.v.) for depreciation in the first year for which a tax deduction is due in respect of a qualifying asset, the allowance being usually additional to the ordinary annual allowance. While the latter is usually calculated with some regard to the actual wear and tear of an asset by reference to its estimated working life, an initial allowance is usually intended as a form of incentive to encourage the entrepreneur to install new plant, machinery, etc. Such allowances, however, may also be regarded as a token of the fact that the largest drop in the value of a depreciating asset occurs in the first year after purchase.

**INKOMEN** — (Holland) Income.
(1) BELASTBAAR INKOMEN is taxable income for purposes of personal income tax.
(2) ONZUIVER INKOMEN is income less deductible expenses but before deduction of (a) "persoonlijke verplichtingen", (b) "buitengewone lasten" and (c) deductible gifts (for purposes of personal income tax).

**INKOMSTEN** — (Holland) Income items.

**INKOMSTENBELASTING** — (Holland) Personal income tax.

**INPUT TAX** — The term is used in connection with VAT to denote the tax embodied in the purchases made by a trader or entrepreneur who will usually be able to obtain a credit for the tax that his suppliers have paid on the goods supplied to him which form his "inputs".

**INSTRUCTION** — (France) Ruling.

**INTEGRATION, VERTICAL** — Where businesses which are concerned with different stages in the production and distribution of goods are amalgamated, this is said to be a vertical integration, in contrast with the "horizontal" integration of firms encountered at the same level of production or distribution. The significance of a vertical integration is mainly for purposes of sales taxation, since a cascade tax may be partly avoided by such an integration, a fact which led to anti-avoidance measures such as the FORFAITAIRE SYSTEM (q.v.) and the ZUSATZSTEUER (q.v.) levied in connection with cascade taxes in Europe.

**INTENSION** — A concept developed by Dr. Bracewell-Milnes, partly as an improvement over terms such as "progressivity", and "intensity" of a tax system, and intended as a mathematical means of comparing systems. Intension incorporates several elements, the level of income which attracts the highest rate of tax, the level of the maximum tax rate, the difference between the highest and lowest rates, and the ratio of the number of taxpayers liable at the highest rate to the total number of taxpayers.

**INTEREST EQUALISATION TAX** — This tax has been levied in the U.S. in order to discourage the investment of money abroad to obtain a higher interest rate than would be obtainable on a local investment. In the U.S. example, certain countries were exempted from the operation of the tax, being countries where the policy of the U.S. government was to permit investments to be made, e.g., as a form of economic aid from the private sector. The levy is intended to "equalise" the interest obtainable from the foreign investment with that obtainable locally by making an appropriate charge on the former.

**INTEREST IN LAND** — The term sometimes used, as a kind of "catchall" expression, in connection with taxes on land development as the subject matter of taxation. It is not necessary to be sole owner of land to benefit from its development, and anyone with an "interest" may do so, and therefore be taxable. (See, e.g., LAND DEVELOPMENT TAX.)

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

**INTEREST ON DRAWBACK** — Where goods which are subject to a high customs or excise duty are exported such that a refund or drawback of the duty is due to the exporter, he may nevertheless have incurred depreciation expenditure by way of interest on the money locked up in the tax. Some countries (notably Britain) therefore have made arrangements for the payment of interest as well as drawback with regard to a limited number of exported items which are subject to heavy duties on import.

**INTEREST ON UNPAID TAX** — Interest on tax which remains unpaid after the due date is normally chargeable in a number of countries, partly to remove a possible incentive to taxpayers to delay agreement of their liability, partly to recoup the taxing authority for the interest loss caused by the delay. Interest will run even though the tax assessment is disputed, and eventually be charged on that part of the finally-determined liability which remains unpaid. The taxpayer is thus encouraged to make payment on account of the tax which *he* regards as the amount due.

**INTER-STATE, AND INTRA-STATE TRANSACTIONS: SALES TAX** — Where sales tax is levied at state or provincial level in a federation of states, sales tax revenue in one state may be avoided by its residents making purchases of goods from businesses in other states, either by mail order or by crossing the state line or boundary on shopping expeditions. Some attempt is usually made to counter such avoidance by requesting firms whose activities cover a number of states or provinces to declare what proportion of their sales relate to residents of the taxing state. (See also SALES AND USE TAX.)

**INTERNAL TAXATION REBATE** — Where goods which are exported have been subjected to indirect taxation within the exporting country, it is normal to rebate or refund such taxation to the exporter. The internal taxation may be readily quantified in the case of a value-added tax (or not imposed in the first place in the case of a single stage tax using a REGISTRATION or RING SYSTEM (q.v.)), but in other cases the quantification may be a matter of some difficulty (see EXPORT REBATE).

**INTERNAL USE OR CONSUMPTION** — Sales taxes are usually levied not only on sales or deliveries to third parties but on taxable goods which are used within the business itself or taken by the proprietors for personal or domestic use. Similarly, in calculating the profits of a business for income tax purposes, account has to be taken of the value of goods and services absorbed for use in the business or taken for domestic or private use by the proprietors.

**INTERNATIONAL BOYCOTT INCOME** — See BOYCOTT.

**INTER VIVOS GIFTS** — See GIFTS INTER VIVOS.

**INVENTORY** — A list or catalogue of articles such as the stock in trade of a business — in North American parlance "inventory" is generally used to refer to the stock in trade itself, i.e., the goods which the business sells, of which stocks are maintained so that customers may be served on demand.

**INVENTORY ADJUSTMENT** — Where the rate of currency inflation in a country is exceptionally high, provision may be made to permit the revaluation of the inventory or stock in trade in hand at the commencement of the trading period, particularly where the quantity of goods held is customarily high in relation to the annual sales. This adjustment is intended to counteract the slightly artificial profit which may be made by realising at current prices goods which were purchased at much lower prices but of which the replacement cost would be considerably higher. (See also STOCK ADJUSTMENTS.)

**INVENTORY DUTY** — The term applied in Scotland to PROBATE DUTY (q.v.) formerly imposed there.

**INVESTERINGSAFTREK** — (Holland) Investment deduction (allowance).

**INVESTMENT ALLOWANCE** — This term has been applied to allowances on depreciable assets for income tax purposes, the allowances being related to the cost of the assets but not being taken into account in calculating the written down value of the asset for tax purposes. For example, if an investment allowance of 20% were made, the total capital allowances for depreciation of the particular asset would amount to a maximum of 120% of the cost, assuming a nil value of the machinery at the end of its working life.

**INVESTMENT GOODS** — See CAPITAL GOODS.

**INVESTMENT GRANT** — A system of investment grants was used for a time in Britain (1965 to 1971), whereby cash was paid out by the government up to a certain percentage of capital expenditure, to encourage entrepreneurs to incur such expenditure on buildings, plant and machinery, etc. Depreciation allowances were granted only on the *net* capital expenditure of the trader.

**INVESTMENT INCOME** — See UNEARNED INCOME.

**INVESTMENT INCOME SURCHARGE** — Some tax regimes favour earned income over investment (sometimes labelled "unearned") income (see EARNED INCOME, RELIEF FOR), by granting relief for the former which is not available for the latter. The other way of discriminating is to charge both types of income at the same basic rates and add a surcharge upon investment income. In the U.K., where the latter system is adopted, the surcharge is at a starting rate of 10%, increasing to a maximum rate of 15%.

**INVESTMENT METHOD** — The method used, in connection with VAT, of giving an immediate credit against tax for that part of expenditure incurred during the year on the acquisition of business assets (such as machinery or plant by a manufacturer) which relates to the tax element in the price of those assets. The AMORTISATION METHOD (q.v.) of spreading the credit may be contrasted. It may also be noted that even where the investment method is used, in the transitional period immediately after the tax is introduced, the tax credit is sometimes abated because of the heavy cost in revenue terms which would be incurred if full allowances were made from the outset.

**INVESTMENT PREMIUM** — See DOLLAR PREMIUM.

**INVESTMENT RELIEF** — Some countries, notably Federal Germany, have encouraged taxpayers to save and invest, and hence to limit current consumption by making a tax allowance in respect of sums invested. In addition, some countries (e.g., U.S.A.), have encouraged investment in developing countries by their own taxpayers by allowing tax relief equivalent to a percentage of such investment. As regards the former type of allowance, there is some administrative difficulty in ensuring that the amount invested does not subsequently become disinvested, or that a sum similar to that invested is withdrawn from some other form of investment, so that there is no real decline in personal consumption or increase in total net investment, in which case tax revenue will have been sacrificed in vain. (See also SAVINGS TAXES.)

**INVESTMENT TRUST** — Special treatment, e.g., in respect of capital gains, may be given to a company qualifying as an "investment trust", e.g., in the U.K. at one time a rate of 17½% instead of the usual rate of 52% was applied. Shareholders who use such a trust for their investments are themselves taxable on capital gains realised on their holdings and may then claim an offset for the gains tax already paid by the trust. To qualify, a company must obey certain rules such as full distribution of income and re-investment of its capital gains.

**INVOICE BASIS** — The method of applying VAT (in contrast to the ACCOUNTS BASIS) to the price at which the goods or services are invoiced, with a deduction for the tax (if any) charged at previous stages. The effect of using the invoice basis is that VAT is eventually charged on the full price paid by the consumer.

**INVOICE, STATUTORY** — The tax administrations of some countries prescribe the form which invoices should take — usually in such a way as to bring out clearly the sales or other taxes payable as a result of the transaction. An alternative sometimes adopted is to stipulate that the form of invoice which the trader wishes to use should first be approved by the authority.

**INVOICE TAX** — A tax, usually at a low rate per cent, upon transactions which are covered by documents, particularly in the form of an invoice. Although the tax may be ostensibly on the *form* of the transaction, in practice it may be extended into a general *transactions* tax to prevent legal avoidance by way of making transactions other than by using invoices. In substance, the tax is a form of cascade tax which often omits the retail stage where sales are unlikely to be adequately documented for the effective operation of such a tax at that stage.

**ITINERANT TRADERS, TAX ON** — Apart from the registration or licence dues often imposed on itinerant traders for the right to trade, some countries make special provisions for taxing itinerants owing to the difficulties of enforcing tax where the taxpayer has no fixed place of business. In regard to sales taxes, it is fairly usual to exclude the itinerant trader from registration for sales tax purposes so that he will buy his goods on the same tax footing as a consumer (though normally with trade discounts), the sales tax being paid by his supplier. Some countries, however, tax itinerants, stall-holders in open markets, etc., on the same lines as ordinary traders but deploy special sections of the tax staff to deal with them.

# J

**JAAR** — (Holland) Year.
(1) AANSLAGJAAR — (Belgium) Assessment year.
(2) BELASTINGJAAR — (Belgium, Holland) Tax year.
(3) BOEKJAAR — (Belgium, Holland) Financial year.
(4) KALENDERJAAR — (Belgium, Holland) Calendar year.

**JEOPARDY ASSESSMENT** — A tax assessment made where there is some danger of tax being lost, e.g., through the time limit for making an assessment running out.

**JOINT ASSESSMENT** — Where taxation of the same kind may be levied at different levels of government within the same country, one authority may use the same tax base as the other for the purpose of charging its tax, and, where the two tax systems are compatible, arrangements may be made to charge both taxes in a joint assessment, which is usually mutually convenient to the taxpayer and the tax departments. Examples of such co-operation include the central and provincial income taxes in Sweden and the state and county/city sales taxes in some of the states in the U.S.A.

**JOINT COLLECTION** — In order to minimise collection costs, in countries where more than one level of government has taxing powers, taxing authorities which collect taxes from the same body of taxpayers, and at roughly the same periods of the year, may combine their efforts so that one collection operation covers all the sums due. In some countries there is joint collection of water and electricity charges, and in Britain water charges or rates are collected jointly with local government rates, while the Inland Revenue Department collects contributions for graduated pensions along with P.A.Y.E. remittances.

# K

**KABUSHIKI-KAISHA** — (Japan) Joint stock company.

**KAPITALERTRAGSTEUER** — (Austria, Germany) Withholding tax on dividends and certain interest.

**KENNEDY ROUND** — One of the main objectives of the General Agreement on Tariffs and Trade is the reduction and stabilisation of tariffs on a reciprocal basis. Five rounds of multilateral negotiations were held between 1947 and 1962 to achieve this objective and a 6th round, which opened on 4 May 1964 and concluded on 30 June 1967, and which achieved substantial reductions, was known as the Kennedy Round.

**KEY INDUSTRY DUTIES** — Duties which were introduced in Britain in 1921 on non-Commonwealth imports to protect certain classes of goods, e.g., synthetic or organic chemicals, scientific and optical instruments and optical glass.

**KICKBACK, ILLEGAL** — A commission paid by A to B, where B has improperly passed on certain business to A, to the latter's profit. In U.S.A. law such payments are specifically disallowed as deductions in computing tax on A's profits.

**KILDESKAT** — (Denmark) Tax at source, withholding tax.

**KINDERAFTREK** — (Holland) Child deduction, abolished in 1978.

**KIRCHENSTEUER** — (Germany) Special income tax levied on behalf of the church of the taxpayer's choice.

**KNOW-HOW** — Information about how best to use patents and processes as a separate item from the patents, etc. themselves is now a recognised element commanding a price in trade and industrial circles. Receipts from the sale of know-how are usually taxable as trade receipts and the purchase, along usually with the cost of an associated patent or process, may rank for tax deductions. In the U.K., for example, expenditure on know-how may be written off at the rate of one-sixth per annum for 6 years.

**KOMMUNESKAT** — (Denmark) Local income tax.

**KOOPMANSGEBRUIK (GOED)** — (Holland) (Sound) commercial practice (rule applied to valuation of assets).

**KÖRPERSCHAFTSTEUER** — (Austria, Germany) Corporate income tax.

**KOSTEN VAN VERWERVING** — (Holland) Expenses incurred to acquire income.

**KUPONSTEUER** — (Germany) Withholding tax on bond interest.

[to be continued]

# Bibliography

# Books

*The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.*

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By B.T. Colditz. Sydney, Taxation Institute Research and Education Trust, 1978. 40 pp., Aus$ 2.-.
Research paper examining the special tax provisions with respect to exemption of income of charities and allowability of deductions for donations to charities in Australia, United Kingdom, U.S.A., Canada and New Zealand. (B. 101.431)

## AUSTRIA

### FORSCHUNGSZUWENDUNGEN ALS STEUERLICHE ABZUGSPOSTEN

By Gerold Stoll. Vienna, Verband der wissenschaftlichen Gesellschaften Österreichs, 1978. 68 pp.
Study of the deductibility for tax purposes of research expenses under Austrian tax law. A comparative analysis, in the form of some charts, with respect to this problem in other countries is appended. (B. 101.510)

### GRUNDRISS DES ÖSTERREICHISCHEN STEUERRECHTS

Band I: Einkommensteuer, Körperschaftsteuer, Gewerbesteuer, Umsatzsteuer. By Werner Doralt and Hans Georg Ruppe.
Vienna, Manzsche Verlags- und Universitätsbuchhandlung; Wirtschaftsverlag Dr. Anton Orac, 1978. 280 pp., ÖS 280.-.
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Eine Einführung. By Peter Swoboda. Vienna, Industrieverlag Peter Linde, 1978. Schriftenreihe der Österreichischen Steuer- und Wirtschaftskartei, No. 14. 82 pp.
Monograph on the various forms of cost accounts and their relation to price policy. (B. 101.525)

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### A STATEMENT OF THE LAWS OF CHILE IN MATTERS AFFECTING BUSINESS

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The book explains the main Chilean laws in matters affecting business such as civil law, commercial law, tax law, labour and social law, etc. (B. 15.827)

## DEVELOPING COUNTRIES

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### CURRENT LEGAL ASPECTS OF DOING BUSINESS IN THE FAR EAST

Editor Richard C. Allison. New York, American Bar Association, 1972. 208 pp., $ 15.-.
Text of proceedings of an American Bar Association National Institute sponsored by the Section of International Law, held in New York on May 19 and 20, 1972. Investment and business law important to foreign investors in Japan are considered (about 150 pages) followed by a forecast of trade and investment trends in the People's Republic of China, Taiwan, Indonesia and South Korea. (B. 51.152)

## FRANCE

### COMMENT CONSTITUER ET GERER UNE S.A.R.L.

13e Edition. By Francis Lemeunier. Paris, Editions J. Delmas et Cie, 1978. 310 pp.
Thirteenth edition of monograph explaining how to establish and administer a limited liability company (société à responsabilité limitée). Tax aspects are dealt with. The material is updated as of July 1, 1978. Text of relevant statutes and a bibliography are appended. (B. 101.511)

## GERMAN FEDERAL REPUBLIC

### AUSSENSTEUERRECHT

By Günther Rudolph. Frankfurt, Kommentator Verlag Gmbh., 1977.
Loose-leaf publication containing the text and administrative guidelines of the Foreign Tax Law and comments, a survey of other provisions in tax laws relevant for residents of Germany with foreign activities and an overview of the tax treaties and treaties for mutual assistance concluded by Germany. (B. 101.539)

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## INDIA

### THE CUSTOMS ACT, 1962

(Act 52 of 1962). Second edition. By B.C. Mitra. Calcutta, Eastern Law House, 1978. 464 pp., US$ 12.-.
Monograph explaining the Indian Customs Act of 1962 as amended. All important decisions, Indian and English, have been included in the commentary. Texts of statutes (Acts, regulations, orders, rules and notifications) have been appended. (B. 51.171)

### THE LAW OF CENTRAL SALES TAX

Third edition. By Shambhu Dayal Singh and Vishnu Dayal Singh. Luchnow, Eastern Book Company, 1977. 747 pp.
Revised edition of monograph explaining the Indian central sales tax. Case law has been kept up to date in the commentary, and relevant statutes have been appended. (B. 51.173)

## INTERNATIONAL

### COMPENSATING INTERNATIONAL EXECUTIVES

New perspectives & practices. New York, Business International Corporation, 1978. 145 pp.
Research report based on international personnel policies of 32 multinational corporations interviewed in order to evaluate their policies and practices as they affect non-local professional and management workforces. (B. 101.485)

### THE EXCHANGE OF INFORMATION UNDER TAX TREATIES

Proceedings of the 19th Technical Conference of the Inter-American Center of Tax Administrators C.I.A.T., Curaçao, Netherlands Antilles, August 28 — September 3, 1977. Published at the request of and in cooperation with C.I.A.T.
Amsterdam, International Bureau of Fiscal Documentation, 1978. Publications of the International Bureau of Fiscal Documentation, No. 25. 195 pp.
Printed text of the papers presented and final report of the conference of the Inter-American Center of Tax Administrators (CIAT) held in Curaçao, Netherlands Antilles, from August 28 to September 3, 1977. (B. 101.508)

### GIDS VOOR DE BELASTINGPARADIJZEN

Beknopte inleiding voor beginnende belastingreizigers.
By Edouard Chambost. Nijmegen, B. Gottmer; Brugge, Orion, 1978. 237 pp., Dfl. 45.90.
Dutch edition of introductory handbook describing and assessing tax havens in the world for both individual persons and companies, illustrated by documents and pictures. (B. 101.541)

### GLOBAL PERSPECTIVES OF AN INTERNATIONAL TAX LAWYER

A memoir. By Mitchell B. Carroll. Hicksville, N.Y., Exposition Press, 1978. 150 pp.
Informative memoirs of world tax developments experienced by a former president, now honorary president, of the International Fiscal Association. (B. 101.444)

### INTERNATIONAL INCOME TAXATION AND AFRICAN DEVELOPING COUNTRIES

By Charles R. Irish. Amsterdam, International Bureau of Fiscal Documentation, 1978. Studies on Taxation and Economic Development, Vol. IV. 100 pp.
Monograph on the international tax system as it operates between Africa and the industrialized countries of Western Europe, North America and Japan. (B. 101.509)

### ISSUES IN INTERNATIONAL TAXATION

In: Law and Policy in International Business. Georgetown, Georgetown University Law Center. Vol. 10, No. 2, 1978. 717 pp.
This issue is dedicated to the late Nathan N. Gordon. The subject matter of the articles deals with aspects of international taxation

as contributed by various authors, inter alia: "Reflections on the allocation of income and expenses among national tax jurisdictions" by Stanley S. Surrey; "International issues in corporate tax integration" by Hugh J. Ault; "The nondiscrimination article in tax treaties" by James G. O'Brien; and "A comparison of the United States and OECD Model Income Tax Conventions" by Robert J. Patrick, Jr. (B. 101.440)

### SOCIAL INDICATORS: PRELIMINARY GUIDELINES AND ILLUSTRATIVE SERIES

New York, United Nations, 1978. Statistical Papers, Series M, No. 63. 134 pp. (B. 101.472)

### USING TAX HAVENS SUCCESSFULLY

By Edouard Chambost. English edition by Thomas Crawley. London, Insititute for International Research, Ltd., 1978, 224 pp., £ 9.95.
English edition of book originally published in French under the title "Guide de Paradis Fiscaux", providing an assessment of tax havens in the world and their use by individuals and companies. (B. 101.515)

## IRELAND

### TOLLEY'S TAXATION IN THE REPUBLIC OF IRELAND 1978/79

By Eric L. Harvey and Nigel A.D. Lambert. Croydon, Tolley Publishing Company, Ltd., 1978. 112 pp., £ 5.-.
A detailed guide to taxation in the Republic of Ireland, including the Finance Act 1978, capital gains tax, capital acquisitions tax, wealth tax, corporation tax and value addied tax. (B. 101.545)

## ITALY

### LA FISCALITE IMMOBILIERE LIEE A LA POLITIQUE D'URBANISME EN ITALIE

By Ignazio Manzoni. Italian National Reports to the Xth International Congress of Comparative Law, Budapest 1978. Milan, Dott. A. Giuffrè Editore, 1978. 34 pp.
Extract of Italian report on real estate taxation and policy of city development delivered at the 10th International Congress of Comparative Law held in Budapest, August 23-28, 1978. (B. 101.405)

### L'IMPOSTA SUL REDDITO DELLE PERSONE GIURIDICHE

By Paolo M. Tabellini. Milan, Dott. A. Giuffrè Editore, 1977. 765 pp.
Handbook on the corporate income tax. The book is updated through 1976. (B. 101.528)

### MANUALE DELLE IMPOSTE DIRETTE

By Giuseppe Giuliani. Milan, Dott. A. Giuffrè Editore, 1976/77. 1711 pp./77 pp.
Handbook on direct individual and corporate income taxes and the collection of taxes. Laws, administrative rulings and case law are arranged per article of the relevant laws. A supplement updates the book to 1977. (B. 101.529/530)

### L'ORDINAMENTO TRIBUTARIO ITALIANO

By Enrico Potito. Milan, Dott. A. Giuffrè Editore, 1978. 775 pp.
Handbook on Italian taxation. After an extensive introduction, the various taxes and duties are explained. The book is updated through February 1978. (B. 101.504)

## KOREA (SOUTH)

### KOREAN TAXATION 1978

Seoul, Tax System Bureau, Ministry of Finance, 1978, 243 pp.
Revised and updated publication explaining the Korean tax structure and administration to foreigners engaged in business activities in Korea and providing information on the Korean tax system to foreign countries, in particular those negotiating tax conventions with Korea. (B. 51. 105)

## MIDDLE EAST

### CURRENT LEGAL ASPECTS OF DOING BUSINESS IN THE MIDDLE EAST – SAUDI ARABIA, EGYPT AND IRAN

Editors: Warren G. Wickersham and Benjamin P. Fishburne, III. Chicago, American Bar Association, 1977. 200 pp., $ 22.-.
Printed text of papers read at the conference convened by the National Institute in Washington on November 11-12, 1979. (B. 51.136)

## THE NETHERLANDS

### DE BELASTING VAN DE TOEKOMST ?

By S. Cnossen. Deventer, Kluwer, 1978. 41 pp., Dfl. 12.50.
Text of speech on expenditure tax as "The tax of the Future", delivered on October 5, 1978 on the occasion of the acceptance by Mr. Cnossen of the office of ordinary professor in tax law at the faculty of economic science at the Erasmus University in Rotterdam. (B. 101.500/553)

### FISCALE ASPECTEN VAN GOEDEREN— EN DIENSTEN—VERKEER TUSSEN GELIEERDE MAATSCHAPPIJEN

By J. de Kater and M.R. Reuvers. Deventer, Kluwer; The Hague, Fenedex, 1978. Fiscale en juridische documentatie voor internationaal zakendoen, No. 2. 53 pp., Dfl. 21.-.
Text of lecture (and ensuing discussion) on intercompany pricing between associated companies given at a seminar on March 7, 1978 convened by Fenedex, The Hague. (101.468)

### AN INFLATION-ADJUSTED TAX SYSTEM

A summary of the report by Professor H.J.Hofstra on the elimination from the Dutch tax system of the distorting effects of inflation. The Hague, Government Printing Office, 1978. 75 pp. (B. 101.502)

### KENBAARHEID EN WENDBAARHEID IN HET FISCALE RECHT

By F.H.M. Grapperhaus. Deventer, FED, 1978. Serie Belastingconsulentendag, No. 23. 80 pp., Dfl. 13.50.
Text of lecture and ensuing discussion on the subject of delimitation of just and unjust interpretation of tax law, from the viewpoints of both the taxpayer and the tax administration. The lecture was held on the occasion of the 1978 Tax Consultant Day (Belastingconsulentendag) on April 29, 1978, convened by the Nederlandse Federatie van Belastingconsulenten (Dutch Federation of Tax Consultants). (B. 101.447)

### PROJECTUITVOERING IN HET MIDDEN-OOSTEN/NIET VERDRAGSLANDEN

Nederlandse en lokale fiscale aspecten, o.a. Saoedi Arabië, Iran, de Golfstaten, Egypte en Libië. By J.M. van Kempen. Deventer, Kluwer; The Hague, Fenedex, 1978. Fiscale en juridische documentatie voor internationaal zakendoen, No. 3. 150 pp.
Study on the unilateral relief provisions of Netherlands tax law with respect to income from construction projects in the Middle East countries (non-tax treaty countries) with references to the tax aspects in such countries as Saudi Arabia, Iran, the Gulf States, Egypt and Libya. (B. 101.507)

### TERUGWERKENDE KRACHT OP HET GEBIED VAN BELASTINGWETGEVING

Preadvies van Mr. H. Prast. Deventer, Kluwer, 1978. Geschriften van de Vereniging voor Belastingwetenschap, No. 150. 48 pp., Dfl. 17.50.
First part of report by H. Prast on the retroactive application of tax law in the Netherlands. (B. 101.499)

**DE WET INVESTERINGSREKENING WIR**

Eerste druk 1978. By F.H. Lugt. Deventer, FED, 1978. Fed's Fiscale Brochures: Diversen 3. 91 pp.
Monograph concerning the new investment incentives.
(B. 101.544)

**WIR EN SIR**

Verslag van een seminar over dit onderwerp, gehouden op 8 juni 1978 te Amsterdam. Deventer, Kluwer, 1978. 100 pp.
Report of a seminar on the new Investment Incentives Law and the Industrial Deconcentration Act, held on June 8, 1978 in Amsterdam. (B. 101.524)

## PAKISTAN

**TAXATION**

The Leading Monthly Journal on Pakistan's Taxation Laws. Chief editor S.M. Raza Naqvi. Volumes 33 and 34, 1976. Lahore, Taxation, 1976. 350 + 300 pp.
Bound volumes 33 and 34, 1976 of the journal Taxation, containing statutes, circulars, articles on taxation, texts of comprehensive double taxation treaties (with Malta, Libya and Poland) and reports of cases of the Supreme and High Courts of Pakistan and India. (B. 51.154/155)

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The Leading Monthly Journal on Pakistan's Taxation Laws. Chief editor S.M. Raza Naqvi. Volumes 35 and 36, 1977. Lahore, Taxation, 1977. 325 + 360 pp.
Bound volumes 35 and 36, 1977 of the journal Taxation, containing statutes, circulars, articles on taxation and reports of cases of the Supreme and High Courts of Pakistan and India. (B. 51.156/157)

## PHILIPPINES

**NATIONAL INTERNAL REVENUE CODE OF 1977**

Manila, Government Printing Office, 1977. 684 pp.
Consolidated text of the National Internal Revenue Code of 1977 which consolidated and codified all national revenue laws of the Philippines. (B. 51.153)

## PORTUGAL

**FUNDO DE DESEMPREGO**

Lisbon, Ministry of Finance, 1976. 45 pp.
Legislation concerning the fund destined to compensate employees in the event they stop working. (B. 101.411)

## SOMALIA

**THE UNIFIED ACCOUNTING SYSTEM FOR SOMALI PUBLIC AGENCIES**

Prepared by Dr. Ahmed H. El-Gowainy. Mogadishu, Somali Institute of Development, Administration and Management, 1976. 286 pp. (B. 10.958)

## SPAIN

**WHERE TO GO ?**

Spain; a practical guide to living in Spain. By Ken Mortlock. London, Finax Publications, 1978. 120 pp., £ 6.-.
Guide describing the factors to be considered before emigrating to Spain and all the procedures that should be followed. Considered are cost of living, property laws, exchange control and taxation laws. (B. 101.448)

## SWITZERLAND

**EINFLUSS DES STEUERRECHTS AUF DAS HANDELSRECHT**

By Walter Ryser. Basel, Helbing & Lichtenhahn Verlag, 1978. Schweizerischer Juristenverein, Vol. 112, Heft 2, 1978.
P. 137-196.
Consideration of the impact of tax law on Swiss commercial law. (B. 101.477)

**EINFÜHRUNG IN DAS SCHWEIZERISCHE AKTIENRECHT**

By Peter Forstmoser and Arthur Meier-Hayoz. Bern, Verlag Stämpfli & Cie AG., 1976. 376 pp.
Entitled "Introduction to the Swiss Company Law", this monograph provides an outline of the most important aspects of Swiss company law. (B. 101.526)

**FEDERALISME COORDONNE**

Eléments pour un synthèse entre l'harmonisation fiscale, la politique régionale et la péréquation financière.
By Jean-Jacques Schwartz. Bern, Verlag Paul Haupt, 1978. Schriftenreihe "Finanzwirtschaft und Finanzrecht", Band 24. 72 pp., Sfrs. 18.-.
Summary explaining the necessity for a synthesis in the treatment of the interdependent issues of tax harmonization, regional policy and equalization in Swiss federal government fiscal policy.
(B. 101.478)

## UNITED KINGDOM

**THE BRITISH TAX SYSTEM**

By J.A. Kay and M.A. King. Oxford, Oxford University Press, 1978. 275 pp.
Study using economic analysis to examine the British tax system with emphasis on the evaluation of the economic effects of each kind of tax and with respect to the tax system as a whole.
(B. 101.550)

**INCOME TAX**

Including corporation tax and capital gains tax. Tenth edition. By Henry Toch. Estover, Plymouth, Macdonald and Evans, Ltd., 1978. 212 pp.
Revised edition of handbook intended for students in accountancy, law, secretarial practice and business studies providing explanation with examples on income tax, corporation tax and capital gains tax. The material is updated as of the Finance Act 1977 and the budget proposals for 1978. (B. 101.480)

**RECEIVERSHIP MANUAL**

By Donald Chilvers and Paul Shewell. Croydon, Tolley Publishing Company, Ltd., 1978. 131 pp., £ 7.50.
Manual considering the principal problems of a person who has been appointed a receiver under debentures. No attempt is made to deal with any differences of law and practice in Scotland and Northern Ireland. (B. 101.479)

**SURVEY INTO COMPANY CAR SCHEMES**

Compiled by G.J. Watson and T. Wilson. Croydon, Tolley Publishing Company, Ltd., 1978. 56 pp. (B. 101.483)

**TAX PLANNING WITH PRECEDENTS**

Eighth edition. by D.C. Potter and A.R. Thornhill. London, Sweet & Maxwell, 1978 388 pp., £ 16.-.
Revised and updated edition of guide in the field of tax planning. The method employed is to discuss the relevant general principles applicable and then to illustrate the practical possibilities with annotated precedents. (B. 101.531)

**TOLLEY'S CORPORATION TAX 1978-79**

A comprehensive detailed guide to corporation tax including the 1978 Finance Act and relevant case law to 31 July 1978. By Eric L. Harvey and David G. Young. Croydon, Tolley Publishing Company, Ltd., 1978. 148 pp., £ 3.50. (B. 101.496)

TOLLEY'S INCOME TAX 1978-79

A comprehensive detailed guide to income tax including the 1978 Finance Act and relevant case law to 31 July 1978.
63rd Edition. By Eric L. Harvey. Croydon, Tolley Publishing Company, Ltd., 1978. 400 pp., £ 6.-. (B. 101.481)

WHEATCROFT AND WHITEMAN ON CAPITAL GAINS TAX

Second supplement. By Robin Mathew. London, Sweet & Maxwell; Edinburgh, W. Green & Son, 1978. 96 pp.
This second supplement to the basic work on capital gains tax includes the 1974 Development Tax and a brief summary of the first draft of the Finance Bill 1978. The material is updated as of January 3, 1978. (B. 101.482)

## U.S.A.

AMERICAN FEDERAL TAX REPORTS

Second series. Volume 41, table of cases to volume 41.
Englewood Cliffs, Prentice-Hall, Inc., 1978. 1582 pp.
This bound volume contains unabridged federal and state court decisions arising under the federal tax laws (previously reported in Prentice-Hall Federal Taxes) on income tax, estate and gift tax and excise tax. (B. 101.549)

FEDERAL BUDGET POLICY

Third edition. By David J. Ott and Attiat F. Ott. Washington, The Brookings Institution, 1977. 178 pp., $ 9.95.
This study aims to describe and analyse the history of U.S. federal expenditures, taxes, the national debt and the budget process and analyses the effects of the fiscal policy on economic activities. (B. 101.457)

FEDERAL TAX GUIDE 1979

Volume 1. Chicago, Commerce Clearing House, Inc., 1978.
Loose-leaf publication consisting of four binders designed to provide information on the federal income tax code. The texts of the Internal Revenue Code and the income tax regulations cover three volumes. The explanation, current reports on changes and the index fill another volume. Supplements will keep the material up to date. (B 101.513)

1979 GUIDEBOOK TO LABOR RELATIONS

Chicago, Commerce Clearing House, Inc., 1978. 392 pp., $ 8.50.
Annual guide explaining and summarizing the general principles of labor relations law and the important rules developed under the statutes and decisions. (B. 101.548)

THE INCOME TAX AND BUSINESS DECISIONS

An introductory tax text. Fourth edition. By William L. Raby. Englewood Cliffs, Prentice-Hall, Inc., 1978. 525 pp.
Introduction explaining tax provisions which affect business and investment decisions. The book's primary emphasis is the income tax, but it also explores transfer taxes as far as they have an impact on the estate planning process. (B. 101.546)

AN INTRODUCTION TO TAXATION

1979 Edition. By Ray M. Sommerfeld, Hershel M. Anderson and Horace R. Brock. New York, Harcourt Brace Jovanovich, Inc., 1978. 500 pp.
Revised tax textbook explaining the tax law in its political, social, and economic context. Each chapter concludes with a number of short-answer questions. (B. 101.512)

NEW PENSION AND EMPLOYEE BENEFITS PROVISIONS INCLUDING REVENUE ACT OF 1978, PREGNANCY DISCRIMINATION AMENDMENT, ERISA REORGANIZATION PLAN

Chicago, Commerce Clearing House, Inc., 1978. 145 pp., $ 3.-.
Report explaining the Revenue Act of 1978, the Pregnancy Discrimination Amendment and the ERISA Reorganization Plan with the texts of the laws. (B. 101.514)

REVENUE ACT OF 1978

Also included Energy Tax Act, Foreign Earned Income Act. Law - Explanation - Committee Reports. Chicago, Commerce Clearing House, Inc., 1978. 650 pp., $ 6.-.
This book sets out the Revenue Act of 1978, the Energy Tax Act and the Foreign Earned Income Act, with the full texts of the laws, controlling committee reports and explanation thereon by the CCH Editorial Staff. (B. 101.547)

REVENUE ACT OF 1978 AND ENERGY TAX ACT OF 1978

Complete explanation - code sections as amended - Committee reports - index. Englewood Cliffs, Prentice-Hall, Inc., 1978. 1004 pp., $ 7.-.
Handbook providing the up to date information needed to research the law enacted by the 1978 Revenue Act and the 1978 Energy Tax Act. (B. 101.487)

SIMPLIFICATION AND COMPREHENSIVE TAX REFORM

By Harvey Galper and Michael Kaufman. Washington, Office of Tax Analysis, U.S. Treasury Department, 1978. OTA Paper No. 34, September 1978. 65 pp.
Study presenting for discussion the basic structure of a tax system predicated on a comprehensive measure of income. (B. 101.491)

U.S. INCENTIVES AND RESTRICTIONS ON FOREIGN INVESTMENT

By Raymond J. Waldmann. Washington, Transnational Investment, Ltd., 1978. 400 pp.
Guide presenting a summary of U.S. federal and state government investment programs and investment restrictions. (B. 101.486)

## VENEZUELA

A STATEMENT OF THE LAWS OF VENEZUELA IN MATTERS AFFECTING BUSINESS

Fourth edition. By Pedro Silveira Barrios, Washington, General Secretariat, Organization of American States, 1977. 333 pp.
Explanation of the legal system, including short explanation of the tax system. (B. 15.826)

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Butterworths, Pty., Ltd., Chatswood.

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Prentice-Hall, Inc., Englewood Cliffs.

# Contents

of the March 1979 issue

# In Memoriam

## K.H. DRONKERS

*It is with deep regret that we announce the death of Dr. K.H. Dronkers at the age of 78 on November 7, 1978 on the island of Tenerife where he had lived for the past few years.*

*Dr. Dronkers will be remembered for his many talents and particularly his wisdom. In the days of Dutch East Indies (now the Republic of Indonesia) he was, for example, a prominent official of the revenue service. With Mr. Th. Lancée, his colleague at the time, he wrote a commentary on the Dutch East Indies Corporate Income Tax Law of 1925 which remained the standard work on the subject for many years, even after Indonesia's independence. At the culmination of his career in the Dutch East Indies, he held the post of Chief Treasurer and Paymaster-General of the Department of Finance.*

*After the Second World War, Dr. Dronkers embarked on a successful banking career with the Nederlands — Indische Handelsbank, later renamed the Nederlandse Overzeebank, and then through mergers as a director of the Amsterdam — Rotterdam Bank in Amsterdam.*

*Dr. Dronkers became well-known in international tax circles through his membership of international commissions, and as Secretary-General of the International Bureau of Fiscal Documentation.*

*A man of few words. A wise man. By their very nature, international associations tend to be beset with internal conflicts and sometimes sharp differences of opinion. The influence of Dr. Dronker's personality was felt not through fiery participation in such discussions but through his calm summing-up of proceedings. His perceptive but uncompromising conclusions were reached with a thoroughness and maturity which won him universal respect. An outstanding lawyer and tax expert, but above all someone with deep understanding of human nature, and the inner peace of a strong character.*

*The strengthening of the structure of the I.F.A. during the ten or so years that he was Secretary General is one of his many achievements from which the present members still benefit. He travelled a great deal and was frequently present at meetings of national groups, not only in the Netherlands but also in France, Germany and elsewhere. At congresses, he usually remained modestly in the background but was in fact the pivot around which everthing else revolved.*

*Dr. Dronkers gave the International Bureau of Fiscal Documentation his wholehearted support. While he himself remained modest and unassuming, his suggestions and advise were always listened to closely.*

*It is a privilege to have know him; as a friend, colleague and an adviser.*

*J. van Hoorn Jr.*

## J. BAUGNIET

*L'I.F.A. vient de perdre un de ses membres les plus anciens et les plus actifs en la personne de M. Jean Baugniet, décédé inopinément à Bruxelles le 1er février 1979 à l'âge de 77 ans.*

*Membre-fondateur de l'association, il a participé à presque tous ses Congrès: il était à la Haye en 1939 et à Sydney en 1978. Pendant quarante années, le défunt a apporté à l'I.F.A. les qualités d'une personnalité attachante et communicative et le concours d'un juriste consommé qui s'intéressait à tous les débats. Son abord sans apprêt, son commerce chaleureux resteront dans la mémoire de tous ceux qui ont eu le privilège de le fréquenter au cours des rencontres informelles qui, en marge des discussions toujours denses et laborieuses, procuraient aux congressistes la plus charmante des détentes.*

*Membre du Comité scientifique permanent et président du Jury du Prix Mitchell Carroll depuis de nombreuses années, M. Baugniet a toujours accompli avec soin et dans un grand souci d'efficacité les missions qui lui furent confiées.*

*Avocat et professeur, ses talents et ses mérites ont été reconnus au plus haut niveau dans son pays, puisqu'il a été recteur de l'Université Libre de Bruxelles, bâtonnier de l'ordre des avocats de la capitale et membre titulaire de l'Académie Royale de Belgique.*

*L'éclat de sa personnalité a passé les frontières; il était professeur honoris causa de plusieurs universités belges et américaines, et aussi l'Université hébraïque de Jérusalem. Pendant la guerre 1940—1945, il fut un résistant courageux et sa vie tout entière a été un exemple de dévouement et d'attachement à son pays et à la démocratie et un modèle de tolérance et de compréhension pour les convictions d'autrui unies à une grande fermeté dans la défense de l'affirmation de ses propres opinions.*

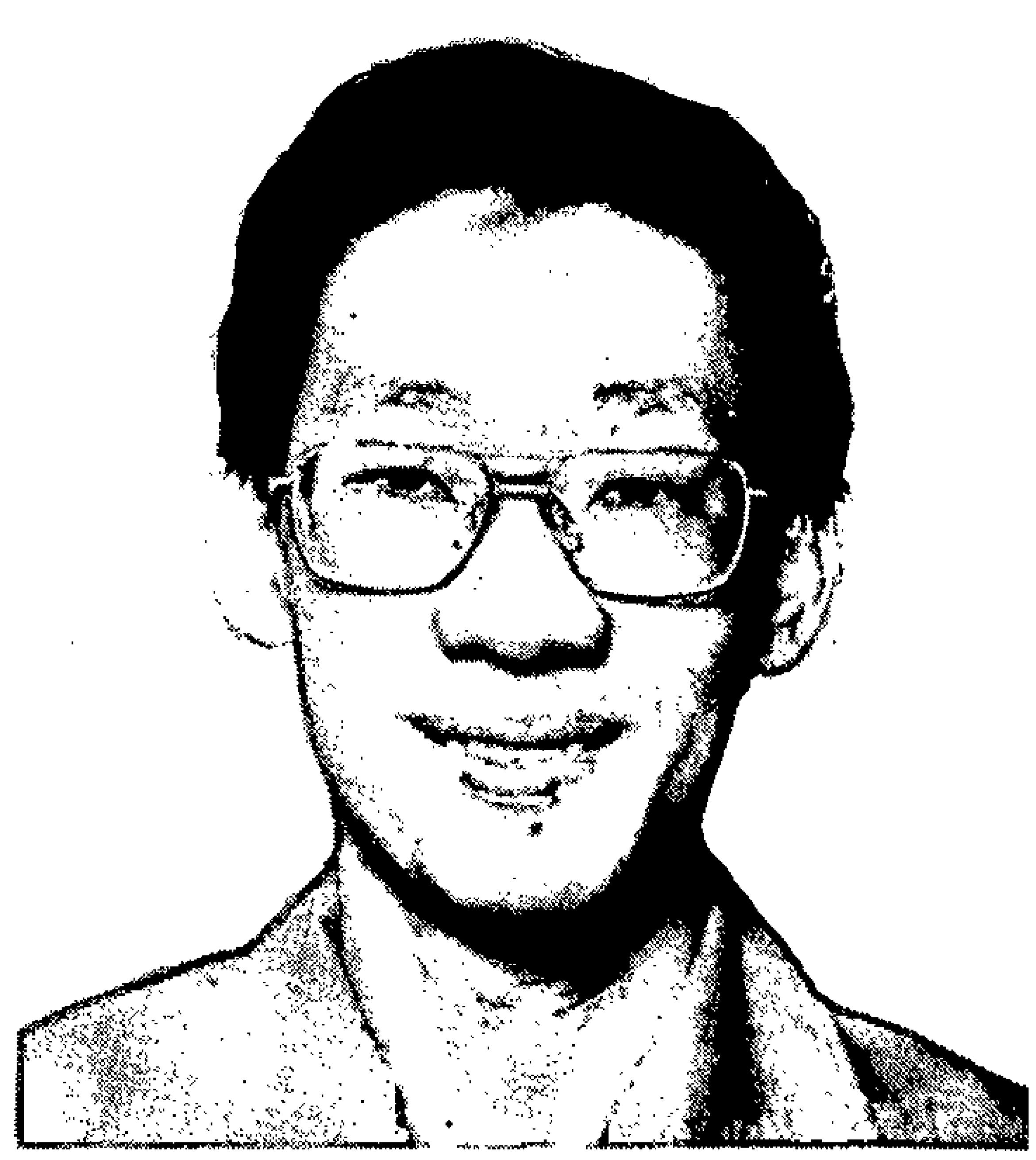
*Cet homme de bien et cet honnête homme restera présent dans la mémoire et dans le coeur de ses amis.*

*E. Schreuder*

**The drawing is reproduced from *Mélanges en hommage au Professeur Jean Baugniet* (1976).**

# MALAYSIA:
# The Real Property Gains Tax Act, 1976 - AN OUTLINE*

By C.S.Yeoh**



## A. INTRODUCTION: THE LAND SPECULATION TAX ACT, 1974

*Capital gains arising out of land and property transactions were, prior to the enforcement of the above Act, exempt from tax. The preamble to the Act, which had effect from February 6, 1973 to November 6, 1975 and received the Royal Assent on March 8, 1974, states that it is an Act to make provision for the imposition, assessment and collection of a tax on capital gains derived from land speculation. It was an accurate description since the main object of the Act was to curb land speculation in order to check the spiralling prices of land and houses in Malaysia. The Act initially provided that the tax of 50 percent was to be levied only on the gain arising out of a disposal of an asset which was owned for less than two years after its date of acquisition and the consideration for the disposal was $200,000 or more.*

*However, by an amendment in 1975 the limit of $200,000 was reduced to $100,000 with effect from November 13, 1974. The Land Speculation Act, 1974 was repealed with effect from November 7, 1975 but without prejudice to the right of the Director General of Inland Revenue to take any action which he was empowered to take under the Act to assess and enforce payment of land speculation tax for the years of assessment 1974 and 1975. For all purposes, therefore, the Act remains in force for the period December 6, 1973 to November 6, 1975 in respect of those transactions for which tax remains to be assessed or collected.*

## B. THE REAL PROPERTY GAINS TAX ACT, 1976

### I. In general

The preamble to the Act, which received the Royal Assent on March 18, 1976, states that it is an Act to provide for the imposition, assessment and collection of a tax on gains derived from the disposal of real property and matters incidental thereto. With the passing of the Act, the limited form of capital gains tax introduced by the Land Speculation Act was further widened. Whereas the Land Speculation Tax Act, 1974 was introduced with the main object of curbing land speculation, the Real Property Gains Tax Act, 1976 can be said to be mainly an act for the collection of revenue with the curbing of land speculation as a secondary motive.

**TABLE OF CONTENTS**



* The law is stated as of October 1, 1978.

** Executive Director, SGV–KC Taxation Services Sdn. Bhd., Kuala Lumpur, Malaysia.

## MALAYSIA: REAL PROPERTY GAINS TAX

**Extract from the text of the Speech by the Minister of Finance Datuk Hussein bin Onn, introducing the 1976 Budget on November 6, 1975.**

As Hon'ble Members are aware, at present, gains derived from a disposal of lands and buildings situated in Malaysia and any interest, option or other rights in or over such lands and buildings, are liable to tax at the rate of 50 percent, [1] if such a disposal is made within two years after the date of the acquisition of the property. However, if the amount or value of the consideration for the disposal does not exceed $100,000, it is exempted from the tax. This tax is provided in the Land Speculation Tax Act, 1974, and it is intended to discourage speculative activities in such property which, among other factors, had contricuted to an alarming rise in the prices of immovable property.

Therefore, a gain made from a disposal of immovable property, beyond the period of two years after its acquisition, is beyond the scope of this land speculation tax. Nor is it liable to income tax under the income tax legislation, since a gain on realisation is not normally regarded as income. *Such gains, if taxed, can provide a good source of revenue to the Government.* From the equity point of view, it cannot be denied that such gains add to a person's wealth in the same way as any additional income such as bonus or dividends. He is certainly better off than a person with the same income, but having no such gains. *It is therefore inequitable that such gains should be free from tax. Furthermore, a tax on such gains would add a further element of progressivity in our tax system. The case for taxing such gains becomes even stronger when they accrue, not out of a person's own exertions, but purely fortuitously, resulting from Government's development efforts.*

*On both revenue and equity grounds, it is now proposed to introduce a tax on gains derived from a disposal of real property, that is, land including building, situated in Malaysia and any interest, option or other right in or over such land.* From this it can be seen that the type of the chargeable asset is still the same as under the Land Speculation Tax Act. For this purpose, it is proposed to introduce a new legislation to be called "*Real Property Gains Tax Act, 1976*" and to repeal the existing Land Speculation Tax Act, 1974. I should make it clear that *the repeal of the Land Speculation Tax Act does not mean that the Government proposes to abandon the intention of discouraging speculative activities in real property.* On the contrary, as will be clear from the proposed provisions for the rates structure and the exemption limit which I shall mention later, *the new legislation will discourage such activities even more.*

Under this proposal, gains from a disposal of real property are to be taxed on a diminishing scale of rates in accordance with the length of the holding period as follows:

- 50 percent if the property is disposed of within the first or second year after the date of its acquisition,
- 40 percent within the third year,
- 30 percent within the fourth year,
- 20 percent within the fifth year, and
- 10 percent within the sixth year or thereafter. [2]

To illustrate, if a person buys a piece of land on 1.1.76 at a cost of $100,000, and sells it in the third year of holding, say on 1.6.78, at $120,000, the gain of $20,000 is to be liable to a 40 percent rate of tax, that is $8,000.

A graduated scale of rates in accordance with the holding period is intended to differentiate between gains which accrue from speculative transactions and gains arising from investment. The shorter the holding period, the greater is the element of speculation and it, therefore, justifies a levy of a higher rate of tax. It will be seen from the rate structure which I have just mentioned, that *the rate applicable to a disposal of real property made within two years after the date of acquisition remains at 50 percent*, as presently provided in the Land Speculation Tax Act.

*It is proposed to provide that where the amount or value of the consideration for the disposal of a property is less than $50,000, such disposal is to be exempted from the tax. This is intended to provide some measure of relief to people of lesser means, who for some reasons have to sell their properties.*

It will be noted that the proposed exemption limit is lower than what is presently provided in the Land Speculation Tax Act, which is $100,000 in the amount or value of the consideration. This figure was originally $200,000, but was reduced to the present figure in the last Budget, in order to make the tax more effective. Further observation into the operation of the land speculation tax, has shown that a very large portion of the sales of real property was in the range of less then $100,000 in value. *A reduction of the exemption limit to the proposed value of less than $50,000 is also justifiable if the speculative activities in land transactions are to be further discouraged.*

As in the case of the land speculation tax, there will be provision for the treatment of losses. However, since in this case the tax is to be imposed on a scale of rates depending on the length of the holding period, the treatment of losses naturally poses more problems than in the case of a flat rate of tax like the land speculation tax, where a loss from one transaction can easily be offset against a gain from another. As an equitable solution to the problem, losses will not be allowed as a deduction from gains. Instead, *tax relief for losses will be allowed, at the rate of tax applicable to the category of disposal giving rise to the loss, as a deduction from the total tax assessed on chargeable gains derived in the year of assessment in which the loss is suffered, with provision to carry forward unabsorbed tax relief for losses.* In this way, neither the tax payer nor the Government will be unduly affected by the treatment of losses.

As to the question of valuation of the property for purpose of this tax, it is proposed to provide a certain rule in determining the value of property acquired in the past. The difference between the acquisition price and disposal, is a gain or loss as the case may be. Acquisition price is the purchase consideration and incidental costs incurred for the purchase of the property by the disposer, plus any further expenses incurred by him in improving the property. However, *in the case of property acquired in the distant past, in view of the difficulty in determining the historical cost and further expenses up to date, the market value of the property as at 1st January, 1970 will be used, instead of the purchase consideration, incidental costs and further expenses incurred by the disposer up to 1st January, 1970.*

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1. Editor's note: Currently 40 percent.
2. Editor's note: Currently 40, 30, 20, 10 and 5 percent.

Apart from the rate structure, the exemption limit, and the special provision for the treatment of gains and losses, the Real Property Gains Tax Bill contains basically the same provisions as the Land Speculation Tax Act, 1974. After all, the present proposal is merely an expansion of the scope of the tax in the Land Speculation Tax Act to cover gains derived from any disposal of land and buildings made beyond two years after their acquisition. However, since the present proposal is to cover not only speculative gains, but also long term gains on disposal of real property, it is considered necessary to introduce a new legislation altogether. *The new legislation, therefore, continues to provide, for example, an exemption from the tax on the gains made from a disposal of one private residence in certain circumstances.* Similarly, genuine housing developers have no cause for alarm because they will not be affected by this tax. Their profits, being regarded as ordinary business income, are liable to ordinary income tax.

*The tax will be imposed on gains made on disposal of real property on or after 7th November, 1975.* It is estimated the tax will generate about $10 million of additional revenue in 1976.

## II. Scope of charge

The tax has effect from November 7, 1975 and is levied on all gains arising out of the disposal of any real property. Real property, which is referred to throughout the Act as "chargeable asset", has been defined as any land situated in Malaysia and any interest, option or other right in or over such land. Land is further defined to include:

(a) the surface of the earth and all substances forming that surface;
(b) the earth below the surface and substance therein;
(c) buildings on land and anything attached to land or permanently fastened to anything attached to land (whether on or below the surface);
(d) standing timber, trees, crops and other vegatation growing on land; and
(e) land covered by water.

Thus the Act only applies to transactions, wherever taking place, in respect of land situated in Malaysia but not land situated outside Malaysia. Gains which are subject to or exempt from income tax are not liable to Real Property Gains Tax.

Whereas Land Speculation Tax was chargeable on gains arising from speculative land transactions, i.e. only on assets disposed of within two years after the date of acquisition of the asset by the disposer, under the Real Property Gains Tax Act, the scope of charge has been extended with the result that both short and long term gains arising from the disposal of land situated in Malaysia are chargeable at varying rates depending on the holding period of each asset. In applying the rate of the tax on chargeable gains, a distinction is made between short and long term gains. Short term gains are taxable at higher rates in order to cover the element of speculation beginning with 50 percent (40 percent from October 29, 1977) for disposals within two years after the date of acquisition and descending to 20 percent (10 percent from October 29, 1977) for disposals in the fifth year after the date of acquisition. Long term gain arising from a disposal in the sixth year is taxable at the lower rate of 10 percent (5 percent from October 29, 1977).

The following notes attempt to explain briefly the provisions and scheme of the Real Property Gains Tax Act, 1976:

## III. Year of assessment

The tax is charged for each year of assessment. The first year of assessment is the period beginning on November 7, 1975 and ending on 31st December, 1976 and thereafter the year of assessment is to be the calendar year starting with the calendar year 1977.

## IV. Basis of assessment

The tax is to be charged on the total amount of chargeable gains accruing to a chargeable person in a year of assessment in respect of the category of disposal. Losses are not allowed as deductions against gains but tax relief is given for allowable losses against the total tax assessed. Unabsorbed tax relief for allowable losses may be carried forward indefinitely.

## V. Rate of tax

The rate of tax chargeable on every complete dollar of the amount of chargeable gains is as follows:

| Category of disposal | Rate of tax with effect from Nov. 7, 1975 to Oct. 28, 1977 | Rate of tax with effect from Oct. 29, 1977 |
|---|---|---|
| Disposal within two years after the date of acquisition of the chargeable asset | 50% | 40% |
| Disposal in the third year after the date of acquisition of the chargeable asset | 40% | 30% |
| Disposal in the fourth year after the date of acquisition of the chargeable asset | 30% | 20% |
| Disposal in the fifth year after the date of acquisition of the chargeable asset | 20% | 10% |
| Disposal in the sixth year after the date of acquisition of the chargeable asset or thereafter | 10% | 5% |

## VI. Chargeable assets

A chargeable asset, for the purposes of the Act, is any land situated in Malaysia and any interest, options and other rights in or over such land. Interest, options and other rights in or over land are situated where the land is situated. The term "rights in or over" includes rights to purchase.

## VII. Persons chargeable

Every person whether or not resident in Malaysia for a year of assessment is chargeable with the tax in respect of chargeable gains accruing to him in that year on the disposal of any chargeable asset.

## VIII. Chargeable gains and losses

Where a chargeable asset is disposed of, then:

(a) if the disposal price exceeds the acquisition price there is a chargeable gain;
(b) if the disposal price is less than the acquisition price there is an allowable loss; and
(c) if the disposal price is equal to the acquisition price, there is neither a chargeable gain nor an allowable loss.

An allowable loss means a loss suffered on the disposal of a chargeable asset which, if it had been a gain, would have been chargeable with the tax.

Gains or losses on assets disposed of at less than $50,000 are not taken into account in computing the gain chargeable to tax for a year of assessment up to October 28, 1977. With effect from October 29, 1977 the Act was amended to provide that all transactions are taxable but an exemption of $5,000 or 10 percent of the chargeable gain, whichever is the greater, will be allowed instead.

Schedule II to the Act sets out the method of determining disposal price and acquisition price and the expenses which may be allowed in computing the amount of chargeable gain or allowable loss.

## IX. Notice to be given on disposal and acquisition

A disposer of a chargeable asset and an acquirer of the asset are required, within 30 days after the making of an agreement for the disposal of the asset, to send separately to the Director-General:

(a) a notification of disposal (or, as the case may be, the acquisition) in the prescribed form with all such particulars as are called for thereby;
(b) where the market value of the asset is for the purposes of the Act to be taken as the consideration for the disposal, a written valuation of the asset by a valuer; and
(c) if he is a nominee, sufficient information to identify the person on whose behalf he is acting.

## X. Payments in advance

On receipt of a notification from a disposer or an acquirer, the Director-General will determine whether any chargeable gain has accrued or will accrue to the disposer in respect of the transaction to which the notification relates, compute the amount of tax which is or will be payable under the Act in respect of any such gain *without* taking into account any allowable loss suffered by the disposer in respect of any other transaction in the year of assessment and serve upon the disposer a written requisition calling upon him to pay the amount so computed.

Any sum so demanded is to be paid by the disposer on the service of the requisition.

The Director-General will send to both the disposer and to the acquirer a certificate of clearance on the prescribed form on payment being made in accordance with the above provision or where he is satisfied that no chargeable gain has arisen.

Where on a disposal the consideration consists wholly or partly of money, the acquirer is required, until he receives the Director-General's certificate of clearance, to retain the whole of that money (subject to a maximum of the amount of tax payable if it was imposed on the full sale price). The Director-General may at any time before he sends the certificate of clearance require the whole or any part of the sum retained to be delivered to him by the acquirer within a time to be specified in the requisition. For example, if a person disposed of an asset for $100,000 and the rate of tax applicable is 40 percent, then the acquirer is obliged to withhold $40,000 and not 40 percent of the chargeable gain.

## XI. Return to be made by chargeable persons

Every chargeable person who disposes of a chargeable asset is required, within three months after the end of a year of assessment in which the disposal took place, to make a return of all disposals of chargeable assets made by him during that year:

(a) specifying in respect of each asset disposed of, the acquisition price, the disposal price and the gain or loss from the disposal;
(b) furnishing all information necessary to determine the acquisition price and disposal price of each asset disposed of; and
(c) a statement of any payment made on the requisition by the Director-General at the time of the disposal of the asset and also the receipts for any such payments.

Every nominee is required within three months after the end of any year of assessment in which he makes disposals of chargeable assets on behalf of any person to make a return specifying:

(a) the name and address of the person on whose behalf the disposal is made;
(b) the assets disposed of; and
(c) the date on which he first began to hold the asset as nominee for that person.

Where any assets acquired:

(a) from any person by a company controlled by that person, by his wife or by him jointly with his wife, or a connected person; or
(b) with the approval of the Director-General, by a company from another company in the same group,

are transferred by the acquiring company to its stock in trade, the acquiring company is required, within thirty (30) days after the transfer, to make a return giving particulars of the assets so transferred.

Where a person is required to make a return for the purposes of the Income Tax law, he is required to make a declaration in the return whether or not he has made disposals of chargeable assets in the year immediately preceding the year of assessment for which the return is made.

### XII. Assessments

Where a person makes a return the Director-General may:

(a) accept the return and make an assessment accordingly; or
(b) make an assessment after making such adjustments as he considers necessary.

Where a person does not make a return, the Director-General, if he is of the opinion that that person is chargeable with the tax, will make an assessment on him accordingly.

### XIII. Advanced assessment

Where it appears to the Director-General, either because a chargeable person is about to leave Malaysia or for any other reason, that an assessment should be made forthwith on that person, he may at any time make whatever assessment he considers appropriate. Any assessment so made is to be adeopted with such revision, if any, as the Director-General thinks necessary, as the assessment for that year in the year of assessment to which it relates when the time allowed for making a return of the disposal has expired.

### XIV. Deceased persons

The death of a chargeable person is not to prevent the making of an assessment in respect of disposals by him before his death. Such assessments may be served on the executor of the deceased person and the assessment will have the same effect as regards imposing a liability on the estate of the deceased person as it would have had if it had been made during his lifetime. However, no such assessment may be made more than 3 years after the end of the year of assessment in which the death took place.

### XV. Additional assessments

The Director-General may, where it appears to him that no or insufficient assessment has been made on a person chargeable to tax for any year of assessment, make within 12 years after the end of that year of assessment, whatever assessment or additional assessment he considers to be appropriate on that person. Where the person chargeable to tax has been guilty of any form of fraud or wilful default in connection with or in relation to the tax, he may make an assessment on that person for the purpose of making good any loss of tax attributable to the fraud or wilful default at any time.

### XVI. When acquirer may be assessed

Where there is a disposal and:

(a) the consideration on the disposal of a chargeable asset consists of another asset (whether chargeable or not); or
(b) there is a failure by both the disposer and the acquirer to notify the Director-General of the intended disposal of a chargeable asset; or
(c) the consideration for the disposal of a chargeable asset is, for the purposes of the Act, the market value of the asset,

the Director-General may make on the acquirer an assessment on an amount equal to the amount of the tax payable by the disposer as well as a sum equal to 10 percent of that amount as penalty. [1]

An assessment made in such circumstances is to be treated for all the purposes of the Act as having the same effect as though it were an assessment made on the person disposing of the asset. In making such an assessment on the acquirer, he is not to be allowed to set off the amount of any losses suffered by him. The acquirer, however, may recover, as a debt due to him from the disposer, the amount of any payment made in pursuance of the assessment; for that purpose, he may require the Director-General to furnish a certificate specifying the amount paid. Any certificate so furnished is to be conclusive evidence of the facts stated therein.

### XVII. Notice of assessment

The Director-General is to serve on every person assessed a notice of assessment indicating:

(a) the year of assessment to which the assessment relates;
(b) the chargeable gains and allowable losses taken into account in making the assessment;
(c) subject to the proviso below:
  (i) the amount of the chargeable gains on which the tax has been assessed;
  (ii) the amount of the tax payable;
  (iii) the place at which and the time within which the payment is to be made; and
  (iv) the existence of a right to appeal.

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1. This paragraph is enacted in Section 16 of the Act to assess and recover the tax payable on the disposal of a chargeable asset on the acquirer instead of the disposer in the circumstances mentioned in (a) and (c) because in both cases the consideration is not for cash but rather in kind e.g. exchange of assets or non-exempt gifts of real property. In the circumstances the acquirer is unable to retain any monies as required under the Act and to prevent loss of revenue, the law imposes on him the responsibility of paying the tax due on the disposal by the transferor with a right of recourse to the transferor for recovery of the tax paid by him (the acquirer).
It is also provided in the proviso to Section 16 that the 10 percent penalty shall not be charged in circumstances (a) and (c) unless the disposer failed to make payment. Therefore, although the provision is there for the Director-General of Inland Revenue to have final recourse to the acquirer to settle the tax payable by the transferor, such powers are not invoked unless there is default by the transferor in settling the tax due from him in a non-cash transaction.

Where a tax is not payable, the notice of assessment is to contain, instead of matters referred to in (c) above, a statement that no tax is payable for the year of assessment in question and a statement of the amount, if any, by which:

(a) the allowable losses for that year exceed the chargeable gains; or
(b) any payment in respect of a gain which is to be taken into account in assessing the tax payable for that year exceeds the tax so payable.

## XVIII. Appeals

A person aggrieved by an assessment made on him may appeal to the Special Commissioners against the assessment in the same manner as an appeal against an assessment of income tax made under the Income Tax Act. The provisions of sections 99 to 102 of the Income Tax Act, in as far as they are applicable and with necessary modifications, apply to an appeal against an assessment made under this Act.

The provisions of Schedule V to the Income Tax Act, 1977 apply with necessary modifications to the hearing of appeals to the Special Commissioners and to the hearing of further appeals.

Where a person appeals under the Act, he is not entitled in the appeal to re-open any issue which has been finally and conclusively settled unless it is an issue already re-opened by the Director-General. [2]

## XIX. Error or mistake relief

A person upon whom a notice of assessment is served may, within 6 years after the end of year of assessment in which the assessment is made, apply to the Director-General for a revision of the assessment on the grounds that the assessment is excessive, by reason of an error or mistake in the return or other statement made by the person for the purposes of the assessment.

No relief, however, may be given in respect of an error or mistake as to the basis on which the liability of the person concerned ought to have been computed where the return containing the error or mistake was, in fact, made on the basis of or in accordance with the practice of the Director-General generally prevailing at the time when the return was made.

## XX. Finality of assessment

An assessment is final and conclusive for all the purposes of the Act as regards the amount of tax payable under it or the allowable loss indicated, as the case may be:

(a) on the expiry of the time for appeal against the assessment; or
(b) where an appeal is made, on the appeal being finally disposed of.

The above does not apply in the case of an advance assessment until it has been adopted as the assessment for the year of assessment to which it relates and does not prevent the Director-General from making, in respect of any year of assessment, a proper assessment for the year or making an additional assessment where there is an underpayment of tax.

## XXI. Payment of tax

Tax payable under an assessment is payable on the service of the notice of assessment on the person assessed and is due and payable at the place specified in that notice, whether or not that person appeals against the assessment.

Where tax payable under an assessment is increased on appeal, the additional tax payable by virtue of the increased assessment is payable on the service of the notice of increased assessment on the person assessed.

Where any tax due and payable on the service of a notice has not been paid within 30 days after the service of the notice, so much of the tax as is unpaid at the end of that period may be increased by a sum equal to 10 percent of the tax so unpaid.

## XXII. Recovery of tax

The Act grants powers similar to those contained in the Income Tax Act for the Director-General to prevent a person from leaving the country without paying all tax payable by him.

Tax due and payable may be recovered by the Government by civil proceedings as a debt due to the Government.

In any proceedings for the recovery of tax, the Court may not entertain any plea that the amount of tax sought to be recovered is excessive, incorrectly assessed or under appeal.

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2. The procedure for appeals as laid out in the Income Tax Act, 1967 is as follows:

Section 99 — A person aggrieved by an assessment made on him may appeal to the Special Commissioners of Income Tax within 30 days of the service of the notice of assessment by a written notice of appeal stating his grounds of appeal.

Section 100 — This section provides for an application for extension of time of appeal in cases where no or late appeals (after the 30 day period) are lodged.

Section 101 — This section provides for the Director-General of Inland Revenue to review the assessment appealed against with a view of coming to an agreement with the taxpayer.

Section 102 — This section provides for the Director-General of Inland Revenue to forward the appeal to the Special Commissioners where he is of the opinion that there is no reasonable prospect of reaching an agreement with the taxpayer.

The Special Commissioners of Income Tax is a special tribunal set-up under the Act and whose members are appointed by the Yang Di-Pertuan Agong. Appeals are usually heard by three Commissioners and at least one of whom must be a person with judicial or other legal experience. Appeals against the decisions of the Special Commissioners may be made, on a point of law, to the High Court and then to the Federal Court and finally to the Privy Council.

 

### XXIII. Repayment of tax

Where it is proved to the satisfaction of the Director-General that any person has paid tax for any year of assessment in excess of the amount payable under the Act, that person is entitled to have the excess refunded by the Government. However, where the excess was paid by the acquirer of an asset, the excess is not to be refunded to the acquirer unless he satisfies the Director-General that he has not recovered it from the disposer. Where the acquirer has recovered the tax from the disposer, the refund is to be made to the disposer.

However, if the acquirer is unable to satisfy the Director-General that he has not recovered the amount from the disposer, then the excess will be retained by the Government.

No claim for repayment is valid unless it is made within six years after the end of the year of assessment to which the claim relates. The right to claim a refund does not operate to extend any time limit for appeal, validate any appeal which is otherwise invalid or authorise the revision of any assessment or other matter which has become final and conclusive. The Government may not be compelled to refund the excess amount of tax paid in respect of an assessment unless the assessment has been finally determined.

### XXIV. Anti-avoidance

Where an asset which is disposed of was acquired by a person making the disposal for a consideration wholly or substantially provided by a *connected person* [3] (otherwise than a bona fide loan made in the course of carrying on the business of a moneylender), the asset is to be deemed to have been disposed of by that connected person and not by the person making the disposal. However, where the asset disposed of was acquired by the person making the disposal from the person who lent the money, that latter person is, for the purposes of computing any gain or loss, to be deemed to have acquired the asset at a price equal to the market value of the asset at the time when the asset was disposed of to the person making the disposal.

Where the Director-General has reason to believe that any transaction has the direct or indirect effect of:

(a) altering the incidence of tax payable;
(b) relieving any person from any liability which has arisen;
(c) evading or avoiding any duty or liability which is imposing; or
(d) hindering or preventing the operation of the Act in any respect;

he may, without prejudice to such validity as the transaction may have in any other respect or for any other purpose, disregard or vary the transaction and make such assessment as he considers just and proper in the circumstances.

"Transaction" in this context means any trust, grant, covenant, agreement, arrangement or other disposition or transaction made or entered into and includes a transaction entered into by two or more persons with any person or persons.

### XXV. Revision of tax

Tax paid or payable by any person may be remitted wholly or in part:

(a) on grounds of poverty by the Director-General;
(b) on grounds of undue hardship or justice and equity by the Minister.

### XXVI. Powers of Director-General

The Director-General has been given the same powers as in the Income Tax Act to call for information and to have access to buildings and documents for the purpose of ascertaining a person's liability to the tax.

### XXVII. Penalties

Any person who fails to give notice of a disposal or fails to make a return or fails to make a declaration in his income tax return as to the disposals made in a year preceding a year of assessment is guilty of an offence and on conviction may be liable to a fine not exceeding $5,000 or to imprisonment for a term not exceeding 12 months or to both. The burden of proving that a return has been made or notification given or the declaration made is upon the accused person.

Where a person fails to give notification of a disposal or fails to make a return under the Act or fails to make the declaration in the income tax return, then if the Director-General has not instituted prosecution proceedings in relation to the failure, he may:

(a) require the person to pay a penalty equal to treble the amount of tax which is payable for that year; and
(b) if that person pays that penalty, not charge that person for an offence under the Act on the same facts.

Any person who makes an incorrect return or gives any incorrect information is, unless he satisfies the Court that the incorrect return or the incorrect information was made or given in good faith, guilty of an offence and, on conviction, may be liable to a fine not exceeding $5,000 and to a penalty of double the amount of tax which has been under-charged in consequence. In lieu of instituting proceedings, the Director-General may require the person to pay a penalty equal to the amount of the tax which has been under-charged in consequence of the incorrect return or information and if the person pays the penalty he is not liable to be charged for the offence.

In the case of wilful default or fraud, on conviction, the person is liable to imprisonment for a term not exceeding three years or to a fine not exceeding $10,000 or to both and to a penalty of treble the amount of tax which has been under-charged.

The provisions relating to the penalties which may be imposed on a person leaving Malaysia without payment of tax, obstruction of officers, breach of secrecy and offences by officials and unauthorised collection and other offences, are broadly similar to those contained in the Income Tax Act.

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3. For a definition see para. 22 of XXX. Schedule II, below.

The Director-General is empowered to compound offences in the same way as he may under the Income Tax Act.

## XXVIII. Administration

The care and management of the tax is with the Director-General of Inland Revenue. His powers are delegated to various officers and the scope of the powers of the officers is set out in the same manner as in the Income Tax Act.

In a suit for tax under the Act a certificate signed by the Director-General giving the name and address of the defendant and the amount of tax due from him is to be sufficient evidence of the amount so due and sufficient authority for the Court to give judgement for that amount.

Except where Schedule I provides otherwise, returns under the Act on behalf of a person are to be made by the person responsible under the Income Tax Law for making a return of the income of that person. If a person is not resident in Malaysia then the trustee, guardian, committee, attorney, factor, agent, receiver, branch or manager of that person in Malaysia is responsible for making the return.

The Director-General is empowered to declare any person to be an agent of another person and the person so declared to be the agent may be required to pay any tax due from any money which may be held by him or due by him to the person whose agent he is declared to be.

The Director-General is to prescribe the forms which are to be used for the purposes of the Act. The Minister may make rules for facilitating the operation of the Act. Such rules may include rules providing for returns to be made in cases other than those in relation to which a return has to be made under the Act.

## XXIX. Schedule I – taxable persons

This Schedule sets out the persons who are to be charged under the Real Property Gains Tax Act. Basically the provisions are similar to those contained in the Income Tax Act but the following differences may be noted.

(1) A partnership or body of persons, and not the individuals constituting it, is assessable and chargeable with the tax in respect of any chargeable gains accruing on the disposal of any chargeable assets of the partnership or body of persons. The precedent partner or the manager, the secretary or the treasurer, as the case may be, of the body of persons is assessable and chargeable with the tax payable by the partnership or the body of persons respectively.

(2) In the case of companies the manager or other principal officer in Malaysia, the directors or the secretary of the Company, are to be jointly and severally assessable and chargeable to tax payable by the company.

Where the Act specifies that a person is to be chargeable or assessable with tax under the Act, the person so specified is to be responsible for paying the tax payable by the chargeable person or body of persons in question and for any other matter to be done by virtue of the Act.

## XXX. Schedule II – computation of taxable gains

This Schedule sets out the manner in which the chargeable gains and allowable losses are to be computed and other related matters (see also Section VIII. supra).

1. Every method, scheme or arrangement by which the ownership of an asset is transferred from one person to another including compulsory acquisition under any law constitutes an acquisition of the asset by the transferee and the disposal of the asset by the transferor.

2. In the following cases, the *disposal price is deemed to be equal* to the acquisition price:

(a) the devolution of the assets of a deceased person on his executors or legatee under a Will or intestacy or a trustee of the trust created under his Will;
(b) transfers of assets owned by an individual, his wife, by them jointly or with a connected person to a company controlled by the relevant person or persons;
(c) transactions between an individual or his wife and a nominee or trustee where beneficial interest does not pass;
(d) the conveyance or transfer of an asset by way of a security or the transfer of a subsisting interest or right by way of a security in or over an asset;
(e) gifts made to the Government, a State Government, a local authority or charitable organisation exempt under the income tax law.

3. Although the above provision states that the assets in the above circumstances are deemed to be transferred at a price equal to the acquisition price of the transferor, thus exempting the transaction from tax, it does not also provide that the date on which the transferor acquired the asset is to be deemed to be the date of acquisition by the transferee.

4. (a) Subject to paragraphs (b) and (c) below, the *acquisition price* of an asset is the amount or value of the consideration in money or money's worth given by or on behalf of the owner wholly and exclusively for the acquisition of the asset (together with the incidental cost of acquisition) less:

(i) any sum received by him by way of compensation for any kind of damage or injury to the asset or for the destruction or dissipation of the asset or for any depreciation or risk of depreciation of the asset;
(ii) any sum received by him under a policy of insurance for any kind of damage or injury to or the loss, destruction or depreciation of the asset;
(iii) any sum forfeited to him as a deposit made in connection with the intended transfer of the asset.

(b) Where any receipt of the kind specified in (i) to (iii) above exceeds the cost of acquisition, the amount of the excess is to be treated as a chargeable gain accruing to the owner at the time when he receives the sum. The acquisition price in such a case is deemed to be nil.

(c) Where an asset, which is disposed of, was acquired by the disposer prior to January 1, 1970 the market value of the asset as at that date shall be substituted for:
(i) the consideration plus incidental costs paid by the purchaser; or
(ii) the value of the asset for estate duty purposes; or
(iii) the amount of the legacy or the value of the asset for estate duty purposes, whichever is lower;

as the case may be. January 1, 1970 is thus the base date for purposes of the Act. By adopting January 1, 1970 as the base date, the effect is that when an asset acquired prior to 1970 is disposed of, the gain, if any, due to the appreciation in value up to December 31, 1969 and so also the loss, if any, due to the decline in value up to December 31, 1969 is excluded for purposes of the Act.

(d) Where on the transfer of an asset the acquisition price paid by the transferor plus the permitted expenses incurred by him are to be taken to be the acquisition price paid by the transferee and subsequent to the transfer, the transferee receives any sum of the kind mentioned in (i) to (iii) above, the amount so received is to be deducted from the deemed acquisition price. If the sum received exceeds the acquisition price then the excess is to be treated as a chargeable gain and the acquisition price in the hands of the transferee is to be treated as nil.

5. The *disposal price* of an asset is the amount or value of the consideration in money or money's worth for the disposal of the asset less:

(i) any expenditure wholly and exclusively incurred on the asset at any time after its acquisition for the purpose of enhancing or preserving the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal; or
(ii) in establishing, preserving or defending his title to or his right to the asset; and
(iii) the incidental costs to the disposer of making the disposal.

Where a person acquired land and incurred expenditure on the construction of a building thereon, the cost of construction of the building will be allowed as a deduction in arriving at the disposal price of the asset. However, if the building was destroyed before the disposal and any recoveries were received in respect of the destruction, no deduction will be allowed in respect of the cost of construction of the building because the expenditure incurred will not be reflected in the state or nature of the asset at the time of disposal of the land.

6. (a) *Incidental costs* in relation to acquisitions and disposals consist of expenditure wholly and exclusively incurred on the acquisition or disposal, as the case may be, of the following kinds:

(i) fees, commission or remuneration paid for the professional services of any surveyor, valuer, accountant, agent or adviser;
(ii) cost of transfer, including stamp duty;
(iii) the cost of advertising to find a seller and any interest paid on capital employed to acquire the asset;
(iv) the cost of advertising to find a buyer and cost incurred in making any valuation or in ascertaining the market value for the purposes of the Act.

(b) Interest which is deductible for income tax purposes is to be excluded for purposes of Real Property Gains Tax.

7. In computing the acquisition price or disposal price of an asset the following items are not to be taken into account:

(a) any outgoings and expenses allowable as deductions in computing adjusted income or adjusted loss for income tax purposes;
(b) any outgoings and expenses which would have been allowable for income tax purposes but for an exemption or insufficiency of gross income; and
(c) any outgoings and expenses which (if the asset on or in respect of which they were incurred was and had at all times been held or used as part of the fixed capital of the business, the profits of which are chargeable to income tax) are allowable as a deduction in computing the adjusted income or adjusted loss of the business for income tax purposes.

8. If an asset is a building which is rented out, normal expenses incurred such as interest on monies borrowed to acquire the asset or to construct a building thereon, quit rent, assessment, repairs, maintenance and upkeep expenditure, would be allowable as deductions for income tax purposes. Where the gross income is less than the amount of the expenditure incurred, the excess would not be allowed as deductions for income tax purposes. Nevertheless, in computing the chargeable gain arising from the disposal of the asset, no part of the expenses of the above kinds, although not fully allowed for tax purposes, could be taken into account in computing the chargeable gain.

9. Any sum received by the owner of an asset, although no asset is acquired by the person paying the capital sum, will be treated as received in respect of a disposal of an asset. This provision applies in particular to:

(i) capital sums received in return for forfeiture or surrender of rights or for refraining from exercising rights; and
(ii) capital sums received as consideration for the use or exploitation of assets.

Compensations and premiums would fall within this category.

The time of disposal in such cases is to be the time when the capital sum is received and the sum so received is to be treated as constituting a chargeable gain accruing at that time.

10. In the following cases the acquisition or disposal of an asset is to be deemed to be for a consideration equal to the market value of the asset:

(a) where a person acquires or disposes of an asset otherwise than by way of a bargain made at arm's length or by way of gift;

(b) where he acquires or disposes the asset wholly or partly:
(i) for a consideration that cannot be valued; or
(ii) in connection with his own or another's loss of office or employment or diminution of emoluments; or
(iii) in consideration for or recognition of his or another's services or past services in any office or employment or of any other service rendered or to be rendered by him or another; or

(c) where he acquires an asset as trustee for the creditors of any person in full or partial satisfaction of any debt due from that person or where he transfers an asset as trustee for the creditors of any person to the creditors in full or partial satisfaction of any debt due to the creditors; or

(d) where he acquires or disposes of an asset in connection with the transfer of a business for a lump sum consideration.

11. Where a person is deemed for the purposes of the Act to acquire an asset at its market value and he subsequently disposes of the asset, the market value is to be adopted as the acquisition price for the purposes of computing any gain accruing to or loss suffered by him on the disposal.

12. (a) The *market value of an asset* is a price which it would fetch if it was sold in a transaction between independent persons dealing at arm's length with each other at the time of the acquisition or disposal.

(b) If the parties to the disposal of an asset are unable to agree on its market value or there is only one party to the disposal of an asset, or the Director-General is of the opinion that the market value of an asset as agreed to by the parties is incorrect, the market value of the asset is to be determined by the Director-General.

(c) Where an asset is disposed of by way of gift then the disposal is deemed to have been made at the market value of the asset. However, where the donor and recipient are of full age and are husband and wife, parent and child or grandparent and grandchild, they may jointly elect to have the disposal treated as a disposal in which there is neither a gain nor a loss to the donor and the recipient is to be deemed to have acquired the asset at the acquisition price paid by the donor plus the permitted expenses incurred by the donor.

(d) Where an asset is exchanged for another asset, the market value of the asset received by the disposer is to be taken as the consideration for the disposal. But if the asset received has no market value the Director-General may take the market value of the asset disposed of as the consideration for the disposal.

13. (a) A chargeable gain or an allowable loss on the disposal of an asset is deemed to accrue to or be suffered by the disposer at the time of the disposal, whether the consideration is payable by instalments or not. The disposal of an asset is deemed to take place:

(i) where there is an agreement for the disposal of the asset, on the date of such agreement; or

(ii) where there is no agreement, on the date of completion of the disposal of the asset.

(b) Except where otherwise provided in any disposal of an asset, the date of acquisition of the asset by the acquirer is deemed to coincide with the date of the disposal of the asset by the disposer.

(c) The date of completion of a disposal means:
(i) the date on which the ownership of the asset disposed of is transferred by the disposer; or
(ii) the date on which the whole of the amount or value of the consideration in money or money's worth for the transfer has been received by the disposer, whichever is the earlier.

(d) A transfer of ownership of an asset is deemed to take place on the date when the last of all such things has been done as is necessary under any written law for the transfer of the ownership of the asset.

14. Where a contract for the disposal of an asset is conditional and the condition is satisfied, the acquisition and disposal of the asset are treated as taking place at the time when the contract is made, unless the amount of the consideration depends wholly or mainly on the value of the asset at the time when the condition is satisfied, in which case the transaction is regarded as taking place when the condition is satisfied.

SOME HIGHLIGHTS OF THE MALAYSIAN REAL PROPERTY GAINS TAX

- The tax is mainly a tax to collect revenue with curbing of land speculation as a secondary motive. An additional effect is that it improves equity since capital gains add to a person's wealth as much as other income.
- Both individuals and legal entities are subject to the tax.
- The rates vary from 40 percent if the disposal takes place within two years to 5 percent if the property is disposed of after five years.
- The taxable base is the difference between the acquisition price and the disposal price.
- There is no adjustment for inflation.
- Qualifying owner-occupied private residences are exempt.

*Transfer of assets between companies*

15. (a) Where, with the prior approval of the Director-General, an asset is transferred between companies in the same group for consideration consisting of shares or substantially of shares and the balance of a money payment for the purpose of bringing about greater efficiency in the operation of the group, the transfer is deemed to take place at the acquisition price of the transferor plus the permitted expenses incurred by the transferor. Where such an asset is taken into the trading stock of the transferee company on or after the date of coming into force of the Act and the value at which the

asset is so taken in exceeds the acquisition price paid by the transferor plus the permitted expenses incurred by the transferor, the taking in is deemed to be a disposal of the asset by the transferee company and the excess constitutes a chargeable gain accruing to the transferee company at the date when the asset or part thereof is taken into stock.

16. The circumstances above are also applicable where the transfer of assets is between companies which are involved in a scheme of reorganisation, reconstruction or amalgamation and where such scheme is carried out in compliance with Government Policy on capital participation in industry.

(b) Where there is a transfer of an asset from one company to another company in a group, whatever price may have been agreed upon between the transferor and the transferee, the companies may apply to the Director-General for approval of the transfer to be treated as having taken place at a price equal to the acquisition price of the transferor so that no such liability to Real Property Gains Tax arises. However, if the transferee treats the asset transferred as its stock in trade, then on the date when the asset is transferred to the stock in trade, the difference between the price at which the asset was in fact transferred to the transferee company and the acquisition price of the transferor will be treated as a chargeable gain of the transferee and be charged to Real Property Gains Tax.

(c) The Director-General may withdraw any approval given in relation to a transfer within 3 years after giving it, if:

(i) it appears to him that the transfer was made wholly or partly for some purpose other than for bringing about greater efficiency in the operation of the group;

(ii) the transferee company ceases to be in the same group of companies as the transferor company; or

(iii) the transferee company ceases to be resident in Malaysia;

and where the approval is withdrawn, the Director-General may make such assessments on the transferor or transferee company as he considers proper in the circumstances.

Where by reason of the acquirer's default the consideration for the disposal or part thereof of an asset has not been received by the disposer, the chargeable gain accruing in respect of the disposal is to be reduced by an amount equal to so much of the consideration as has not been received by the disposer.

17. For certain assets the acquisition price is as follows:

(a) in the case of a gift of an asset on death, the recipient is deemed to acquire the asset at acquisition price equal to the value of the asset for estate duty purposes or its value as at January 1, 1970 if the deceased died before that date;

(b) where a legatee accepts an asset in place of a money legacy, the asset is deemed to be acquired by the legatee at a price equal to the amount of the legacy or the value of the asset for estate duty purposes, whichever is the lower, or its value as at January 1, 1970 if the legacy or asset was received before that date;

(c) where an asset of a deceased person is disposed of by his executors or by the trustees of a trust created under his Will, the executors or trustees are deemed to have acquired the asset at a price equal to the value of the asset for estate duty purposes or its value as at January 1, 1970 whichever is the later;

(d) where there has been a withdrawal of the approval for the transfer of an asset from one company to another in a group and an asset acquired by the transferee is disposed of outside the group, the disposer is to be deemed to have acquired the asset at a price equal to the disposal price taken by the Director-General in making any assessment on the transferor company or its value as at January 1, 1970 whichever is the later;

(e) where an asset has been transferred by an individual, by his wife or by them jointly or with a connected person, and the asset is subsequently disposed of by the company, the company is deemed to have acquired the asset at a price equal to the acquisition price paid by the transferor plus the permitted expenses incurred by the transferor or its value as at January 1, 1970. Where the company transfers the asset into the trading stock of the company at a value which exceeds the acquisition price, as so defined, the taking in is deemed to be a disposal of the asset by the company and the excess constitutes a chargeable gain accruing to the company at the time when the asset or part thereof is taken into stock.

18. Where an asset is acquired subject to a subsisting charge or encumbrance, any payment made by the acquirer on account of the charge or encumbrance is deemed to form part of the acquisition price, and where the asset is disposed of subject to an existing charge or encumbrance, the full amount of the liability assumed by the acquirer is deemed to form part of the disposal price.

19. Where, on a person making a disposal, any description of property derived from the asset remains undisposed of, there is deemed to be a part disposal of an asset and where there is a part disposal of an asset, the acquisition price of the asset and any allowable expenses are to be apportioned between that part of the asset and the remainder thereof on whatever basis is most appropriate; so much of it as is so apportioned to the part of the asset disposed of is to be taken as the acquisition price of that part.

20. Where an asset consists of a lease and part of the asset becomes subject to a sublease for which a premium is paid, a fraction of the acquisition price of the asset which bears the same proportion to the whole price as the multiple of the duration of the sublease and the area subleased bears to the multiple of the duration and area of the lease is to be taken as the acquisition price for the part subleased.

21. In the case of a distribution of assets by an investment club, an investment trust, a unit trust or a partnership, among all its members, each member is deemed

to acquire the assets received by him at an acquisition price equal to that paid for the appropriate assets plus any permitted expenses incurred thereon by the investment club, investment trust, unit trust or partnership, as the case may be.

22. (a) An asset acquired as a result of a transaction between connected persons is treated as having been acquired otherwise than by way of a bargain made at arm's length.

(b) The following relationships give rise to persons being treated as *connected persons* for the purposes of the Act:
(i) husband and wife or a relative of the individual;
(ii) a trusteee or a settlor and any person connected with such individual;
(iii) a partner and husband and wife or relative of the partner.

(c) In the case of companies, if the same person has control of them, or a person has control of one and persons connected with him have control over another or if two or more groups of persons have control of each company and the groups either consist of the same persons or of persons connected with them, the companies are connected with each other.

(d) If a person has control over a company or if the person and persons connected with him together have control of it, they and the company are connected with each other.

(e) Where two or more persons acting together can secure or exercise control of a company or persons acting on the directions of any of them to secure or exercise control of a company, they are connected with the company.

23. Where land was acquired before the date of coming into force of the Act and the construction of building on the land was either begun on or after the date of the coming into force of the Act or begun before that date and finished on or after that date, the asset is deemed to have been acquired on or after that date at a price equal to the acquisition price of the land. The cost of construction and other expenses incurred is then to be treated as permitted expenses in computing the gain or loss on a subsequent disposal of the asset.

24. Where, under an agreement made for the disposal of an asset before the date of the coming into force of the Act, payment for the asset was to be by instalments, the date of disposal and acquisition is to be the date on which all the instalments were paid. Where all the instalments were paid after the date of the coming into force of the Act, the disposal and acquisition is to be treated as having been made after that date.

25. (a) The grant of a lease is to be treated as disposal of the asset, namely, the lease.

(b) Where the lessee transfers the lease for which he has paid a premium, a fraction of the premium paid by him and attributable to the unexpired term of the lease is to be treated as the acquisition price of the lease. Where the lease is transferred without consideration, or for a consideration which is of only a nominal value, the premium paid is to be disregarded in computing the acquisition price of the lease on the subsequent disposal of the lease by the transferee. The question whether a consideration is of only nominal value is to be determined by the Director-General whose decision is final and not subject to appeal.

26. A person who disposes of land which is or has been leased is not entitled to deduct from the disposal price any expenditure incurred by the lessee in erecting buildings on or otherwise improving the land.

27. No allowance is to be made in computing the disposal price:

(a) in the case of a transfer of a lease, for any liability remaining that was assumed by the disposer which is contingent on a default in respect of liabilities assumed by the acquirer; or
(b) for any contingent liability of the disposer in respect of any covenant for quiet enjoyment or other obligation assumed by the transferor; or
(c) for any contingent liability in respect of a warranty or representation made on the disposal of the asset.

However, if after the disposal a liability of the kind mentioned therein has become enforceable and is being or has been enforced, the Director-General is to make such adjustments as the circumstances may require.

28. (a) The grant of an option over a chargeable asset is to be treated as a disposal of a chargeable asset, namely, the option.

(b) Where a right under an option is exercised, the grant of the option and disposal is to be regarded as one transaction and the amount paid for the option is deemed to be part of the consideration for the disposal of the asset.

(c) Where a right under an option is disposed of at a loss, the loss is not to be taken as an allowable loss unless the right is subsequently exercised by the person acquiring the right or his successors.

29. Transactions by nominees or trustees for persons absolutely entitled as against the nominee or trustee are to be treated as carried out by the nominee or trustee on behalf of the person or persons for whom he is a nominee or trustee.

30. Where an asset has been given by way of security or is charged and the person entitled to the security or to the benefit of the charge or encumbrance disposes of the asset for the purposes of enforcing or giving effect to the security, charge or encumbrance, he is to be treated as if he were a nominee for the person entitled to the asset.

31. Expenditure incurred in relation to an asset which is to be reimbursed to the disposer by any other person or by any government or other authority is not to be taken into account as expenditure allowable for the purpose of the Act.

32. Any allowable loss suffered in a year of assessment is not to be allowed as a deduction against chargeable gains accruing in any previous year of assessment.

33. Any deduction allowable on the disposal of an asset may not be deducted more than once in a computation under the Schedule.

34. A loss suffered in respect of the disposal of an asset is not to be allowed if:

(a) the date of the disposal was before the date of the coming into force of the Act; or
(b) any gain accruing in respect of the disposal would have been exempt from tax under this Act; or
(c) the disposal is not included in a return made under the Act.

*Transfer of chargeable asset from an individual to a controlled company*

35. (a) Where an asset is transferred to a company by a person having control over the company or by his wife or connected person for a consideration consisting of shares in the company or for consideration consisting substantially of shares and partly of money, the acquisition price paid for the asset by the transferor plus permitted expenses incurred by him less the amount of any money payment is to be taken as the acquisition price of the shares.

(b) Where the money payment exceeds the acquisition price paid for the asset by the transferor plus the permitted expenses, the acquisition price of the shares is to be treated as nil and, if the payment was made on or after the date of the coming into force of the Act, the excess is to constitute a chargeable gain accruing to the transferor.

(c) A disposal of any of the shares acquired by the transferor is deemed to be a disposal of a chargeable asset by the transferor.

36. Where an asset is an asset of a trust or partnership then, in whatever person the ownership of the asset is vested, the acquisition or disposal of the asset is to be treated as an acquisition or disposal by the trustees or the partnership at a price at which the asset was in fact acquired or disposed of and any gain or loss in respect of the disposal is to be assessed on or attributed to the trustees or the partnership.

37. (a) Where a person who is the owner of an asset is a member of a partnership or becomes a member of the partnership on its formation or in any other way and transfers the asset to the partnership, the partnership is deemed to acquire the asset at an acquisition price equal to the price paid by the person plus the permitted expenses incurred by him before he transfers it to the partnership.

(b) Where one partnership is succeeded by another and at least one person who was a member of the old partnership is a member of the new partnership, both partnerships are to be treated as one continuing partnership.

(c) Where on the dissolution of a partnership a person who is a member of the partnership immediately before its dissolution carries on the business formerly carried on by the dissolved partnership and acquires any of the assets which were formerly assets of the dissolved partnership, he is deemed to have acquired those assets at the price at which the partnership acquired or is deemed to have acquired them.

(d) Where after the death of a member of the partnership his executor or legatee withdraws from the partnership and thereby causes any assets of the partnership to cease to be the assets or interest of the partnership, there is deemed to be a disposal of the asset of the partnership at a price equal to its acquisition price.

## XXXI. Schedule III – exemption of private residences

1. Section 8 of the Act provides that a gain accruing to an individual in respect of the disposal by him of his private residence is to be exempt from tax. However, the exemption only applies if it falls within the rules set out in this Schedule.

2. A building or part of a building is not owned by any person for the purposes of the schedule unless he is registered under the law relating to the registration of title of the land as proprietor of the land on which it stands or as a holder of the lease of that land, or if he was the purchaser of that land under an agreement of purchase and sale of that land.

3. A residence owned and occupied by an individual's wife or by an individual and his wife jointly is to be treated for the purposes of the schedule only to be owned and occupied by the individual.

4. Where an individual is exempted on the gain accruing in respect of the disposal of a residence, the wife is not to be chargeable with tax on the same gain.

5. A private residence is a building or part of a building owned by an individual and occupied by him immediately before the time of its disposal as his only place of residence in Malaysia or rented out by him for occupation as a place of residence.

6. The exemption is not to apply to an individual who owns and is occupying two or more private residences in Malaysia on the coming into force of the Act except as provided for in the Schedule.

7. A private residence owned and occupied by an individual in such circumstances that a gain accruing in respect of the disposal would qualify for an exemption is referred to as a "qualified private residence". A qualified private residence will continue to be so qualified although the individual acquires any further private residence.

8. An individual, who is occupying two or more private residences in Malaysia on the coming into force of the Act, is required to nominate one of those residences for the purposes of the exemption and any residence so nominated is to be treated as the individual's only private residence in Malaysia.

9. An individual, who owned and occupied one private residence only on the coming into force of the Act or has nominated a private residence, is not entitled to treat any other residence as his private residence for the purposes of the exemption, unless the residence owned and occupied on the coming into force of the Act or

the residence so nominated was in fact owned by his wife and in consequence of a dissolution of marriage or separation of spouses is no longer occupied by him.

10. An individual is entitled to exemption under Section 8 in respect of the disposal of one private residence only, provided that:

(a) he elects that such exemption shall apply to that private residence;
(b) on such election being made, there shall be no further exemption in respect of the disposal of any of his other private residences;
(c) the election so made shall be addressed in writing to the Director-General and shall be irrevocable.

An individual who has been granted an exemption under the repealed provisions of the Land Speculation Tax Act, 1974 is not entitled to any further exemption under this Act.

11. Where an individual, who owns and occupies two or more private residences on the coming into force of the Act, failed to nominate a private residence in accordance with the Schedule, the exemption is not to apply to a gain accruing in respect of the disposal of any of those residences. However, if after disposing of one or more, he nominates, as provided in the Schedule, one of those residences which remain in his ownership and occupation, or if only one of those residences remains in his ownership and occupation, the exemption will apply to a gain accruing in respect of the disposal of that particular residence.

12. Every nomination of a private residence is to be made in writing:

(a) where he occupies more than one residence, within three months after the coming into force of the Act;
(b) where a marriage is dissolved or the spouses separate, within three months after the dissolution or separation; and
(c) in a case to which the preceding paragraph applies, within three months after he has become entitled to do so.

13. Where a gain accrues or a loss is suffered in respect of the disposal of a building which is only partly occupied as a private residence by the disposer, only a portion of the gain is to be exempt or a part not allowable and the portion so exempt or not allowable is to be computed by reference to the area occupied as the residence of the individual as a fraction of the total area of the building.

14. Where a part of the land attaching to a private residence as its garden or grounds is disposed of without the residence, then:

(a) if the land on which the residence stands is acquired by the disposer without the residence, then the acquisition price of the part disposed of is to be apportioned by reference to the area concerned;
(b) if the land on which the residence stands is acquired with the residence and the total area of that land exceeds one acre, the acquisition price of the land without the residence is to be deemed to be one-third of the total acquisition price and the acquisition price of the part disposed of is to be apportioned by reference to the area of the land;
(c) if the land on which the residence stands is acquired by the disposer with the residence and the total area of the land is one acre or less, then a proportion of the disposal price as the area disposed of bears to the total area of the land is deemed to be chargeable gain.

### XXXII. Schedule IV – exemption

The following are exempt from tax:

(1) a gain accruing in respect of the disposal of a chargeable asset before the date of the coming into force of the Act;
(2) an amount of 5,000 ringgit or ten percent of the chargeable gain, whichever is greater, in respect of a chargeable gain accruing on the disposal of a chargeable asset;
(3) a gain accruing to the Government, a state Government or a local authority.

### EXAMPLE I

A taxpayer acquired a piece of vacant land on December 1, 1960 for $100,000. He sold the property on July 1, 1978 for $600,000. The market value of the property as at January 1, 1970 per a valuation report is $400,000. He had to pay the valuer $500 for the report, 2% commission to the broker and legal fees of $500. What is his tax liability?

*Answer:* Year of assessment 1978

| | $ | $ |
|---|---|---|
| Disposal price | | 600,000 |
| Less: | | |
| Acquisition price — market value as at 1.1.70 | 400,000 | |
| Commission (2%) | 12,000 | |
| Valuation fee | 500 | |
| Legal fees | 500 | |
| | | 413,000 |
| | | 187,000 |
| Less: | | |
| Exemption $5,000 or 10% of $187,000 whichever is the greater | | 18,700 |
| Chargeable gain | | 168,300 |
| Tax thereon at 5% | | 8,415 |

 

## EXAMPLE II

Assuming that in the same year, the taxpayer also sold another property at a loss of $15,000. This property was acquired by him on March 1, 1976 and was sold on November 30, 1978. Compute the tax payable.

*Answer:* Year of assessment 1978

| | $ |
|---|---|
| Tax payable as per above | 8,415 |
| Less: | |
| Tax relief allowed for loss (30% x $15,000) | 4,500 |
| Tax payable | 3,915 |

NB: As the property was sold in the third year of acquisition the applicable rate of tax is 30%.

## EXAMPLE III

X acquired an asset on January 1, 1972 and made a gift of it to his major son B on June 1, 1976. They both elected under paragraph 12 of Schedule 2 so that X makes neither a chargeable gain nor loss. X's acquisition price of the property was —

| | $ |
|---|---|
| Cost of property | 100,000 |
| Improvements and alterations | 50,000 |
| Architect's fee | 1,000 |
| Legal and stamp fees | 2,000 |
| Commission paid | 2,000 |
| | 155,000 |

As the property was transferred to B, B's acquisition cost is $155,000 and assuming B sold the property in August 1979 for $250,000, compute his liability.

*Answer*

| | $ | $ |
|---|---|---|
| Disposal price | | 250,000 |
| Acquisition price | 155,000 | |
| Incidental costs of disposal (say) | 5,000 | |
| | | 160,000 |
| | | 90,000 |
| Less: | | |
| Exemption — $5,000 or 10% of $90,000 whichever is the greater | | 9,000 |
| | | 81,000 |
| Tax thereon at 30% | | 24,300 |

NB: As B's date of acquisition is June 1, 1976, the disposal will be in the third year and thus the applicable rate is 30%.

## EXAMPLE IV

Company Z acquired an asset on December 10, 1973 and transferred it to Company Y on November 9, 1976 with the prior approval of the Director-General of Inland Revenue at a value of $300,000. Company Z's acquisition price in 1973 was $200,000 inclusive of all incidental expenses. Company Y commenced business as a housing developer in February 1977 and transferred the asset to development account as trading stock at a value of $300,000. Compute Company Y's tax liability.

*Answer*

| | $ |
|---|---|
| Company Z's acquisition price | 200,000 |
| Company Y's value on transfer to current asset account (trading stock) | 300,000 |
| | 100,000 |
| Less: | |
| Exemption — $5,000 or 10% of $100,000 whichever is the greater | 10,000 |
| Chargeable gain | 90,000 |
| Tax thereon at 40% | 36,000 |

NB: As Company Y took the asset into trading stock within two years after the date of transfer by Company Z, the rate of tax applicable is 40%.

# UNITED STATES:
# Five Percent Withholding Rate Denied to Antilles Holding*

**Netherlands Antilles; tax avoidance**
A domestic corporation that does not provide information when requested by the Service to establishment that its relationship with its Netherlands Antilles parent was not arranged or maintained primarily with the intention of securing the reduced tax rate on dividends provided by Article VII (1) of the U.S. – Netherlands tax convention as extended to the Netherlands Antilles has not satisfied all requirements for obtaining the 5 percent rate.

Advice has been requested whether a dividend to be paid to a Netherlands Antilles corporation under the circumstances described below will be subject to a reduced rate of withholding of United States tax pursuant to Article VII (1) of the 1948 Income Tax Convention between the United States and the Netherlands, T.D. 5778, 1950-1 C.B. 92, as extended to the Netherlands Antilles by the Protocol of June 15, 1955, T.D. 6153, 1955-2 C.B. 777 (the Convention), and as modified and supplemented by the Protocol of October 23, 1963, 1965-1 C.B. 624 (the Protocol).

P, a foreign corporation organized in 1975 under the laws of the Netherlands Antilles, owns all the stock of S, a domestic corporation.

P's sole shareholder is an individual, A, who is not a citizen or a resident of the United States, the Netherlands, or the Netherlands Antilles.

A's country of residence does not have a tax convention with the United States. P does not have a permanent establishment in the United States.

S was incorporated in state X on June 30, 1971. S is an operating company that has never had any income from interest, dividends, or passive investment. S has issued and outstanding 10x shares of voting stock, each share of which is entitled to one vote. S had gross income for taxable year 1975, 1976, and 1977 of 50x dollars, 55x dollars, and 65x dollars, respectively.

In the past when S has paid dividends to P, P in turn has paid dividends to A that were identical in amount to those paid by S to P. S plans to pay another dividend to P during 1978.

Article VII (1) of the Convention, as it applies to the Netherlands Antilles, provides that:

*The rate of United States tax on dividends derived from a United States corporation by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment shall not exceed 15 percent: Provided that such rate of tax shall not exceed 5 percent if such Netherlands corporation controls, directly or indirectly, at least 95 percent of the entire voting power in the corporation paying the dividend and not more than 25 percent of the gross income of such paying corporation is derived from interest and dividends, other than interest and dividends from its own subsidiary corporation. Such reduction of the rate to 5 percent shall not apply if the relationship of the two corporations has been arranged or is maintained primarily with the intention of securing such reduced rate.*

Section 505.302 (c) (1) of the Convention withholding regulations provides, in part, that under the proviso of Article VII (1) of the Convention, dividends derived from a domestic corporation by an Antilles corporation that controls, directly or indirectly, at the time the dividend is paid, 95 percent of more of the entire voting power in the corporation paying the dividend are subject to United States tax at a rate not in excess of 5 percent if (i) not more than 25 percent of the gross income of the paying corporation for the three year period immediately preceding the taxable year in which the dividend is paid consists of dividends and interest, (ii) the relationship between the paying corporation and the Antilles corporation has not been arranged or maintained primarily with the intention of securing the reduced rate of 5 percent, and (iii) the Antilles corporation at no time during the taxable year in which such dividends are derived has engaged in trade or business within the United States through a permanent establishment.

In the instant situation, S declined to provide information when requested by the Internal Revenue Service to establish that the relationship between S and P was not arranged or maintained primarily with the intention of securing the 5 percent rate. Specifically, S was requested to demonstrate that business exigencies dictated the organization of P in the Netherlands Antilles and that any dividends distributed from P to A were paid not merely as a result of the receipt of a distribution from S. S failed to provide information that the corporate structure of P and S is not an arrangement primarily motivated by tax avoidance purposes.

Consequently, all requirements for obtaining the 5 percent rate have not been satisfied.

Accordingly, the dividend to be paid to P by S during 1978 will not qualify for the withholding of United States tax at the rate of 5 percent. The dividends will qualify for the 15 percent rate if the dividends constitute dividends derived from a United States corporation by a resident or corporation of the Netherlands Antilles.

* Revenue Ruling 79-65, Internal Revenue Bulletin No. 8 of February 20, 1979 at 48.

# INDIA:
# Union Budget 1979
## Extracts from the 1979 Budget Speech

On February 28, 1979 the Union Finance Minister Charan Singh presented the Union Budget 1979 to Parliament for approval. Following is an extract of his Budget Speech as fas as tax proposals are concerned.

*I now come to my proposals on fresh taxation.*

*A gap of this magnitude* [1] *cannot obviously be covered without a large tax effort. However, in addition to mobilising the required resources, my tax proposals aim at three objectives which, I think, would be acceptable to everyone in this House. In a country in which the bulk of the population lives below the poverty line disparities in income have to be minimised. Such disparities lead to luxury consumption which affects the propensity to save and the will to work hard. Therefore, tax policy should seek to reduce such disparities.*

*Secondly, they aim at increasing production and avoiding waste. Poverty elimination requires primarily an increase in production. Since resources are scarce, tax policy should prevent a diversion of resources to wasteful and unproductive uses and conserve them for productive purposes. I should also discourage such consumption as is positively injurious to people's health.*

*Thirdly, they aim at eliminating unemployment and under-employment by stimulating agricultural production, by encouraging labour intensive techniques of production and by improving the competitive capacity of small scale and cottage industries in relation to large scale industry.*

### I. DIRECT TAXES

Let me take up direct taxes first.

I propose to raise only the rate of surcharge for Union purposes on income-tax in the case of all categories of non-corporate taxpayers from 15 percent to 20 percent. The effect of this proposal will be to raise the marginal rate of personal income-tax from 69 percent at present to 72 percent. This measure will yield an additional revenue of Rs. 46 crores in a year. The accretion during 1979-80 will, however, be of the order of Rs. 37 crores. This is a small sacrifice I am asking the 35 lakh [2] taxpayers, who constitute an insignificant proportion of the total population, and who receive a substantial share of the country's income, to make for their poorer fellow citizens.

#### Increase of individual and corporate income-tax and wealth tax; continuation of the compulsory deposit scheme

I am aware of the views of the State Governments against recourse to surcharge for Union purposes as the revenue accruing from surcharge is not shareable with the States. But in framing my other fiscal proposals I have taken care to see that the States get their legitimate share of the gains from the additional tax effort of the Centre.

Under the rate schedule prescribed in the Finance Act, 1978, in cases where the taxable income exceeds the exemption limit by a small margin, the tax liability is limited to 70 percent of the excess over Rs. 10,000. This provision operates rather harshly in some cases. In order to provide for a smoother progression in marginal cases, I propose to limit the tax payable in such cases to 30 percent of the excess over Rs. 10,000. This will benefit individuals having incomes up to Rs. 12,000.

In view of the imperative need for resources, I propose to continue the Compulsory Deposit Scheme for Income-tax Payers for a further period of two years. This will generate additional resources to the tune of Rs. 160 crores during the financial year 1979-80.

Inequalities of wealth have even less justification than inequalities of income. I, therefore, propose to raise the rates of wealth-tax on high slabs of net wealth. The rate will now be 3 percent as against the current rate of 2.5 percent on the net wealth between Rs. 10 lakhs and Rs. 15 lakhs and 5 percent as against 3.5 percent on net wealth over Rs. 15 lakhs. The rates of wealth-tax on slabs up to Rs. 10 lakhs will remain unchanged. There will be corresponding changes in the rates applicable to Hindu undivided families having one or more members with independent net wealth exceeding the exemption limit. These changes will yield an additional revenue of Rs. 6.6 crores in a year. Since, however, the new rates of wealth-tax will apply prospectively from the assessment year 1980-81, there will be no accretion to revenue during 1979-80.

It has to be recognised that by merely adjusting direct tax rates we cannot reduce disparities in income and wealth to tolerable levels. As the House knows, tax evasion which is the basic cause of generation of black money greatly affects the progressive impact of direct taxes. Black money is a corrosive influence which works through the entire economy. It is important that this scourge is fought through the effective implementation of our tax laws. I wish to assure the House that I shall address myself to this task with the utmost zeal and vigour.

As I am raising the surcharge on income-tax on personal incomes, I think the corporate sector should also be required to contribute a little more to the exchequer. I accordingly propose to raise the surcharge on income-tax in the case of companies from 5 percent to 7.5 percent. This will not cast a heavy burden on them, because the effective rate of taxation on corporations is lower than the nominal rates. This measure will yield an additional revenue of about Rs. 35 crores in a year. The accretion during the year 1979-80 will, however, be of the order of Rs. 28 crores.

#### Abolition of capital gains tax exemption and reduction of other advantages benefitting high-income taxpayers

The scheme of taxation of capital gains was modified in 1977 in several directions. One of the changes made was to provide for exemption from income-tax on long-term capital gains if the sale proceeds of any asset were re-invested within six months in certain preferred assets. Since asset owners secure capital gains largely through no effort on their own part, this exemption confers an unfair advantage on asset holders as compared to income earners and thus contributes to the disparity in society. I therefore, propose to withdraw this exemption

1. Rs. 10,975 crores (1 crore = 10,000,000).
2. 1 lakh = 100,000.

**FINANCE BILL – 1979**

## SUMMARY OF IMPORTANT CHANGES PROPOSED IN DIRECT TAXATION

By K.C. Khanna

### PERSONAL TAXATION

(a) It is proposed to increase the surcharge on personal income-tax from 15 percent to 20 percent thereby raising the maximum rate of personal income-tax from the existing 69 percent to 72 percent.

(b) It is proposed to modify the existing provisions relating to the deduction in respect of long-term savings through life insurance, contributions to provident funds, superannuation funds etc. as follows:

(i) the quantum of deduction in respect of long-term savings for the first Rs. 5,000 of the qualifying amount will remain unaltered at the rate of 100 percent;

(ii) the deduction for the next Rs. 5,000 will be granted at the rate of 35 percent as against the existing 50 percent; and

(iii) the deduction in respect of the balance will be granted at the rate of 20 percent instead of the existing 40 percent.

The proposed changes will apply for the assessment year 1980-81, i.e. incomes earned during the salary year 1979-80.

(c) The compulsory deposit scheme for income-tax payers is proposed to be continued for another two years at the existing rates.

(d) At present, capital gains arising from the transfer of long-term capital assets are exempt from tax if the consideration for the transfer is invested in specified financial assets within a period of six months from the transfer. It is intended to withdraw the aforesaid exemption in respect of transfers of long-term capital assets made after 28th February, 1979.

(e) It is proposed to enlarge the definition of "technician" by empowering the Central Government to notify any additional field in which a foreign technician having the requisite specialised knowledge and skill would become liable for tax exemption. The proposed amendment will take effect from 1st June 1979 and will apply to the assessment year 1980-81.

### WEALTH TAX

It is proposed to raise the rates of wealth tax in the higher slabs of net wealth. For individuals, the suggested rate will be 3 percent instead of the existing 2½ percent on the slab of net wealth from Rs. 1,000,001 to Rs. 1,500,000 and 5 percent on the slab of net wealth over Rs. 1,500,000 as against the existing 3½ percent. The proposed rates will come into force from the assessment year 1980-81.

### CORPORATE TAXATION

(a) While the basic rates of corporate taxation will remain unaltered, it is proposed to increase the surcharge on corporate income-tax from 5 percent to 7½ percent in all cases thus raising the rate of tax applicable to a widely-held domestic company to 59.12 percent. However, the suggested increase in surcharge will not affect the rates of tax applicable to foreign companies on royalties and technical know-how fees payable under agreements made on or after 1st April 1976, and on income from dividends.

(b) At present, a "tax holiday" on profits of new industrial undertakings within specified limits and conditions is allowed for a prescribed number of years commencing from the assessment year in which the undertaking begins manufacture, provided such manufacture is commenced not later than 31st March, 1981. It is suggested to withdraw the "tax holiday", with effect from 1st April, 1979, with respect to "non-priority" industries listed in the Eleventh Schedule to the Income Tax Act, 1961.

(c) It is proposed to allow a deduction in respect of donations made to an approved association or institution which has as its object the training of persons for implementing programmes of rural development.

(d) It is proposed to provide that expenditure incurred by all domestic companies on advertisements or publicity outside India in respect of goods, services or facilities dealt in or provided by the taxpayer in the course of the business, and also other specified expenditure, will qualify for a weighted deduction of $133^1/_3$ percent of the actual expenditure incurred. The suggested tax benefit will be admissible with effect from the assessment year 1980-81.

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of capital gains in respect of transfers made after 28th February, 1979. This measure will yield an additional revenue of Rs. 14 crores annually. Since, however, advance tax is not payable in respect of capital gains, there will be no accretion to revenue during the year 1979-80.

The present concessions in respect of long-term savings through life insurance premia, provident fund contributions and other approved forms of savings, though they subserve certain desirable social and economic objectives, give a disproportionately large tax benefit to taxpayers in higher income brackets. At present, 100 percent deduction is allowed in respect of first Rs. 5,000 of qualifying savings, 50 percent on the next Rs. 5,000 of such savings and 40 percent on the balance. Under my proposal, while the first Rs. 50,000 of qualifying savings will continue to be eligible for 100 percent deduction, the deduction in respect of the next Rs. 5,000 of such savings will be reduced to 35 percent and in respect of the balance to 20 percent. This measure will yield Rs. 9.6 crores annually. The accretion during the financial year 1979-80 will be Rs. 7.6 crores.

I propose to lower the threshold for payment of advance tax by the registered firms from Rs. 30,000 to Rs. 20,000. This measure will yield an additional revenue of Rs. 12 crores during 1979-80.

#### Promotion of labour intensive techniques through taxation to combat unemployment

The large scale unemployment in the country requires the promotion of labour intensive techniques instead of capital intensive techniques. While it may be true that in some industries the choice of techniques is limited, our preference should be for labour intensive methods of production wherever feasible. Our fiscal laws and tax concessions in particular should be so designed as to foster production techniques which enlarge opportunities for employment.

I, therefore, propose to appoint an Expert

Committee of economists and tax administrators to study the impact of concessions provided for in our tax laws — particularly those relating to corporation tax and Central excise — on the techniques of production used in industry and make recommendations which will encourage the adoption of labour intensive methods of production. The composition of the Committee and its terms of reference will be settled soon and it will be asked to submit its Report with the least possible delay.

One of the tax concessions which is related to the employment of capital is the "tax holiday" provision in the Income-tax Act. This concession is at present available in respect of all industrial undertakings that go into production before 1st April, 1981. I propose to withdraw this concession in the case of industrial undertakings engaged in non-priority industries listed in the Eleventh Schedule to the Income-tax Act, if they go into production after 31st March, 1979.

### Stimulation of agriculture through tax concessions granted to rural banking and various other tax measures

In recent years, commercial banks, particularly public sector banks, have been asked to reach out into the rural areas and to expand rural credit. In order to promote rural banking and to assist the scheduled commercial banks in making adequate provisions from their current income to provide for risks in rural advances, I propose to amend the Income-tax Act to grant a deduction in respect of provisions made for bad and doubtful debts by scheduled commercial banks relating to advances made by their rural branches. Such a deduction will, however, be limited to 1.5 percent of the aggregate average advances made by the rural branches. This measure will result in a revenue loss of Rs. 12 crores during 1979-80 but it will be in a good cause.

I have earlier referred to the exemption from the corporation tax which I wish to extend to the Agricultural Refinance and Development Corporation. This is in line with a similar exemption already being enjoyed by the Industrial Development Bank of India. This decision will result in a revenue loss of Rs. 5 crores annually. The loss during 1979-80 is estimated at Rs. 10 crores because advance tax paid during 1978-79 also is refundable.

At present, expenditure incurred by companies and co-operative societies on approved programmes of rural development qualifies for deduction in computing their taxable profits. For this purpose, the programme has to be approved by the "prescribed authority", which is an Inter-Ministerial Committee headed by the Secretary, Ministry of Agriculture and Irrigation. Companies and co-operatives societies have shown considerable interest in rural development programmes. To expedite the clearance of such schemes of rural development, I propose to provide that they will henceforth be approved at the State level by a Committee consisting of the Commissioner of Income-tax and a senior officer of the State Government nominated by it.

I also propose to exempt from income-tax donations made by taxpayers to approved institutions engaged in imparting training to persons to equip them for implementing rural development programmes.

At present, taxpayers engaged in business or profession alone are entitled to 100 percent deduction in respect of donations made to approved institutions engaged in carrying out programmes of rural development. I propose to extend this concession to other categories of taxpayers as well. A similar dispensation will be extended to donations for scientific research made to approved scientific research associations, universities, colleges and other institutions.

I propose to provide that insurance premia paid by federal milk co-operatives societies for insuring cattle belonging to members of affiliated primary co-operative societies shall be allowed to be deducted in computing their taxable profits.

In order to promote the cultivation of mushrooms, I propose to exempt from income-tax one-third of the income derived from the business of mushroom growing under controlled conditions, or Rs. 10,000, whichever is higher.

As Hon'ble Members are aware, the Finance (No. 2) Act, 1977, has conferred exemption from income-tax on the Khadi and Village Industries Commission. I now propose to exempt from income-tax the income of the State Khadi and Village Industries Boards set up under the State Acts.

Consumer co-operative societies have been doing commendable work in supplying goods to consumers at reasonable prices. In order to encourage the development of such societies so that they can play a proper part in the public distribution system that is sought to be developed, I propose to raise the quantum of tax-exempt profits in the case of such societies from the present level of Rs. 20,000 to Rs. 40,000.

### Export promotion measures will be liberalised

The scope of section 35B of the Income-tax Act relating to export markets development allowance was curtailed last year. I have referred earlier to the decline in exports in the current year and the need to promote them. Therefore, to enable exporters to develop export markets on a long-term basis, I propose to liberalise the scope of the export markets development allowance. A weighted deduction under section 35B of the Income-tax Act will now be available to all exporters at a uniform rate of 133.3 percent of the qualifying expenditure. For this purpose, expenditure on advertisement or publicity outside India in respect of the goods, services or facilities dealt in or provided by the taxpayer in the course of his business will be included in the qualifying expenditure. This concession will result in a revenue loss of about Rs. 5 crores annually. The loss in 1979-80 will, however, be of the order of Rs. 4 crores.

In order to encourage the writing of University level text books in Hindi and other Indian languages, I propose to allow a deduction equal to 25 percent of the income derived by the authors of such books. Authors of dictionaries and encyclopaedias in these languages will also get the benefit of a similar deduction in the computation of their taxable income. This concession will be available for the assessment year 1980-81 and four subsequent years.

While I want to step up the drive against tax evasion, I also would like to promote greater expedition in the settlement of income-tax cases. At present, the Income-tax Settlement Commission is debarred from proceeding with a case if the Commissioner of Income-tax objects to the application being proceeded with on certain grounds. The Direct Tax Laws Committee has recommended that the application for settlement should be rejected only after the Commission is satisfied that the objection has been raised by the Commissioner on proper and valid grounds. I propose to implement this recommandation subject to the safeguard that before overruling the objection raised by the Commissioner of Income-tax, the Settlement Commission should hear him.

The Direct Tax Laws Committee has also proposed certain amendments to the Income-tax Act and the Wealth-tax Act with a view to plugging some loopholes in the provisions relating to prevention of tax avoidance through intra-family transfers of income and wealth. I have accepted their recommendations and given effect to them through the Finance Bill.

### Conspicuous consumption in luxury hotels more heavily taxed

As I mentioned earlier the second objective of my proposals is to prevent the life style of the affluent sections from having an adverse impact on saving and investment through the demonstration effect. In this connection, the lavish manner in which expenditure is incurred on accommodation and entertainment in luxury hotels calls for serious notice. With a view to checking such conspicuous consumption in luxury hotels, I propose to levy a new tax on the gross receipts of hotels. Since it is my intention that States should continue to levy sales tax as hitherto on items of food and drink supplied to guests in hotels, the sale proceeds of these items will not be included in the tax base. The details of this new measure are being worked out and the necessary legislation in this regard will be introduced in Parliament soon.

Other changes being made in the Income-tax law through the Finance Bill are of minor significance and are largely in the nature of clarification and rationalisation of existing provisions.

The total addition to revenues from all these tax measures will be Rs. 101.2 crores in a full year and Rs. 58.6 crores during 1979-80. Of this, about Rs. 12 crores will accrue to the States as their share in 1979-80. Besides, additional resources of Rs. 160 crores will accrue in 1979-80 from the continuance of the Compulsory Deposit Scheme for Income-tax Payers.

## II. INDIRECT TAXES

I now turn to indirect taxes.

I would like to straightaway indicate the more significant reliefs in excise duties which I propose to provide. The Central excise duties on all chemical fertilizers will be reduced to 50 percent of the existing rates. This will mean that the basic Central excise duty on urea, which is the most important chemical fertilizer, will be reduced from 15 percent *ad valorem* to 7-½ percent *ad valorem*; that on single and triple super phosphate fertilizer will be reduced from 7.5 percent to 3.75 percent *ad valorem.* This reduction will also be correspondingly reflected in the countervailing duties leviable on imported chemical fertilizers. With this change, it should be possible to reduce the price of urea by about Rs. 100 per tonne. The prices of other kinds of fertilizers will also become lower with reference to the excise duty relief now announced. This decision would result in a sacrifice of revenue of Rs. 75.6 scrores under Central excise and Rs. 30 crores under customs.

### Relief for agriculture by reducing tax on fertilizer, diesel oil and PVC pipes

Although the number of electric pump sets is increasing rapidly with increasing rural electrification, farmers have still to use pump sets driven by diesel engines in large parts of our country. As a measure of relief to this large class I propose to reduce the excise duty on light diesel oil from the existing level of Rs. 155.72 per kilolitre to Rs. 75 per kilolitre. I am aware that only 45 percent of this oil is used in the agricultural sector. Since it is difficult to monitor end use and a significant quantity of even the balance is used for generating power and by small industry, I propose to extend the benefit of this reduction in excise duty to all users without any distinction. The loss to the exchequer on account of this concession will be Rs. 12.40 crores per annum.

I also propose to exempt power tillers imported by State Agro-Industries Corporations and the Central Government totally from customs duty as these implements can promote agricultural production in small holdings. Hon'ble Members may be aware that indigenously manufactured power tillers are already exempt from Central excise duties.

Pipes made of PVC resins can reduce seepage and wastage of water in fields and thereby increase the effectiveness of irrigation. Since I wish to make this raw material available at cheaper prices for the manufacture of PVC pipes for irrigation and at the same time prevent a misuse of the concession for other purposes, I propose, as an experimental measure, to exempt PVC resins imported for the purpose from customs duties as soon as the modalities of a scheme which will serve both the objectives have been worked out.

### Relief for medicine

I would also refer to the relief in the field of drugs and medicines. I propose to fully exempt from customs duties 22 specified bulk drugs required for the formulation of life saving drugs, and to reduce the customs duty on 17 specified bulk drug intermediates from a total of 75 percent *ad valorem* to 25 percent *ad valorem.* On the excise side, I propose to exempt patent or proprietary medicines, including life saving drugs, from the levy of the special excise duty. Taking these measures together, the revenue sacrifice is estimated to be of the order of Rs. 7.04 crores a year.

### New measures for the tobacco industry

I now turn to a proposal of far-reaching significance. This concerns unmanufactured tobacco, excise on which dates back to the year 1943. This levy brings the excise machinery into contact with a large number of growers and licensees. I propose to completely exempt unmanufactured tobacco from excise duties, including additional excise duties and thus, relieve at one stroke, nearly a million tobacco growers, curers, small dealers and warehouse licensees from excise control. I have no doubt that this bold decision to do away with a vexatious levy — a legacy of the colonial era — will be widely welcomed by farmers in the tobacco growing tracts of our country. This measure would involve loss of Central excise revenue of the order of Rs. 121.20 crores. I, however, propose to recoup Rs. 115.71 crores of this loss through suitable upward adjustments in the rates of duties on manufactured tobacco products.

I shall touch upon cigarettes later. For the present, I shall deal with the other manufactured tobacco products. In respect of branded *biris,* the present tobacco stage duty plus biri duty comes to about Rs. 3 per thousand biris; I propose to fix a consolidated rate of Rs. 3.60 per thousand branded biris. Unbranded biris produced by manufacturers of both branded and unbranded biris will pay the same duty. At present, unbranded biris are exempt from biri duty; but they are subject to tobacco stage duty which works to about ninety paise per thousand biris. I propose to levy a nominal consolidated duty of Rs. 1.60 per thousand on other unbranded biris. However, to provide relief to the really small manufacturers of unbranded biris, I propose to exempt manufacturers who produce only unbranded biris from payment of duty on their clearances of the first 60 lakhs biris in a year. I also propose to make suitable upward duty adjustments in respect of chewing tobacco, snuff and smoking mixtures. I also propose to levy a duty of 20 percent *ad valorem* on branded manufactured *hookah* tobacco.

As an interim measure, I propose to provide for suitable relief in product stage duty in the case of those products manufactured out of duty paid unmanufactured tobacco except in respect of smoking mixtures and manufactured hookah tobacco.

### The Indirect Taxation Enquiry Committee (Jha Committee)

Hon'ble Members will recall that the Indirect Taxation Enquiry Committee under Shri L.K. Jha submitted Part II of its final report in January, 1978. [3] The Committee has indicated the broad lines on which rationalisation of the excise tariff should be attempted both in the short term as well as in the long term. I have given close and careful consideration to the Committee's recommendations. A major restructuring of the excise tariff has to be ruled out in view of the need for resources and on other pragmatic considerations. Also there is reason to apprehend that a major departure from the present pattern of excise taxation may upset the balance between different sectors of production. However, as part of the follow-up action on the Committee's recommendations, I have attempted to restructure the excise duty rates on a wide range of consumer and finished products.

Let me state at the outset that as a result of this restructuring, the number of effec-

3. See also G. Thimmaiah: Tax Reform in India. An evaluation of the Report of the Indirect Taxation Enquiry Committee (1977-78) in Bulletin for International Fiscal Documentation, February 1979 at 51.

tive excise duty rates have been reduced from 28 to 16 in respect of commodities covered by the present exercise. I have also availed of this opportunity to introduce further progression in the duty structure and stepped up the duty on quite a few luxury and semi-luxury items. Excise duties are being increased on cosmetics and toilet preparations (other than perfumed hair oil) from 63 percent to 100 percent, on airconditioners from 105 percent to 110 percent, on parts of refrigerating and air-conditioning machinery from 105 percent to 125 percent, on stereo and hi-fi equipment from 36.75 percent to 40 percent, on higher priced television sets from 21 percent to 30 percent, on higher priced radios and radiograms from 36.75 percent to 40 percent. I have maintained the duty differential of 15 percent *ad valorem* in respect of those electronic products where such duty differential exists for small scale units.

I have also taken this opportunity to step up suitably the duty rates on durable consumer articles on the consideration that the outlay on these items is mostly of a non-recurring nature and the incidence of duty is spread over a period of time. In this category, I propose to increase excise duties on pressure cookers from 10.5 percent to 15 percent, on steel furniture from 21 percent to 25 percent, on domestic electrical appliances from 26.25 percent to 30 percent, and on safes and strong boxes from 21 percent to 35 percent.

I have also selected some consumer items like soap, tooth paste, tooth brush and detergents, for increase in duties taking care, at the same time, to see that the goods produced by the small units in the decentralised sector are not adversely affected by this increase. Excise duties will go up on household and laundry soap from 5.25 percent to 20 percent, on low priced toilet soap from 10.5 percent to 15 percent, on high priced toilet soap from 15.75 percent to 20 percent, on detergents from 13.13 percent to 20 percent and on tooth paste from 10.5 percent to 25 percent. I also propose to impose a 25 percent duty on tooth brushes. Let me state clearly that my objective in increasing the rates on these commodities is partly to ensure that the small-scale manufacturers, with the advantage of duty exemption, are able to increase their share of the market for these products.

Among food items, I have avoided imposing any further burden on articles of mass consumption such as processed edible oils or vanaspati. I have, in fact, reduced the duty on vanaspati by exempting it from special excise duty. However, I have considered items like prepared or preserved food, instant coffee, biscuits, processed cheese, cocoa powder, chewing gum and chocolates as fit for further increases, bearing in mind the sections of the society that consume such items. Thus, excise duties are increased on instant coffee from 21 percent to 25 percent, on prepared or preserved food, biscuits and processed cheese from 10.5 percent to 15 percent and on cocoa powder, chewing gum and chocolates from 10.5 percent to 20 percent. In aerated waters, I propose to increase the duty rate on plain soda from 15.75 percent to 20 percent. In respect of other aerated waters I propose to have two rates—one of 60 percent for those containing caffeine and the other of 30 percent for those not containing caffeine. I also propose to withdraw the present concessional rate applicable to clearances of the first 50 lakh bottles in a financial year. However, the existing exemptions in respect of aerated waters in favour of small manufacturers will continue.

## Restructuration of duties on consumer products

In restructuring the duty rates on consumer products, I have reduced the incidence on a number of items by exempting them from special excise duty. I would like to make particular mention of the duty reduction from 42 percent to 30 percent on fluorescent lighting tubes, which are widely used for street lighting and which help in reducing the consumption of electricity. I also propose to extend the scope of the present excise exemption for low priced footwear valued up to Rs. 5 per pair to footwear valued up to Rs. 10 per pair.

I have also rationalised the rates applicable to personalised modes of transport. Mopeds, which are used by comparatively less affluent people and consume less fuel, will bear a lower duty of 10 percent as against the existing rate of about 13.1 percent. Scooters, motor cycles and three-wheelers will bear 20 percent as against the existing level of 13.13 percent, while cars will pay duty at 25 percent as against the existing rate of 18.38 percent. The concessional rate applicable to cars used as taxis and auto-rickshaws will be increased from 10 percent to 15 percent. The rate on commercial vehicles will also go up marginally from 13.1 percent to 15 percent as part of the scheme of rationalisation.

In manufactured inputs, I have mainly confined myself to streamlining the existing rates having regard to their usage and their relative importance. The details of these changes are contained in the Budget papers.

Another tax reform suggested by the Indirect Taxation Enquiry Committee is to extend pro forma credit facilities in respect of the duty paid on inputs used in the manufacture of finished products. Presently, such facilities are available in a limited area. Wide extension of these facilities as recommended by the Committee would have major revenue implications apart from throwing additional administrative burden in working these procedures. However, industry has been urging that this measure be given a trial. I propose to extend, as an experimental measure, the provision of pro forma credit to some of the products of the engineering industry, where the incidence of duty on inputs is perceptible. While doing so, I have also proposed upward rate adjustments in respect of some of the final products. The details of these changes are available in the Budget papers.

The net revenue effect of the proposals for restructuring the Central excise tariff, along with a few minor changes in some of the items affected, is a gain of about Rs. 100 crores in a full year.

## Increase of indirect tax to raise resources

I now turn to substantive proposals to raise resources.

On the excise side, the most important proposals relate to a few major products of the petroleum group. Hon'ble Members are aware that the OPEC countries have announced a phased programme of increase in the price of crude oil. We are still, to a significant extent, dependent on imports of crude oil and the anticipated increase in the out-flow of foreign exchange consequent on the increases in crude prices is substantial. After the initial drop in consumption of petroleum products in the wake of the steep increase in crude prices in the year 1973, consumption has registered a sizable upward trend. From the point of view of evolving a viable energy policy which minimises the strain on our foreign exchange resources, I have no doubt that it is essential to restrain the consumption of the more important petroleum products. My revenue proposals have been formulated keeping this important objective in mind.

I propose to raise the Central excise duty on motor spirit from the existing level of Rs. 2,253.88 to Rs. 2,750 per kilolitre. Since the bulk of the consumption of petrol is by the upper classes in society I have no regrets in doing this. I also propose to raise the duty on high speed diesel oil from the existing level of Rs. 404.04 to Rs. 500 per kilolitre because of the rapid growth in its consumption.

As Hon'ble Members are aware, kerosene was being used, in that past, to adulterate high speed diesel oil when there was a price differential in favour of kerosene. It has been our endeavour in the last few years to check this tendency by maintaining, as far as possible, parity between the rates of duty on these two products. Besides, we have had, in the recent past, to rely heavily on imports of kerosene. Bearing these considerations in mind, I propose to increase the duty on kerosene from the existing level of Rs. 408.19 to Rs. 500 per kilolitre. I also propose to effect a sympathetic increase in the rate of duty on liquefied petroleum gas, which is primarily used as cooking fuel in urban and semi-urban areas, from the existing level of Rs. 262.50 per metric tonne to Rs. 400 per metric tonne.

My proposals relating to the petroleum products are expected to yield an additional revenue of Rs. 223.25 crores under Central excise and Rs. 55.7 crores under customs.

Next, I propose to increase the rate of duty on the residuary heading Item 68 of the Central Excise Tariff from the existing level of 5 percent to 8 percent *ad valorem*. This will yield an additional revenue of Rs. 100 crores. As Hon'ble Members are aware, there is already a provision for giving set off of the duty paid on goods falling under Item 68 which are used in the manufacture of other excisable goods. The increased levy should, therefore, not have any appreciable cascading effect.

As the House is aware, small scale manufacturers producing goods falling under Item 68, whose clearances of all excisable goods during the preceding year had not exceeded Rs. 30 lakhs, presently enjoy exemption from duty payable on their first clearances up to a value of Rs. 30 lakhs. There have been persistent representations that in computing the eligibility of a small scale unit for this concession, the value of goods falling under Items other than Item 68 should be excluded. There have also been demands that the clearances for exports should be excluded so that the units in the small scale sector are encouraged to step up their export efforts. I accept the validity of these demands. Keeping these as well as the proposed increase in duty under Item 68 in view, I propose to rationalise the existing scheme of exemption. Under the revised scheme which would be effective from 1st April, 1979, small scale manufacturers whose clearances for home consumption of goods falling under Item 68 in the preceding financial year did not exceed Rs. 30 lakhs would enjoy complete exemption from the duty payable under Item 68, on their first clearances of a value up to Rs. 15 lakhs; they would pay duty at 4 percent, which is half of the rate of duty proposed for this item, on clearances between Rs. 15 lakhs and Rs. 30 lakhs.

As the Hon'ble Members are aware, the scheme of excise duty concession to encourge higher production in selected industries, which was announced in the year 1976, is due to expire on 31-3-1979. I do not propose to continue the scheme beyond this date. This withdrawal is expected to yield an additional revenue of Rs. 40 crores.

I have also taken this opportunity to review a number of existing notifications and I propose to modify or withdraw some of them. The details of this will be found in the Budget papers.

In may search for additional resources I have, of necessity, to fall back upon the old faithful, cigarettes. I have already referred to the withdrawal of the duty on tobacco at the unmanufactured stage which is borne by cigarettes. I now propose to adjust the rate structure on cigarettes in such a way as to further secure an additional sum of Rs. 60 crores from this item. Taking into account the revenue expected to accrue from this measure and the recasting of the rate structure applicable to the manufactured tobacco products, which I have referred to earlier, the States' share in respect of additional excise duty in lieu of sales tax will go up by Rs. 18.31 crores a year.

As Hon'ble Member are aware, the excise duty mechanism has been used consciously to encourage the production of matches in the non-merchandised sector. I propose to carry this process farther by stepping up the duty on matches produced by the mechanised sector from the existing level of Rs. 4.83 per gross boxes of 50 matches to Rs. 9.20. I also propose to round off the existing level of duty applicable to the non-mechanised sector, other than cottage units, from the existing level of Rs. 4.52 to Rs. 4.50. As regards cottage sector units, I propose to reduce the duty applicable to them from Rs. 3.36 to Rs. 1.60. I am sure this package of measures will result in a further accelerated growth of the non-mechanised sector in general and cottage units in particular. The additional revenue yield from this measure is expected to be of the order of Rs. 8 crores during a year.

Machine-made carpets produced in a few organised units constitute an item of elite consumption. I can see no justification for encouraging this line of production when we have a large number of traditional carpet weavers whose skills have won international renown. I would not like the livelihood of these weavers to be threatened by the proliferation of machine-made carpets. I, therefore, propose to impose a duty of 30 percent on such machine-made carpets. Handmade carpets will be totally exempt from this levy. The estimated additional yield from this proposal is Rs. 1.9 crores.

Consistent with the above approach, with a view to encouraging labour oriented non-power processing sector of the cotton textile industry, I propose to withdraw the concessional rate of 8 percent *ad valorem* on power-processed white powerloom cotton fabrics of finer varieties so that such fabrics also pay the same rate of 12 percent *ad valorem* as is applicable to other power-processed fabrics.

This Government is committed to the encouragement of the handloom sector. The competitive capacity of handloom fabrics in relation to fabrics produced by powerlooms and composite mills has to be improved further. I, therefore, propose to increase the excise duty on cotton and cellulosic spun yarn of finer counts used by composite textile mills and powerlooms by about 10 percent of the existing rates. Details of these changes are available in the Budget papers. Additional revenue expected from these measures is about Rs. 10 crores.

The special duties of excise imposed as a part of the 1978 Budget are due to expire on 31-3-1979. I propose to continue these levies for another year at the existing rate of 1/20th of the effective basic excise duties. However, it is proposed to exempt from this levy items in respect of which rates have been restructured as well as the new levies; the existing exemption in respect of electricity, coal and Item 68 will also be continued.

## Customs duties: withdrawal of exemption from countervailing duties

I shall now deal with the proposals concerning customs duties. The most important of them relates to withdrawal of the existing exemption from countervailing duties of customs applicable to imported goods, which attract classification under Item 68 of the Central Excise Tariff. When this residuary entry was introduced in that Tariff in 1975, imported goods were exempt from the corresponding countervailing duty of customs. This exemption which was initially granted when the excise duty on indigenous goods was 1 percent *ad valorem* has continued, even though the rate has sucessively been stepped up to 5 percent. As I have already stated, I have proposed a further increase in the Central excise duty under Item 68, from 5 percent to 8 percent *ad valorem*. In this context and as a measure of protection to the indigenous goods classifiable under Item 68, I propose to withdraw the existing exemption in respect of imported goods. In withdrawing this exemption, however, I have not proposed any change in the duty in regard to project imports and also the items of machinery on which the customs duty was, in the recent past, reduced to 25 percent *ad valorem* on the consideration that such machinery is not indigenously produced. This measure will yield an additional revenue of Rs. 96 crores by way of countervailing duty.

In the context of the sizable gap between supply and demand of edible oils, substantial imports of these oils have taken place in the past and are continuing. As a means of assuring remunerative prices to indigenous producers of oil seeds, I propose to levy basic customs duty on palm oil, rapeseed oil, soyabean oil, sunflower oil and palmolein oil at 12½ percent *ad valorem*. They will, however, be exempt from auxiliary and countervailing duties. This measure is expected to yield an additional revenue of Rs. 33.5 crores.

It is proposed to continue the auxiliary duties of customs for the next financial year at the existing levels.

Taking Union excise duties and customs duties together, my proposals will lead to a net revenue gain of Rs. 606.14 crores in a full year, of which Rs. 413.15 crores will accrue to the Centre and Rs. 192.99 crores to the States.

Where changes are proposed to be made by notifications, effective from the 1st March, 1979, copies of such notifications will be laid on the Table of the House in due course.

Members are aware that in respect of every international journey paid for in Indian currency, Foreign Travel Tax is being collected from passengers. In order to simplify the administration of the tax, and to guard against the possibility of evasion,

I propose to revise the scheme and replace the ad valorem levy with a specific one. The new arrangements will be brought into force as soon as possible after legislation in this behalf is enacted. This measure will not have any significant revenue effect.

I have now a few words to say on behalf of my colleague, the Minister of Communications. As Hon'ble Members are aware, the unit costs of a number of our postal services exceed the revenues they fetch. Moreover, the modernisation of telecommunication services involves large capital investment. These factors necessitate an increase in postal and telecommunication tariffs. A memorandum showing the proposed tariffs is being circulated along with the Budget papers. The letter card (inland letter) and the letter will cost five paise more. The rate for the post card has been left untouched. As regards telecommunication tariffs, the ordinary telegram of 8 words will cost Rs. 2.25 as against Rs. 2 at present and each additional word will cost 30 paise as against 25 paise at present. The rate for press telegrams will, however, remain unchanged. Local call charges, beyond 1,750 calls per quarter, will be 40 paise par call, as against 30 paise at present. I will not go into other details which are given in the memorandum. The tariff revisions, which will be given effect to from a date to be notified by the Government after the Finance Bill is passed, are estimated to result in additional revenue of Rs. 57.96 crores per annum. The yield during 1979-80 is placed at Rs. 48.30 crores and has been accounted for in estimating the internal resources of the Posts and Telegraphs.

Our tax effort will bring in about Rs. 665 crores, of which Rs. 205 crores will accrue to the States leaving Rs. 460 crores with the Centre. Taking also into account Rs. 160 crores of accretions of compulsory deposits by income-tax payers, there will be a residual deficit of Rs. 1,355 crores, which I propose to leave uncovered. I have assessed carefully the inflationary potential of a deficit of this size. The large food output of the current year, the large stocks of food and other commodities that we have, the large volume of foreign exchange reserves and a continuation of the current supply management and restrictionist monetary policies give me confidence that we shall be able to maintain reasonable price stability in the coming year.

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*With this I have come to the end of my labours. I have attempted in this budget to put the maximum emphasis on agricultural and rural development and labour intensive industry, because it is now accepted by all that only that way can we eradicate poverty and unemployment in the country. I have, however, not neglected large industry and infrastructure in the process. On the contrary, I have positively encouraged them. But I have no sympathy with those industries which cater to the wants of the rich. We can have no room for production which caters to the rich and is thus a visible manifestation of the disparities which exist in society.*

*The elimination of the kind of poverty which exists in our country cannot be achieved overnight. It is a long process which involves large investment through the mobilisation of surplus resources wherever they exist in society, better organisation and the development and transfer of appropriate know-how to millions of small persons engaged in agriculture and allied occupations and village industries throughout the country. The ultimate objective is not merely to raise the standard of living of the poor but to build a society of men and women with skills, resources, imagination, and above all, hope. I like to think that this budget is a small step in that direction. But its success really depends upon a national consensus about the desirability of the objective and the need to work hard for it and a willingness on the part of the powerful and affluent sections of society to make the necessary sacrifices. I seek the help of this House in achieving such a consensus and securing the required sacrifices.*

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# SRI LANKA: BUDGET 1979

*Reproduced below is an extract from the Budget Speech for 1979 presented on November 15, 1978 by Mr. Ronnie de Mel, the Minister of Finance and Planning of The Democratic Socialist Republic of Sri Lanka. The extract only covers the proposed tax changes.*

### NEW INLAND REVENUE LAW

Mr. Speaker, the present tax system in this country is complicated, complex and confusing and increasingly difficult to administer. It has become necessary, therefore, to rationalise and simplify the entire system. A simple and consistent tax structure is essential not only for effective administration but also to eliminate the fairly widespread avoidance and evasion of tax.

The Inland Revenue Act which is now in force was enacted in 1963. Several amendments have been made to this Act from time to time. The piecemeal and ad hoc amendments made in recent years have cluttered up practically every section of the Act. A number of these amendments apply to specific years of assessment and are no longer in force. Our tax laws have become a veritable jungle. I propose, Mr. Speaker, to introduce in this House, immediately after the Budget Debate, a completely new Inland Revenue Act which will come into effect from the year 1979-80. This new Act will co-ordinate our tax legislation and rationalise the entire tax structure of the country. Order will replace chaos.

The new Inland Revenue Act contemplated by our Government will form the basis of a stable long-term scheme. A stable tax system will enable a person to plan his investment activities effectively over the next few years. Rapid changes in tax legislation are not conducive to economic growth and development and dampen confidence among potential investors. We hope to avoid such changes in future.

Mr. Speaker, a simple Income Tax Return is a sine qua non of a simplified tax system. It is a gross under-statement to describe our present tax return form as one of the longest and most complicated in the world — a veritable mountain producing a mouse! I hope to put an end to this scandalous waste of paper and the time of the taxpayer as well as of the tax administrator. The Tax Return, in future, will be a simple form which any tax-payer will be able to fill up on his own if he chooses to do so.

Income Tax is paid, at present, on employment income on the current year basis and on other incomes on the preceding year basis. Tax on employment income is thus paid while it is earned while tax on other income is paid after a lapse of time. Non-employment income in a certain year may be high, but the tax on that income will have to be paid in a later year when income may become low. As a result the taxpayer may find it difficult to pay his taxes. This delay in the payment of tax from sources other than employment means that the effect of Government's fiscal policy will be felt by the taxpayer only in a later year. Also the Government will not receive the immediate benefit of the tax on increased income.

With a view to removing this anomaly, I propose, Mr. Speaker, to implement a scheme which seeks to assess all income on a current year basis with effect from the Year of Assessment 1979/80. This will simplify the entire system. In order to effect the switchover, Income Tax will be payable on two bases for the year of assessment 1979/80. Income Tax will be payable under the Self Assessment Scheme on all income of the current year i.e. on income from 1st April, 1979 to 31st March, 1980. The income of the preceding year i.e. income from 1st April, 1978 to 31st March, 1979 from sources other than employment will be assessed to tax by the Assessors of the Department of Inland Revenue and notices will be issued to taxpayers calling for payment of this tax in 20 equal instalments over a five-year period. This will prevent any undue hardship caused by the change in the system.

Mr. Speaker, I regret I cannot exempt from income tax non-employment income earned during the transition period. Our financial requirements for development and employment are of such a magnitude that the Government just cannot afford to forgo any tax on income which has been received. Other countries which have switched over to the current year basis of assessment have adopted this same procedure.

### TAXATION OF INDIVIDUALS

A feature of the present system of taxation of individuals is the advantage that is granted to employees as compared with other classes of taxpayers. An employee is exempt from income tax on an income up to Rs. 9,000. Where the two spouses are both employed each spouse could claim an allowance of up to Rs. 9,000 from employment income so that in these cases the exemption limit could increase to Rs. 18,000. In the case of non-employees, however, the exemption limit for an individual is only Rs. 6,000. The maximum exemption limit in the case of a family consisting of husband, wife (both non-employees) and three children would be only Rs. 8,000.

In addition, where husband and wife are both employed their incomes are taxed separately up to an aggregated income of Rs. 30,000, i.e. each spouse is treated as a separate individual. This facility is not available to self-employed persons and other taxpayers. Further an employee who does not claim the allowance of Rs. 9,000 is granted over and above the allowances granted to other taxpayers, an earned income relief of an amount up to Rs. 3,000.

The Government, Mr. Speaker, places great emphasis on increasing economic activity through self-employment and entrepreneurship. Income from self-employment is equally the product of effort as in the case of employment and is quite often the product of greater effort and higher risk. We wish to encourage every individual to contribute his utmost to development and economic growth and encourage wives also to share in this effort. Hitherto, any income a wife earned from her own effort such as catering, dress-making and other worthwhile occupations has, in many cases, not been included in the returns of income for tax purposes because it would be aggregated with the husband's income and taxed at the higher rates. With the growth of employment of women, the time has surely come to treat men and woman on an equal footing so far as taxation is concerned.

I also propose, Mr. Speaker, to extend the present scheme of Limited Non-Aggregation of Employment Income of Husband and Wife to all categories of income. Henceforth the income of the two spouses will not be aggregated whatever the source of their income may be. The income of children under 18 will be added to that of their father during the subsistence of the marriage. Where the marriage ceases to subsist the income of the child will be added to that of the parent who in fact maintains the child. The new scheme of taxing each spouse on his or her income will pave the way for wives to engage in useful occupations, pay a reasonable tax on the income earned and make a positive contribution to the national effort towards generating economic growth. Liberation of women, should surely be followed by the liberation of the tax system for women!

In place of the present system of allowances, I propose, Mr. Speaker, to grant a flat allowance of Rs. 12,000 to each taxpayer who is a resident individual. This means, in fact, that nobody with an income of less than Rs. 12,000 per year or Rs. 1,000 a month pays income tax in future. This will be a great boon to the lower middle class which has been called upon to bear a heavy burden in recent times. Since the husband and wife are assessed as separate individuals, each of them will be entitled to this allowance in determining liability to tax. The allowance of Rs. 12,000 will be a fixed amount and will not vary with the number of children. I trust this will be an appropriate disincentive to large families. It is my intention to introduce further tax disincentives to large families in due course. Population growth must be curbed if we are to achieve our objectives of eliminating unemployment, shortages of food and housing and the depletion of our natural resources. Tax policy will be geared to this end.

Mr. Speaker, I also propose to grant adequate concessions to persons who contribute to the overall effort of domestic savings and investment. Our foremost need is more and more savings and more and more investment. In providing these reliefs and the reliefs mentioned earlier, I have borne in mind the need for simplicity in the tax system. At present a large number of total or partial deductions are granted as deductions from assessable income in order to encourage certain selected transactions. Among these deductions are contributions made by employees to approved provident funds, premia paid on life insurance and annuity policies, approved investments, approved donations and donations to the Government or Local Government institutions. They also include expenditure incurred by any person with my approval on Government development projects. There exist not only a multiplicity of reliefs and deductions, but also considerable confusion arising from the different limits for different types of reliefs based on upper ceilings, proportions of assessable income and proportions of the payment or investment which qualifies for relief. The present scheme of reliefs also compartmentalizes the different categories of payments or investments and restricts the taxpayer's right to obtain maximum relief by combining the different payments and investments according to his own free choice.

I propose, Mr. Speaker, that in respect of all the payments and investments referred to above and premia for medical insurance, the full payment will qualify for relief subject only to the overall limitation that the total of the deductions from a person's assessable income must not exceed 1/3 of his or her assessable income.

These deductions will also include investment relief for housing. The present scheme of granting investment relief for housing will be simplified. An individual who constructs a house with a loan taken from the Commissioner for National Housing, a Bank, or other approved institution, will in future be able to deduct from his or her income the capital repaid subject to a maximum limit of 1/3 of his income for all reliefs. An individual who constructs a house using his own financial resources could also deduct from his income the amounts spent subject to the same maximim limits. He could carry forward and deduct the balance of the construction cost over the next four years. This will eliminate the present anomalous situation where persons who have their own resources resort to obtaining loans in order to obtain greater tax relief.

The same relief granted for the construction of a house will also apply to the purchase of one house or one site for the construction of a house.

Mr. Speaker, it is my fervent hope that these tax reliefs will lead to a new boom in house construction by the private sector complementary to the large-scale One Hundred Thousand Houses Programme of the Hon'ble Prime Minister.

The limit of 1/3 of the assessable income for all deductions will not, however, apply to donations to Government and Local Government institutions and expenditure on approved Government projects. Donations to Government will also include works of art, antiques etc. In the case of these donations and expenditure, the full amount will be deductable without any upper limit. Any amount which cannot be deducted in any one year of assessment could be carried forward and deducted in subsequent years. The greatest concessions will be given to those who help the Government's development programme.

At present, Mr. Speaker, investment relief once granted is withdrawn if the investment is realized within five years. This provision hinders the free transfer of shares and housing stock. In future, investment relief granted on the purchase of shares in approved investments will not be withdrawn if the proceeds are re-invested in shares in other approved investments. Investment relief will, however, not be granted on the sum re-invested. A person can claim investment relief for housing so long as he continues to own the house. Relief already granted will not be withdrawn if the house is sold.

I must emphasize, Mr. Speaker, that a company which is approved for certain objects and obtains the benefit of investment relief must utilize its funds for these very same objects. Investment relief granted will be withdrawn if there are any abuses in this regard.

Once the above co-ordinated scheme of reliefs is implemented, contributions to approved or regulated scheme of superannuation as well as the deduction allowed to professionally qualified employees for subscriptions to professional associations, purchase of books, etc. will also be included in the payments which qualify for relief. The upper limit of 1/3 of the assessable income will apply to these reliefs too.

In addition to these reliefs, I propose, Mr. Speaker, to grant a direct incentive for savings deposited in the National Savings Bank. At present, up to Rs. 1,000 of the interest paid by the National Savings Bank to an individual is exempted from income tax. In the case of a family unit, this exemption is granted up to six individuals in the family. I propose, Mr. Speaker, to exempt from income tax 1/3 of the interest received by an individual from savings deposited in the National Savings Bank, or up to Rs. 2,000 per individual whichever is higher. I hope that this will be an added incentive to mobilization of savings in this country.

### PUBLIC SERVICE EMOLUMENTS

The Public Service, has been going through a difficult period. The apathy and lethargy in certain sections of the Public Service has been the direct result of a lack of proper motivation and incentives to give of one's best due to poor salary and working conditions. As a consequence there has been a drain of talent both to foreign countries and to the private sector at home. There is no reason as to why Sri Lankans who work so hard abroad should not give of their best at home provided conditions are made favourable for them. Our Government has decided to lay the foundation for this within the limit of the resources at our disposal. We have decided to take two steps in this regard. The first is to increase salaries and wages. We have already done so in my Budget of last year and I have already announced a further increase in this Budget. A Salary Review Committee under Mr. V. Tennekoon, retired Chief Justice has also been appointed to look into the salary structure in the Public Service. The second is to free public servants from all income tax on their official Public Service emoluments with effect from the year of assessment 1979/80. This will be a far-reaching and revolutionary change in the Public Service and should lead to a contented Public Sector giving of its best to the country. We hope that public servants will now be in the vanguard rather than in the rear in the march towards economic development and growth. These concessions will also apply to Judges, employees of Public Corporations, Statutory Boards, Universities, the Local Government Service and pensioners of any of these employments.

### TAX HOLIDAYS

In last year's Budget, this Government provided several tax holidays with a view to encouraging development and increasing employment. I propose, Mr. Speaker, to streamline and enlarge the scope of these tax holidays bearing in mind certain difficulties which have been experienced over the years in the operation of the Tax Holiday Scheme.

In the Inland Revenue (Amendment) Law No. 30 of 1978, a tax holiday was provided to small and medium scale industries located outside municipal limits. The capital of the industry which would qualify for this tax holiday was limited to Rs. 500,000. Representations have been made that a much higher level of capital is required today for even small and medium-sized industries. I propose, therefore, to increase this limit to Rs. 1 million. Correspondingly, the limit of profit exempt from tax during the tax holiday period will be increased from the earlier Rs. 100,000 to Rs. 200,000 per year. Also, as I shall indicate later, the entirety of the dividends declared by these companies during the tax holiday period will be exempt from income tax.

Export-oriented companies were granted tax holidays in earlier years under section 7A of the Inland Revenue Act. This section provided for an eight-year tax holiday on export profits from the date of incorporation of the company. Although this relief was in the statute book the previous Government had, as a matter of policy, stopped granting tax holidays under this section after June, 1975. Major export industries located in the Investment Promotion Zone are granted tax holidays by negotiation with the Greater Colombo Economic Commission. In order to encourage export activity outside the Investment Promotion Zone, I propose to consider for approval under section 7A of the Inland Revenue Act companies which manufacture non-traditional products for export. The grant of the tax holiday will be considered in the case of new companies incorporated on or after 15th November, 1978. The tax holiday will also be limited to a maximum of five years.

### CAPITAL ALLOWANCES

Mr. Speaker, in the Budget for 1978, I introduced a new scheme of capital allowances for plant, machinery, fixtures and buildings. An allowance equal to the full cost of plant, machinery and fixtures purchased and used in a trade, business, profession or vocation was granted as a deduction in computing income. The full cost was also allowed in the case of buildings constructed for use as dwelling houses for non-executive employees. In the case of certain other buildings constructed by industrial and agricultural undertakings and approved projects, an allowance of 50 percent of the cost was granted. Warehouses too qualify for this allowance as long as they are used in the business of the owner.

I am of opinion that the granting of these capital allowances places capital intensive businesses at a distinct advantage over labour intensive businesses which are the paramount need of our country. However, in view of the fact that businesses had been starved of capital equipment during the years before 1977 and in view of the overall need for replacement and expansion of machinery, equipment etc. these allowances had to be granted to enable businesses to start off without undue liquidity problems. Mr. Speaker, I feel the time is opportune to shift the emphasis from mere increase in prodution to increase in production combined with a substantial increase in employment. I propose, therefore, with effect from 1st April, 1980, to introduce a new scheme of capital allowances. A fixed percentage of the cost of construction of buildings and of the cost of acquisition of plant, machinery and fixtures, depending on the life of such assets will be written off annually over a period of years under this scheme. This scheme will be in conformity with the present accounting and commercial practice in other countries. At the same time it will remove the bias of the present system towards capital intensive as against labour intensive businesses. It will also eliminate certain abuses in the present scheme.

Mr. Speaker, the present scheme of granting a 100 percent allowance for plant, machinery and fixtures and a 50 percent allowance for certain buildings, will, however, continue to operate until 31st March, 1980. Businesses, therefore, could modernise and expand their production units till 31st March, 1980, without losing any of the benefits of the scheme announced last year. I anticipate that my proposal announced well in time will result in immediate investment to replace, modernise and expand where necessary.

The defect in the present scheme of capital allowances is that commercial buildings do not qualify for the grant of capital allowances unless they are constructed by industrial or agricultural undertakings or approved projects for their own use. Today, there is an urgent and pressing need for commercial buildings especially in the context of the rapid growth of the economy. I propose, therefore, Mr. Speaker, to extend the grant of capital allowances for commercial buildings constructed by any company for its own use or for letting. Since this allowance will be available only for one year, we propose to grant this concession to any company that has taken meaningful and positive steps to construct commercial buildings prior to 31st March, 1980.

### DEDUCTION OF EXPENSES ON COMPANY FORMATION AND RESEARCH

I have stated, Mr. Speaker, that it is the policy of this Government to encourage economic development through company-formation. As an added incentive to the incorporation of companies, I propose to permit the deduction of company-formation expenses in calculating the profits of a company.

Approved export-oriented businesses have hitherto been allowed to deduct expenditure incurred by them in research in Sri Lanka. I propose, Mr. Speaker, to grant a deduction to all businesses for research expenditure incurred by them. I hope this will provide an impetus to research and development in the commercial, industrial and other sectors which is a crying need in our country today.

We hope to introduce a new Company Law and to establish a proper Stock Exchange in due course. This will be the foundation for a reformed and revitalised private sector.

### HOUSING

In addition to the relief for investment in housing which I mentioned earlier, several other tax reliefs are at present available for housing. These include exemption of the net annual value of one house used as a residence, exemption of income from new houses for specified periods and exemption of the whole or a part of the capital gains or trade profits on transfer of houses. These reliefs, though liberal, are hemmed in by a number of exemptions and qualifications making confusion worse confounded. I, therefore propose, Mr. Speaker, to standardise and simplify these reliefs.

The profits from the construction and sale of houses already receive full exemption from income tax where the floor area of the house is 500 square feet or less, 75 percent exemption up to 1,250 square feet and 50 percent exemption up to 2,000 square feet. The restriction by reference to floor area encourages the construction of smaller houses for sale which is desirable. There will be no other restriction on this exemption.

The present exemption of the capital gains on the first sale of a house constructed by an individual, which is subject to restrictions relating to floor area and extent of land, will, however, be replaced by a total exemption of the capital gains arising from the first sale of a newly constructed house. Where any individual has for the first time sold a house on or after 1st April, 1978, he will be exempt from capital gains irrespective of whether the house sold was constructed, purchased or inherited by him.

The grant of these reliefs as well as investment relief for the purchase of houses will, I hope, eliminate the serious undervaluation of house property in deeds of transfer as the purchaser will now obtain substantial relief on the purchase price paid for a house. It will, therefore, be in his interest to ensure that the full purchase consideration is stated on the deed of transfer.

### SALE OF PADDY TO THE PADDY MARKETING BOARD

Income tax concessions were offered to encourage individuals to sell paddy to the Paddy Marketing Board. These concessions were offered at a time when it was necessary to encourage people to sell paddy to this organisation. With the revision of the rice rationing scheme and with the bumper harvests that we have been enjoying, these concessions are no longer necessary. I propose to withdraw the exemption from income tax on the profits on sale of paddy to the Paddy Marketing Board.

### CAPITAL GAINS

The present concessions on Capital Gains Tax allowed for immovable properties will also be extended to movable properties including shares in public and private companies. This takes into account inflation which has taken place since the 1950's when the Capital Gains Tax was introduced.

### INCOME TAX RATE SCHEDULE FOR INDIVIDUALS

Mr. Speaker, in the last Budget the maximum marginal rate at which income tax was payable by a resident individual was increased from 50 percent to 70 percent. I propose to continue the operation of this marginal rate. The marginal rate of 70 percent will not bear too heavily on individuals in view of the scheme of reliefs I proposed earlier. Far reaching incentives have also been granted to those individuals who contribute to the growth of the economy.

In the present rate schedule for income tax, the first two slabs are increased by Rs. 600 for the wife, Rs. 600 for one or two children or dependents, and a further Rs. 600 for three or more children or dependents. The present method of granting relief provides the least amount of relief at the lower income ranges where relief is most required. I propose, Mr. Speaker, to introduce a rate schedule of income tax that is not dependent on family circumstances. Relief to the lower income groups is provided by the increase in the tax free allowance to Rs. 12,000 which means that nobody pays any tax up to an income of Rs. 1,000 per month from all sources.

The same income tax rate schedule will apply to non-resident individuals. However, non-resident individuals will not be entitled to the tax free allowance of Rs. 12,000 which is provided for resident individuals.

The new system will considerably simplify the rate schedules and grant relief where relief is due. In these matters of taxation, it is good for us to reflect sometimes on the advice of our revered teacher, the Lord Buddha who stated 2,500 years ago, "A wise ruler gives to his people when they are in need and collects from them when they are prosperous. He should exercise his correct judgment when collecting taxes and make the levy as light as possible, thus keeping his people consonant."

### TAXATION OF COMPANIES

Mr. Speaker, at present a resident company is liable to income tax on its profits at a rate of 60 percent. It is required, in addition, to pay a refundable tax of 33 1/3 percent on dividends declared. This rate of 60 percent is one of the highest rates of Company Tax levied in any country. If our intention is to promote company formation, investment, and rapid development, it is imperative that this rate should be reduced to a reasonable level. The rate of Company Tax in most countries in our region is generally around 40 to 45 percent. I propose, Mr. Speaker, to reduce our rate of Company Tax to 50 percent. A company will, however, continue to pay the refundable tax of 33 1/3 percent on dividends declared.

Although the rate of Company Tax is being reduced, the actual tax payable by a company will not in effect be reduced for the next five years if the income of the company remains the same. Because of the change over the current year basis of taxation, the company will be required to pay income tax on its profits for each succeeding year at 50 percent and the taxes payable for the year of assessment 1979/80 on the preceding year basis over a period of five years, i.e. at the rate of 10 percent per year. This will in effect mean 60 percent for the next five years. However, I anticipate, Mr. Speaker, that companies will make use of the present opportunity to develop their businesses, increase their investments, and thereby make higher profits. A company which responds to my call for development will naturally benefit as the tax on the increased income in future will be at the rate of 50 percent.

At present, Mr. Speaker, concessional treatment is granted to small companies in order to encourage company formation. Where the issued capital of a company does not exceed Rs. 250,000, the first Rs. 50,000 of the profits of the company are taxed at a reduced rate of 35 percent. Where the profits of the company exceed Rs. 50,000 the excess is also added to the tax payable by the company until the tax rate reaches the present company rate of 60 percent. This Government, Mr. Speaker, places emphasis on private sector participation in development. We desire more and more company formation, particularly small companies for agriculture, horticulture, food production, fisheries and rural industries. With this objective and also taking into account the present increased capital requirements, I propose to grant special relief to small companies, the issued capital of which do not exceed Rs. 500,000. These companies will be taxed on a graded scale of corporate tax. The first Rs. 50,000 of taxable income will be taxed at 20 percent, the next Rs. 100,000 at 30 percent and the balance at 40 percent.

The present concession applicable to broad-based People's Companies will also be continued. People's Companies with an issued capital of less than Rs. 500,000 could obtain the additional benefits now applicable to small companies.

Foreign companies will be required to pay income tax at the rate of tax payable by the resident company, i.e. 50 percent plus an additional 5 percent in lieu of Estate Duty. They will continue to pay the wealth tax and the non-refundable tax on remittances of profits to which they are at present liable.

### RELIGIOUS AND CHARITABLE INSTITUTIONS

Mr. Speaker, I also propose to grant certain tax concessions to religious and charitable institutions. The rate of tax on religious and charitable institutions will be reduced from the present rate of 23 to 20 percent.

### SPORTS CLUBS

While there is an urgent need, Mr. Speaker, to promote sports in this country, sports clubs continue to be taxed on the net annual value of their premises and their sports grounds. The levy of this tax on such notional income not only creates hardship, but is also anomalous in a situation where an individual is exempt from income tax on the net annual value of a house owned and occupied by him. I therefore propose, Mr. Speaker, to exempt sports clubs from the payment of income tax on the net annual value of premises owned and used by them in the course of their sports acitivities. However, if such grounds, etc., are rented out, the rental income will be liable to income tax as part of the business profits of the Sports Club. This concession will apply only to clubs promoting genuine physical sports and recreation. It will not apply to social clubs.

### WEALTH TAX

With regard to Wealth Tax, Mr. Speaker, I wish to provide some relief by exempting from tax the value of one house owned and occupied by the taxpayer. At present all house property owned by an individual is included in the wealth tax return. With the recent inflation in house property values, the payment of wealth tax on a house which a taxpayer owns and uses as his residence imposes tremendous hardship on the taxpayer. This is particularly so as he does not derive any income from the house he uses as his residence. I, therefore, propose to exempt from wealth tax the value of one house owned and occupied by an individual. In addition to providing much needed relief, this proposal would also encourage the construction of houses for one's own occupation thereby easing the acute housing shortage.

As in the case of income tax, the wealth of the two spouses will be taxed separately. The wealth of children under 18 will be aggregated with that of the father during the subsistence of the marriage. If a marriage does not subsist, the wealth of the children will be aggregated with that of the spouse who in fact maintains the children.

### INTEREST ON DELAYED REFUNDS

Mr. Speaker, a person who does not pay his taxes in time is called upon to pay, in addition to the tax, an automatic penalty. This induces prompt payment of taxes. But there is no corresponding payment to a taxpayer who has overpaid his taxes and whose refunds are held up in the Department of Inland Revenue. I propose to provide with effect from the year of assessment 1979/80 for the payment of interest at 1 percent per month on refunds which are overdue. This will, I hope, ensure prompt settlement of refund claims by the Department. Where taxes are overpaid on self-assessment the interest will accrue after six months from the date of the claim for refund. Where assessments made have been reduced on appeal interest will accrue from six months after the date on which the assessment becomes final and conclusive.

### TAX AMNESTY FOR INVESTMENTS

Mr. Speaker, production and employment are the primary goals of this Government. With this end in view, I wish to explore all avenues of mobilising resources for investment. It is well known that there is a substantial amount of black money in the economy. The only method of getting this money into the economy and making it available for investment is to declare a tax amnesty. I admit, Mr. Speaker, that the grant of an amnesty is to a certain extent unfair by the honest taxpayer. However, keeping in mind the need for investment and employment, I propose to declare an amnesty for a period of 4 months commencing on 1st December 1978 and ending on 31st March 1979.

Amnesties have been declared before in 1964 by the SLFP Government, in 1965 by the U.N.P. Government and in 1971 by the last Government. This Amnesty will be different from previous amnesties in that it will be linked directly to specific investment in approved areas which will help to sustain the development programme of the Government. It will, thus, be an Investment Amnesty rather than a general amnesty of the type granted in the past. Such an amnesty has necessarily to be a cash amnesty. The undeclared income must be deposited in cash and invested in approved investments.

The tax amnesties offered in the past applied only to income tax. The taxpayer who took advantage of the amnesty could still be subjected to normal assessments in respect of his other tax liabilities including the Business Turnover Tax. I am of the opinion, that if an amnesty is to be effective, it should cover all taxes and levies. The present amnesty will, therefore, cover all taxes and levies administered by the Department of Inland Revenue and no questions will be asked. The amnesty will be complete.

I am aware that since the previous amnesties were administered by the Department of Inland Revenue the response was not as good as it should have been. I am, therefore, proposing a new method of administering the amnesty. The Inland Revenue Department will not administer this Amnesty.

It has been the usual practice in the past to levy a tax rate of 33 1/3 percent on the amnesty declaration. Under earlier amnesties, however, a taxpayer having paid his 33 1/3 percent tax was free to spend the rest of the money in any manner he chose without any conditions being imposed. As the present Amnesty will only cover money invested in approved investments, a tax rate of 30 percent will be levied.

The Amnesty will apply only to persons who make investments in specified development projects. These investments may be made with undeclared profits of any period prior to 31st March, 1977. Persons who wish to take advantage of the Amnesty will be required, in the first instance to deposit their moneys in special accounts in the National Savings Bank. These monies could be withdrawn after the amnesty period for investment in specified areas; otherwise they must be kept in such a special account till 31st March, 1983. Monies lying in these special accounts in the National Savings Bank and awaiting investment will earn interest at the savings deposit rate of 8.4 percent.

The approved areas in which investments could be made under this scheme will include companies with which the Greater Colombo Economic Commission has entered into agreements under section 17 of the Greater Colombo Economic Commission Law, and approved investments in industries, agriculture, horticulture, fisheries, tourism, housing including projects approved by the Urban Development Authority etc., donations to the Government and expenditure incurred by the private sector on approved projects included by the Government in the Government's Development Plan. In view of the fact that the incomes invested in these areas would already have benefited from the amnesty, such investment and expenditure will not qualify for any other relief available under the Inland Revenue Act.

The amnesty will not apply to cases already under investigation. However, the Inland Revenue Department will not investigate any declaration under the amnesty. It will be entirely administered by the National Savings Bank. Taxpayers will deal direct with the National Savings Bank. They will not be required even to call at the Department of Inland Revenue to make their declarations. The tax due on the amounts deposited will be remitted by the National Savings Bank to the Department of Inland Revenue. The mode of acquisition of the monies invested in these accounts in the National Savings Bank will not be questioned at any time by the Department of Inland Revenue.

## BANKS DEBITS TAX

A Bank Debits Tax is at present levied on debits to a person's current account. Although the rate of Bank Debits Tax is very small it acts as a disincentive to the banking habit. I propose, Mr. Speaker, to repeal this tax. The repeal of this tax will result in the loss only of a part of the revenue which is now collected from this tax as its abolition will increase the business profits of depositors and thereby increase the income tax paid by them. A part of this tax will also be recouped by an increase of the present concessionary Stamp duty of 6 cents levied on every cheque leaf issued by a bank to 10 cents.

## ESTATE DUTY

In my Budget Speech last year, I introduced a common rate schedule for estate duty and gifts tax in order to simplify the existing system. I now intend to introduce a few more reforms to give further relief and to correct certain anomalies in the law. There is a saying that "even at death, the taxman cometh" but let me try to soften the blow and ease the hardships. I am reminded at this point of Virgil's celebrated line in his Aeneid where he describes the dead in the underworld stretching their hands with yearning for the further shore — "Tendebantque manus ripae ulterioris amore" — Like Charon let me help these souls across with the least pain and suffering for those they leave behind.

I propose, therefore, to raise the exemption limit for estate duty from Rs. 50,000 to Rs. 100,000. In view of the effects of inflation it is clear that some relief is necessary. The present exemption limit of Rs. 50,000 has been in force for the last twelve years. While the reduction in revenue resulting from my present proposal will be negligible, the relief will be substantial at the lower levels.

I also intend giving some additional relief to house-owners in the case of smaller estates. Previously, where the total estate was less than Rs. 150,000 and the testator owned one residence, relief was granted in respect of this residence. I intend to broaden this relief by applying it to the value of one house in all cases. However, the relief will be limited to Rs. 300,000 or the value of the house whichever is less.

One of the problems that cause particular hardship in relation to Estate duty is the fact that payment can become difficult where the cash left at death is limited. Often properties have to be sold to meet the duty payable. In order to mitigate the hardship caused, I propose to provide for an exemption from estate duty of that part of the proceeds of a life insurance policy as is required to pay the Estate duty. Incidentally, this will also encourage the prudent habit of taking life insurance policies.

I am also providing for the following exemptions:

(a) the value of a single annuity up to Rs. 10,000;
(b) legacies to bona fide employees up to Rs. 10,000 if they take effect within a period of two years of death;
(c) bequests made to an approved charity up to Rs. 100,000 it they take effect within a period of two years of death;
(d) household and personal effects including jewellery up to Rs. 25,000; and
(e) the value of a life interest passing on death relating to property gifted to the Government retaining life interest.

The present rate of interest on delayed payments is 4 percent and has been unchanged since 1938. Honourable Members will agree that this is far too low a rate and results in the non-payment of estate duty by certain persons for long periods. I, therefore, intend raising the rate of interest to 8 percent from the present 4 percent for the second and third years of non-payment and to 12 percent after the third year. Provision will also be made for the calculation of interest for a quarter rather than on a daily basis.

I shall also take early steps to rectify certain other anomalies and bring the Estate Duty Ordinance up to date.

## STAMP DUTY

The Stamp Ordinance is the oldest revenue law which the Department of Inland Revenue administers. It has been in existence since 1909 and during the last 69 years it has only been subject to a few amendments. It is my intention to amend it taking into account the various changes that have taken place in the social and economic spheres in this country.

I wish to place more responsibility on notaries in respect of proper stamping of instruments in relation to their value. In order to achieve this objective, I have decided to bring to book those notaries who do not place the proper value on instruments with a view to evading stamp duty. I, therefore, propose to levy penalties by amending the Stamp Ordinance.

A few years ago the Stamp Ordinance was amended to enable employers to pay composition duties on salary receipts. But not many employers came under this scheme.

I, therefore, propose to make it compulsory for certain categories of employers with large work forces to pay these composition duties. This measure would not only add to revenue but also increase compliance which was not forthcoming all these years because it was optional.

At present there are varying rate bands and varying rates within the Stamp Duty rate schedule. I propose to simplify this as much as possible in conformity with current commercial practices.

As it is the Government's intention to encourage the formation of limited liability companies, I propose to reduce the stamp duty on issue of shares from 1 percent, to ½ percent. I also propose, as a corollary to this, to revise the existing high rate band for transfer of shares by introducing a flat rate of 1 percent. This will encourage more activity in share transactions. The loss in revenue by these reductions would be negligible. Any such loss, I believe, would be more than compensated by the increased activity in the Share Market which we envisage.

The law governing the issue of receipts in respect of monies received over Rs. 20 has been in existence for a long time. In view of the new economic conditions, I propose to raise the limit to Rs. 100 and increase the Stamp Duty to 25 cents. This will eliminate unnecessary hardship to persons dealing in small amounts, particularly the low income groups.

Mr. Speaker, I am confident that the entire tax system of the country will be considerably simplified by these far reaching changes and that they would produce a net increase in revenue as well.

#### FREE TRADE ZONE

Mr. Speaker, remarkable progress has been made in the Free Trade Zone Project, which is the second major project designed by our Government to foster the development of the economy. The Greater Colombo Economic Commission, which administers an area of authority of 190 square miles, has decided to develop two or three zones initially, the first at Katunayake.

The Katunayake Investment Promotion Zone is approximately 500 acres in extent and the capital cost of facilities to be provided by way of internal roads, electricity, water supply, drainage and sewerage, post and telecommunications, etc., is estimated to be around Rs. 300 million. A major part of this work is already underway and will be completed early next year. A sophisticated telecommunication system with international direct dialling facilities will be available by the end of 1979. A 10-line SPC telex exchange and 100 telex machines are also to be installed.

Outside the Zone, efficient roadways between the Zone and Colombo city, modern cargo handling facilities including container cargo handling at the Colombo Port and modern air cargo facilities at the Airport are also being planned. It is also proposed to develop Negombo as a town to service the Zone.

The Commission grants incentives on a graded scale taking into consideration such factors as employment creation, use of local raw materials, foreign exchange earnings, capital investment and transfer of technology. The incentives include exemption from import duty on equipment and production inputs, and from export duty on products. Tax holidays of around five to seven years and, on expiry of the holiday, very low rates of turnover tax of around 2 percent on exports and 10 percent tax on royalty and technical services, are also allowed. In special cases with substantial capital investment and/or introduction and development of new technology, additional concessions are granted.

According to the Commission, 118 specific enquiries and project applications were received upto the end of October, 1978, of which 46 projects with an estimated total capital investment of Rs. 1,600 million, and involving a range of products from garments to building materials, industrial chemicals, sailing crafts and fishing gear have been approved. The foreign capital component of these projects is Rs. 1,160 million. Of the approved projects 24 enterprises have already signed formal agreements with the Commission and many of them have commenced building operations. Two factories are expected to go into production shortly. According to estimates made by the Commission, the approved enterprises will, at capacity operation, generate a total employment of over 26,000 and earn foreign exchange amounting to over Rs. 1,000 million per annum.

The foreign collaborators in the projects approved so far come from U.S.A., U.K., West Germany, Switzerland, Belgium, India, Norway, France, Hong Kong, Thailand, Singapore, Malaysia, Iran, Korea and Dubai.


**In next issues:**

Brazilian legislation on industrial development
— by *Antonio Mendes*

Use of presumptive tax assessment techniques in taxation of small traders and professionals in Africa
— by *I.A. Malik*

France: Re-orientation of the discussion on capital taxation
— by *Jean-Loup Haÿ*

United States income taxation of foreign investment in U.S. real estate
— by *Robert C. Forst*

Recent theoretical developments in public finance
— by *Nizar Jetha*

Continuation of *H.W.T. Pepper's* Tax Glossary


 

# ASIA:
# Recent Developments in Regional Tax Cooperation *

*The efforts of the Asian and Pacific Development Administration Center (APDAC) to improve the tax administration in Asian countries*

## Introduction

The Asian and Pacific Development Administration Center (APDAC), formerly known as the Asian Center for Development Administration (ACDA), has embarked on a program to improve the tax administration in Asian countries.

A preliminary organizational meeting of representatives from a number of Asian countries was held in Kuala Lumpur, Malaysia, from April 17-22, 1978. The goal of this meeting was defining and formulating more clearly the structure of APDAC's Program on Tax Administration, and to make recommendations for a Seminar to be held in early 1979 to discuss matters connected with improvement of tax administration, including strategies for the training of tax officials and the development of training courses.

It is hoped, that with the realisation of the objectives of the Program and the resulting improvement in tax administration in each of the respective Asian countries, the urgent and escalating amounts of funds needed for national development and economic welfare for the people in the region will be assured. The program for improvement of the tax administration in Asian countries focussed primarily on the administration of direct taxes, such as individual income tax and corporate income tax.

Present at this organizational meeting were representatives from India, Indonesia, Malaysia, the Philippines, Sri Lanka, Singapore and Thailand. Each representative who attended the meeting delivered a paper setting out his own ideas and suggestions relating to the outline, scope and methodology of the program. These papers formed the basis of the discussions at the meeting.

Other documents used at the organizational meeting were extracts from the reports of the Study Group for Asian Tax Administration and Research (SGATAR) [1] and parts of the Report of the 1974 tax seminar conducted by the German Foundation for International Development. [2]

## The Meeting on the Improvement of Tax Administration

The Organizational Meeting resolved that its main focus, in keeping with its objective to improve tax administration, must be directed towards the training of tax officials. Efforts at improving tax administration are seriously impaired at their outset by the shortage of qualified personnel in the majority of the participating Asian countries. Although all the participating countries have training programs it was generally concluded that they tended to concentrate on the training of lower level technical grades. Generally fewer programs were available for the training of the middle and upper level personnel. The Meeting recommended that APDAC should, therefore, concentrate on programs for the training of middle and upper level staff and focus its attention on establishing training programs in the managerial aspects of tax administration. In addition, it was suggested that APDAC collaborate with establishing training programs in the managerial aspects of tax administration. In addition, it was suggested that APDAC collaborate with established training centers to conduct regional courses or seminars on specific subjects or areas of tax administration, e.g. investigation techniques and tax research.

Tax research involves an in-depth study of the tax system, i.e.:

(1) tax structure;
(2) tax administration;
(3) public tax consciousness.

The Organizational Meeting recognised the fact that tax research was a useful tool not only for the formulation of tax policy, but also to assist in a more effective administration and enforcement of the tax system. The meeting also recommended to APDAC that tax research be fully discussed at the forthcoming seminar early in 1979 with an in-depth study made on the role of research in tax administration. It was decided that perhaps APDAC can also attempt to collect information relating to the tax manuals used in different Asian countries and, on request by a particular country, to assist in preparing or revising their own tax manuals.

Finally, it was suggested that APDAC should attempt to compile a directory of experts and a bibliography of publications on tax pertaining to the Asian region. Participating countries can assist in this project by providing the information relating to their countries. The meeting concluded that the countries which will be invited to the proposed Seminar are not to exceed ten and that they should be composed of the ASEAN member countries and other interested countries.

The proposed actual number of participants should not exceed 25 but exceptions can be made for middle level officials who would be classified as observers who would also benefit from the exercise. [3]

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* Note submitted by Mr. K.S. Jap.

1. See "Asia: Regional cooperation in taxation and customs", by Mr. K.S. Jap. *Bulletin for International Fiscal Documentation*, 1978/1, pages 23-25.

2. Report on the Seminar Tax Law and Tax Policy in Industrialized and Less Industrialized Countries for Directors and Senior Officers from Asia in the Federal Republic of Germany from 19 May to 8 June 1974.

3. Report of the Consultative Meeting of Improvement of Tax Administration. *Tax Monthly*, April 1978.

# IRELAND: BUDGET 1979

On February 8, 1979 the Minister for Finance, Mr Colley, pronounced his Budget Speech. An extract of the relevant tax aspects is reproduced below.

The additional expenditure allocations which I have announced will add a total of £141 million to my starting current deficit of £208 million. From this I am deducting £40 million for unspent balances in the hands of Departments at the end of 1978, giving a current deficit of £309 million.

Thus, taking account of the Exchequer borrowing requirement for capital purposes of £490 million, the overall Exchequer borrowing requirement for 1979 stands at £799 million at this point.

Before presenting my specific tax proposals, I would like to stress that the Government's objective is to minimise the tax burden, to ensure that it is spread equitably and does not discourage personal and corporate initiative.

Many significant changes in taxation have already been introduced by the Government from which all sectors have benefited. The personal and corporate taxation concessions in last year's Budget will cost some £130 million this year. The abolition of rates on domestic dwellings and the removal of motor vehicle duties from all but large cars will cost about £124 million this year. The proposals which I will outline today are designed to carry our policies a stage further.

## INDIVIDUAL INCOME TAX: ALLOWANCES, RATES AND BANDS

The increases provided last year in the main personal allowances for income tax purposes were unprecedented in size. They have been, and continue to be, of substantial real benefit to all income taxpayers.

It is not to be expected that reliefs of such a large order could be repeated this year. Nevertheless, subject to the resources constraint, the Government wish to give further expression to their policy of reducing the disincentive effects of personal taxation. With this in view I propose a further improvement in personal allowances combined with an amendment of the lower income tax bands.

The increases in the personal allowances will be as follows:

- the single allowance to be increased from £865 by £250 to £1,115;
- the widowed allowance to be increased from £935 by £250 to £1,185, and
- the married allowance to be increased from £1,730 by £500 to £2,230.

The structural modification consists of abolishing the 20 percent rate of income tax payable at present on the first £500 of taxable income and applying the rate of 25 percent to the first £1,100 of taxable income, that is, after the personal and other allowances, including the increases I have just mentioned, have been taken into account.

These changes will benefit all married taxpayers, of whom some 21,000 will be completely freed from liability. The great majority of other taxpayers will also benefit and about 19,000 of them will be freed from any liability to income tax.

In the case of married taxpayers without children the liabilities, if not removed altogether, will be cut by amounts ranging from £100 to £135 a year, depending on income.

The effects for married couples with children will be broadly similar, but here it is necessary to take into account also two other Budget changes which I have already outlined, namely, the increases in the Social Welfare Children's Allowances and the associated reduction of £22 in the Income Tax Child Allowance of £240 per child.

For those not removed from tax liability, the combined effects of the changes in income tax and in the Social Welfare Children's Allowances will be to benefit married couples by amounts varying upwards from about £100 a year in cases where their children qualify for the Social Welfare Allowances.

As regards taxpayers who are single or widowed without children, most of these will benefit by varying amounts. For those of them who are not entitled to any allowance other than the single or widowed person's allowance and whose incomes exceed £7715 or £7785, as appropriate, there will be tax increases not exceeding £15 a year. If these taxpayers are, in fact, entitled to other allowances, these income points will be higher.

The document, "Principal Features of the Budget", gives further examples of the effects of the various changes I have mentioned. The cost of these changes in personal allowances and in the tax rates and bands will be £30 million in 1979 and £47 million in a full year.

For single or widowed taxpayers with dependent children there will be a substantial new relief which I shall now indicate.

## ONE-PARENT FAMILIES

A category deserving of particular consideration is the one-parent family. Where the parent of a dependent child or children is widowed, deserted, separated or unmarried, the special circumstances justify, in my view, the giving of additional tax relief. I have decided that this should be done by the introduction of a special allowance of £250. The allowance will apply as from April 6th next and will be in addition to whatever other allowances and reliefs are available under existing law. The cost of the relief will be £700,000 in 1979. The necessary provisions will be contained in the Finance Bill.

## INTEREST RELIEF

As deputies will be aware, income tax relief is given in respect of personal interest, including house-mortgage interest. This relief is a valuable one for householders who, it must be remembered, have also benefited from the abolition of domestic rates.

Since 1974, there has been a limit of £2,000 a year on the amount of personal interest qualifying for relief. There have been many representations for an increase in the limit to take account of changed circumstances. I have decided to raise the limit to £2,400 a year, with effect from April 6th next.

I have also decided that the relief ordinarily allowable should be scaled down appropriately in cases where an employee enjoys a preferential rate of interest. The reduced relief in such cases will be computed by reference to the proportion that the actual rate of interest paid bears to a specified rate.

The necessary provisions to give effect to these changes in interest relief will be included in the Finance Bill. There will be no net cost to the Exchequer.

## TRUSTEE SAVINGS BANKS

The increase in the limit on interest relief will benefit house-buyers, so this is an appropriate point at which to men-

tion a measure which will increase the amount of funds available to house-buyers.
I propose to empower the trustee savings banks to grant house mortgage loans. The overall limit on lending by these banks will still apply — 15 percent of the balances due to depositors — but, since their aggregate lending has generally been well within this limit, it still leaves them worthwhile scope for additional lending in the housing area.
The same requirements will apply in regard to the allocation of mortgage funds and Certificates of Reasonable Value as are being applied by the Minister for the Environment in the case of the building societies.

## HEALTH INSURANCE

At present, premiums paid under permanent health insurance schemes, which are schemes designed to maintain earnings during illness, are not allowed as deductions for tax purposes. The benefits payable are not regarded as income chargeable to tax unless and until they have been received for over a year.
It is now proposed that tax relief will be given in respect of such premiums, but the benefits under the policies will be treated as taxable income from the outset. The change will take effect from April 6th, 1980.

## BUSINESS INCENTIVES

The tax and other measures taken by the Government over the past 18 months have afforded very considerable stimulus to enterprise and have created a climate in which the business world can plan ahead with confidence.
The various substantial tax reliefs for families and individuals have operated to boost demand. In addition, I introduced in last year's Budget a package of tax changes designed to ensure direct relief for businesses. Chief among these changes were the large increase in the profits thresholds for Corporation Tax and the improvement of the three-year scheme for an incentive rate of 25 percent for manufacturing companies.

## EXPORT SALES RELIEF

I should also mention the new scheme, already announced by the Minister for Industry, Commerce and Energy, for the replacement of export sales relief. The 10 percent rate of Corporation Tax, which will be applicable to manufacturing profits earned from January, 1981, to the end of the century, should act as a dramatic stimulus immediately and lead to continuing growth over the years ahead.

## STOCK (INVENTORY) RELIEF

I have been asked to consider sympathetically the continuation of stock relief which, under existing legislation, is available for stock increases in accounting periods ending before April 6th, 1978.
This *ad hoc* relief was introduced as a temporary measure in the 1975 Budget in recognition of the fact that, because of very heavy inflation, a substantial portion of the accounting profits of many businesses was, in practice, tied up in increased costs of trading stock. It has since been continued, with some modifications.
In considering the question of a continuance of the relief, it is appropriate to have regard to the reduction of the rate of inflation which has taken place. The rate is now down significantly below the level which led to the introduction of stock relief and the grounds for continuing it have diminished, to say the least. However, I have decided to give it for a further year, on the basic of allowing three-quarters of the relief granted heretofore. The renewal will cost the Exchequer £5 million this year. The detailed technical provisions will be contained in the Finance Bill.

## INVESTMENT ALLOWANCE (DEDUCTION)

I intend to move in the Finance Bill that the existing legislation governing the special investment allowance of 20 percent for new plant and machinery in the designated areas be renewed for a further period up to the end of 1980, after which the proposed Corporation Tax scheme for manufacturing companies will apply throughout the State.

## CAPITAL ALLOWANCE

At present capital allowances on new plant and machinery are given on the basis of gross cost; in other words, no deduction is made in respect of grants payable from public funds. The effect of this is that the Exchequer gives tax relief in respect of a considerable element of expenditure which the Exchequer itself has borne. This has always been recognised as anomalous and there can be no reasonable ground for complaint if this anomaly is removed. I intend to do so in the Finance Bill.

## INDUSTRY: GENERAL

Clearly, the direct Exchequer cost of tax incentives is not the only indicator of the Government's priority for industrial expansion. So, also, are the massive increases in the expenditure allocations for industrial promotion, development and credit, and for the infrastructural development needed to support industry.
The general regime for industry is one of the most favourable in the world, comprising as it does an impressive array of incentives.
The Government now looks to private sector enterprise to make decisive progress this year towards achieving the national investment and employment targets.
All enterprises, irrespective of size, have a part to play. The contribution that can be made by small and medium-sized firms should not be underestimated. The Government is gratified by the tremendous response from such firms to the special investment loan facilities that are being provided for them by the Industrial Credit Company in conjunction with the European Investment Bank.
The favourable interest rate charged on such loans is made possible by the fact that the foreign exchange risk on the loans is being borne by the Exchequer. This assistance will continue to be available.
For business as a whole, 1979 is a year of opportunity and challenge. Part of the challenge will be provided by participation in the EMS. The potential benefits from participation are considerable. For its part, the Government stands by the assurance already given that, if any significant short-term difficulties should arise from our decision to participate in the system, the Government will respond in a positive and sympathetic way.

## VALUE-ADDED TAX

I come now to a proposal affecting value-added tax.
As deputies will be aware, one of the changes required by the EEC Sixth Directive on VAT, which was adopted by the Community in 1977, is the abolition of the first tier of the special two-tier VAT which applies at present to a limited range of goods. As announced some time ago, March 1st, 1979, the first tier of the two-tier VAT will be replaced by appropriate excise duties designed to match the part of the VAT revenue forgone.
I have, however, received representations seeking a variation of that intention in so far as certain goods handled by the electrical trade are concerned. The representations made have stressed the adverse effects on traders in the State of cross-Border smuggling of these goods and have sought an alleviation of this position through a reduction of tax. The Revenue Commissioners are, of course, making every effort to prevent

this smuggling and the associated tax evasion. Having reviewed the position, I have decided, by way of concession, to refrain from imposing excise duties on two of the categories of goods in question, namely, radios and record players, but a VAT rate of 20 percent will apply to them instead of 10 percent. This will bring the VAT treatment of these goods, from March 1st, 1979, into line with that of other related items.

The concessions will cost about £1 million in 1979, inclusive of £0.3 million in respect of a special relief required in order to avoid double taxation, of stocks which will have already borne the first tier of VAT.

## FARMER'S TAX

It is estimated that total farm income last year was almost 140 percent higher than in 1973, the year of our entry to the EEC. That figure understates the actual improvement in the fortunes of our individual farmers because farm income is now divided among a smaller number of farmers than was the case six years ago. Our main agricultural products have had the benefits of guaranteed prices and unlimited outlets. Investment in farming is continuing at a high rate and the prosperity of agriculture — and of rural Ireland in general — is plain for all to see.

This prosperity is highlighted by the 1977 Farm Management Survey of An Foras Taluntais, published last August. The Survey noted that "the standard of living enjoyed by a sizeable proportion of our farmers must have improved out of all recognition and that modernised farming is very prosperous, with many farmers having assets, investment levels and incomes formerly associated with the world of commerce only."

During these years, the farming community has continued to benefit from a degree of State support which is very considerable. The Estimates for 1979 contain a total provision of £160 million for State aid to agriculture. In addition, it is estimated that the European Agricultural Guidance and Guarantee Fund will benefit Irish agriculture to the extent of some £385 million. It is clear that Irish agriculture can no longer be regarded as an underendowed sector of our economy.

It is against this background of increasing prosperity that we must look at the question of farmer taxation. Farmers will pay about £16 million in income tax in 1979 and about £36 million in rates on land. This total of £52 million represents a contribution of 5½ percent of farm income. Last year the contribution was £38 million, or 4½ percent of farm income. Making due allowance for investment needs in agriculture, the farmer's contribution falls far short of the share of income contributed in taxation by the rest of the community, as is clear from the fact that employees paid about £526 million in income tax in 1978, representing about 16 percent of their earnings.

## THRIVING SECTOR OF ECONOMY

It is equitable that such a thriving sector of the economy should move as rapidly as possible, without damage to its continued expansion, to the stage of full acceptance of its share of funding the community's needs. It is only fair to say that comments from individuals and those in a representative capacity would indicate that the general body of farmers is willing to do so.

In line with this principle, I am taking further measures this year to increase the farming sector's contribution to the cost of public services. The threshold for liability to income tax will be reduced from £60 RV to £50 RV, making a further 6,000 full-time farmers, or 27,000 in all, liable for tax. Also, the multiplier which is used to calculate farmers' income on the notional basis will be increased from 90 to 125. This new multiplier is fully justified by reference to farm incomes in 1978.

As a result of these changes, farmers' income tax will yield about £30 million in the income tax year 1979/80, almost all of which will accrue in the calendar year 1980.

There are two other income tax matters I should mention. The farming organisations have drawn my attention to the possibility that a farmer who had opted to have his income assessed on the notional basis could find himself then being taxed on an income assessment appreciably in excess of his actual profits, because under the provisions of the Finance Act, 1978, he must continue on that notional basis for two subsequent years. This could happen, particularly in a case where stock losses occurred by reason of disease.

I arranged to have this problem examin-

## HIGHLIGHTS OF THE IRISH BUDGET 1979

*On February 8, 1979 the Minister for Finance pronounced his Budget Speech. Some of the most significant features are the following:*

- *The reduction of individual income tax by increasing various personal allowances (deductions). A new £250 allowance will be introduced for one-parent families.*
- *The maximum deductible amount for personal interest will be increased from £2,000 to £2,400.*
- *Premiums paid for schemes to maintain earnings during illness will become deductible whereas the benefits received under such a scheme will be henceforth taxable.*
- *The rate structure of individual income tax will be changed, i.e. the 20 percent rate will be abolished and the 25 percent rate will apply to the first £1,100 of taxable income.*
- *Confirmation of the introduction, as of January 1, 1981 of the 10 percent corporation tax rate for manufacturing companies.*
- *Various incentives for business will be continued. For instance, stock (inventory) relief will be extended for one more year on the basis of three quarters of the existing relief. The investment allowance of 20 percent for new plant and machinery in designated areas will be renewed for an additional period up to the end of 1980.*
- *On March 1, 1979 new provisions of VAT will become effective as a result of the changes which Ireland is required to make under the Sixth Directive on VAT. This will, inter alia, result in the abolition of the first tier of the special two-tier VAT. This first tier will be generally replaced by an excise duty except for radios and record players. However, these items will be subject to 20 percent of VAT instead of the normal 10 percent.*
- *The excise duties on tobacco and alcoholic beverages will be increased.*

ed in discussions over the past year between the farming organisations and the Revenue Commissioners.
These discussions have now resulted in an agreed recommendation to the effect that a farmer may opt out of the notional basis at any stage provided he remains on accounts for the year concerned and the two subsequent years; the Revenue Commissioners would have the right to demand accounts for the preceding one or two years of notional assessment and to reassess accordingly if the accounts indicated a higher tax liability. I am pleased to accept this recommendation, and I will include provisions accordingly in this year's Finance Bill. I consider that this arrangement will remove any danger of a farmer having to pay tax on an income he did not have, while at the same time it guards against the possibility of tax avoidance, which is the basic aim of the three-year requirement.

### AGRICULTURAL LEVY

The second matter concerns income averaging. I announced in last year's Budget that discussions were to take place between the farming organisations and the Revenue Commissioners about the possibility of providing for a suitable system of income averaging. These discussions are now nearing completion and I expect to be in a position to make the necessary provision in the Finance Bill.
My final item concerning farmers relates to the cost of services. In addition to the measures which are being taken to recover a proportion of the cost of the animal disease eradication programmes, the Government consider that the farming community is now in a position to pay for the cost of the education, research and advisory services specially provided for agriculture.
These are estimated to cost about £30 million in the current year. The cost will be recovered by means of a levy of two percent on the following agricultural products — cattle, milk, pigs, sheep, sugar beet and cereals. These products will account for an estimated 90 percent of total agricultural output this year.
The levy will be charged at the point of sale of the products into the processing stage and on unprocessed exports. It will be introduced as from May 1st, 1979 in the case of cattle and milk and as from August 1st, 1979 in the case of the remaining products. These are the earliest dates from which the necessary statutory and administrative arrangements can take effect. It is estimated that the levy will produce about £16 million in this financial year.
It would defeat the purpose of the levy if it were to be passed on to domestic consumers through the price of food. The Government will be concerned to ensure that this does not happen.

### TOBACCO AND ALCOHOLIC DRINKS

Mr Colley said that the Government had decided that the various additions to the deficit on current account should in part be offset by the following increases in indirect taxation.
It was three years, he said, since the excise duties on tobacco products and alcoholic beverages were last raised and it was appropriate to look to these for an additional contribution this year. The proposed increases are as follows:

#### TOBACCO

An increase of 6p is proposed in the tax element in the retail price of the packet of 20 cigarettes in the most popular price category. Pro rate increases are proposed for cigars and other tobacco products. These increases are estimated to bring in extra revenue of £16 million in 1979.

#### SPIRITS

An additional 6p is proposed in the tax element in the retail price of a glass of spirits. This will mean an extra 3p on the normal half-glass measure. This is estimated to bring in extra revenue of £10.5 million in 1979.

#### BEER

An increase of 2p is proposed in the tax element in the retail price of the pint of beer. This is estimated to bring in extra revenue of £9 million in 1979.

#### WINE

An increase of 10p is proposed in the tax element in the retail price of a bottle of table wine. In the case of stronger wines and sparkling wines the proposed increase is 20p per bottle. These increases are estimated to bring in extra revenue of £2 million in 1979.

#### CIDER AND PERRY

The existing rate of excise duty of 5p per gallon on cider and perry has not been altered since 1940 and is now completely out of line with the duties charged on other alcoholic beverages. Moreover, changes in traditional methods of manufacture have led to a situation where it is feasible to produce cider and perry at a much higher than usual alcoholic strength. Whilst this very strong cider would not constitute a significant proportion of total sales it is proper, nevertheless, that the excise duty structure should reflect the differences in strengths.
Accordingly, the excise duty will in future provide for three categories. The rate for the lowest category, which includes ordinary cider and perry, will be 30p per gallon. The rate for the intermediate category will be £1.25 per gallon and the rate for the strongest category will be the same as the new rate for made wine, that is £2.466 per gallon.
These changes represent an increase of roughly 6p in the tax element in the price of an ordinary flagon of cider. The increases for the stronger cider and perry would be greater, depending on their alcoholic strength. It is estimated that these changes will bring in extra revenue of £200,000 in 1979.
The various increases in excise duties will operate from midnight tonight (Wednesday). They will yield £37.7 million of extra revenue this year. It is estimated that they will have the effect of increasing the Consumer Price Index by about 1.1 percent.
The Minister for Industry, Commerce and Energy will make an announcement shortly about price increases on some of these commodities which have been recommended by the National prices Commission.

### SMALL BREWERIES

By way of a concession, Mr Colley intends to continue for a further year, at a cost of £270,000 in 1979, the scheme, introduced in the 1978 Budget, which re-adjusts the incidence of excise duty on beer so that the smaller producers bear a somewhat lesser burden of duty while the larger producers pay somewhat more.

### TAX EVASION

I indicated when dealing with the provisions this year for job creation that I propose a substantial strengthening of revenue staff to intensify the campaign against tax evasion.
There is evidence that some self-employed persons, such as traders, landlords of residential premises and professional people, who would be liable for tax, are not making any returns of their income to the Revenue Commissioners.
Even in those cases where accounts are furnished, there are indications that there may be evasion. Some people in the community may not be making any contribution at all to the Exchequer when they should be doing so, or may be making a grossly inadequate one.
I am determined that this situation must be tackled as a matter of urgency.

Progress has been made already in combatting evasion. Forms of evasion have been identified and dealt with by devising systems of control, as for example in the case of the taxation of certain groups in the building trade.

Back duty enquiries have been intensified in the special cases which come to the attention of the Investigation Branch. These measures, however, are proving inadequate and it is clear that existing Revenue staff resources are not sufficient to deal with the problem.

I am therefore making provision for a substantial strengthening of the staffing of the Revenue Commissioners in order to enable them to mount an effective and comprehensive attack on evasion.

The campaign will include such measures as examination in depth of particular accounts and, where there are indications of evasion, reconciling them with the general state of the business and the taxpayer's life-style. Evasion will also be followed up more intensively in the case of PAYE and VAT.

In future, more emphasis will be placed on legal proceedings, rather than compromise action, where the making of false returns is uncovered.

I am confident that this deployment of resources will prove worthwhile from the point of view of revenue collection and equity among taxpayers.

The revenue changes which I have outlined involve tax concessions amounting to £37 million in 1979 and tax and other revenue increases which will bring in an extra £57 million in 1979. This gives a net increase in revenue of £20 million. The current deficit will therefore be £289 million, compared with £397 million last year, a reduction of £108 million or 27 percent.

My final Exchequer borrowing requirement is £779 million, which is 10½ percent of GNP, in line with the Government's policy commitment.

# THAILAND:
# Promotion of International Trading Companies

## I. INTRODUCTION

In an effort to boost Thai exports the Government has introduced a wide range of incentives for so-called 'promoted trading companies', i.e. international trading companies which are granted the promotional privileges under the Law on promotion of investment. The Board of Investment (BOI), chaired by Prime Minister Kriangsak Chomanan, issued Announcement NO. 40/2521 of October 3, 1978 by virtue of which business operations by promoted trading companies are entitled to the tax incentives and other privileges under the Investment Promotion Act of 1977. This Announcement No. 40/2521 is effective as of September 28, 1978.

In addition, the Thai Revenue Code and the Royal Decree No. 54 B.E. 2517 (1974) re Reduction and Exemption of Business Tax have been implemented and amended by Royal Decrees in line with the incentives granted under the Announcement of the Board of Investment No. 40/2521.

These Royal Decrees are:
(i) The Royal Decree issued in accordance with the provisions of the Revenue Code governing Exemption of Business Tax (no. 78) B.E. 2521 (1978) which was published in the Government Gazette, Special Issue, Volume 95, Part 120, dated October 30, 1978, pages 45-47;
(ii) The Royal Decree issued in accordance with the provisions of the Revenue Code governing Exemption of Business Tax (No. 79) B.E. 2521 (1978) which was published in the Government Gazette, Special Issue, Volume 95, Part 120, dated October 30, 1978, pages 48-50.

## II. Conditions to be met

In order to qualify for the incentives, the following conditions must be satisfied:
(a) The company must be granted the 'promoted status' by the Board of Investment.
(b) The promoted trading companies may be public companies, limited companies or partnerships. However, they must become public companies within 5 years and listed with the Securities Exchange of Thailand (SET).
(c) The promoted trading company must have an initial minimum paid-up capital of 30 million baht. The minimum paid up capital must be increased to 50 million baht within 3 years from the date of commencement of operations.
(d) The Thai holding must be at least 75 percent.
(e) A minimum of 300 million baht worth of goods must be exported in the first year of operation; this must be increased to 400 million baht in the second year and to a minimum of 500 million baht each year thereafter.
(f) The goods to be exported are classified into 3 lists. The value of the export of the goods in list 1 to be included in the export target may not exceed 100 million baht a year. The value of goods in list 2 may not exceed 250 million baht a year. The export value of goods in list 3 must not be less than 50 million baht in the first year, 100 million baht in the second year and 150 million baht in the third year.

**List 1**
Cattle, water buffalo, frozen fish, frozen squid, tapioca products (including tapioca flour), maize, rice, rice products, sorghum, castor seed, cotton seed, sugar, molasses, fishmeal, portland cement, tungsten, rubber, cattle and buffalo hide and leather, kenaf, tin, mineral ores, and goods whose exports are legally controlled.

**List 2**
Frozen chicken, dry squid, frozen shrimp, poultry, orchids, beans, fresh fruits, sesame, canned fish, canned marine products, canned pineapple, tobacco leaves, plastic and plastic products, fluorite, veneer wood, parquet wood, wooden utensils, synthetic thread, synthetic yarn, cotton yarn, cotton textiles, kapok, jute products, readymade clothes, jewelry and pearls, electronic circuits, and furniture and parts thereof.

**List 3**
All goods other than goods shown in lists 1 and 2.

## III. Incentives

The following incentives are provided:
— Exemption of import tax on raw materials imported by the promoted trading companies for the use in the manufacture of the goods exported.
— Exemption of business tax on raw materials imported by the promoted trading companies or supplied by local suppliers for the use in the manufacture of the exported goods.
— Business tax exemption for manufacturers selling such goods to promoted trading companies.
— Business tax exemption for companies contracted by the promoted trading companies to produce such goods.
— Business tax exemption for brokers or agents who sell their products to trading companies.
— Deduction of foreign tax from Thai corporation tax

on the operations abroad of the promoted trading companies.

- Double deduction of export development expenses including foreign branch establishment costs, foreign branch operational expenses, costs of sending trade missions, advertising and marketing expenses.
- Permission to open foreign currency deposit accounts.
- Loans on attractive terms to be given by the Bank of Thailand.

The BOI may, however, announce any change or amendment of the above lists og goods, without affecting the persons who prior to the date of the change have been operating their promoted business for a period not exceeding five years.

It should be noted that promoted trading companies are not entitled to exemption from the juristic person income tax as granted under Section 31 of the Promotion of Investment Act B.E. 2520 (1977).

## IV. APPLICATION FOR PROMOTED TRADING COMPANY STATUS

It is reported that companies belonging to the Siam Motors Group and some other companies have organized themselves into a new trading company under the name International Trade Company Limited to seek promotional privileges from the Board of Investment under Industrial Category 6.13 "International Trading Company".

The International Trade Company Limited comprises the Thai-Scott Company Limited, Sammit Motors Company Limited, Thai Metal Drum Industry Company Limited, Siam Motors Company Limited, Universal Mining Company Limited, etc.

Fluorite is the main product that will be handled in the export business of the new international trading company at an estimated annual turnover of 100 million baht. In addition, among other products for export are tissue paper, oil filters and automotive parts. [1]

1. News Synopsis, Bangkok, October 30, 1978.

## U.S.A.: TAXATION OF U.S. TRANSFERORS ON TRANSFERS OF PROPERTY TO FOREIGN ENTITIES *

*Sec. 1491 of the U.S. Internal Revenue Code applies a special "excise tax" to certain transfers of appreciated property to foreign entities, when such transfers are effected to avoid payment of federal income tax.*

### Imposition of the Tax

*The tax is imposed on the transfer of property by a U.S. citizen or resident, a domestic corporation or partnership, or an estate or trust subject to U.S. taxation to a foreign corporation (as a contribution to capital or as paid-in surplus), a foreign partnership, or a foreign estate or trust. Under the Revenue Act of 1978, a non-resident alien who is married to a U.S. citizen or resident and who elects to be treated as a resident for joint tax return purposes is treated as a resident for purposes of Sec. 1491, and is thus subject to the tax.*

*The tax rate is 35 percent of the excess of the fair market value of the transferred property over the sum of the adjusted basis plus any gain recognized by the transferor at the time of the transfer. Thus, the tax applies only to that amount of gain which is not recognized by the transferor at time of transfer.*

*Note that prior to the Tax Reform Act of 1976, this tax was applied only to transfers of appreciated securities, and at a rate of 27½ percent of the excess of fair market value over adjusted basis (i.e. without regard to recognized gain).*

### Applicability of the Tax

*The tax applies to all transfers, including tax-free exchanges, whether or not made with donative intent, and whether or not made at fair market value.*

*However, Sec. 1492 provides a number of exemptions from the applicability of Sec. 1491. The excise tax is not imposed where the transferee is a tax-exempt organization. Nor does it apply to contributions by controlling shareholders to the capital of foreign corporations. And, the tax will not be levied if the transferor elects, under Sec. 1057, to treat the transfer as a sale or exchange, and to recognize as gain the amount by which fair market value exceeds adjusted basis.*

*A further exemption is that where the transferor can establish to the satisfaction of the Secretary of the*

* Note submitted by Mr. Glenn A. Abraham.

*Treasury that the transfer is not intended to avoid income taxes. (Although Sec. 1492 requires that such be established prior to transfer, Sec. 1494(b) provides that, if after transfer the taxpayer does so establish, then the tax may be abated, refunded or remitted.) Normally, where the transferor is directly or indirectly related to the transferee, the transfer is subject to the tax.*

**Payment and Collection**

*Sec. 1494 provides that the transferor must file a verified return on the day of the transfer. Unless the transfer is exempted from taxation under a provision of Sec. 1492, the tax is due and payable immediately.*

*The statutory deficiency procedures of Secs. 6211-6216 do not apply to the Sec. 1491 excise tax.*

# Conference Diary

## APRIL 1979

*AMR International:* Project Financing (including tax implications of project financing), London (U.K.), April 2-3 (English).

*Management Centre Europe:* International Taxation (a working conference), Vienna (Austria), April 18-20 (English, French and German).

*Institute for International Research:* 1979 Corporate Tax Conference, London (U.K.), April 25-27 (English).

*Business International Institute:* International Seminar (including International Taxation), Port Chester, New York (U.S.A.), April 30 - May 11 (English).

## MAY 1979

*Seminar Services International:* The 10th multi-choice International Tax Planning Symposium, Montreux (Switzerland), May 7-9 (English, French and German).

*Investment and Property Studies:* The Vienna Conference (including international tax planning), Vienna (Austria), May 16-18 (English).

## JUNE 1979

*The Taxation Institute of Australia:* First International Convention (including Fundamental Concept in Double Taxation Treaties, Guide to Estate Planning Far East Locations), Hong Kong, June 10-16 (English).

*Management Centre Europe:* International Tax Management, Brussels (Belgium), June 21-22 (English).

## SEPTEMBER 1979

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FOR FURTHER INFORMATION PLEASE WRITE TO:

AMR International, 6-10 Frederick Close, Stanhope Place, London W2 2HD (U.K.)

Business International Institute, 12-14 chemin Rieu, 1208 Geneva 17 (Switzerland).

Business Perspectives: 11 Alexander Place, London SW7 2SG. Tel. 01-589-3197. Telex: 917036.

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

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# CUMULATIVE INDEX 1979 ~ Nos. 1 and 2

# Contents

of the April 1979 issue

# FRANCE: A Re-Orientation of the Discussion on Capital Taxation - PART 1

by Jean-Loup Haÿ*

## I. INTRODUCTION

*On January 12, 1979 the French Government presented a report to Parliament entitled "Prélèvement sur les fortunes" (Imposition of wealth tax), the purpose of which is to study the imposition of tax on large individual fortunes. This Report, which was drafted by a Committee composed of Messrs.* G. Ventejol, R. Blot *and* J. Méraud, *does no more than present the outline of a solution. It now rests upon the legislature to solve a great number of practical problems.*

*It may be expected that the French Parliament will during the Spring 1979 sessions devote many sittings to the debate on the direction the reform of the tax system on individual wealth should take. When this has been decided upon the Government will most certainly submit a draft bill.*

*At first glance the task of the legislature and the executive does not at all appear to be easy and this for deveral reasons.*

*The first one is that it is particularly difficult to propose the reform of certain parts of the French tax system without engendering passionate reactions whose effect will be to deprive the discussion of all calmness and objectivity.*

*The second reason is that numerous bills and proposals to adopt an annual net wealth tax (A.W.T.)* [1] *have already been presented during the years following the introduction of the National Solidarity Law (Impôt de Solidarité Nationale) in 1945.* [2]

*The third reason is linked to the fact that in the matter of capital taxation the experts present sharply opposed opinions. Indeed some of them consider that "capital is already overtaxed",* [3] *whereas for others the adoption of an A.W.T. would notably be a means to increase the degree of equity of the French tax system.*

*Finally, it is possible to mention a fourth reason, since many persons are convinced that there is a close connection between the study of the problems concerning the taxation of wealth and reflection upon our tax system as a whole. Such study presents for them an excellent opportunity to propose a general tax reform which would make our tax system simpler and clearer.*

*Thus, there will be no doubt that the Report of the Committee — which has indisputable merits and which contains proposals which are worth considering — will greatly assist the Members of Parliament. Taking into account the experiences of the past and the impact of numerous proposals for a tax reform,* [4] *the French Government will have a variety of opinions at its disposal to assist it in its decision as to what action should be undertaken.*

*This paper is an attempt to throw some light on the reasoning used by the Members of the Committee in their Report and the course of action they advocate, selecting those points which are essential for our subject. The paper further intends to show the development of thought of the "trois sages" (i.e. the "three wise men" as the Members of the Committee are usually called) through the analysis of the form and outline of the Report as well as by the demonstration of the importance of the conclusions and proposals.*

*A preliminary inspection of the outline adopted for the Report shows that its first part contains a survey of certain aspects of the French and foreign tax systems. In the second part the Committee discusses the various options and their merits in the tax, economic, social and administrative fields.*

COMPOSITION OF THE COMMITTEE

- Mr. Gabriel VENTEJOL, Chairman of the French Economic and Social Council
- Mr. Robert BLOT, Inspector General of Finance
- Mr. Jacques MERAUD, Inspector General of the I.N.S.E.E. (National Institute for Statistics and Economic Studies, Member of the Board of the Center for Study of Incomes and Costs, Chairman of the Committee on "Social Inequalities"
- Mr. Patrick CAREIL, Committee Reporter, Inspector of Finances
- Mr. Yvon LEFEBVRE, Inspector of Taxes, in charge of the Secretariat of the Commission

* Research Fellow at the University of Nice and the Center for International Tax Research. Mr. Haÿ is the author of "*Techniques et Politique d'Imposition du Capital*" which is his doctoral thesis presented on November 30, 1978. He has been in contact with Mr. Careil, the Committee Reporter, who indicated that the above work has been used as one of the Committee's main sources of information.

1. *Note from the editor.* Mr. Haÿ will in a future article to be published in the *Bulletin* present and analyse the bills and proposals for the introduction of a tax on capital and wealth which have been published in France since 1914.
2. This war wealth levy was composed of a capital levy based on the value of individual wealth on June 4, 1945 and a capital increment levy imposed on the increase of capital acquired between January 1, 1940 and June 4, 1945. The rates of the first tax ranged from 3 to 20 percent whereas the rates of the second tax started at 5 percent at the bottom of the rate table but reached 100 percent at the highest brackets. For more details and an international comparison, see Robson, P.: "CAPITAL LEVIES IN WESTERN EUROPE AFTER THE SECOND WORLD WAR" in the *Review of Economic Studies* 27 (72), 1959, pp. 23-43.
3. This is in fact the title of an article by P. Salin, *Le Monde*, January 16, 1979, pp. 19-20.
4. *Note from the editor.* The paper announced in note 1 above will present a description of the different taxes on wealth and capital imposed in France.

## OUTLINE OF THE REPORT

The draft version of the Report, which has been printed in a limited edition and is not available to the general public, is divided into two volumes:

VOLUME I: This Volume contains — in addition to (i) copies of the letters exchanged between the French Prime Minister, Mr. Raymond *Barre* and the members of the Committee; (ii) an extract of the official statement of the Council of Ministers of July 5, 1978 proposing the nomination of the "trois sages"; and (iii) a brief foreword — the following material:

(a) a synthesis which:
- shows the necessity of the imposition of tax;
- delimits the scope of the research intended;
- recapitulates the arguments in favor of an annual wealth tax and the effects of the introduction of such tax;
- demonstrates that the solution should be found in eliminating the defects of the French capital transfer tax system by adopting measures which ensure social justice, further economic progress and increase tax revenue.

(b) the text of the report itself which is divided in two parts each containing three chapters, as follows:

| | |
|---|---|
| *Part One:* | The aspects of French and foreign tax systems which are related to individual wealth. |
| Chapter I: | The taxation of wealth: a permanent problem in tax theory and history. |
| Chapter II: | The taxation of capital assets in France. |
| Chapter III: | The taxation of capital assets in foreign countries. |
| *Part Two:* | Thoughts and proposals of the Committee. |
| Chapter IV: | The reasons for taxing wealth. |
| Chapter V: | The advantages and disadvantages of an annual wealth tax. |
| Chapter VI: | The justification and the methods of a reform of succession and gift duties. |

VOLUME II: This volume contains the supplements to the Report, inter alia:

(a) a list of 46 persons selected for their particular qualifications who gave oral evidence — eventually submitting written evidence — to the Committee (Appendix 1);

(b) a list of 68 bibliographical sources in connection with the subject (Appendix 2);

(c) the appendices relating to each of the first three chapters (Part I of the Report) i.e.:
- for Chapter I — appendices 3 through 5,
- for Chapter II — appendices 6 through 25,
- for Chapter II — appendices 26 through 31.

In its final version, for public distribution by "La Documentation Française", the Report will be divided in three volumes, namely:

| | |
|---|---|
| VOLUME I: | the synthesis, the report itself and the appendices. |
| VOLUME II: | the tax experiments in foreign countries and an extract from the bibliography which appears in the doctoral thesis of the author of the present article. |
| VOLUME III: | The minutes of the session during which oral evidence was given. |

## II. THE "TECHNICAL" APPROACH: CLASSIFICATION, BURDEN AND PLACE OF TAXES ON WEALTH

The analytical and statistical information gathered by the Committee with a view to examining the taxation methods with respect to individual capital in France and the O.E.C.D. Member Countries enables one to distinguish four different groups.

The first two groups pertain to the oldest method of taxation of wealth which is known in France, i.e. the succession duties.[5] We will analyse the arguments which are used to show the lack of balance in the French capital transfer tax system and then proceed to comparison of the tax burden in a number of hypothetical cases followed by a discussion of the significance for total tax revenue of the capital transfer tax systems in a number of foreign countries.

The second two groups are basically concerned with capital taxes which have regard to other taxable events, such as the possession, the disposal or the acquisition of property. The discussion mainly focuses on the A.W.T., but other capital taxes such as land tax, capital gains tax and tax on capital transfers are also dealt with.

### A. The taxation of capital transfers in France: a system to reform

For the detailed study of the French capital transfer tax system (succession and gift duties) the Committee Reporter concludes that:

(i) the French succession and gift duty system is not sufficiently progressive, since the rate applicable to the last bracket is relatively low and since 1959 no sufficient inflation adjustment has been applied to its rate structure nor to the exemptions it offers;

(ii) because there are numerous statutory and effective exemptions, it is in particular the large estates which can avoid totally or partially the capital transfer tax;

(iii) various measures in favor of gifts reduce the progression even further.[6]

#### a. Progressivity of the tax

The first defect of the current French capital transfer tax system (see (i) above) has been thoroughly examined by the Committee. In this paper we will limit ourselves to the reproduction of the tables related to the succession duty on the transfer of wealth in the direct line of consanguinity.

Taking into account the rate and exemption changes

5. As indicated by the Committee Reporter, the French succession duties date from the Edict of 1645 which was extended by the Order in Council of 1703 (see the text of the Report in its draft version at 16). However, during the Middle Ages the Suzerain taxed every portion of an estate acquired by the successor of a Vassal (Report at 16, footnote 5).

6. See the Report, draft version, Vol. 1 at 39 (end of Chapter II,1).

which were introduced in 1959, 1968 and 1974 [7] the Committee shows the results of the non-adjustment for inflation of:

(i) The exemption which is granted to inheritors in the direct line of consanguinity, i.e. each heir or legatee in the direct line (father, mother, surviving children and those taking on behalf of a deceased child) may each take a certain amount free of succession duty. This exemption is also given to the surviving spouse (see Table I);

(ii) The tax credit which is granted to a spouse or to an inheritor in the direct line who has three or more children (either living or represented by living heirs). The tax credit is available for each child beyond the second one (see Table II);

(iii) The rate schedule of the sucession duty (see Table III).

**TABLE I**

**EXEMPTION FOR TRANSFERS IN THE DIRECT LINE**

| | 1959 | 1974 | 1978 |
|---|---|---|---|
| In Fr.Frs. in the year concerned | 100,000 | 175,000 | 175,000 |
| In Fr.Frs at their value in 1978 | 309,000 | 257,250 | 175,000 |

**TABLE II**

**TAX CREDIT FOR EACH CHILD BEYOND THE SECOND ONE**

| | 1952 | 1959 | 1978 |
|---|---|---|---|
| In Fr.Frs. in the year concerned | 2,000 | 2,000 | 2,000 |
| In Fr.Frs. at their value in 1978 | 7,860 | 6,180 | 2,000 |

**TABLE III**

**RATE SCHEDULE**

| Tax rate | 1959 in Fr.Frs. in the year concerned | 1959 in Fr.Frs. at their value in 1978 | 1978 |
|---|---|---|---|
| 5% | < 50,000 | < 154,000 | < 50,000 |
| 10% | 50,000-100,000 | 154,000-309,000 | 50,000- 75,000 |
| 15% | > 100,000 | > 309,000 | 75,000-100,000 |
| 20% | – | – | > 100,000 |

A synthesis of these different influences directly linked to the rate of inflation in France from 1959 through 1978 is presented in Table IV. The conclusion which may be drawn from that table is that:

(1) inflation has had since 1959 a disturbing influence on the French inheritance tax system;

(2) the increase of the burden of the inheritance tax has been inversely proportionate to the importance of the amount acquired by the heir or legatee; and

(3) the introduction of a new bracket of 20 percent for amounts acquired in excess of 100,000 Fr.Frs. has not actually increased the progressivity of the inheritance tax.

### b. Adverse effect of exemptions

The second defect of the French capital transfer tax — which causes a further disturbing effect — finds its origin in the various statutory and effective exemptions which permit large estates partially or totally to escape capital transfer taxation. For example, a great number of immovable and movable assets can at their first transfer be transferred exempt from tax, provided that certain conditions which contain a time element have been met (e.g. dwelling houses which have been constructed after December 31, 1947).

For some other assets, only 25 percent of their actual value constitutes the taxable base on which the succession or gift duty is imposed. This is, for instance, the case with rural real property which has been rented under a long-term contract.

Finally, substantial advantages can be derived from the use of the so-called "pacte tontinier", which is a sort of association among persons who are in the receipt of perpetual or life annuities, with the agreement that the shares or the annuities of those who die shall accrue to the survivors. Such a transfer is not subject to the normal rate of succession duty but to a flat 5.4 percent rate which is the rate generally applicable to capital transactions. In addition to these exemptions which legally reduce the taxable base, some taxpayers benefit from the fact that certain assets are "anonymous", i.e. not registered in the name of their owner, so that it will be hard for the tax administration to prove that they have been transferred. Other forms of tax evasion also exist which cause a *de facto* reduction of the taxable base or sometimes even result in an outright exemption. The social and economic consequences of these phenomena are serious because they tend to be cumulative, i.e. if the transfer of assets is concealed at one transfer it is most likely that they will also not be declared at the next transfer and so on.

### c. Gifts

The third defect of the French capital transfer tax system is the number of benefits granted in the case of gifts inter vivos. For instance, in the case of a "donation-partage", which is a kind of a gift in contemplation of death, reduced rates apply (reduction of 25 percent)

7. These changes concern mainly (i) the adoption of rate schedules with rates of 5, 10 and 15 percent and the grant of an exemption of 100,000 Fr.Frs. to the surviving spouse and each child (Law of December 28, 1959),(ii) the introduction of an additional bracket of 20 percent (Law of December 27, 1968) and (iii) the increase of the above exemption from 100,000 to 175,000 Fr.Frs. (Finance Act 1974).

**TABLE IV**

**COMPARISON OF THE INHERITANCE TAX BURDEN IN 1959 AND 1978**

(Computed in Fr.Frs. at their 1978 value)

| Portion of the estate | 150,000 | 325,000 | 500,000 | 1 million | 5 million | In excess of 10 million |
|---|---|---|---|---|---|---|
| *Amount of tax calculated in conformity with 1959 rules* | | | | | | |
| Exemption 309,000 | – | 16,000 | 191,000 | 691,000 | 4,691,000 | |
| Duties 5% | | 800 | 7,725 | 7,725 | 7,725 | |
| 10% | | | 3,700 | 15,500 | 15,500 | |
| 15% | | | – | 57,300 | 657,300 | |
| TOTAL | | | 11,425 | 80,520 | 680,520 | |
| Tax credit for 4 children: 2 x 6,180 = 12,360 | – | 0 | 0 | 68,160 | 668,160 | |
| Tax burden in % in 1959 | 0 | 0 | 0 | 7 | 13.5 | rate approaches 15% |
| *Tax due in 1978* | | | | | | |
| Exemption 175,000 | – | 150,000 | 325,000 | 825,000 | 4,825,000 | |
| Duties 5% | | 2,500 | 2,500 | 2,500 | 2,500 | |
| 10% | | 2,500 | 2,500 | 2,500 | 2,500 | |
| 15% | | 3,750 | 3,750 | 3,750 | 3,750 | |
| 20% | | 10,000 | 45,000 | 145,000 | 945,000 | |
| TOTAL | | 18,750 | 53,750 | 153,750 | 953,750 | |
| Tax credit for 4 children: 2 x 2,000 = 4,000 | | 14,750 | 49,750 | 149,750 | 949,750 | |
| Tax burden in % in 1978 | 0 | 5 | 10 | 15 | 19 | rate approaches 20% |
| Difference in tax burden 1978/1959 | 0 | + 5 | + 10 | + 8 | + 5.5 | + 5 |

if such a gift is made to a donee in the direct line. In the case of donation of "bare ownership" the taxable base is substantially reduced (i.e. if the donee is younger that 20 years gift duty is only due on 30 percent of the value of the asset). Under this scheme the original owner retains the beneficial use of the asset whereas the donee possesses the bare legal title to the property, which will, however, ripen into full ownership at the death of the donor. Since there is no transfer at the death of the latter no duties are imposed.

A striking example is also where a gift is made in the form of a "manual gift" (i.e. a "gift by direct tradition" whereby property is physically handed over to the donee, for instance cash). In such a case no gift duty is due and the gift is also disregarded at the death of the donor, except where the donee is an heir.

## B. The capital transfer tax systems in some O.E.C.D. countries: examples to follow

A study which is limited to the characteristics of the French capital transfer tax system is not the best means to conceive a policy correcting its defects or to determine the function of capital transfer taxes in the tax system as a whole.

Consequently, the Committee analyses various systems applicable in a number of O.E.C.D. countries from both the theoretical and practical points of view.

(a) In order to show the differences in capital transfer taxation the Committee Reporter has drawn up a graph (Figure 1) which compares the capital transfer taxes of seven countries whose economic and social development level is similar to that of France. For this purpose he has computed the hypothetical capital transfer tax which would be due in case an inheritance is acquired in the direct line and at varying amounts. The following three assumptions have been made:

(i) the deceased has only one heir;
(ii) the heir has two children;
(iii) in the case of the United States only the Federal Estate tax is taken into account. [8]

The advantage of this approach is that it not only shows that the progressivity of capital transfer taxes in France is relatively ineffective but it also indicates that the way to ensure (i) an effective exemption of small inheritances, (ii) a light tax burden on average inheritances and (iii) a heavy burden on major inheritances is that which is followed by the United States Estate Tax legislation at the Federal level.

(b) If such a reform of the French capital transfer tax system were to be envisaged it would result in a combined reform of the top and lowest rates as well

8. See the Report, draft version, Vol. 1, at 113.

as of the exemptions and the threshold at which the maximum marginal rate would apply.[9] In addition, like the policies adopted in the United Kingdom and the United States[10] reducing the tax advantages of trust property, France could reduce the opportunities to evade tax. Thus France could retain — if not increase — its current level of the capital transfer tax as a percentage of GNP and as a percentage of total tax revenue.[11]

(c) A very important conclusion reached by the Committee with respect to the function of various capital taxes in the tax system as a whole is that there is no positive correlation between the A.W.T. and a high yield of capital transfer taxes. On the one hand it can be concluded from Table V there is no correlation between the levels of the top rates and the existence of an A.W.T. in a tax system; on the other hand it appears from Table VI that the countries which have the highest yield of capital transfer tax have no A.W.T.[12]

9. See Table V.
10. These policies concern trusts and settlements in the United Kingdom which are treated in Schedule 6 of Finance Act 1975, and in the United States the treatment of the so-called "generation-skipping trust" which was amended by the Tax Reform of 1976.
11. See Tables VI.A and VI.B.
12. The case of Ireland is a particular one because of the major reform of the capital tax system enacted in 1974-75.

**TABLE V**

**CAPITAL TRANSFER TAXES ON INHERITANCES:**

**THRESHOLDS AND RATES**

(in Fr.Frs.)

| Countries | Categories of beneficiaries | Exemption (including brackets at zero rates) | Minimum rate % | Level at which top rate applies | Top rate % |
|---|---|---|---|---|---|
| Austria + | Surviving spouse | 8,150 | 2 | | 15* |
| | Children | 8,150 | 2 | | 15* |
| | Grandchildren | 8,150 | 4 | | 25* |
| | Parents | 1,630 | 6 | 16.3 million Fr.Frs. | 40* |
| | Brothers and sisters | 4,130 | 6 | | 40* |
| | Nephews and nieces | 1,630 | 8 | | 50* |
| | Non-related persons | 410 | 14 | | 60* |
| Belgium + | Surviving spouse | 25,450 | 3 or 7 | | 17 or 3 |
| | Children | 25,450 | 3 | | 17 |
| | Grandchildren | none | 3 | | 17 |
| | Parents | none | 3 | 1,270,000 | 17 |
| | Brothers and sisters | none | 13 | | 65 |
| | Nephews and nieces | none | 15 | | 70 |
| | Non-related persons | none | 20 | | 75 |
| Denmark + | Surviving spouse | 81,000 | 2 | | 32 |
| | Children | 6,500 | 2 | | 32 |
| | Grandchildren | 6,500 | 2 | | 32 |
| | Parents | 40 | 10 | 760,000 | 80 |
| | Brothers and sisters | 40 | 10 | | 80 |
| | Nephews and nieces | 40 | 10 | | 80 |
| | Non-related persons | 40 | 15 | | 90 |
| Finland + | Surviving spouse | 10,450 | 3.5 | | 11 |
| | Children | 2,600 | 3.5 | | 11 |
| | Grandchildren | 2,600 | 3.5 | | 11 |
| | Parents | 2,600 | 3.5 | 130,200 | 11 |
| | Brothers and sisters | 2,600 | 7 | | 22 |
| | Nephews and nieces | 2,600 | 10.5 | | 35 |
| | Non-related persons | 2,600 | 17.5 | | 55 |
| France | Surviving spouse | 175,000 | 5 | | 20 |
| | Children | 175,000 | 5 | 100,000 | 20 |
| | Grandchildren | 175,000 | 5 | | 20 |
| | Parents | 175,000 | 5 | | 20 |
| | Brothers and sisters | 10,000 | 35 | 150,000 | 45 |
| | Nephews and nieces | 10,000 | 55 | flat rate | 55 |
| | Non-related persons | 10,000 | 60 | | 60 |
| Germany + | Surviving spouse | 480,500 | 3 | | 35* |
| | Children | 173,000 | 3 | | 35* |
| | Grandchildren | 96,000 | 6 | | 50* |
| | Parents | 18,750 | 11 | 192.5 million Fr.Frs. | 65* |
| | Brothers and sisters | 18,750 | 11 | | 65* |
| | Nephews and nieces | 18,750 | 11 | | 70* |
| | Non-related persons | 5,750 | 20 | | 70* |

\+ This symbol indicates those countries where an annual wealth tax was in effect on 1st January 1976.
* Global progression (average rate).

TABLE V (CONTINUED)

| Countries | Categories of beneficiaries | Exemption (including brackets at zero rates) | Minimum rate % | Level at which top rate applies | Top rate % |
|---|---|---|---|---|---|
| Ireland + | Surviving spouse | 1,520,000 | 25 | | 50 |
| | Children | 1,520,000 | 25 | 2,535,000 | 50 |
| | Grandchildren | 152,000 | 5 | | 50 |
| | Parents | 152,000 | 5 | 1,955,000 | 50 |
| | Brothers and sisters | 101,500 | 10 | | 50 |
| | Nephews and nieces | 101,500 | 10 | 1,045,000 | 50 |
| | Non-related persons | 50,750 | 20 | 892,500 | 60 |
| Italy | Surviving spouse | | | | |
| | Children | | | | |
| | Grandchildren | | | | |
| | Parents | | | | |
| | Brothers and sisters | 25,500 | 3 | 7,350,000 | 19 |
| | Nephews and nieces | 14,650 | 3 | 7,350,000 | 24 |
| | Non-related persons | 7,350 | 3 | 7,350,000 | 29 |
| Japan | Surviving spouse | | | | |
| | Children | | | | |
| | Grandchildren | | | | |
| | Parents | | 10 | 8,200,000 | 75 |
| | Brothers and sisters | | | | |
| | Nephews and nieces | | | | |
| | Non-related persons | | | | |
| Luxembourg + | Surviving spouse | | 2.5 or 5 | | 4.4 or 11 |
| | Children | | 2.5 or 5 | | 4.4 or 11 |
| | Grandchildren | | 2.5 or 5 | | 4.4 or 11 |
| | Parents | 2,550 | 2.5 or 5 | 2,230,000 | 4.4 or 11 |
| | Brothers and sisters | | 15 | | 33 |
| | Nephews and nieces | | 15 | | 33 |
| | Non-related persons | | 15 | | 33 |
| Netherlands + | Surviving spouse | 470,000 | 3 | | 17 |
| | Children | 11,250 | 3 | | 17 |
| | Grandchildren | 11,250 | 5 | | 22 |
| | Parents | 94,000 | 10 | 940,000 | 28 |
| | Brothers and sisters | 3,000 | 18 | | 36 |
| | Nephews and nieces | 3,000 | 27 | | 45 |
| | Non-related persons | 3,000 | 36 | | 54 |
| | Non-profit institutions | 19,000 | | | |
| Norway + | Surviving spouse | total exemption | — | — | |
| | Children | | 8 | 405,450 | 35 |
| | Grandchildren | | 10 | 315,300 | 50 |
| | Parents | 45,050 | 8 | 405,540 | 35 |
| | Brothers and sisters | | 10 | | 50 |
| | Nephews and nieces | | 20 | 315,300 | 60 |
| | Non-related persons | | 20 | | 60 |
| Portugal | Surviving spouse | 36,500 | 8 | | 32 |
| | Children | 36,500 | 4 | | 35 |
| | Grandchildren | 36,500 | 4 | | 35 |
| | Parents | 18,250 | 10 | 9,100,000 | 48 |
| | Brothers and sisters | 18,250 | 10 | | 48 |
| | Nephews and nieces | 1,825 | 30 | | 75 |
| | Non-related persons | 1,825 | 30 | | 75 |
| Spain | Surviving spouse | 840 | 3 | | 21 |
| | Children | 840 | 3 | | 21 |
| | Grandchildren | 840 | 3 | | 21 |
| | Parents | 840 | 5 | 8,350,000 | 26 |
| | Brothers and sisters | | 28 | | 58 |
| | Nephews and nieces | | 40 | | 69 |
| | Non-related persons | | 58 | | 84 |

\+ This symbol indicates those countries where an annual wealth tax was in effect on 1st January 1976.
* Global progression (average rate).

TABLE V (CONTINUED)

| Countries | Categories of beneficiaries | Exemption (including brackets at zero rates) | Minimum rate % | Level at which top rate applies | Top rate % |
|---|---|---|---|---|---|
| Sweden + | Surviving spouse | 34,250 | 5 | 5,700,000 | 65 |
| | Children | 17,150 | 5 | | 65 |
| | Grandchildren | 17,150 | 5 | 1,141,550 | 65 |
| | Parents | 3,450 | 8 | | 72 |
| | Brothers and sisters | 3,450 | 8 | | 72 |
| | Nephews and nieces | 3,450 | 8 | | 72 |
| | Non-related persons | 3,450 | 8 | | 72 |
| Switzerland (Zurich) + | Surviving spouse | | | | |
| | Children | 57,250 | 2 | 950,000 | 6 |
| | Grandchildren | 57,250 | 2 | | 6 |
| | Parents | 57,250 | 4 | | 12 |
| | Brothers and sisters | 9,750 | 6 | | 18 |
| | Nephews and nieces | | 10 | | 30 |
| | Non-related persons | | 12 | | 36 |

\+ This symbol indicates those countries where an annual wealth tax was in effect on 1st January 1976.
* Global progression (average rate).

## C. The Annual Wealth Tax as a source of disparities and low yield

When studying the A.W.T. the Committee focussed its attention mainly on three points regarding technical aspects and yield.

(a) The search for taxable wealth and the determination of its value meets with a number of problems. In the first place "objets d'art", jewels, bearer securities, gold, etc. are often "anonymous" in the sense that there is either no legal obligation to have such property registered in the name of the owner or that there is no actual possibility to ascertain whether the taxpayers own such property. Secondly, even if it should be possible to establish the ownership of such property the tax administration often possesses only feeble means of checking on the taxpayers.

In this respect the Committee Reporter implicitly touches on a important aspect, i.e. that the more general the A.W.T. is made, or correlatively the more power of control that is granted to the tax administration, the more the individual taxpayer will be restricted in his investment decisions. Waiving bank secrecy may be one aspect of such restriction.

(b) Some detrimental disparities may appear with respect to the valuation of property, either because of different periods of time between two valuations or

TABLE VI.A

TAX BURDEN ON WEALTH, CAPITAL AND MOVEMENTS OF CAPITAL (IN % OF GNP)

| Kind of tax | Austria | Denmark | United States | Finland | France | United Kingdom | Ireland | Luxembourg | Norway | Netherlands | Germany | Sweden | Switzerland |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Land taxes | 0.33 | 1.73 | 3.68 | – | 0.7 | 3.98 | 2.5 | 0.28 | 0.17 | 0.63 | 0.4 | – | 0.17 |
| paid by households | | | 2.28 | | | 1.79 | | | | | | | |
| paid by corporate enterprises | | | 1.4 | | | 2.19 | | | | | | | |
| Annual Wealth Tax | 0.41 | 0.2 | – | 0.2 | – | – | 0.11 | 0.33 | 0.66 | 0.25 | 0.44 | 0.23 | 1.37 |
| paid by households | | | | | | | | | | | | | |
| paid by corporate enterprises | | | | | | | | | | | | | |
| Capital Transfer Taxes | 0.08 | 0.16 | 0.42 | 0.09 | 0.28 | 0.3 | 0.38 | 0.16 | 0.1 | 0.17 | 0.05 | 0.11 | 0.21 |
| on gifts | | | 0.03 | | | 0.3 | | | | | | | |
| on successions | | | 0.38 | | | | | | | | | | |
| Taxes on Capital Transactions | 0.2 | 0.47 | 0.03 | 0.48 | 0.48 | 0.26 | 0.32 | 0.87 | 0.09 | 0.42 | 0.2 | 0.17 | 0.38 |
| Taxes on Industry and Trade (Professional Tax) | 0.70 | – | – | – | 1.09 | – | – | – | – | – | 0.85 | – | – |
| Capital Gains Taxes | – | 0.02 | 0.58 | 0.04 | 0.02 | 0.51 | – | – | – | – | – | – | 0.34 |
| TOTAL | 1.72 | 2.58 | 4.71 | 0.81 | 2.57 | 5.05 | 3.31 | 1.64 | 1.02 | 1.47 | 1.94 | 0.51 | 2.47 |

TABLE VI.B

TAX BURDEN ON WEALTH, CAPITAL AND MOVEMENTS OF CAPITAL (IN % OF TOTAL TAX YIELD)

| Kind of tax | Austria | Denmark | United States | Finland | France | United King- dom | Ireland | Luxem- bourg | Norway | Nether- lands | Germany | Sweden | Switzer- land |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Land taxes | 0.84 | 4.03 | 12.15 | – | 1.89 | 10.84 | 7.33 | 0.6 | 0.37 | 1.35 | 1.13 | | 0.58 |
| paid by households | 0.21 | | 7.53 | | 1 | 4.88 | | | | | 0.68 | | 0.58 |
| paid by corporate enterprises | 0.63 | | 4.62 | | 0.89 | 5.96 | | | | | 0.45 | | |
| Annual Wealth Tax | 1.05 | 0.46 | – | 0.53 | – | – | 0.31 | 0.7 | 1.49 | 0.53 | 1.24 | 0.49 | 4.63 |
| paid by households | 0.38 | 0.46 | – | 0.51 | | | | 0.23 | 0.89 | 0.53 | 0.46 | 0.48 | 2.83 |
| paid by corporate enterprises | 0.67 | – | – | 0.02 | | | | 0.47 | 0.6 | | 0.78 | 0.01 | 1.8 |
| Capital Transfer Taxes | 0.2 | 0.38 | 1.38 | 0.23 | 0.76 | 0.81 | 1.13 | 0.34 | 0.22 | 0.37 | 0.14 | 0.25 | 0.72 |
| on gifts | | | 0.11 | | 0.1 | 0.81 | | | | 0.03 | 0.03 | 0.02 | |
| on successions | | | 1.27 | | 0.66 | | 1.13 | | 0.22 | 0.34 | 0.11 | 0.23 | 0.72 |
| Taxes on Capital Transactions | 0.52 | 1.1 | 0.1 | 1.29 | 1.31 | 0.7 | 0.94 | 3.38 | 0.2 | 0.9 | 0.57 | 0.36 | 1.3 |
| Taxes on Industry and Trade (Professional Tax) | 1.78 | – | – | – | 2.95 | – | – | 4.93 | – | – | 2.42 | – | – |
| Capital Gains Taxes | – | 0.05 | 1.92 | 0.11 | 0.05 | 1.38 | – | – | – | – | – | – | 1.15 |
| TOTAL | 4.39 | 6.02 | 15.55 | 2.16 | 6.93 | 13.73 | 9.71 | 9.95 | 2.28 | 3.15 | 5.50 | 1.10 | 8.38 |

because of different procedures used to compute the value of the taxpayer's assets.

The risk exists that the task of the tax administration will be made heavier and more complex if there will be a tendency to reduce the period of time between valuations so as to approach as closely as possible the actual value of the assets.

(c) The yield of the A.W.T. is not only low, but it also tends to decrease. Tables VI.A and VI.B show that except in the case of Switzerland the total revenue received from an A.W.T. does not exceed 1.5 percent of the total tax revenues.

The Committee, when comparing the statistical data with the technical and legal aspects of the A.W.T., remarks that in addition there are two paradoxes connected with this tax, i.e.:

- in the Scandinavian countries where the valuation procedure is rather rigorous and where the rates of the A.W.T. are both progressive and high, the yield of this tax as a percentage of GNP is lower than in Austria, Germany, Luxembourg and Switzerland where its application and the valuation procedures are less strict and where the rate is generally lower;
- in seven of the nine countries imposing an A.W.T., the yield of this tax does not exceed 0.25 percent of GNP, irrespective of the rates and taxable base.

Therefore, the A.W.T. does not appear to provide a good solution for France. This becomes increasingly valid if the other statistical data related to the various kinds of capital tax are considered.

## D. Capital taxation by using different non-exclusive taxes

The Committee examines each type of tax on wealth, capital and "manifestations" of capital, such as capital gains, transfer of capital and income from capital which are currently in force in France.

TABLE VII

BREAK DOWN OF TAX YIELDS OF CAPITAL TAXES IN FRANCE

| Kind of tax | Yield in 1,000,000,000 Fr.Frs. (1977) | Yield as a % of total taxation (state and local authorities) |
|---|---|---|
| Tax on unimproved real property | 2.9 | 0.72% |
| Tax on improved real property | 6.8 | 1.7 % |
| Business (professional) tax | 23.1 | 5.8 % |
| Succession and gift duties | 3.76 | 0.95% |
| Taxes on capital and financial transactions | 3.5 | 1.12% |
| Special tax on cars | 3.3 | 0.82% |
| Capital gains taxes | 0.624 | 0.16% |
| Taxes on income from land | 3.3 | 0.82% |
| Taxes on income from stocks and shares | 10.7 | 2.7 % |

(a) The Committee notes that there is a great number of such taxes, that their rates are not negligible and that their total yield is substantial.[13] Indeed, according to a conservative estimate the French capital taxes in 1977 produced 2.07 percent of total tax revenue. This percentage includes only the capital transfer taxes (succession and gift duties) and the tax on capital transactions (i.e. the "droits d'enregistrement sur les mutations à titre onéreux", such as the registration duty on the transfer of land). If the yield of the land taxes, the taxes on motorcars and the capital gains tax is added to the yield of the above taxes a percentage of 5.47 is obtained. Final-

13. See Table VII.

ly, if one takes into account the business tax (taxe professionnelle), 50 percent of which is based on capital, [14] the total reaches a tax burden equal to 8.37 percent of the total tax revenue.

(b) The Committee is not only interested in these quantitative aspects but also in the different treatments which are based on the nature of the capital assets. A great number of assets — some of them movable and some immovable — are not only exempt from capital transfer tax or receive privileged treatment under this tax but are also exempt from other taxes. [15] On the other hands, other assets [16] are brought within the scope of many taxes and thus suffer a high rate of tax in relation to their real market value.

(c) Considering the observations made by the Committee as to (i) the fact that the tax base of the A.W.T. systems studied in the report is "non-general" in its scope but rather focusses on certain categories of assets and (ii) the fact that the capital taxes in force in France have a much more global impact also with respect to the tax burden suffered by the taxpayers, it seems perfectly justified that the Committe reached the opinion that the reform of one of the other types of tax on wealth or capital (i.e. succession and gift duties) is the best solution as an alternative to the introduction of an A.W.T.

(d) A brief comparison of the burden and function of different taxes based on capital in a number of O.E.C.D. countries supports this conviction. Indeed, the data presented in Table VI.A prove that:

(i) The total burden of the different taxes on capital and wealth imposed in France places this country just ahead of the United Kingdom and the United States where no A.W.T. exists but just behind most of the countries where there is such A.W.T.;

(ii) The yield of capital transfer taxes and land taxes is generally more substantial in those countries where the A.W.T. does not exist;

(iii) The yield of A.W.T. should to some extent be considered a compensation for the lack of a tax based on realized capital gains.

***

It appears that on the one hand the statistical data and the information with respect to the structure of capital taxes which were available to the Committee were not in favor of the adoption of an A.W.T. After rejecting this method of taxation and justifying its opinion the Committee would have been entitled to consider its task completed.

On the other hand, it was clear that the question of a possible reform of the French tax system has not been solved.

When considering the theoretical and practical arguments used by the opponents and supporters of an A.W.T. the Committee was obliged to express its thoughts and to carry on the debate on the same level at which present discussions are being held. In doing so the Committee could state that it thought the introduction of an A.W.T. to be inopportune and it could suggest another solution based on the observation of the factual situation in France and abroad, also taking into account certain goals which it had earlier defined.

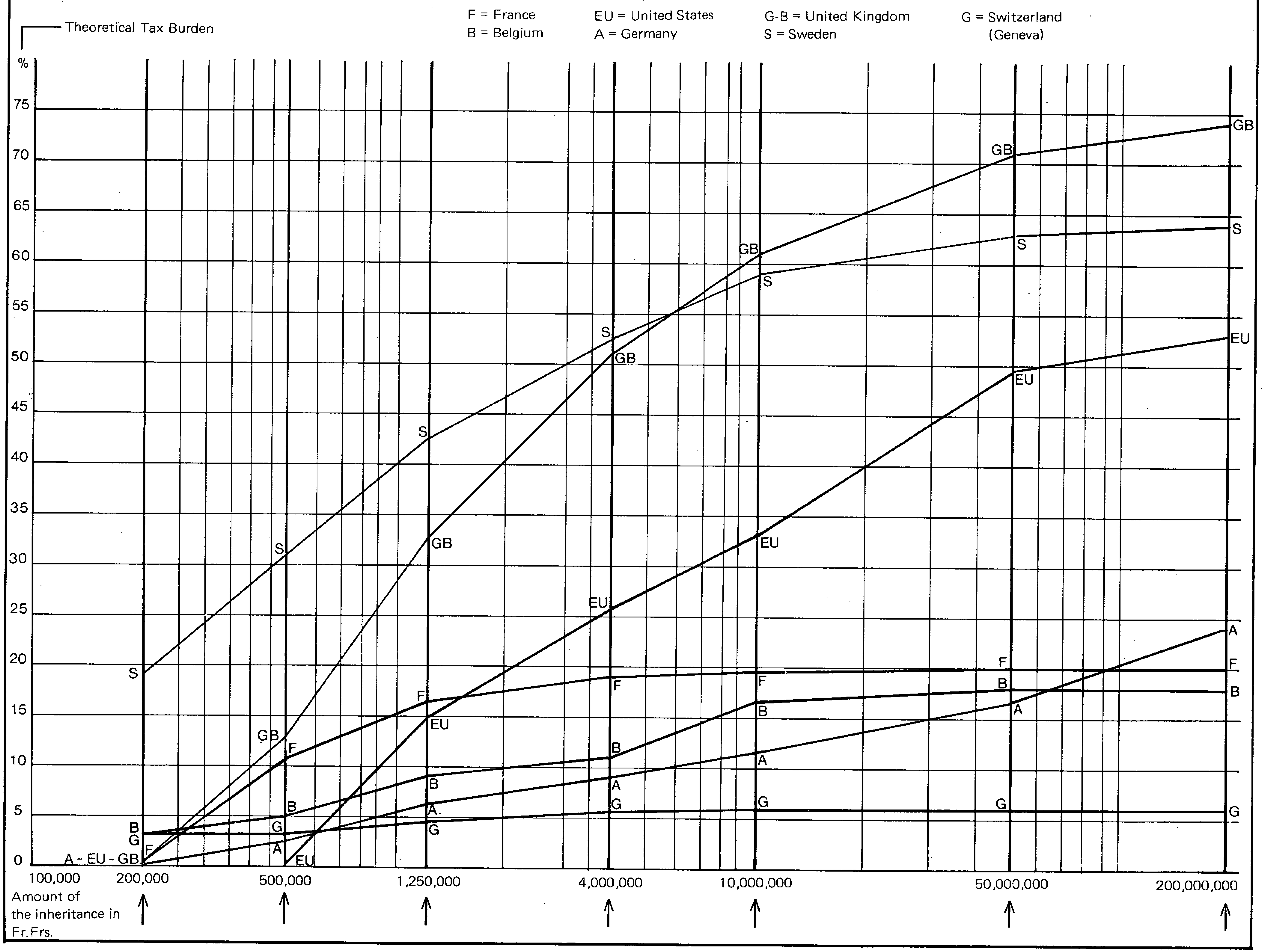
14. The other part (50 percent) of the tax base is constituted by wages paid (payroll).

15. In particular, cash vouchers and Treasury Bills.

16. The worst tax treatment seems to be the one which is imposed on immovable assets used for industrial and commercial activities.

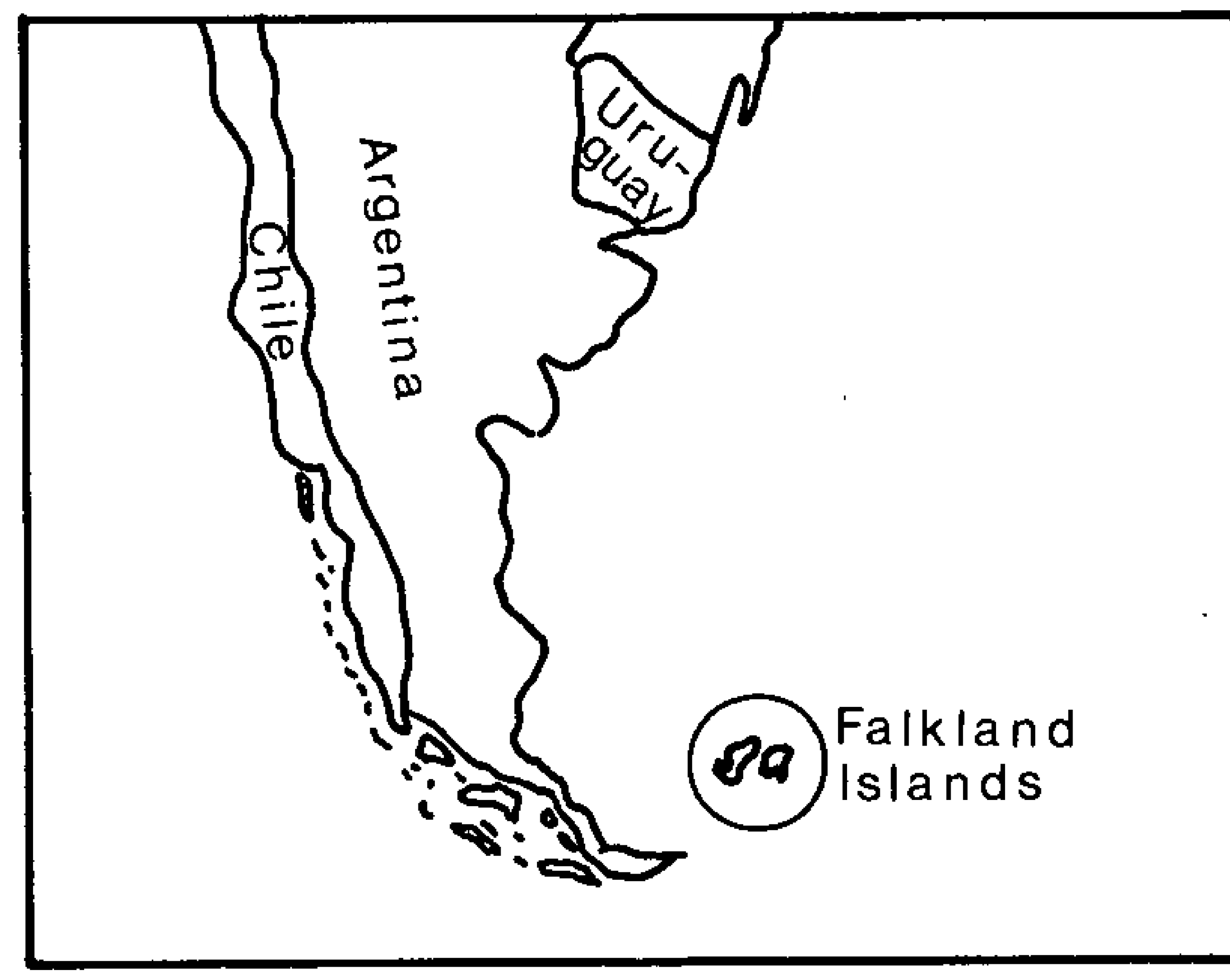
[to be continued]

**Figure 1 — Theoretical burden of duties on the portion of the estate received in the direct line in seven countries**



# The Falkland Islands:
# A Brief Survey of the Tax System

by H.W.T. Pepper




CONTENTS



## 1. Introduction

The economy of the Falklands is basically a monoculture, the overwhelmingly important product and export being long-staple wool of the Shetland variety. Other productive activities in the cash economy are the tourist industry (mainly relatively brief calls by cruise ships), a small export of sheepskins, and a small production of mementoes for sale to tourists. Potential industries for the future include the exploitation of the rich beds of kelp around the islands for the manufacture of alginates, deep-sea fishing, and oil exploration.

The small population (approx. 1800) are virtually self-sufficient in fresh vegetables, grown locally, and meat, but flour, sugar, tinned goods, and other groceries are imported, as well as all manufactured goods.

## 2. Communications

Apart from calls by cruise ships, and a chartered freighter which brings in supplies and takes out wool 4 times a year, there is a twice-weekly air service linking the islands to Argentina and the rest of the world. There are also telephone, telex, and cable connections with the rest of the world. Internal communication is mainly by seaplane and boat, using the many fine harbours, and overland by 4-wheel drive landrover. A highway is, however, now being built to connect the capital Port Stanley to the main "provincial" settlement at Darwin.

## 3. Government revenue

Government revenue is derived mainly from two sources; income tax on individuals and companies, and customs duties on alcohol and tobacco products. Tax revenue comprises direct and indirect taxation in the ratio of 5:1 in favour of direct tax, a most unusual situation in an underdeveloped country, though of course quite compatible with social justice. Freight charges on imports are very high and there are virtually no customs duties on items other than tobacco and alcohol.

Philatelic and numismatic issues produce relatively large (non-tax) revenue from overseas sales.

There are no sales taxes, nor any form of levy on the production or export of wool, nor on the small export of hides and skins. There are no land or property taxes except in the capital, Port Stanley, where there is an annual levy ("rates") on the annual (rental) value of real property.

## 4. Death duties

Death duties have little importance as a revenue source. The maximum rate is 10 percent but most property is outside the scope of the levy since most land and buildings are owned by overseas companies, whose shareholders are also resident overseas.

## 5. Company taxation

*a. Registration*
The maximum fee payable on registration of a company in the Falklands is £250. This is a once-for-all fee, there being no subsequent annual registration fees, though there are trivial fees for filing documents etc.

*b. Income tax*
Companies' incomes are subject to income tax at a flat

rate of 45 percent — the same rules on taxable and deductible items applying as those to businesses carried on by individuals and partnerships. Dividends paid are not deductible from income but there is full imputation of the company tax of 45 percent in dividends paid to shareholders out of such income. See following notes on Income Tax in general.

## 6. Income taxation

*a. General: scope*

Income tax in the Falkland Islands applies to income arising in the country, and to the foreign income of persons resident in the Islands. In the case of individuals foreign income is fully assessable if the individual is domiciled and ordinarily resident as well as resident in the country (see also separate notes under companies and individuals). Certain types of income are exempt from tax in the Falklands, viz.,:

- the official income of the Governor, and of diplomatic and consular officials;
- remuneration of members of H.M. Armed Forces and H.M. Government officers generally (the exemption does not extend to Falklands Government employees);
- wounds and disability pensions;
- income of local authorities
- charities' incomes;
- building societies;
- friendly societies;
- Government savings bank's income and interest credited by the bank to depositors;
- Government educational grants.

There are special arrangements for the taxation of whalers and sealers but these are of no present significance since these trades have ceased.

*b. Deductions allowable*

The following deductions are allowable in arriving at the taxable income, whether the business is carried on by companies or individuals either sole or in partnership:

All outgoings and expenses wholly and exclusively incurred during the basis year by the taxpayer in production of the income including the following:

(a) interest on borrowed capital used in acquiring the income;
(b) rent of land and buildings used in acquiring the income;
(c) replacement of obsolete plant and machinery (see also "Obsolescence" below);
(d) expenditure on repairs of premises, plant and machinery, repair or alteration of articles used in acquiring the income;
(e) bad and (reserves for) doubtful debts (recoveries are treated as income);
(f) annuities paid.

*Note* The restriction of deductions to those "wholly and exclusively incurred . . . . . in production of the income" is similar to that in the British Income Tax Code — accordingly a large body of British case law on the subject of what is "wholly and exclusively incurred" is relevant in determining what is appropriately deductible in the Falklands.

*c. Companies income tax*

A company is regarded as "resident" in the Falklands for tax purposes if the management and control is exercised in the country. A resident company is taxable on its world income. A non-resident company is taxable only on its income arising in the Falklands.

Company income, from whatever source, is taxable at a flat rate of 45 percent, subject to relief for double taxation, and for dividend tax (q.v.).

*d. Individual income tax*

*(i) Residence and scope*

An individual who is resident in the Falkland Islands, and also ordinarily resident and domiciled there, is taxable on his world-wide income, whether remitted or not.

There is an exception to the above rule in that "earned" income from overseas, i.e., remuneration, or a pension relating to an employment previously carried on overseas, is taxable upon persons in the above category only to the extent that the income is remitted to the Falkland Islands, and then, of course, subject to any double taxation relief that may be due.

If an individual is resident, but either not ordinarily resident, *or* not domiciled in the country, he is liable to tax on his world-wide income, but only on that part which is derived in the country, and that part of his overseas income which is remitted to the Falklands.

An individual who is not resident in the Falklands is taxable there only on income arising in the country. An individual is not regarded as resident in the Falklands for a particular tax year if he is present in the country for a temporary purpose only and is there for less than 6 months of the year.

*(ii) Computation of individual income tax*

The question of whether income should be taxed on the "arising" or "remittance" basis is dealt with in the immediately preceding paragraphs. Deductions from income are dealt with above under that heading.

In addition, however, individuals resident in the Falklands are entitled to certain personal reliefs as indicated below.

*(iii) Personal reliefs*

Certain deductions are made from the assessable income of a resident individual in computing the amount of income to be subjected to tax, viz.:

| | | |
|---|---|---|
| *Personal relief* | Individual | £400 |
| | Wife | £350 |
| *Child relief* | Each child | £300 |
| | Child being educated overseas (each) | £320 |
| *Dependent relative* | | |
| | Each | £300 |
| | Female relative in charge of children | £175 |

*Earned income relief*
1/5th of earned income (maximum relief = £850)

*Wife's earned income relief*
1/5th of her earned income (maximum relief = £850)

*Old age relief* (persons over 65) (married) — a deduction of 2/3rds difference between total income and £1050
(single) — a deduction of 1/3rd difference between total income and £1050

N.B. the old age relief only helps those with incomes below £1,050.

*Dividend tax relief*
See penultimate paragraph of these notes.

*(iv) Tax rates*
The tax rates applicable to the incomes of resident individuals, after all deductions and reliefs are deducted are:

| *Taxable income* | | *Rates (%)* |
|---|---|---|
| First | £ 500 | 17½ |
| Next | £ 500 | 22½ |
| Next | £ 500 | 27½ |
| Next | £1,000 | 35 |
| Next | £1,000 | 40 |
| Next | £1,000 | 45 |
| Remainder | | 50 |

*e. Double taxation relief*
There is a Double Taxation Agreement between the Falkland Islands and the United Kingdom. The Agreement has also been extended to Denmark, Norway, Sweden, Switzerland and the USA.

If a taxpayer is resident in the Falklands for tax purposes, relief is given from Falklands tax in respect of the foreign tax at the rate of tax applied to the doubly-taxed income in the foreign country or at ½ the Falklands rate of tax, whichever is less.

The relief applied to doubly-taxed income in the Falklands where the taxpayer is non-resident, is ½ the rate of tax applied in the foreign country.

*f. Example of computation of individual's income tax liability*

A has the following income:

| | £ |
|---|---|
| Salary from employment | 5,000 |
| Dividends from local company | 200 |
| Wife's salary (part-time job) | 1,000 |
| | 6,200 |

Less

| | | | |
|---|---|---|---|
| Earned income relief | | | |
| self | 850 (max.) | | |
| wife | 200 (1/5th of £1,000) | | |
| Personal relief | | | |
| self | 400 | | |
| wife | 350 | | |
| Child relief | | | |
| 2 x 300 = | 600 | | |
| 1 x 320 = | 320 | | |
| Dependent relative | 300 | 3,020 | |
| Taxable income | | 3,180 | |

| | | | % | £ |
|---|---|---|---|---|
| | 500 | | @ 17½ = | 87.5 |
| | 500 | | @ 22½ = | 112.5 |
| | 500 | | @ 27½ = | 137.5 |
| | 1,000 | 2,500 | @ 35 = | 350.0 |
| | | 680 | @ 40 = | 272.0 |
| Total tax | | | = | 959.5 |
| less dividend tax credit | | 200 | @ 45 = | 90.0 |
| Net total tax payable | | | = | 869.5 |

*g. Basis of assessment*
The tax year commences 1 January and ends 31 December, and tax is assessed on the income of the previous year, both for individuals and companies.

Where the accounts of a business are annually made up to some date other than 31 December, the Tax Department will normally accept the accounting year instead of the calendar year as the basis year the profits of which will be assessed in the tax year.

*h. Losses*
A loss made in the tax year may be offset against the assessment of that year (which is based on the previous year's income) or be carried forward to set against future income of the taxpayer, at the taxpayer's option.

*i. Depreciation*
Depreciation allowances are given in respect of property including plant and machinery used in producing the income. The rate of allowance is required to be the "reasonable" rate, which of course, varies from item to item. Depreciable assets include agricultural buildings and fencing. Allowances are computed on original cost in the first year; subsequently on written-down value.

*j. Obsolescence*
When assets are scrapped, or sold for less than the written-down value after deducting depreciation allowances, an allowance is due of the difference between the written-down value and the sale proceeds, if any.

*k. Example of depreciation calculation*
Asset (machinery) bought for £4,000 1 March 1974.
Rate of Depreciation agreed at 15 percent.
Machinery damaged and scrapped October 1978.
New (replacement) machine bought for £6,000 October 1978.

The depreciation allowances are as follows:

| | | | *Allowance* |
|---|---|---|---|
| Cost of machine = | | 4,000 | |
| 1975 Tax year | 15% dep'n | 600 | 600 |
| Written-down-value | | 3,400 | |
| 1976 Tax year | 15% | 510 | 510 |
| W.D.V. | | 2,890 | |
| 1977 Tax year | 15% | 433 | 433 |

| | | | | |
|---|---|---|---|---|
| W.D.V. | | | 2,457 | |
| 1978 Tax year | 15% | | 369 | 369 |
| W.D.V. | | | 2,088 | |
| Scrapped in 1978: proceeds | | | 150 | |
| ("Obsolescence" allowance | | | 1,938) | |
| New machine bought 1978 | | | 6,000 | |
| 1979 Tax year depreciation | 15% | 1938 + | 900 | 2,838 |
| | | | 5,100 | |
| 1980 Tax year | 15% | | 765 | 765 |
| W.D.V. | | | 4,335 | |

*l. Dividend tax relief*

Tax is deductible from dividends paid by Falkland Island companies at the rate of 45 percent, the rate of tax applicable to the income of the company out of which the dividends are paid, i.e., there is full imputation of the company tax to the shareholder.

The shareholder is assessable on the *gross* dividend but receives relief in respect of the 45 percent tax deducted. Where the shareholder is a resident individual the tax charged upon his total income may be payable at a lower rate of tax than 45 percent, in which case there will be a net gain to him in respect of the tax imputed to the dividend.

## 7. Customs duties

Almost the whole revenue from customs duties is obtained from the duties on alcohol and tobacco, which are as follows:

| | |
|---|---|
| Beer, ale, etc. | £0.33 per gallon |
| Spirits | £15.00 per gallon |
| Wines | £0.90 per gallon |
| Vermouth, sherry and port | £1.10 per gallon |
| Cigars | £5.00 per pound avoirdupois |
| Cigarettes | £3.30 per pound avoirdupois |
| Tobacco | £2.80 per pound avoirdupois |

I.A.Malik*:

# Use of Presumptive Tax Assessment Techniques in Taxation of Small Traders and Professionals in Africa

## I. INTRODUCTION

*The small traders and various categories of self-employed are generally recognised as hard to tax groups of taxpayers. In more developed countries however, the problem is not so acute as in the less developed countries because of the wider coverage of the tax systems and the existence of comparatively better and efficient tax administrations. However, the problem of taxing these groups of taxpayers is particularly acute in African developing countries in view of the general low tax morality, illiteracy and inadequate tax administrations. This has resulted in a situation in which the number of potential taxpayers required to meet their tax obligations under their existing tax laws is very large.*

*Fiscal policy makers and tax administrators are naturally disturbed with this situation which not only results in the loss of much needed tax revenues to the Governments concerned but also causes further distortions in the principles of equity in taxation. This awareness is at the back of the mind of tax administrators in many countries who have started experimenting in recent years with the adoption of special tax assessment techniques in such cases.*

**TABLE OF CONTENTS**



## II. DIMENSION OF THE PROBLEM

The self-employed categories of taxpayers in African developing countries, as in other countries, cover a wide spectrum. In these categories are included such occupational groups as small and medium sized traders, retailers, furniture makers, masons, carpenters, fitters, electricians, tailors, taxi or truck owners, transport contractors, bar, cafe and teashop owners, shoemakers, bakers, barbers, doctors, herbalists, lawyers, oath commissioners, photographers, goldsmiths, garages, repair centres and fishermen, etc.

There is no doubt that the bulk of income earners in these categories in Africa have low incomes which fall below the exemption limits provided in the tax laws of the countries concerned. However the numbers above the exemption limits who are not caught in the tax net are quite substantial. The crucial task of the tax administrators in these countries therefore is:
(a) to identify these potential taxpayers and
(b) to assess and collect the tax which is due.

There are no doubt enormous difficulties involved in this task. Most of these income earners do not keep any proper accounts which could form the basis of preparing their tax returns as required. Even in cases in which accounts are kept, the non-submission of the tax returns to the authorities is deliberate. In many developing countries in Africa, because of weak and inefficient tax administrators there are hardly any attempts to force these tax evaders to comply with the requirements of the tax law. Even in countries where the tax administrators are abreast of the problem this has not been tackled in a well-planned and co-ordinated manner with the result that the measures taken being sporadic in character do not often produce the desired results. This weakness

* ECA Senior Regional Adviser in Public Finance & Budgetary Management. The material presented in this article is based on a draft ECA study recently conducted by the author. This study is in course of finalisation and the author would feel grateful for any suggestions and materials to make it more comprehensive. The opinions expressed in this article are those of the author and do not necessarily represent the views of the ECA.

on the part of the tax administrators is well known to the tax evaders who make full use of it to their advantage.

It need hardly be emphasised that the successful imposition of income tax requires the wide-spread acceptance and prevalence of the practice of the maintenance of proper accounting records and compliance with the provisions of the law for the submission of account returns. However, these essential prerequisites are still lacking in many African countries especially in the cases of small traders and other categories of self-employed income earners. In a situation like this the question arises what is to be done? Should the countries concerned wait until the taxpayers fulfill this essential condition or the tax administrations become sufficiently strong and efficient to be able to force the defaulters to comply with the provisions of the law? There are obvious dangers in this approach of waiting until things become better. In the meantime this would perpetuate the patterns of tax evasion and make indulgence in the same a rewarding exercise. Further it would accentuate the income distribution distortions. Therefore, in view of these circumstances, the developing countries in Africa cannot afford to wait. The need for generating ever increasing amounts of domestic resources for the economic and social development of these countries is so great that something has surely to be done in the short run to plug the loopholes of tax evasion as fas as possible and at the same time to take measures to strengthen and improve the tax administration.

**In developing countries lump sum taxation is a prerequisite for an equitable tax system which offers governments the means to further social and economic development**

Under normal circumstances, the tax administration would be concerned with the determination of the actual income of the taxpayer. Where this is not possible, because of lack of accounting records and non-submission of tax returns or submission of incorrect returns, the tax legislation in practically all cases allows the tax authorities to resort to techniques of determining or estimating income for tax purposes. It would not be wrong to say that the essence of the concept behind the exercise of estimation or presumption is the same although there may be differences in the methodology applied. It is interesting to note that there are different names given to this exercise in different countries depending on the information, factors or techniques made use of in reaching income estimates in the absence of information on real taxable income. The tax systems based on the British Law, for example, more commonly use the term "Best Judgement Assessment". In Sweden the term applied is "Discretionary Assessment". Brazil uses the term "Assessment Ex-officio", France applies the term "Taxation d'office" while Switzerland uses the term "Estimated Assessment". The tax systems of some countries have also a lump sum tax or "Impôt Spécial" or agreed income tax or "forfait".

# What is ECA?

ECA or the Economic Commission for Africa is a regional economic commission of the United Nations whose purpose is to initiate and to take part in measures for facilitating Africa's economic development. It was founded in 1958, and its headquarters are located in Addis Ababa, Ethiopia.
Other regional commissions are the Economic Commission for Europe (ECE), the Economic and Social Commission for Asia and the Pacific (ESCAP), the Economic Commission for Latin America (ECLA) and the Economic Commission for Western Asia (ECWA).

Members of ECA are:

Algeria
Angola
Benin
Botswana
Burundi
Cameroon
Cape Verde
Central African Empire
Chad
Comoros
Congo
Egypt
Equatorial Guinea
Ethiopia
Gabon
The Gambia
Ghana
Guinea
Guinea-Bissau
Ivory Coast
Kenya
Lesotho
Liberia
Libya
Madagascar
Malawi
Mali
Mauritania
Mauritius
Morocco
Mozambique
Niger
Nigeria
Rwanda
São Tomé and Príncipe
Senegal
Sierra Leone
Somalia
South Africa (suspended since 1963)
Sudan
Swaziland
Tanzania
Togo
Tunisia
Uganda
Upper Volta
Zaïre
Zambia

Associate members are: France, Namibia (South West Africa) and the United Kingdom, whereas Djibouti became eligible for full membership when it joined the United Nations in September 1977.

The organization of the ECA consists, inter alia, of the Conference of Ministers which decides on matters of general policy and priority to be assigned to the program and other activities of the Commission. The latter's task is to promote and facilitate concerted action for the social and economic development of African countries. A Technical Committee is charged with the examination of studies prepared by the ECA secretariat and the Executive Committee assists the Executive Secretary in implementing the work program and the resolutions of the Commission.

The "Best Judgement Assessment" in trying to determine real income as far as possible generally assumes the character of a sanction. However, the taxpayer may be given the right to show, if he is able to, that the assessment made upon him is an overestimation. On the other hand, "Estimated, Presumptive or Potential Income Assessments" are usually based on some external factors of "signs of wealth", averages, gross sales, value of property, number of employees, location of business, types of trade inventories, age and quality of equipment used and so on. Thus, instead of trying to judge or determine real income by these approaches, it is attempted to determine as far as possible a substitute for real taxable income with the help of such criteria as become available easily. It is not my intention here to go into details on the differences in terminology in these cases.[1] The essence of the matter in all such approaches is that the tax administrator relinquishes the idea of having recourse to the actual accounts records to determine taxable income under the normal procedures. The tax returns may still be required to be submitted and the account books produced under the law as it stands but in actual practice, in view of the obvious difficulties, these requirements may not be insisted upon. Once the system of presumptive or estimated assessment is made applicable (by law generally), the basis for assessments cannot be changed by the administration unless the taxpayer agrees to submit full accounts and agrees to be assessed in future on the basis of his returns of actual income. In that case he will be struck from the list of assessees on estimated or presumptive basis. *Mr. A. Lapidoth*[2] thinks that if the taxpayer is given the option to prove his actual income the assessment resembles that of a "Best Judgement Assessment". However, if he is deprived of the right to prove his actual income the assessment is on estimated income. There is no doubt that Mr. Lapidoth has made a great contribution in making these distinctions clear in view of the variety of approaches used. These clarifications can be considered in the light of the tax law of each country and the rules and procedures laid down thereunder.

In actual practice, in most of the countries in Africa the tax administration is authorised to presume income where the taxpayer fails to supply information for a direct determination. However, in most cases the taxpayer is given the right to rebut the presumption by providing adequate proof. Since the taxpayer is entitled to rebut the "Best Judgement Assessment" as well, there is not much difference in actual application of presumptive, estimated, or best judgement assessments in the African situation. However, what is important is the right of rebuttal by the taxpayer. As the exercise of this right would be subject to the production of proper returns and records required under the law, this would provide an incentive to the taxpayers to comply with these requirements. Presumption at somewhat higher rates than seems probable may even have the effect of forcing the taxpayers to keep and produce proper records, thus laying the basis for the application of normal procedures which should be the ultimate aim of tax administration.

## III. SOME COUNTRY EXPERIENCES

*In the light of the above discussion of the dimensions of the problem, let us now look briefly at the experiences of some of the African countries, and some other countries which have a strong influence on the African tax systems, in the use of presumptive or estimated assessment techniques.*

### A. The French legacy – "Régime du forfait" ("Forfait" regime)

The experience of France itself is quite rich in this respect. Moreover, France has bequeathed the legacy to most of the French-speaking countries in Africa. So it would be helpful to begin with a look at the French system. The basic features of this system are:

#### 1. Estimating taxable income

For more than 1,000,000 French businessmen, the normal procedures for determining taxable income have little relevance. These taxpayers are not required to report their actual business income (bénéfice réel); instead, each taxpayer individually makes a bilateral agreement with the tax administration as to the amount of his estimated business income. This is France's celebrated *"forfait" regime.*

The taxable income which the "forfait" system seeks to fix is "normal income" which is not the income that an enterprise actually earns in a particular year; it is the sum that an enterprise should normally be able to earn, determined in so far as possible on the basis of income earned over several years (a period sufficiently long so that the income fixed may be considered as the expression of average results). The "forfait" system applied to business income is an "individual forfait", as distinguished from the "collective forfait" applied to agricultural income. The aim is to determine the average income of a particular taxpayer, not of a class of taxpayers.

The starting point in the determination of normal income is the submission by the taxpayer of form 951. The taxpayer and the administration then proceed to reach agreement (or disagreement) on the amount of the taxpayer's normal business income. The agreement under the present law establishes a figure applicable for two years; the year prior to the year during which the agreement is reached, and the year during which the agreement is reached. In the majority of cases, and under ordinary circumstances, this agreed figure is renewed for another one-year period by tacit agreement (renouvelé par tacite reconduction). But the agreed figure

1. For a more detailed discussion on semantic and conceptual differences in the use of these terms refer to "The Use of Estimation for the Assessment of Taxable Business Income" by A. Lapidoth in the series Selected Monographs on Taxation, Vol. 4 published by the Harvard Law School and the International Bureau of Fiscal Documentation (1977). See also his article: "The Israeli experience of using tachshiv for estimating taxable income", in 31 Bulletin 99, 417 (1977).
2. Id.

may be denounced for the future by either party. "Denunciation" of the agreed income figure does not involve abandonment of the agreed income system and a change to the actual income system; it means only that one party to the agreement is dissatisfied with the agreed figure and seeks to establish a higher or lower figure. Nevertheless, business taxpayers who keep adequate books have a unilateral option to be taxed on the basis of actual income.

The General Tax Division periodically issues instructions to the local tax authorities to aid them in administering the agreed income system. These instructions are of considerable importance in determining the policies to be followed by local tax agents. In June 1959, for example, material was issued to tax inspectors covering toys and games, at both manufacturing and retail stages. Such matters as diversity of products, impossibility of long production runs, typical prices, seasonal factors, nature of customers, geographical dispersion, kind of equipment, relative importance of hand labour, circuits of distribution, and inventory requirements were discussed. Cost breakdowns for typical products were given, as well as estimated or average profit. Net income was estimated at 6 to 8 percent of sales, smaller enterprises might earn 10 percent, and family firms employing no outside labour, 12 percent or more. The document was supplemented by a confidential study available only to agents of the administration and directed especially to the problems of verification. The most important feature of this study was a detailed analysis of the evolution of the industry, increase or decrease in number of firms, average sales, average income and the like. Such national studies are sometimes supplemented by departmental monographs of a similar nature.

In addition to using the more or less general statistical material, the tax inspector will compare the taxpayer's reported figures with those of other taxpayers in the same business and locality. These figures are typically arranged in the order of reported turnover, which is regarded as "the most characteristic element of the enterprise". Any unusual feature of the particular taxpayer's figures may then become apparent.

### 2. Determination of income on the basis of external criteria of wealth

The provisions of the French tax law have also laid down that if determination of taxable income on the basis of external criteria of wealth is warranted, and if the income declared by the taxpayer is less than that determined by this method, the higher figure is used instead of the declared figures. The presumption that the taxpayer's income is not less than that so determined is irrebuttable under the law; the taxpayer may not show, for example, that he is living on capital, on sums received from the sale of capital assets, on gifts or loans, or that he did not in fact receive the amount of income he is presumed to have enjoyed.

### 3. Unilateral estimation of income

Apart from the case in which income is presumed to exist on the basis of external criteria of wealth, there are various cases in which the tax administration may make a unilateral estimate of the taxpayer's income. In these latter cases, however, no conclusive presumption is established and the taxpayer may, if he can sustain the burden of proof, demonstrate that his income is less then the government's estimate. This procedure is called "taxation ex officio" (taxation d'office) and is used primarily as a sanction against delinquent taxpayers in the cases listed below:

(a) a taxpayer has failed to file a timely return;
(b) a taxpayer has filed a return but then failed to make a timely response to a demand by the tax administration for implementation or justification of data on the return;
(c) a taxpayer's "personal expenditures", open and notorious, exceed his reported income; and
(d) a taxpayer being an individual neither domiciled nor resident in France who has income from French sources and failed to designate a representative in France when asked to do so by the tax administration.

### 4. Individuals not domiciled but maintaining a residence in France

are taxed only on income from sources in France. However their taxable income is conclusively presumed to be not less than three times the rental value of the residence which they maintain in France.

### 5. Income from professional sources and non-commercial activities

Income received from the practice of the liberal professions, e.g. doctors, lawyers, architects, writers, accountants, painters, composers, etc. and related occupations, is taxed as a separate category of income in France as "income from non-commercial activity". Most taxpayers receiving income under this category have an option either to report actual net income or to come to an agreement with the tax administration on the estimated amount of presumed net income from the activity. This process of estimation is essentially similar to the agreed income regime ("forfait") available in some cases for business income as already described above. However, if such persons habitually engage in "commercial" activity, their income is treated as income from business rather than income from non-commercial activities.

To summarise the French system in respect of taxation of small enterprises, it may be stated that there are two main types as follows:

(a) *The contractual "forfait"*
This is an agreed assessment applied to small traders whose turnover is below a certain ceiling and to those who exercise a profession, but not to companies. The taxpayer applies for this type of assessment at the end of the year preceding the year for which it is claimed. He is obliged to furnish a return of turnover, purchases, stocks, wages, number of vehicles, size of the family and other details. After discussion with the taxpayer, the tax department determines an agreed figure of assessment, which is valid for two or three consecutive years, as the case may be. In some countries following the French system, if the taxpayer objects to the proposed assessment a settlement may be reached by a joint Committee. In some other countries, agreement on the

assessment of a whole class of taxpayers, such as doctors, is reached between the tax department and the professional association concerned. In the case of Niger, for instance, if the taxpayer does not keep any records at all and is unable to complete the return, tax is fixed at double the amount of trade licence fees paid by him.

(b) *The unilateral "forfait"*
This is an imposed or arbitrary assessment. It also applies to individuals. The taxpayer is obliged to furnish information about his turnover, and the tax department determines the income by applying a ratio to the turnover as prescribed by the Ministry of Finance for different types of business.

## 6. Some observations on French techniques

The unique aspect of the above feature of presumptive techniques in the French tax system is its wide scope. The French feel that no other country gives as important a place to the agreed income method of determining taxable income. Observers outside France are, however, of the opinion that the systems may result in the systematic undervaluation of business income. This has not been denied in France. The French answer to the charge is that in this respect, at least, the administrator has been wiser than the legislator. It is argued that the progressive individual income tax rates imposed by the tax code, compounded by inflation which puts taxpayers in higher income brackets than justified by the actual increases in their purchasing power or economic status, would result in an intolerable tax burden on small business enterprises if they were taxed on their actual income. It is observed that although the French tax code contains rules designed to counteract the impact of inflation (in the field of inventory valuation and depreciation, for example), in practice these rules aid only larger enterprises, which are not eligible for the agreed income system in any event.

In support of the system the French also often express the view that small business taxpayers are incapable of computing their actual income and the Government is incapable of verifying it. The bookkeeping knowledge and standards of the small businessmen using the agreed income regime are such, it is felt, that it is unrealistic to expect them to keep the kind of records needed for a determination of actual income. At the same time, the number of small businessmen of this kind is so large that the administration could not be expected to make an adequate verification of actual income reported in each case. The agreed income system, it is stressed, seeks to reduce the bookkeeping obligations of these taxpayers and to permit the determination of taxable income by agreement without the necessity for an elaborate audit.

There is no doubt that the French "forfait" regime is a necessary compromise between simplicity and ease of application on the one hand and exactitude on the other. The French experience demonstrates clearly the important role that presumptive techniques can play in tax administration, especially in developing countries where the administrative resources are very thin. However, it must be emphasised that in the application of such techniques in tax assessment the calibre and honesty of the tax inspectors and other tax staff who have authority in the matter is of crucial importance to the success or failure of such techniques. As regards the revenue and economic effect, there may be difference of opinion. But in a situation of large scale tax avoidance and tax evasion the use of these techniques may be of great significance in raising tax revenues.

In so far as the economic effects of a presumptive income tax are concerned, it may be mentioned in passing that while an income tax levied on a presumptive basis is in theory an attempt to tax income, it is actually a tax on the factors on which the presumptive income tax is based. The economic effects of a presumptive income tax are therefore quite different from those of a true tax on net income and it will tend to be shifted like any other tax on factors.

In short the advantages and disadvantages of the "forfait" system may be summarised as follows:

## 7. Advantages

(i) It is easy to administer.
(ii) It suits countries suffering from a shortage of staff.
(iii) Assessments, once settled, are valid for two or three consecutive years.

## 8. Disadvantages of the system

(i) It does not encourage the taxpayer to improve or modernise his accounts.
(ii) The taxpayer generally has an advantage over the tax department.
(iii) Very large numbers of taxpayers seek to be assessed under this system, obviously because of its advantages.
(iv) It fails to collect full taxes from the taxpayers.

## B. Estimated or best judgement assessments

This system is prevalent in some of the English-speaking countries. It applies not only to small traders and taxpayers but also to companies which fail to furnish the statutory return and accounts within the statutory period or whose accounts are defective and unacceptable. The assessment is made to the best of the ability of the assessment officer. It is based on the application of a rate of gross profit to the turnover, investments made by the taxpayers, the size of his family expenditure, or on the basis of past year's assessments. The taxpayer may accept the assessment and pay the tax. If he objects he has to pay half the tax assessed and furnish accounts. If the accounts are acceptable, assessment is revised accordingly. If they are unacceptable, the objection is dismissed and the taxpayer has a right of further appeal to the court for final determination.

In French-speaking African countries, a similar system applies to individuals and companies which do not submit returns in time (taxation d'office); if the assessment is objected to, the burden of proof is on the taxpayer. The same system is also prevalent in Nigeria but with one difference. If the taxpayer objects to the assessment, he must pay full tax on the undisputed income and half the tax attributable to the disputed income.

### C. Presumptive assessments

Under this system, the tax department issues a presumptive or estimated assessment in the beginning of the year. For instance, in the case of Ghana where this system is applied the presumptive assessments are issued in July. The assessment is based on the previous year's figures or gross profit rate generally observed in similar businesses. This system is applied in Ghana to all types of taxpayers, including companies but excluding wage earners and salaried employees. The taxpayer may accept the assessment and pay the tax. If he objects, he has to pay half the assessed tax and furnish a return and accounts, on the basis of which the assessment may be revised either upwards or downwards. This technique is very effective in collecting taxes at the beginning of the assessment year itself and thus is helpful in improving the cash position of the Government. It also spurs the taxpayers to furnish their returns and accounts promptly.

### D. Standard assessments

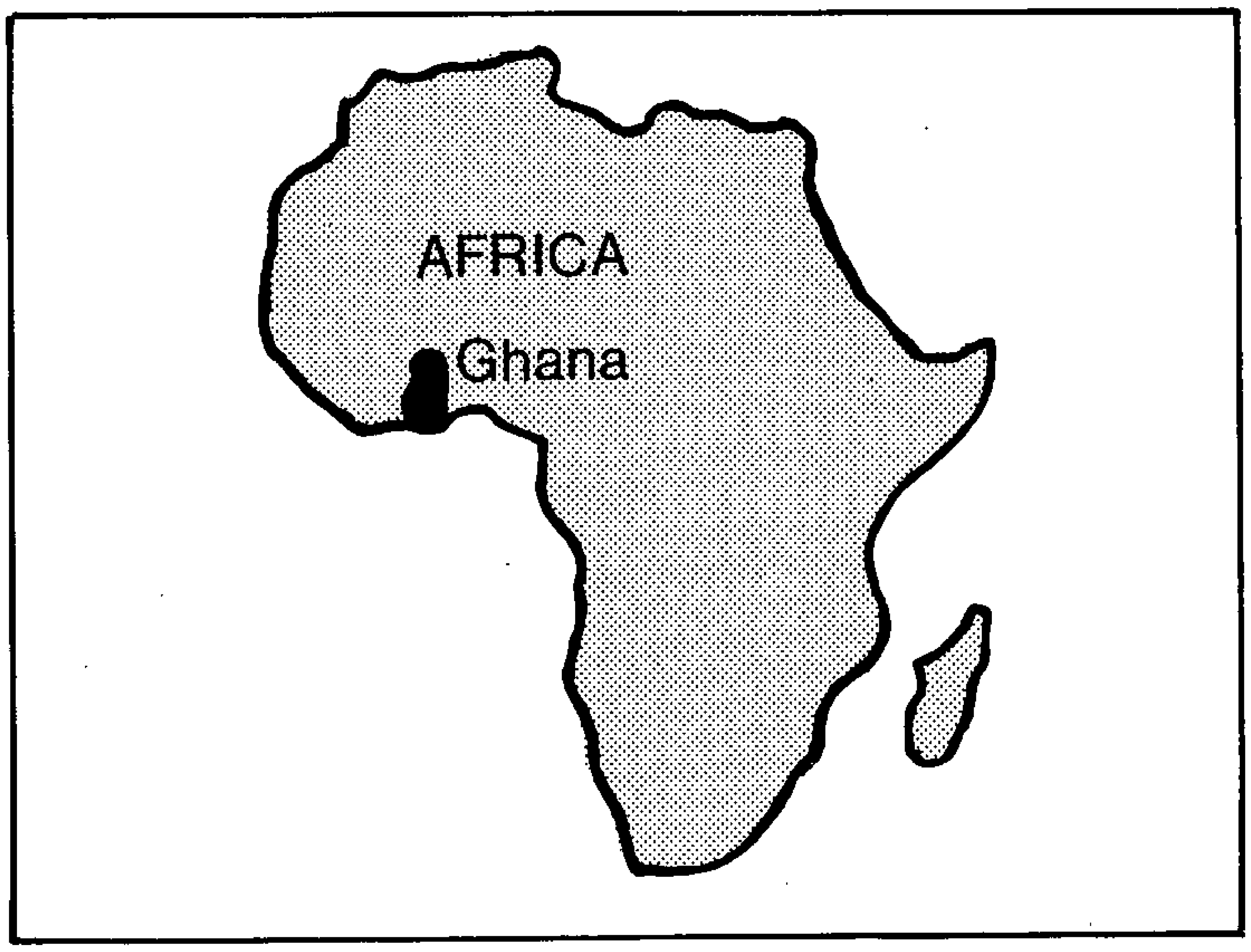
This system is prevalent in Ghana and some of the states in Nigeria. It is based on law and prescribes a certain fixed amount of tax to be paid by persons engaged in specific trades and professions, such as artisans, lawyers, doctors, nurses, midwives, taxi owners, blacksmiths, barbers, tailors, etc. The taxpayer has to pay the fixed amount applicable to him irrespective of his actual earnings, but is still obliged to file his return and accounts. If his real liability is found to be more than the standard tax collected, additional assessments can be made to recover the additional tax. The advantages of this system are a minimum of administrative work, convenience to taxpayers who do not or cannot keep accounts, and early collection of tax. The disadvantage is that the standard tax may be less than the actual amount due from lawyers, doctors, etc. Better trained staff and simple procedures are keys to the success of the system. In some Nigerian states where the system is applied, it covers a much wider field of individuals and professionals than in Ghana. The standard assessment, once made, is final in Nigeria.

In view of the detailed application of the Standard Assessments in Ghana the case material on the system is presented below.

## IV. GHANA'S SYSTEM OF STANDARD ASSESSMENT

The experience of Ghana in this respect is very significant. The system of standard assessment was introduced there in 1963 by the enactment of the Standard Assessment Act which provided for the collection of a standard income tax from certain classes of self-employed individuals before actual assessments were made on them. The Commissioner of Income tax was thereby empowered to specify by Legislative Instrument the class of persons subject to the standard assessment regulations, and the standard rate and manner of its payment by each such class. The intention behind the introduction of the system was to bring the large number of self-employed individuals and small traders assessable to income tax within its net. The Income Tax Law provided that any person whose income in any year exceeded N₵400 was liable to pay income tax. There were many traders and other self-employed persons who enjoyed net incomes above this exemption limit but were not paying any income tax to the Government. Faced with the continuing pressure for increased real revenues to finance an expanding public sector, the Government of Ghana had to take measures to tackle effectively the problem of large scale tax avoidance by such persons. In view of the scarcity of tax administrators, it was found necessary to develop a system which should not only be simple to operate but also effective in bringing the large number of self-employed individuals within the tax net. Recourse was therefore taken to apply rough and ready presumptive techniques to reach incomes in the self-employed sector of the economy.

As the first step towards reaching such persons was their location and identification, a decree was issued requiring all persons carrying on any trade, business or profession — as specified in the schedule attached to the decree — in any year of assessment to register with the Commissioner of Income Tax on payment of a prescribed nominal fee of N₵2. However, such persons who were required to be registered or licensed or granted permit, etc. by any other authority were not required to register with the Income Tax Department. In such cases the decree provided for the issue of notices to the authorities concerned not to register or grant permit, etc. without the production of a tax clearance certificate by the person concerned from the Income Tax Department. In view of non-compliance with these requirements by many persons, it was found necessary to assemble a small field staff within the Income Tax Department to go round in a systematic manner to collect information about the potential taxpayers who were not included in the list of income tax assessees and to follow up the matter with the issues of notices and reminders, etc. As a large number of self-employed persons like taxi drivers, wine and beer sellers, contractors, designers and midwives, etc. were already registered with authorities like police, ministry of health and



public works department, etc., their help was invaluable in locating them. Help in certain cases — although not to the desired extent — was also received from local councils and municipalities.

However, for lack of adequate staff the entire country could not be covered in a comprehensive manner and the main emphasis continued to be on urban centres and classes of professions for which information became available from subsidiary sources. In the beginning, help was also received from the Income Tax Police Squad of 24 policement in civilian clothes under an inspector attached to the Income Tax Department. They were primarily used for serving notices and getting addresses, etc. They could also draw help from the regular police department for getting the enquiry forms filled in by the persons concerned. The assistance rendered by the police squad was of particular help in the case of vehicle owners. Despite all this, however, there was a general reluctance on the part of the police department to provide its services over a wide area for tax purposes.

In order especially to extend the coverage of the system outside the capital city, a mobile unit was formed in 1970. It covered fairly satisfactorily the urban centres of Accra, Tema, Cape Coast and some other places. For lack of financial resources, however, the employment of this mobile unit could not be continued for very long.

Despite the fact that the standard assessment tax system has been in operation in Ghana for about the last fifteen years, there is still a large number of viable cases not covered by the system, especially in the outlying districts. The number of standard assessment cases registered with the Revenue Department as of 31 December 1970 was 99,000 against the total number of self-employed persons of 2,253,000 in the whole country, based on the census conducted in 1960 by the Town and Country Planning Division of the Ministry of Lands as quoted in the National Physical Development Plan 1963-1970. There is no doubt that the census figure of self-employed persons may contain a large number of fishermen and other self-employed persons from the agricultural sector who, because of their illiteracy and poverty, may not be expected to comply with even the registration requirements. However, this comparison shows the extent of the problem still to be faced, especially in the outlying areas.

The essence of the system as incorporated in the Ghana decree to ensure compliance was the production of *tax clearance certificates* in respect of payment of standard assessment tax as a prerequisite for issue of a licence, permit or registration deed or for clearance of goods intended for sale from any part of any factory, payment of insurance money in respect of any claim made under any policy, issue of authorisation in respect of the construction of any building, sale or grant of any lease by the State Housing Corporation, issue of import licence to any trader or the award of any contract for the execution of any works, etc. the consideration of which was not less than N₵1,000 or the sale of external currency by an authorised dealer under the Exchange Control Act. The tax clearance certificate in such cases meant a certificate issued by the Commissioner of Income Tax stating that no tax was due from the person to whom the certificate related or that such person had made arrangements satisfactory to the Commissioner for the payment of the tax due from him.

For the purpose of the Standard Assessment Act the Commissioner was also authorised:

(a) to inspect any premises for the purpose of the Act, and
(b) to request in writing any person to keep such records, returns and other documents as he may determine for the purposes of the Act and to furnish any such records, returns or documents to him within the period specified in the request. Failure to comply with this requirement or to furnish false or incorrect records, returns or documents was punishable under the Act.

In case of default the standard tax could be sued for and recovered in a court of competent jurisdiction by the Commissioner in his official name with full costs of suit from the persons liable to pay such tax as a debt due to the Government.

The major tasks to be performed as already referred to above were (i) the preparation as far as possible of a comprehensive list of self-employed persons under various occupational groups; (ii) the formulation of standard assessment instruments fixing the rates; and (iii) the issue of notices to persons concerned to come and pay to the Income Tax Department.

In case of non-compliance by certain individuals the Income Tax Staff went round, gathered relevant particulars and issued notices of assessment for the current year. If there was reason to belive on the basis of information collected that grounds existed for assessment for earlier years, notices were accordingly issued for previous years as well.

The standard rates were worked out on the average chargeable income of some taxable units taken at random under each class of self-employed categories.

## 1. Control forms and records

The Income Tax Department maintains a Standard Assessment Card for each self-employed assessee. This shows his name, address, assessment number, registration number, occupation and payments made for each quarter. A Standard Assessment Control Register is also maintained with the Inspector of Taxes in Charge of Standard Assessment Tax in the Income Tax Commissioner's Office. This is designed to serve as a double check in case any of the cards gets lost. Moreover, it serves as a ready reference to the Inspector for control purposes. The Standard Assessment Cards are kept with the cashier of the Income Tax Department and entries of the payments made are recorded on the card from the duplicate copies of the receipts issued at the time payments are made by different assessees.

## 2. Observations on the Ghana system

Although the system provides for the collection of a standard income tax as an advance before actual assessments on the submission of regular returns, the payment of the standard tax is generally not followed by the submission of income tax returns although this is required under the Income Tax Decree. Most of the assessees covered under the Standard Assessment Tax System being illiterate, the submission of income tax returns with proper details is not even insisted upon and followed by the Income Tax Department. This has resulted in the perpetuation of the system of standard assessment, which is no doubt against the spirit and purpose of the original enactment.

The major advantage of the Standard Assessment Tax System as applied in Ghana is no doubt its administrative simplicity. If a too complicated system is adopted in a developing country like Ghana, it can easily be worse in all respects than the alternative of tying to apply the regular income tax. Better staff and simple procedures are the keys to success. It may be required by law that all persons engaged in trade, business or the professions maintain accounting records in some standard, simple, easily understood form. This requirement may be enforced by special penalties on the keeping of inadequate records and by allowing specific inducements to the keeping of correct records. These inducements might include, for example, the right to claim accelerated depreciation and to carry forward losses. The need is to extend the coverage of the system in Ghana to derive full revenue and other advantages. It is also necessary to keep the operations of the Standard Assessment Tax System under constant review and to improve its application with a view to encouraging the maximum number of assessees to submit their regular income tax returns. It is crucial that progress towards a shift from presumptive to book basis is maintained. The greatest incentive to this shift would be presumption at a high rate. There would also be great advantage in strengthening of investigation teams and streamlining of investigation procedures.

The over use of presumptive techniques without procedures for investigation and review would result in "freezing" many potential regular taxpayers into an inequitable and arbitrary position. Even if the initial presumptive factors chosen and the value attributed to them were accurate, they tend to become much less so over time.

The system particularly failed in the case of small traders and "Mamis", or market women, who were taken from the list of standard assessees in 1969. The bulk of the small traders thus continued to be a tax problem in Ghana. There is a general feeling in the country that this class of persons, especially a large number of market women, continue to escape the income tax even in cases where their incomes are in fact high enough to make them liable to tax. In view of the huge number of illiterate petty traders in Ghana, it is of course difficult to enforce successfully any scheme for giving incentive to proper record keeping.

The levy of higher licence fees on retailers no doubt could be used with some advantage if there were a system of proper trade licensing in the country. However, the levy of high licence fees and their differentiation according to widely different sizes and profitability of establishment would also involve the same problems of enforcement and collection as the standard assessment.

Perhaps the reason for the failure of the Standard Assessment Tax System in the case of market women and small traders in Ghana was due to the fact that the assessing officials were not able in many cases to determine the right income class for tax purposes of different traders. As the three groups of standard tax system traders determined had to pay N₵50, N₵100 or N₵200, respectively, many of them found it burdensome, and as the procedures for review in individual cases of hardship were not applied, this led to a general dissatisfaction; thus, the system had to be withdrawn on political grounds. In determining the three groups of small traders referred to above, an attempt was made to determine the tax liability of individual traders on the basis of information about the monetary limit of their credit purchases from the wholesalers as recorded on their passbooks. But as soon as the passboks began to be used for purposes of assessments, many retailers chose to pay their suppliers in cash to avoid disclosing their turnover. There was hardly any effective way to check this tendency.

Although the operation of the standard assessment tax system in Ghana has not been an unqualified success, the presumptive techniques of assessing small traders and other professionals is attracting increasing attention of other African developing countries; the ECA Fiscal Advisory Service has been involved in determining the feasibility of the introduction of presumptive techniques on the pattern adopted by Ghana. The observations of one of such missions are given in brief towards the end of this article for illustrative purpose.

## V. CASE STUDY OF MAURITIUS: RECOMMENDATION OF BEST JUDGEMENT ASSESSMENTS

A local training workshop in Budget-Plan Harmonization and Tax Policy and Administration conducted by the *Economic Commission for Africa* at Mauritius in February 1977 devoted special attention to the problem of [3] taxation of traders and professionals. The general feeling of the Workshop was that not much income tax was being collected from traders in general and professionals. It was also agreed that a good number of small traders would have income below the exemption limit on account of personal deductions. However, the Workshop had no doubt that a substantial number of them had income above the exemption limit and were not in the tax net because of enormous administrative difficulties.

The Workshop further noted that the Income Tax Department had the same problem not only with traders who were not on the tax register but also with those who appeared on it. Most of the income earners do not keep any proper records in contravention of the provisions of the law which could be enforced to ascertain their income for tax purposes. Invariably, the reasons for non-compliance on the part of earners ranged from illiteracy, and total absence of commercial principles to lack of tax morality and the quasi-certainty on their

3. Mission Report by Mr. I.A. Malik, ECA Senior Regional Adviser in Public Finance and Budgetary Management, February 1977.

part that the arm of the Income Tax Department was quite short and would not reach them.

The Workshop considered the measures adopted in certain other countries to deal with the problem of effective taxation of traders, etc. The Workshop noted that under the French "forfait" regime traders were not required to show their actual business income; instead they entered into agreement with the Tax Department as to the amount of their estimated business income. The Workshop was informed that the Mauritius Income Tax Commissioner had conducted talks in Reunion on the "forfait" regime. On the basis of the information gathered by him, it appeared that the businessmen there had to keep records of all purchases, opening and closing balances of inventories and overhead expenses. A percentage of gross profit was then applied and the estimated income was then arrived at. The recording of purchases had to be policed at several levels. The Workshop thought, however, that such policing would involve serious administrative problems which the Income Tax Department would not be able to cope with in Mauritius. About Ghana's experience with the Standard Assessment the Workshop noted the tremendous difficulties faced in the matter of obtaining information and tracing the small businessmen.

*Best judgement assessments*

The Workshop therefore did not favour formally adopting the "forfait" regime or standard assessments, but favoured calling its own presumptive technique "Best Judgement Assessments". These, it thought, should be raised in accordance with the present practice of the Income Tax Department pursuant to Sections 75 and 76 of the Income Tax Act 1974 — in those cases where either few or no records are kept or the records are inadequate or unreliable.

A best judgement estimate of a trader's income for tax purposes is similar to standard assessment and would be based on the following factors:
(i) application of a reasonable percentage to turnover, which is itself adjusted to cover possible understatement;
(ii) investments made by the taxpayer;
(iii) his annual requirements for family consumption and other private expenditure; and
(iv) his past years' assessments.

In this connection the Workshop made two further recommendations:
(i) The number of field inspections should be substantially increased. The reasons are: firstly, to have first hand reports on the quality, size and nature of the businesses; and, secondly, on-the-spot visists might have a desirable deterrent effect not only on the particular businessman but equally on his neighbours.
(ii) The Act under which trade licences are issued should be amended with a view to compelling the traders to produce a tax clearance certificate from the Income Tax Department before their licences are renewed. The Act may, for example, require businessmen to produce the tax clearance certificate once every two years or such other periods as directed by the Commissioner. Thus, instead of the Department chasing the businessmen, the latter would have to come to the Department. This measure would also pave the way for quick settlement of the arrears backlog.

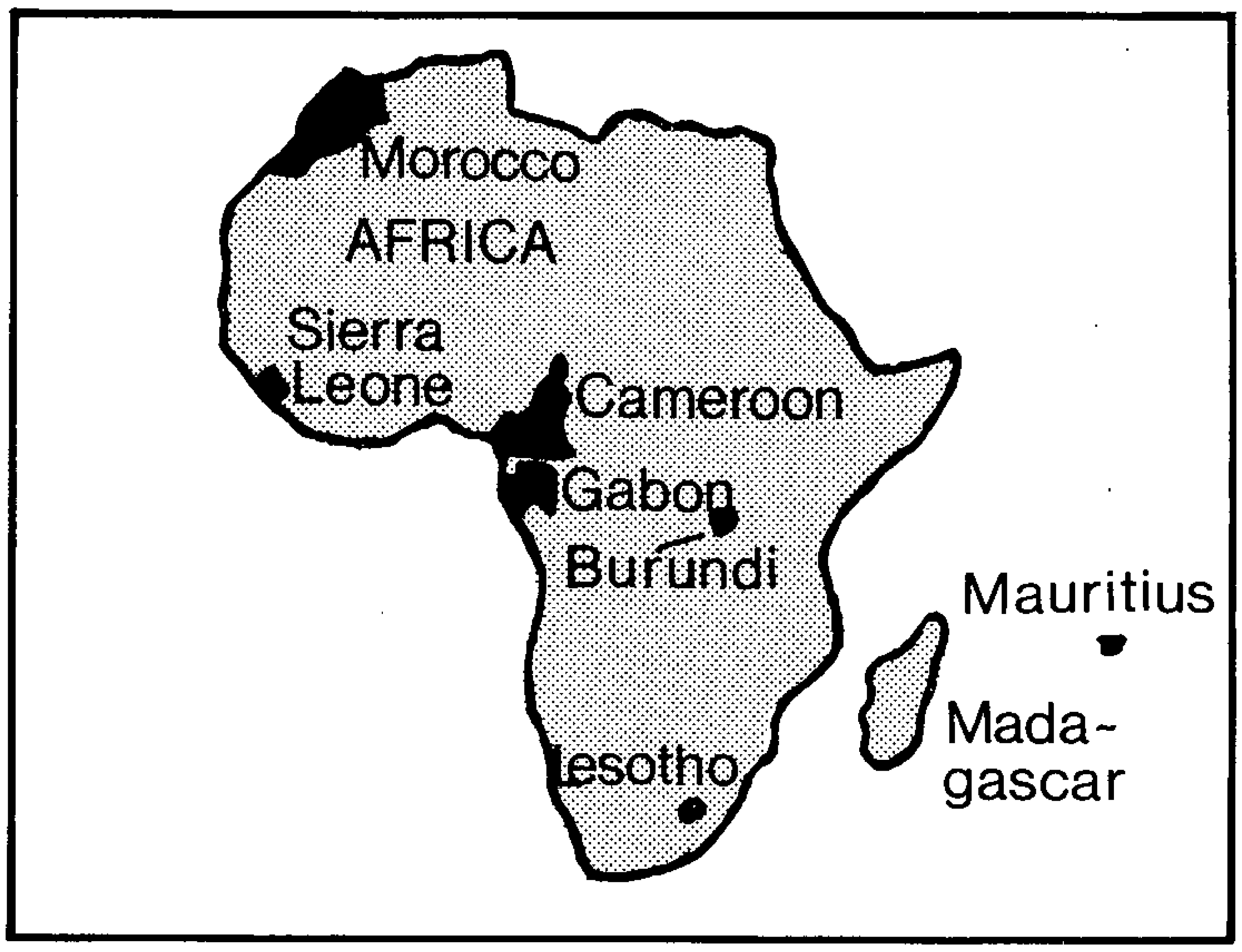
## VI. BURUNDI'S SYSTEM OF TAXING PROFESSIONAL INCOME: FIXED TAX SYSTEM

The base of this tax is profits of industrial or real property undertakings, remuneration of various kinds, profits of liberal professions and all other profits. Profits from liberal professions are taxed gross less professional expenses, which in the absence of evidence are fixed at 25 percent of receipts but may not exceed 300,000 francs.

Persons liable to pay a fixed tax must submit before 1 March of each year the special declaration as laid down by law. Individuals must sign their declarations before 1 April or within three months after the end of their accounting year. The taxation authority may fix the tax due:
(i) if the declaration is sent in late or not at all;
(ii) if a foreign company does not submit a special account of its dealings in Burundi;
(iii) if evidence supporting information required or an answer is not sent in within the proper period; or
(iv) an account is submitted in irregular form.

*Professional tax assessments*
Assessment and inspection are performed by tax inspectors. Tax is assessed in accordance with declarations signed by persons liable to tax. The taxable gains of taxpayers who keep regular accounts are determined in accordance with their actual gains; those of others with an assessment made by the authority under its statutory powers. Since 1967 providers of services or accommodation where turnover does not exceed 5,000,000 (other taxpayers, 10,000,000) francs a year may simply be charged the professional tax. This measure has reduced the number of verifications needed and has brought in more income tax. The introduction of the *fixed tax* system followed since 1967 consisted chiefly in the enactment of a general power to inspect and require disclosure of documents by corporations and individuals.

The fixed taxes at present are more or less efficiently imposed and the compilation of files has made it possible to identify and tax most of the population who ought to pay.




## VII. THE PROPORTIONAL TAX SYSTEM OF CAMEROON

There are two systems of taxing the profits of business, craft and non-commercial undertakings:
(i) The system for impersonal profits which is governed by the same rules as corporation tax.
(ii) The presumptive system for taxpayers in the category liable to the tax on business or craft profits with an annual turnover not exceeding 20,000,000 francs in the case of commercial transactions or 5,000,000 francs in all other cases and liable to the tax on non-commercial profits where the turnover does not exceed 7,500,000 francs.

In the case of taxpayers engaged in business with an annual turnover not exceeding 2,000,000 francs the proportional tax is fixed presumptively at 50 percent of the principal amount of the licence duty and is collected at the same time as this duty. It is also worth noting that the tax system for agricultural profits is also presumptive. The taxpayer may not be taxed on the real profit unless he exercises an option to be taxed on this basis.

Moreover persons who cannot be considered liable to the progressive surtax (levied on the total income from various sources less the non-exhaustively listed charges if they are not taken into account in assessing the income liable to the proportional tax) or the minimum of 2,400 francs are liable to the presumptive tax. The peasantry and some traders are, generally speaking, taxable in this way.

The co-efficient of the presumptive tax, which is fixed yearly by the National Assembly, may vary from one department, arrondissement, district or commune to another in accordance with its economic rating. The basic rate, known as rate A, applies to the standard level of living in the area concerned. Higher rates apply to taxpayers with a higher standard of living than that of taxpayers taxable by rate A. There are, therefore, four rates:

| | |
|---|---|
| Rate A: | varies from 250 to 1400 francs |
| Rate B: | twice rate A |
| Rate C: | three times rate A |
| Rate D: | four times rate A |

The taxpayers are classified by a roving commission in each administrative division. The village or ward chiefs collect the tax and issue vouchers certifying payment. Though this method of collecting tax is often adversely criticised, it seems the best suited to the peasants' circumstances since it makes them put their produce on the market. The yield of this tax was about 1,100 million francs in 1973.

## VIII. THE ANTICIPATED PAYMENT SYSTEM OF GABON

The small traders are required to pay their personal taxes at the same time as their licence fees. There are the class 7 licensees, i.e. those with a capital of between 100,000 and 500,000 francs and the class 8 licensees, with a capital of not more than 100,000 francs. At the beginning of the calendar year or of the financial year, these taxpayers pay, at the same time as their licence tax, the fixed income tax, the fixed national solidarity tax and the neighbourhood tax. Taxi owners are also required to pay in advance a six-monthly licence fee including the tax on individual and commercial profits, the general income tax and the turnover tax.

## IX. MADAGASCAR'S FIXED CHARGE SYSTEM

A person who has neither a professional establishment, his normal residence, nor real property in Madagascar but who nevertheless conducts a business there subject to the tax on profits, the general tax on income and the single tax on turnover, is required to pay the fixed charge. The basis for the charge is determined by the volume of gross receipts. The rate charged is fixed at 1 percent for activities subject to the trade tax only, 13 percent for activities subject to both the trade tax and the single tax on turnover and 20 percent for activities subject to all the taxes and charges.

## X. THE TAXATION OF SELF-EMPLOYED IN SIERRA LEONE

The tax administration is concerned with the problem of identification of self-employed taxpayers. A significant part of the self-employed citizens are small shopkeepers, hawkers, small transport operators and various craftsmen. There are also small farmers scattered about in the interior. There is at present no complete record of the self-employed population and it is not possible with the present organisation of the Income Tax Department to carry out a survey to identify all self-employed taxpayers in the country. Some remedy to help reduce this problem has been applied by the enactment of the Business Registration Act. The Act makes it compulsory for every self-employed person, including companies, to register his business and to renew such registration annually, making it an offence and providing penalties for failure to do so. The effective implementation of the provisions of the Act will help the Tax Department to a great extent in identifying many taxpayers.

The problem of determining the correct annual income of the identified taxpayer is even a bigger problem. Many self-employed persons do not keep books of accounts, or, if they keep them, they are in most cases incomplete and inaccurate. The Income Tax Act provides a penalty for persons who fail to keep records, but, from experience, it is difficult to force a person who does not normally keep records for his own interest to keep them for purposes of income tax. If he is compelled to keep records by the imposition of penalties, he will only enter what he likes to enter; in the end, such records may not help the department to solve its problem. Consideration should also be taken of the degree of literacy of many of the traders and businessmen and the fact that the small ones could not afford to employ qualified bookkeepers or the services of professional accountants to look after their books.

As a measure to deal with this situation, especially the determination of the income of the numerous small taxpayers, the Income Tax Standard Assessment Orders 1973 were introduced and published on 30 March 1973. These orders provided for the payment of a certain annual amount of minimum tax by identified classes of self-employed persons either in one payment or by installments on specified dates without the Commissioner of Income Tax issuing any notice of assessment. The Commissioner nevertheless still had the power to make an assessment on any person who fell within the abovementioned identified classes if he considered it necessary, in which case the minimum tax paid under the Standard Assessment Orders would be given as a set off in determining the net tax payable on the assessment. Although the order was introduced in 1973, its actual operation has remained suspended due to administrative difficulties.

## XI. MOROCCO'S SOLUTION

Two principal direct taxes are applied to traders and professionals. These are:

A. *The Licence Tax (Contribution des patentes).* It is levied on the exercise of an industrial, trade or liberal profession, irrespective of the profit earned. It is based not on income but on certain external signs characteristic of the profession. The tax is levied on any individual or legal entity, irrespective of nationality, engaging in a profession, industry or trade in Morocco. Exemptions are made for persons engaging in a taxable profession only in the exercise of a public function. Farmers are also exempt for the sale of their harvest and cattle other than in a shop. The basis for taxation is determined each year by an Assessment Board, in the light of rental value and the number of persons employed. The professions are classified, according to their nature, in two tables:
Table A: Trade, small-scale industry and liberal professions, comprising six classes;
Table B: comprises two classes for certain professions and for industry.

The tax consists of:
(1) A proportional tax on the normal gross rental value of the business premises, as well as on all production means and material, depending on whether the profession is classed in Table A or Table B. The rate of this tax ranges from 10 to 30 percent.
(2)A tax per person employed which ranges, depending on the classification, from 10 to 24 dirhams. For the purpose of this tax, all persons employed by a company in any capacity are counted, with the exception of the senior partner and other partners.
(3) A variable tax on the characteristic elements of certain professions classified in Table B (for example, motive power).

The law provides for a minimum of taxation calculated in the light of the classification of the establishment and the municipalities in which it is active. Special surtaxes, six in number, are charged in addition to the base tax. The taxes amounting to less than 10 DH are not collected. These taxes are levied for the benefit of the State, urban municipalities and chambers of commerce and industry.

B. *The tax on professional profits.* The tax is levied on the profits of the trades, industries and professions subject to the licence tax, and on the profits derived from all gainful employment and other sources of profit not subject to the licence tax or to a special tax. Companies, whatever their form and purpose, are subject to the tax on professional profits in so far as concerns their profits or gains not subject to another tax, or not expressly exempt therefrom. There are two systems for assessing the taxable profits:
(1) The lump sum system. This form is part of the ordinary law. The taxable profit is determined by applying to the turnover a coefficient which is established for each branch of activity by decree of the Minister of Finance. For taxpayers not coming under the real net profit system, gross annual income may not be lower than a minimum income equal to the total of two elements, one fixed and the other variable, which are determined in the light of the basis used for the licence tax for the preceding year. The variable element is determined by applying to the rental value used to calculate the proportional licence tax a coefficient which may not exceed five.
(2) The real net profit system. The taxpayers have the option, irrevocable for two years, of coming under the real net profit system. However this system is compulsory for companies and other legal entities. For businesses holding concessions to operate a public utility or public service, and for others liable to the tax whose turnover reaches or exceeds 1,000,000 DH in the case of a company selling goods or providing housing, and 200,000 DH for other cases, the net real profit for the financial year consists of the margin of gross profits over costs and expenses paid or incurred for business purposes. The tax assessment on professional activities not subject to licensing is established in the light of total net gains and profits of the year. Taxpayers are required to sign, before 1 April, a statement of turnover. Those taxed under the net real profit system must submit copies of the balance sheet, the trading account, the profit and loss account, the statement of overheads, depreciation, reserves and payment to third parties. Failure to do so will render them liable to arbitrary taxation.

## XII. ECA STUDY: CASE STUDY OF THE LESOTHO PROBLEM [4]

A mission was undertaken in 1971 by the Economic Commission for Africa at the request of the Government of Lesotho to determine the feasibility of the introduction of a Standard Assessment Tax System to cover small traders.

This request followed an appraisal by the Government of the recommendations contained in the International Monetary Fund's "*Report on Direct Taxation*", undertaken by Mr. F.G. Reynolds in 1969. The IMF report recommended that "Trading and other similar licence fees should be increased substantially but should become partly deductible from Income Tax". In this respect the mission further recommended that there was an immediate case for imposing a system of standard assessments on the Ghanian pattern so that income could be imputed statutorily to all persons engaged in trade varying in amount with the estimated profitability of each kind of trade, and in some instance with the locality.

The salient features of the ECA survey are summarised below.

Lesotho, a small, mainly mountainous country of 11,716 square miles and a population of a little less than 1,000,000 with a per capita income of about US$ 90, is entirely surrounded by the Republic of South Africa. Wool and mohair account for some 70 percent of the country's export earnings. Another 15 percent is contributed by mining of diamonds. Few industries exist presently although various tax incentives are allowed to investors in manufacturing and processing ventures. Lesotho is a part of the South Africa Customs Union and the South African monetary area, with the South

4. Mission Report of Mr. I.A. Malik, ECA Regional Adviser in Public Finance on "Feasibility of the Introduction of Standard Assessment Tax System in Lesotho to cover small traders, etc.", ECA, Addis Ababa, September 1971.

African Rand being used as a currency. More than half of the local revenues are raised under the Customs Agreement with South Africa, Botswana and Swaziland. The wholesale trade is largely managed by firms which have their head offices in the Republic of South Africa.

Trading conditions are largely dependent on crop yields, but returning migrant workers from South Africa create a substantial cash flow, which is a mainstay in time of drought.

## 1. Trade licensing

An elaborate system of trade licensing is in operation under the Trading Proclamation of 1951 which had as its main purpose the control of trade by the establishment of Boards with power to refuse an application for a trade licence for various reasons like overtrading or the financial position of the applicant. Different rates of licence fees are levied on different categories of traders. There are also rate differentials between reserve and non-reserve areas and Lesotho and non-Lesotho traders. The system of trade licensing can no doubt play a vital role in taxation of traders.

Income tax and company tax legislation are closely modelled on the legislation in force in the Republic of South Africa. Liberal personal income tax relief is provided in the form of tax rebates on account of domestic circumstances. Besides the regular income tax and company tax, there is a basic tax payable by every male citizen. A "pay as you earn" system of tax collection covers salaried persons more or less adequately since 1969. Revenues from basic tax constitute over 50 percent of the total receipts from direct taxes. The scope for Government initiative in raising revenues through indirect taxes, viz. customs, excise or sales tax rates, is absent except in the context of the Customs Union Agreement. This leaves the field of direct taxes to be looked into not only in respect of choice of new tax measures but also in making improvements in tax administration and procedures for plugging the loopholes of tax avoidance and tax evasion.

## 2. Pool of untaxed traders and professionals

The above background and considerations called for the determination of the number of potential traders, etc. who were not in the tax net and formulation of measures for bringing them in.

The mission in this respect went through the records of various business names registered with the licensing authorities in various districts of the country. The information collected in this respect showed the total number of traders, etc. registered in the whole country during 1971 as 6,244. This number was on the low side, as in the case of three districts (viz. Mafetong, Q. Nek and Mohales Hock) information abou the number of transport contractors, and taxi and bus owners, etc. could not be collected in time, and in the case of other districts as well for which this information was collected there was short reporting as well. No beershop licences were included in the information supplied for Mafetong and Leribe districts. Despite these shortcomings in data, the mission reached the following conclusions.

### a. Normal income tax procedures

The categories of licensed wholesalers, bankers, clubs, hotels, industrial manufacturers, speculators, etc., being small and manageable enough, could be dealt with under the normal income tax procedures. The remaining important categories of traders which contained the bulk of the untaxed pool were identified as follows:

| *Nature of business licence* | *Number of licences* |
|---|---|
| 1. General traders | 258 |
| 2. Bakeries | 129 |
| 3. Wood and coal merchants | 118 |
| 4. Transport contractors, buses and taxis, etc. | 192 |
| 5. Bucheries | 698 |
| 6. Restricted traders | 1,402 |
| 7. Cafés | 2,311 |
| 8. Beershops (reserve areas) | 523 |
| 9. Millers | 340 |
| | 5,971 |

It was found that the number of traders (including companies) who were making returns for normal tax purposes did not exceed 350. This included about 50 wholesalers, banking institutions, manufacturers, hotels and speculators, etc. not included in the above nine classes of traders. It was estimated that out of the above number of 5,971 traders, big and small, the maximum number submitting income tax returns under the normal procedures did not exceed 300 taxpayers. This left about 5,671 traders, big and small, which formed part of the untaxed pool. Observation and analysis (on a sampling basis) of these categories of licensed trading establishments and their average monthly turnovers around some districts (both in reserve and non-reserve areas) established that at the most 10-13 percent of this number (say 600-800) could be considered as doubtful cases with net incomes below the taxable limit of R250. This margin, it was thought, would also cover some cases of fictitious licensees who had obtained trading licences but were not actually in business. They were paying licence fees in order to derive the benefit of wholesale purchases for themselves and their friends or possibly sale to hawkers. A proper application of trade licensing and tax procedures, it was suggested, would eliminate this fictitious element. Allowing for these and some other factors the mission found that a substantial number of 4,800 were then successfully evading payment of income tax.

### b. Need for adoption of presumptive techniques

The mission suggested that while measures should be taken to strengthen the tax administration to deal with the above potential taxpayers, recourse should be taken to rough and ready techniques similar to the Ghanaian standard assessment system in the short run. The mission observed that any attempt under the existing situation to deal with these cases would result in poor response and might result in widespread non-enforcement which would prejudice the whole future of income taxation of the self-employed.

### c. Income imputation

To begin, income imputation for tax purposes may be made for the major categories referred to above as these covered the bulk of tax evading traders. In view of the different circumstances of traders under these categories, depending on their average turnover and location, etc., it would be necessary to establish two or more classes of standard tax rate ranging from higher to middle and lower brackets of small traders according to their presumptive incomes. The major technical problem in this respect which needed to be clarified related to the factors that should be taken into account in determining the presumptive tax rates. Among those factors could be cited gross sales, value of property, housing of the trading establishment, number of employees, location of business, type of trade, inventory, age and quality of equipment used, private style of living of traders and so on. Variations could be constructed for different trades: for instance, in the case of taxi-drivers the year and make of vehicle and estimated mileage might be taken into account. All this, however, involves complicated and refined investigations in each individual case and would be difficult to carry out fairly and effectively in view of the existing constraints. A sophisticated system of investigations was not therefore recommended for Lesotho at that stage, since the evasion problem itself arose from the scarcity of trained administrators and the administration's inability to determine the very sorts of norms and standards needed in any complicated presumptive system. The fact of the matter was that the small traders in Lesotho, generally speaking, were incapable of computing their actual income, and the Income Tax Department as then constituted was by and large incapable of verifying it. The bookkeeping knowledge and the standards of small traders were such that it would be unrealistic to expect them to keep the kind of records needed for a determination of actual income. Moreover, in view of the large number of traders involved who were scattered throughout the country and difficult to reach even in some cases because of lack of proper roads or other means of communication, the administration could not be expected to make an adequate verification of actual income or for that matter to indulge in the exercise of determining presumptive income in each and every case.

### d. Monthly turnovers

Despite the above difficulties, however, the mission observed that a fruitful attempt could be made to determine the average monthly turnover of distinct classes in each trade category on a sample basis in different locations in each district, and on this basis to work out average taxable incomes and standard tax rates for different classes of each trade. Generally speaking, the mission worked out that the average taxable income would be about 8-10 percent of the annual average turnover. This assumption was also borne out by an "*ILO survey of small-scale enterprises in Maseru*" conducted by Mr. B. Koch in February 1970. Mr. Koch then found that out of 53 retailers surveyed in Maseru, 18 had a monthly turnover of less than R250; 26 had a monthly turnover between R250—R1,200; 5 had a monthly turnover between R1,200—R1,300 and 4 had a monthly turnover more than R3,000. The report of this survey also mentioned that gross profit on groceries was about 15 percent and gross profit on soft goods was about 30 percent. In view of this analysis, the net profit, including salary of the owner/manager, might be assumed to be in any case below 10 percent of the turnover. While suggesting the measure of about 10 percent of turnover in determining taxable income, the mission cautioned that enterprises be carefully classified by type and location. The degree of refinement that could be employed in this respect would have to be seen in relation to the tolerable inequities and the cost and effect of taking more details into account. It was observed that one obvious flaw in the application of standard tax rates determined according to the above method would be that these did not take into account family circumstances of individual taxpayers as was the case in the application of normal income tax which allowed the deduction subject to certain limitations of allowances and rebates from income tax payable in consideration of such circumstances. However, as it would always be open to any taxpayer to get his name removed from the list of standard tax assessees by submitting a proper tax return, the inequities of the standard tax assessment system could be removed by taking such action. Moreover, the discretion of the tax authorities in placing a taxpayer in a lower standard tax bracket could be used to decide cases of hardship when appeals supported by proper facts and details were submitted for their decision. It was made clear that the standard assessment tax system, in providing for a unilateral estimation of tax liability by the tax administration, was a sanction against taxpayers who failed to file returns. It permitted the determination of tax liability without the necessity of an elaborate audit. *As such, it was at best a necessary compromise* between simplicity and ease of application on the one hand and exactitude on the other.

### e. Incentives for submitting returns

The ultimate object of the standard assessment tax system, it was explained, should be to induce taxpayers to settle their tax liabilities on the basis of actual submission of income tax returns required under normal circumstances rather than on the basis of standard rates determined unilaterally. The greatest incentive to this shift would be the establishment of high presumptive incomes. A milder alternative would be to grant special concessions and incentives only to these traders, etc. who maintain adequate records. It must, however, be ensured that the option to be taxed on the basis of actual income rather than on the basis of standard rates should be allowed to be exercised only by a taxpayer who can meet the bookkeeping requirements imposed on other taxpayers reporting actual business income. The taxpayer must, for example, attach to his income tax return a copy of a balance sheet and profit and loss statement.

### f. Monetary limits of application

It was thought necessary to specify monetary limits of income to ensure that the standard assessment tax system be made applicable only to small businessmen. All major business enterprises above the prescribed limits must be made to report actual income for tax assessment. If during the course of investigation any cases of higher taxable income are found which are covered under the standard tax assessment system, these should be promptly taken out of the ambit of the system and regular files opened for them for consideration under the normal tax procedures.

### g. Standard rates

On the basis of a sample survey of various trading establishments in different income brackets, the mission attempted to suggest standard rates for the categories of traders referred to above for four classes determined on the basis of annual average turnover in the four districts of Maseru, Teyateyanang, Leribe, and Butha-Buthe. It was noticed that nearly 10-15 percent of the small licensed traders had average annual turnover less than R3,500, with their net taxable income after deducting general expenses less than the exemption limit of R250. The average turnovers and standard rates for the four classes which were worked out for incomes above the exemption limit were as follows:

| Class | Broad range of average annual turnover | Standard tax per annum |
|---|---|---|
| A | above R20,000 | R120 |
| B | between R15,000–20,000 | R80 |
| C | between R 7,000–15,000 | R40 |
| D | between R 3,500– 7,000 | R20 |

In case of transport contractors, however, the following rates were suggested on the basis of capacity and weight.

| Class | | Standard rate per annum |
|---|---|---|
| A | in respect of each vehicle up to 5 tons | R32 |
| B | in respect of each vehicle above 5 tons | R80 |
| C | taxi owners in respect of each vehicle | R32 |

These standard rates were suggested with due regard to the net average taxable incomes expected after deduction of general expenses, etc. and average deduction of allowances and rebates, subject to the limitation that the net tax payable is not allowed to fall below the specified limits. It was made clear that these rates were tentative and had been worked out on the basis of existing tax legislation for illustrative purpose and their primary aim was to initiate the process of thinking and verification by the Income Tax Department to refine the methodology further. It was further elaborated by the mission that the exercise in determining standard tax rates for different classes under each category of traders would involve application of judgement on the part of the authorities. The important thing to remember, however, was that the income tax officer or his staff should not act dishonestly, vindictively or capriciously in determining the class to which any particular taxpayer would belong. This should be determined as objectively as possible and guarded against through a percentage test check of the assessments at higher levels.

### h. Overlapping trade categories

For purpose of grant of trade licences the mission surmised that the categories mentioned above appeared to be distinct, but in actual practice there was a considerable overlapping of commodities dealt with by licensed traders. A grocery, a cafe and a restricted trader, for instance, would have many common items in which they were dealing. The most important consideration in such cases, therefore, was their turnover rather than the commodities in which they were dealing.

### i. Licensing malpractices

It was also reported that some wholesalers were selling goods even to persons who did not hold licences. This cut across the interest of licensed retailers. It was suggested, therefore, that a person or company having a wholesale licence should not be allowed to have retail outlets at the same time. Moreoever, people who had obtained trading licences but who had not erected their business houses often abused their licences by buying goods from wholesalers for non-licence holders, thus illegally competing with proper trading licensees. The mission believed that the introduction of the standard assessment tax system would facilitate the task of eliminating such malpractices considerably.

### j. Collaboration between the Ministry of Trade and Income Tax Department

The mission strongly urged the need for close collaboration between the Trade and Income Tax Departments not only for the proper functioning of the trade licensing system but also for tax purposes. In this connection, it was suggested that in cases where under any enactment any person or authority is empowered to issue a licence, a permit, a registration certificate or any other similar document to such small traders, etc., the Collector of Revenue should request officially such person or authority in writing not to issue such document unless the person applying therefor produces to such person or authority a tax clearance certificate issued by the collector or other officer authorised on his behalf indicating that the standard assessment of tax or instalments thereof liable to be paid by such applicant have been paid. When this practice was firmly established it would automatically ensure compliance with the requirements of the standard assessment tax system.

### k. Set off against income tax liability

It should also be provided that the payment of the standard tax could be set off against the income tax actually payable by any person. Connected with this is the requirement to remove a person from the list of persons subject to the standard tax assessment on the submission of a proper income tax return to the satisfaction of the Collector of Revenue. Thereafter his case would have to be dealt with as a regular income tax assessee.

### l. Period of application of the system

The mission recommended that the system be applied initially for a period of three years and that before the end of the period the results obtained should be reviewed and decision taken about the extent of the continued application of the system along with any amendments that might be called for in the standard rates and the classes of persons to be covered by it. It was also suggested that more categories of traders like drycleaners, hairdressers, tailors, motor garages, electricians, carpenters, watchmakers and bricklayers, etc. could be added and brought under the system as might be found necessary. It was also noted that the transport contractors and bus and taxi owners presented a special problem as they were not carried at all on the list of licences. Special measures should, therefore, be taken with the authorities responsible for registration and inspection of vehicles and the police to recover the amounts of standard tax from them.

### m. Administrative procedures

On the administration of the system it was suggested that a Senior Inspector of Taxes should be made responsible for looking after the operation of the system under the overall supervision of the Chief Collector of Revenue. The first assessments on the introduction of the system should be completely checked by the Income Tax Officer. A test check of at least 25 percent should also be carried out by the collector of revenues personally. While it would be desirable to administer the system from Maseru in matters of making assessments and watching recoveries, etc., it would be necessary to involve the sub-accountancies as far as possible in making recoveries and the introduction of the system in its initial stages. A complete card index and taxpayer rolls should be maintained of all the standard tax assessees in the Income Tax Office for prompt follow-up action. Bi-monthly progress reports on the progress of recoveries under the system should be prepared by the Income Tax Inspector concerned and submitted for the information of the Accountant General through the Chief Collector of Revenue. This report should also be periodically submitted for the information of the Permanent Secretary of Finance.

## XIII. BROAD CONCLUSIONS AND SUGGESTIONS

Many countries are faced with the problem of the control of compliance with the tax obligations due from small traders and professionals. This group is generally formed by owners of small industrial business, retailers, craftsmen, etc., who usually do not have the type of business organisation that keeps the minimum accounts records needed for submission of meaningful tax returns.

Since in most such cases it is not possible to conduct audits of such concerns, most of the developing countries in Africa are resorting to some sort of arbitrary imputation of the income that may be determined by some sort of rough and ready techniques. But since the number of such potential taxpayers is very large and the income tax administration in most countries is understaffed, the problem is only handled marginally and the bulk of such potential taxpayers continues to be outside the tax nets. Even where comprehensive campaigns of tax audits could be mounted, the problem cannot be handled in normal circumstances in most cases either because of illiteracy or lack of tax morality: information needed for determining tax liabilities, viz. books and records, is not generally forthcoming and even when it were forthcoming it would not even be adequate to assess the amount of actual income. Moreover from the point of view of the tax administration, there are also limitations of an economic nature since the cost of audit, etc. is in many cases larger than the tax liability involved. In the case of a developing country in Latin America, for instance, where serious efforts were made to tackle this problem it was found that small taxpayers who were forced to pay differences and fines through audits, as a result of having declared income below actual income, in a few months returned to the practice of declaring income below actual income, and but a few months later returned to the practice of declaring income for derisive amounts. [5]

Since the problem is very much before us we have to find practical solutions to deal with the situations in the light of our existing African realities — political, administrative and resource wise — which differ in different countries. However, in view of the need for revenues and to establish an equitable tax system, it is necessary to find solutions to the problem in a pragmatic manner applicable both in the short run and in the long run. The country surveys given above are instances of systematic attempts made by African and other countries to deal with the problem and there is no doubt that they are on the road to deal with the same in an effective manner. At the conclusion of this article the author does not want to be dogmatic in suggesting any one solution applicable to all conditions. However, in order to act as a catalyst for the African countries to concentrate attention on the problem, a resume of some of the relevant basic conditions is given below:

i) Experience has shown that the problem of tax evasion discussed in this study cannot be effectively solved through repressive measures, since these could lead to serious problems.
ii) The ideal system in this field seems to be that of establishing a single tax on low income taxpayers which may be based on their working capital or an assessment of their income by the tax office. However, variants of this criterion could be introduced, depending on administrative feasibility, etc.
iii) In order not to bring about too much resistance from taxpayers, it may be necessary in most of the conditions to adopt a system for establishing some fixed dues on the basis of assumed income and profit, especially in the case of low income taxpayers.
iv) It may be convenient to take gross income as a basis for differentiation of the small taxpayer from the large enterprise in the establishment of special pro-

5. See a case study on Mexico, "Treatment of Small Taxpayers" by Mr. Eduardo Acevedo C. in Fourth General Assembly Proceedings of Inter-American Center of Tax Administrators (1970).

cedures for tax payment. Although in normal circumstances, the difference between large and small taxpayers continues to be based on the annual amount of their net income from sales or services, other possible solutions could be studied by taking into account the fact that this very net income causes the greatest distortion on the taxpayers' return. The amount of inventories, total assets and invested capital could also be successfully considered as factors that could allow for the identification of the small taxpayer. However, these may sometimes be misleading as they do not give a correct idea of the importance of the business concern since they are only of use if the longer or shorter rotation of inventories is also considered. Considering all circumstances, it seems better to assume that net income gives a better indication of the taxable capacity of the taxpayer. Each country would thus have to decide on a broad definition of its small traders, etc.

v) It is essential that any new presumptive, fixed or standard assessment tax system be properly explained to the taxpayers and their agreement obtained in order to obtain as far as possible the immediate fulfullment of their tax obligations rather than resorting to long drawn out and cumbersome legal procedures.

vi) Since in most cases it may be found that the estimates that the taxpayers supply with respect to their total income would not be true, they should be required to provide data on purchases and sales and the monthly turnover, the number of employees in their service, the salaries paid, rentals for the site of the business, expenses for light, telephone, state taxes, social security and other expenses in connection with the business, with special emphasis on the cost of the merchandise. Special forms could be devised to elicit such information. Moreover it may be necessary to form special squads of officials with full knowledge of tax provisions along with accounting and trade practices. Selected establishments should be visited by these squads to verify the data filled in the forms. The visiting inspectors should try to reach agreement on the disputed areas in the information filled in the forms so that as far as possible agreement is reached on assumed income that will form the basis for tax assessment.

vii) Income tax could be assessed on the net assumed income by applying the percentages established by law for assessment in each branch of activity in those cases in which it cannot be based on normal accounting procedures, that is to say, the taxable income could be derived from the multiplication of the estimated income by the respective legal ratio. To the result of this operation a progressive rate established by law could be applied in order to obtain the assumed income. In those cases in which it is found that the ratios are notoriously higher than the taxes actually paid by the taxpayer, a special rapid investigation could be carried out to determine the ratio to be applied.

viii) Since the system adopted would be based on assumed income, it would be necessary to carry out periodical reviews, say, after every 3-4 years of modifications in output, turnover or other indicators. Help in such reviews could be obtained from established traders' associations or chambers of commerce etc.

ix) In case of enterprises, traders, etc. who keep records in the manner required by the law and submit regular tax returns, they should not be subjected to the presumptive assessments unless there are strong reasons to doubt the accuracy of the returns and records produced.

x) We have discussed in this paper the presumptive assessments for purposes of income tax. However, presumptive or assumed assessments could also be made in case of sales tax, etc. or such presumptions could be combined for these two taxes and the taxpayer could liquidate his tax liability by a single payment in case of sales tax and income tax, e.g. as is done in Chile. However, arrangements in this case have to be devised for broad agreement of the taxpayers. It is evident that this again is a matter which it is not proposed to go into detail here and has to be left to the differing conditions. It must, however, be emphasised that a definite solution to the problem of taxation of small traders must be found within the existing boundaries of the tax structure. In this context it would be necessary to take into account the situation of low income business firms as regards the tax on sales and services but also as regards income tax and licence fees if any to be paid by them.

xi) In the last analysis any presumptive, standard or fixed system to be enforced in respect of small taxpayers must be analysed in terms of the cost-benefit principle so that the simplicity or applicability of the system must be in direct proportion to its yield and ease in controls. However, in view of substantial income tax evasion and avoidance in these areas, new and imaginative procedures have to be evolved and applied where existing procedures have failed. In any case, the filing requirements should be made obligatory for all self-employed persons engaged in certain activities, including trade, restraurants, service establishments, small manufacturing and all licensed establishments and professions.

xii) It has been clearly demonstrated in the country case studies that renewal of a licence to operate should be made contingent on proof of payment of tax by the production of a tax clearance certificate or the filing of the tax return.

xiii) Legal provisions should be introduced in the tax laws whenever these are found to be necessary in order to enable the tax administrations to assume income where the taxpayer fails to supply information for a direct determination. It may be reiterated that in cases where a presumptive tax is applied, the taxpayer should have the right to rebut the presumption if he wants to do so, by producing proof of actual costs, gross income, exemptions and deductions, etc. There is no doubt that effective income tax enforcement is not now possible without presumptive power, and such power must be used in an equitable manner.

# United Kingdom:
# Mr. Healey's Caretaker Budget

On April 3, 1979 the Chancellor of the Exchequer pronounced his Budget Speech which because of the pending elections announced no major new developments. His statements with respect to taxation are reproduced below:

I come now to the coverage of the Finance Bill. The purpose of the Bill is to enable the tax régime to continue on its present basis during the period when Parliament is dissolved. It follows discussions which my Rt Hon. friend the Chief Secretary and I have had with the Rt Hon. Member for Surrey East and his colleagues and is intended to ensure that, so far as circumstances allow, the Chancellor of the Exchequer in the incoming Government, whoever he may be, will be faced with the same scope for tax changes in his Budget as would have been available to me had I been standing here in rather different circumstances.

### RENEWAL OF ANNUAL TAXES

As the House knows, some of our taxes — income tax, corporation tax and advance corporation tax — have to be imposed each year. Under the Provisional Collection of Taxes Act income tax can be collected until 5 May on the basis of the law prevailing in the tax year now ending, but there is no power to continue its collection beyond that date. Similar provisions relate to corporation tax and advance corporation tax. Hence the first and foremost purpose of the Finance Bill is to renew these annual taxes at the rates in force over the last twelve months.

### INDEXATION PROVISIONS

However, it has been necessary to go a little further than that. In renewing the income tax we have had to take account of the indexation provisions to be found in section 22 of the Finance Act 1977 — the so-called Rooker-Wise amendments. These require that, unless the House decides otherwise by affirmative Order, the main personal allowances — that is the single allowance and the wife's earned income relief, the married allowance, the age allowances and the additional personal allowance which, broadly, is given to single parents — should be revalorized each year in line with the increase in the retail price index over the previous calendar year. I have no intention of asking the House to lay aside the Rooker-Wise amendment this year. Indeed, if I had been able to introduce a normal Budget I would have proposed an increase in income tax thresholds higher than envisaged in section 22 of the Finance Act. Parliament has decided that these increases in the allowances should be made and hence it seems right that any continuation of the income tax in this caretaker Budget should fully reflect that fact. This indeed is the effect of the law, although the actual figures to which the allowances would be increased under the indexation provision are not precisely specified. Moreover there could be some confusion if the indexed allowances took immediate effect and were then changed a second time by the new Chancellor.

There was more than one way open to us of dealing with this situation, but the solution we have adopted is to lay down in the Finance Bill new figures for the main personal allowances which correspond (subject to rounding adjustment upwards) to the figures which are required under the indexation provisions. The percentage increase required under the latter — that is to say the increase in the retail price index for the calendar year 1978 — was 8.9 percent, but because of the rounding adjustments the actual increase in the allowances proposed in the Bill is just over 9 percent. However, we have also provided that no changes should be made in the amounts of tax due under P.A.Y.E. until 1 August 1979. The purpose of this is to give the next Chancellor time to decide what he wishes to propose to the House before pay packets are effected. By this means we shall have made clear what the revalorized allowances should be and we have ensured that no-one can proceed against the Inland Revenue for failure to implement a statutory responsibility. But we have done so in such a way as to give rise to no Party advantage.

I wish to stress the point that, if the next Government secured the agreement of the new House not to implement the Rooker-Wise amendment, the increases in allowances now set out would never actually be implemented and they would not be reflected in pay packets. They will not take effect before or during the Election campaign and they will only take effect after the Election if they remain unchanged by any Budget introduced thereafter.

## APPENDIX I ~ 1979-80 Rates and allowances

Note: The rates and allowances may possibly be altered by a subsequent Finance Act.

INCOME TAX

| | % |
|---|---|
| Lower rate | |
| (payable on first £ 750)* | 25 |
| Basic rate | |
| (payable on next £ 7,250)* | 33 |
| Higher rates | |
| (payable on excess of £ 8,000) | |
| next £ 1,000 | 40 |
| next £ 1,000 | 45 |
| next £ 1,000 | 50 |
| next £ 1,500 | 55 |
| next £ 1,500 | 60 |
| next £ 2,000 | 65 |
| next £ 2,500 | 70 |
| next £ 5,500 | 75 |
| Remainder | 83 |

* The lower rate may apply to an increased amount, with a corresponding restriction in tax at the basic rate, where there are wife's earnings.

| | |
|---|---|
| Investment income surcharge | |
| Taxpayers under 65 | |
| First £ 1,700 | Nil |
| Next £ 550 | 10 |
| Remainder | 15 |
| Taxpayers over 65 | |
| First £ 2,500 | Nil |
| Next £ 500 | 10 |
| Remainder | 15 |
| Age allowance | £ |
| Single | 1,420 |
| Married | 2,265 |
| (Income limit £ 4,400) | |

| | |
|---|---|
| Personal allowance | |
| Single | 1,075 |
| Married | 1,675 |
| Wife's earned income allowance | 1,075 |
| Additional personal allowance | 600 |
| Dependent relative allowance | 100 or 145 |
| Housekeeper allowance | 100 |
| Son or daughter's service allowance | 55 |
| Child minder housekeeper allowance | 100 |
| Blind persons allowance | 180 |

Child allowance —
no allowance available except for:
(a) students;
(b) children residing overseas.

| | |
|---|---|
| Limit of relief for interest on loans for the purchase or improvement of land | 25,000 |

CORPORATION TAX
FINANCIAL YEAR 1978

| | % |
|---|---|
| Full rate | 52 |
| Small companies rate | 42 |
| Small companies — marginal relief: | |
| Lower relevant maximum | £50,000 |
| Upper relevant maximum | £85,000 |
| Fraction | 1/7th |

ADVANCE CORPORATION TAX
FINANCIAL YEAR 1979

33/67ths

On the other hand if the next Government wishes to maintain or increase them it will be able to do so within weeks of introducing its Budget without waiting for 1 August. And in that case they will of course be back-dated to 6 April.

### REMOVAL OF CHILD ALLOWANCES

I now turn to the child tax allowances. The House will recall that these allowances have been progressively reduced over the last two years at the same time as child benefit was introduced and increased. My Rt Hon. friend the Chief Secretary announced last July that proposals would be included in this year's Finance Bill for the final abolition of these allowances, apart from non-resident children and the purely transitional provisions for certain students. Moreover — and here again I must salute the efforts of one of the Government's supporters, in this case my Hon. friend for Islington South — the present arrangements for the allowances have been made only on a year by year basis. Hence if no provisions were to be made in this Bill for the child allowances, they would revert to the level at which they were last fixed permanently, that is to say the level for 1975-76 — at a cost of well over £ 1 billion in a full year. Accordingly in order to remove any uncertainty and to ensure that no-one can seek to get his allowances restored the Bill provides for the removal of the allowances along the lines which my Rt Hon. friend originally announced to take place simultaneously with the increase of £ 1 in Child Benefits.

### 1979-80 P.A.Y.E. CODE NUMBERS

The Inland Revenue have already prepared the 1979-80 P.A.Y.E. code numbers on the basis that the House would approve the proposals in my Rt Hon. friend's announcement. Hence the deductions which family men will suffer in their pay packets next week will reflect the loss of the allowances: at the same time, however, child benefit is being increased to £ 4 per week and for over 90 percent of families the increase in the child benefit will be greater than the effect of the loss of child tax allowance. Indeed if account is taken also of the 70 p advance payment of child benefit made last November more than ninety-nine families out of a hundred entitled to child benefit will see their income increased.

### MORTGAGE INTEREST

Finally the Finance Bill provides for the continuation for another year of the ceiling on mortgage interest relief at £ 25,000. No change of policy is implied here and it will be open to the next Chancellor to propose that the figure be varied if he considers that desirable.

This, then, is a caretaker Finance Bill. It provides what is essential in order to ensure that our tax affairs are carried on in an orderly manner while Parliament is dissolved and ensures that the next Chancellor will be able to consider his Budget proposals against a backcloth essentially similar to that against which in other circumstances I might have been producing a normal Budget today.

## APPENDIX II ~ Finance Bill Resolutions

INCOME TAX

(1) Income tax for the year 1979-80 shall be charged at the same rates as for the year 1978-79.

(2) In section 8 of the Income and Corporation Taxes Act 1970 (personal reliefs):

(a) in subsection (1)(a) (married) for "£ 1,535" there shall be substituted "£ 1,675";

(b) in subsection (1)(b) (single) and (2) (wife's earned income relief) for "£ 985" there shall be substituted "£ 1,075";

(c) in subsection (1A) (age allowance) for "£ 2,075" and "£ 1,300" there shall be substituted "£ 2,265" and "£ 1,420" respectively;

(d) in subsection (1B) (income limit for age allowance) for "£ 4,000" there shall be substituted "£ 4,400";

and in section 14(2) and (3) of that Act (additional relief for widows and others in respect of children) for "£ 550" there shall be substituted "£ 600".

(3) Neither paragraph (2) above nor section 22(2) or (3) of the Finance Act 1977 shall require any change to be made in the amounts deductible or repayable under section 204 of the said Act of 1970 (pay as you earn) before 1 August 1979.

(4) No relief shall be given under section 10 of the said Act of 1970 (child tax allowances) for the year 1979-80 or any subsequent year of assessment except in the case of a child to whom section 25 or 26 of the said Act of 1977 applies.

(5) In paragraph 5(1) of the Schedule 1 to the Finance Act 1974 (limit on relief for interest on certain loans for the purchase or improvement of land) the references to £ 25,000 shall have effect for the year 1979-80 as well as for previous years of assessment.

CORPORATION TAX

(1) Corporation tax shall be charged for the financial year 1978 at the same rate as for the financial year 1977; and the small companies rate and the fraction mentioned in section 95(2) of the Finance Act 1972 (marginal relief for small companies) shall also be the same for the financial year 1978 as for the financial year 1977.

(2) The rate of advance corporation tax for the financial year 1979 shall be the same as for the financial year 1978.

# Tax Plans of the Conservative Party....

The tax policy which will be followed by the Conservative Party — if it comes into power — centers around the reduction of individual income tax, the reform of Capital Transfer Tax (inheritance and gift tax) and Capital Gains Tax. Some of the most significant passages in the Conservative Manifesto 1979 read as follows:

### CUTTING INCOME TAX

"We shall cut income tax at all levels to reward hard work, responsibility and success; tackle the poverty trap; encourage saving and the wider ownership of property; simplify taxes—like VAT; and reduce tax bureaucracy.

It is especially important to cut the absurdly high marginal rates of tax both at the bottom and top of the income scale. It must pay a man or woman significantly more to be in, rather than out of, work. Raising tax thresholds will let the low-paid out of the tax net altogether, and unemployment and short-term sickness benefit must be brought into the computation of annual income.

The top rate of income tax should be cut to the European average and the higher tax bands widened. To encourage saving we will reduce the burden of the investment income surcharge. This will greatly help those pensioners who pay this additional tax on the income from their life-time savings, and who suffer so badly by comparison with members of occupational or inflation-proofed pension schemes.

Growing North Sea oil revenues and reductions in Labour's public spending plans will not be enough to pay for the income tax cuts the country needs. We must therefore be prepared to switch to some extent from taxes on earnings to taxes on spending. Value Added Tax does not apply, and will not be extended, to necessities like food, fuel, housing and transport. Moreover the levels of State pensions and other benefits take price rises into account."

### A PROPERTY – OWNING DEMOCRACY

"We reject Labour's plan for a Wealth Tax. We shall deal with the most damaging features of the Capital Transfer and Capital Gains Taxes, and propose a simpler and less oppressive system of capital taxation in the longer term. We will expand and build on existing schemes for encouraging employee share-ownership and our tax policies generally will provide incentive to save and build up capital."

Lee Fook Hong F.C.I.S., F.A.I.A.:

# Singapore's 1979 Budget - A Summary

On March 5, 1979, Mr. Goh Chok Tong, Senior Minister of State for Finance, presented his 1979 Budget to the Parliament of the Republic of Singapore. Before outlining the financial policy for the coming year, he made a survey of the economic performance of Singapore in 1978.

He revealed that the Singapore economy grew by 8.6 percent in 1978 as compared to 7.8 percent in 1977. The economic growth for the previous year was considered satisfactory but its performance was modest compared to Taiwan, South Korea and Hong Kong.

Singapore's external trade increased by 15 percent but it was lower than the rate of 18 percent achieved in 1977. Imports increased at a faster rate than exports and Singapore's balance of payment continued to be in healthy surplus because of higher capital inflows.

On problems and prospects for 1979, the Minister said that he was not optimistic about the outlook for economic growth in 1979. In view of the present cautious growth policies of industralised countries, the proposed four-stage oil price increase and the protectionist policies of developed countries, the Minister warned that past efforts and performance had to be improved if the same growth rate in 1979 as in 1978 were to be achieved.

In examing the specific objectives that Singapore is pursuing in 1979, the Minister first spoke on industrial development and announced:

> "To further assist product development, we will be prepared to extend to new manufacturing companies the existing provision which currently permits only existing companies to deduct expenditure incurred on *research and development* for Income Tax purposes."

On trade development, the Minister said the prospects for world trade expansion in 1979 are not bright. He added,

> "The double tax deduction scheme currently applicable to expenses incurred in the participation in trade fairs, trade missions and setting up of overseas offices has been found to be useful to exporters. Since its introduction, 503 companies have taken advantage of the scheme. *To encourage more aggressive marketing overseas, the double tax deduction scheme will now also apply to expenses incurred in advertising and promotional campaigns overseas, the production of sales literatures and brochures, and the undertaking of market surveys.*"

On services development, the Minister revealed that there was further growth in 1978 in the field of tourism. He said:

> "If the protectionist policy in civil aviation of Australia succeeds, and worse, proliferates, the volume of tourist stopover traffic in Singapore will decrease. We must therefore increasingly develop Singapore as a destination point in the Pacific area. Tourists can only be attracted to Singapore if there are sufficient attractions and diversions here and in the neighbouring countries. One way to do this is to develop Singapore into a resort destination. Unfortunately, there are currently no resort hotels of international class in Singapore. *We are therefore prepared to consider giving incentives to a limited number of first class resort hotels which could be developed on Sentosa.*"

It has also been pointed out by the Minister that there is a need to further develop the convention business in Singapore and to maximise the export of Singapore professional and technical expertise. The proposed reduction in company taxation for earnings derived by consultancy companies or firms from approved overseas projects to 20 percent will stimulate more efforts by the private sector to penetrate the overseas market.

After quoting figures for the total estimated expenditure and revenue for the financial year 1979, the Minister proposed the following tax concessions:

### 1. Personal Income Tax

*(a) Central Provident Fund Contribution*

The maximum allowable relief for Central Provident Fund Contribution will be increased from $4,000 per year to $5,000 per year with effect from Year of Assessment 1980.

*(b) Pension*

Tax exemption will be granted on the whole of the pension income of resident pensioners with effect from Year of Assessment 1979.

### 2. Company Income Tax

*(a) Off-shore insurance business*

The 10 percent concessionary tax rate on income derived from off-shore re-insurance business is extended to income derived from general inward direct insurance business covering off-shore risks with effect from Year of Assessment 1980.

*(b) Company-owned cars*

The maximum allowable capital allowance for company-owned cars is increased from $15,000 to $25,000 with effect from April 1979.

*(c) Double tax deduction*

Double tax deduction will be allowed for expenses incurred by exporters in advertising and promotional campaigns overseas, production of sales literature and brochures and the undertaking of market surveys. The concession is to encourage more aggressive marketing overseas.

*(d) Research and development*

Tax deduction for expenditure incurred on research and development granted to existing companies will be extended to new manufacturing companies. This is to further assist product development.

## 3. Estate Duty

The exemption limit for estate duty will be raised from $100,000 to $300,000. This will be effective from April 1, 1979. The existing $100,000 limit still applies regardless of the composition of the estate, but the additional $200,000 relief is applicable only to "one" residential property up to that value and not including other assets.

For example, if the estate comprises a house assessed at $250,000 and other assets of $100,000, estate duty will be payable on $50,000 only — i.e. on the value of the house above $200,000.

The $200,000 limit for the house will apply to the full share of any one house in a deceased's estate. If the deceased is a part owner of a house, the exemption will depend on his proportionate share of that house. A house given as an inter vivos gift will not qualify for the exemption, notwithstanding that the value of the house is included in the valuation of the estate if the gift is made within five years of the date of death.

Houses which are registered in the names of companies will not be eligible for the concession which will apply to only residential units.

***

As can be seen from some of the above concessions for personal income tax and estate duty, the aim is to reward hard work and encourage saving for home ownership and old age security.

The 1979 budget has offered not only no new taxes but several tax concessions. It has been described by the Minister as a "completely painless budget and even mildly pleasurable." Some businessmen have commented that it is a cautious and realistic budget which will stimulate the investment climate and the national economy. "Prepare for the worst and work to achieve the best is the philosophy of the 1979 budget", said the Minister in his conclusion.

# Towards an Islamic Order in Pakistan:

# INTRODUCTION OF ISLAMIC TAXES (Zakat and Ushr)

by Drs. M.P. Dominic

The President of Pakistan, in a major address on February 10, 1979 on the establishment of Islamic order in Pakistan, announced the introduction of Islamic taxes: Zakat and Ushr. The President hopes that the introduction of these two Islamic taxes will be the first step towards Islamisation of the individual and collective life. The imposition of these taxes and the use of the proceeds for purposes ordained by Islamic law is considered one of the fundamental pillars of Islam. The Federal Minister and Deputy Chairman of the Planning Commission, Prof. Khurshid Ahmad, stressed that Islamisation also fitted in with the Government's aim of making the country self-reliant in a short period and eliminating poverty from the country.

On February 13, 1979, the draft Collection of Zakat and Ushr Order was issued. Suggestions to improve the draft order will be received by the Law Division up to April 30, 1979. The Order is proposed to be promulgated on July 1, 1979, the commencement date of the new fiscal year.

Islamic law imposes an obligation on the State to collect Zakat and Ushr from all Muslims in possession of "Nisab" (see below). The purposes for which the taxes are collected are also specified in Islamic law. Basically, the proceeds from collection of such taxes must be used to assist the needy to lead a life free from hunger and poverty.

## ZAKAT

Zakat is a form of wealth tax; it will be charged and collected from every "Shahib-i-Nisab" for each Zakat year in respect of the assets as on the valuation date. The rate is 2.5 percent. "Shahib-i-Nisab" means a person who owns or possesses assets of the value of "Nisab" or more, but does not include the Federal Government or a local authority or a company or other enterprise wholly owned by the Federal Government, a provincial Government or a local authority. "Nisab" means assets equal in value to 87.48 grams of fine gold. The currency equivalent of "Nisab" will be notified for each Zakat year.

Zakat will be imposed only on Muslims and a company or other association of persons, whether incorporated or not, a majority of the share of assets of which is held by Muslims.

Deduction will be allowed for debts from the value of the assets on which Zakat is imposed in the manner and to the extent specified in the rules. However, no deduction will be allowed in respect of debts which are incurred in respect of assets not liable to Zakat.

Zakat in respect of "Amwale-Batinah" (invisible assets), current account deposits with banks and other financial institutions, animal and fish and other catch or produce of the sea will not be compulsorily collected; it may be paid voluntarily. A "Shahib-i-Nisab" from whom Zakat is not compulsorily realisable under the Collection of Zakat and Ushr Order, or the amount of the Zakat realised from whom is less than what is payable under the Islamic Law, may voluntarily pay the Zakat or the difference, as the case may be. "Amwale-Batinah" means such assets as are ordinarily not publicly known and are held in private custody by any person; it includes gold and silver and other precious metals and stones and manufactures thereof, cash not deposited with a bank or other financial institution and prize bonds.

In other words, Zakat will be compulsorily collected only on "Amwale-Zahirah" (visible assets). The "Amwale-Zahirah" assets are set out in the Schedule to the draft Order. They are:

(1) financial deposits in banks and financial institutions above 1,000 Rs. and excluding those in current accounts;
(2) government saving certificates such as defence bonds or NIT Units: Zakat will be payable on the face value of the units at the time of payment of return;
(3) ICP Fund certificates, shares in limited companies and insurance policies: Zakat will be deducted at source after the adjustment of liability on account of debts;
(4) assets of more than 10,000 Rs. in commercial and industrial undertakings: Zakat will be charged on the market value on the valuation date; in the case of industrial undertakings, the charge would be on finished goods and raw materials.

No Zakat will be compulsorily collected on buildings, shops and houses.

Zakat paid will be deductible from taxable income for income tax purposes. Assets on which the Government will collect Zakat will be exempt from wealth tax assessment. Information furnished to the Government on assets for levy of Zakat will be treated as secret and will not be used against the persons supplying it for any other purpose.

## USHR

In the agricultural sector, the draft Order envisages a compulsory levy of 5 percent (Ushr) on all agricultural produce. It will be charged and collected from land owner, grantee, lessee or lease holder. A holder of unirrigated land may voluntarily pay an additional 5 percent of the produce. Ushr will be the first charge on the produce and will be collected in cash. However, where produce consists of wheat or paddy, Ushr may be collected either in cash or in kind.

The rate of Ushr fixed in the Shariah is 10 percent of the agricultural produce on barani (unirrigated) land and 5 percent of the produce on well and canal-irrigated lands. However, under the draft Order compulsory collection will be made only at 5 percent on agricultural produce on barani lands; the other 5 percent payment is voluntary.

Exemption from payment of Ushr is given if the produce from the land is less than 5 "Wasqs" (948 kilograms) of wheat or its equivalent in value in the case of other crops. The currency equivalent of 5 Wasqs of wheat will be notified for each Zakat year. A person eligible under Islamic law to receive assistance from the Zakat Fund will be exempt from payment of Ushr.

Ushr may also be paid voluntarily by a person from whom Ushr is not realisable under the Collection of Zakat and Ushr Order or the amount of the Ushr realised from whom is less than what is payable under the Islamic Law.

Ushr will replace land revenue and the development less leviable under any provincial law on lands in respect of which Ushr is levied. But water tax will continue. It is expected that the yield from Ushr will be ten times the present yield from land revenue. The collection of Ushr will be enforced from October 1979.

The payment of Zakat and Ushr will be made to the Zakat Fund. The Zakat fund will have three accounts: local, provincial and Central.

*Local account*

All sums collected on account of Zakat and Ushr at the local level in a village, "Mohallah" or locality will be deposited in this account.

*Provincial account*

25 percent of the local account deposits will be credited to the provincial account.

*Central account*

Zakat levied directly on deposits and assets with the banks and other financial institutions will be deposited in this account. As and when necessary, money will be diverted from the Central account to the local and provincial accounts.

In addition, alms and donations will also be credited to these accounts.

The Central account has already been established with 2,250 million Rs. This amount includes contributions from King Khalid bin Abdul Aziz and Crown Prince Fahd bin Abdul Aziz of Saudi Arabia and the President of the United Arab Emirates, Shikh Zaid bin Sultan Al-Nahyan.

The moneys in the Zakat Fund will be applied in accordance with Islamic law for the following purposes:

(a) rehabilitation of, and assistance to:
 (i) the poor and destitute;
 (ii) handicapped and disabled persons;
 (iii) orphans and widows in need of such assistance;
(b) establishment of hospitals for the benefit of the poor;
(c) establishment of educational, industrial and vocational training institutions to impart skills to the needy for the purpose of gainful employment;
(d) meeting expenditure on the collection and administration of Zakat and Ushr; and
(e) any other purpose permitted by Islamic law.

The establishment of hospitals and educational, industrial and vocational training institutions will be made through a loan from the Fund and shall be repaid over a period by charging appropriate fees from persons using facilities of those institutions, except persons who are eligible to receive Zakat or Ushr.

Every person who pays Zakat or Ushr will be entitled to indicate to the Administrator General or his nominee that an amount not exceeding 15 percent of his payment be disbursed to designated institutions. He may also claim reimbursement of a like amount on production of evidence that he has already spent the amount on any of the said purposes.

It is being emphasised that Zakat and Ushr payments should not be considered as an increase in the tax burden on the payer but as part of his religious duties.

The economic consequences arising from the introduction of these taxes are not yet clear. Money in circulation in Pakistan has risen since the announcement of the introduction of these two taxes. Currency bills issued in the week following the announcement increased by 10.1 percent from the previous week; currency in circulation increased by 9.7 percent from the previous week. There was also an increased demand for bank loans in the week. Call and short term money loans increased by $3.7 million from the previous week. Current accounts and time deposits declined by $17.3 million. Whether this increase in money circulation is a short or long term consequence is not clear. Bankers are divided in their opinion.

Prof. Khurshid Ahmad, the Federal Minister and Deputy Chairman of the Planning Commission, estimated that the yield from the two Islamic taxes will be 3,000 million Rs. He also estimates that the yield from Ushr will be 10 times the present yield from land revenue. However, it must be noted that there will be a reduction in the Government's present revenue arising from the income tax deduction for Zakat tax payment and the exemption from wealth tax. The Minister of Finance has been cautious in estimating the yield from the imposition of these two taxes and he expressed the hope that the receipts will be substantial to meet the obligations for which Zakat and Ushr are to be expended.

Pakistan, by tying the eradication of poverty to religious duty, may achieve a certain amount of social security for the poor. Hence, they may be considered as social security deductions earmarked for the poorer sections of Pakistan.

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### FINLAND

**SKATTEFÖRFATTNINGARNA 1978**

6th Edition. Edited by Hillel Skurnik. Helsinki, Finlands Juristförbund, 1978. 460 pp.
Compendium of Finnish tax laws in the Swedish language. Case law has been included and the laws are printed as of No. 314/78 of the Official Gazette of Finland. (B. 101.657)

### FRANCE

**FISCALE ASPECTEN VAN ONROEREND GOED IN FRANKRIJK**

By R. Boon, G. Brunschot and A. Leemreis. The Hague, Fenedex, 1978. 27 pp., 44.20 Dfl.
Study of the taxation of real property investment in France. (B. 101.628)

**LES SIGNES EXTERIEURS DE REVENUS**

Le contrôle et la reconstitution du revenu global par l'administration fiscale. By Jean-Pierre Casimir. Paris, L.G.D.J.; Dijon, Librairie de l'Université, 1979. 510 pp., 106,— Ffr.
Study of income taxation based on external signs of wealth of the taxpayer, or in other words his way of living rather than his declaration of annual income. (B. 101.614)

## HONG KONG

### GUIDEBOOK TO TAXATION AND INVESTMENT LAW IN HONG KONG

By John Bush. North Ryde, CCH Australia, Ltd., 1978. 257 pp. Reference work to inform local and foreign businessmen and lawyers transacting business in Hong Kong. Dealt with are the constitution and framework of Government, company law, taxation, stamp and estate duty, banking and finance and exchange control. (B. 51.268/269)

### HONG KONG ANNUAL DEPARTMENT REPORT

By the Commissioner of Inland Revenue R.V. Giddy for the financial year 1977-78. Hong Kong, Government Printer, 1978. 70 pp. (B. 51.205)

## ICELAND

### TAXES IN ICELAND 1978

Short description of the taxation of individuals and companies in Iceland 1978. (Assessment year 1978; tax year (income year) 1977). Prepared by S. Thorbjörnsson, Director of Internal Revenue, August 1978. Reykjavik, Government Printer, 1978. 17 pp. (B. 101.516)

## INDIA

### AN OUTLINE OF LABOUR LEGISLATION AND PRACTICES IN INDIA

New Delhi, Indian Investment Centre, 1976. 60 pp.
Second revised edition of information guide on labour law in India. (B. 51.241)

### EXCHANGE CONTROL

New Delhi, Indian Investment Centre, 1975. 72 pp.
The Foreign Exchange Regulation Act explained. (B. 51.242)

### TAXATION IN INDIA

Questions and answers. New Delhi, Indian Investment Centre, 1977. 55 pp.
Explanation of the direct taxes levied in India. Supplement of September 1978 updates the basic work. (B. 51.243)

### TAXES AND INCENTIVES 1978-79

A guide for investors. New Delhi, Indian Investment Centre, 1978. 141 pp.
Revised edition of guide providing information on direct taxes in India, i.e. individual income tax, corporate income tax, wealth tax, gift tax and estate duty. (B. 51.244)

### TAX INCENTIVES AND EXPORT INCENTIVES IN INDIA

New Delhi, Indian Investment Centre, 1977. 57 pp.
Summary of tax incentives and export incentives in India. An addendum to the basic brochure of September is appended to the 1977 edition. (B. 51.248)

## INTERNATIONAL

### EXCISE SYSTEMS

A global study of the selective taxation of goods and services. By Sijbren Cnossen. London, The Johns Hopkins University Press, 1977. 192 pp., £ 9.75.
Study of excise systems in the world (without socialist countries) with reference to sales tax systems. (B. 101.624/625)

### FOREIGN INVESTMENT POLICIES

Select country profiles. New Delhi, Indian Investment Centre, 1976. 118 + 95 pp.
Profiles, in 2 volumes, on 22 countries in the world regarding foreign investment policies, the procedures of investment, corporate tax structure and various concessions. The countries dealt with are considered of importance to Indian entrepreneurs who want to invest outside India. (B. 51.245)

### PRINZIPIEN DES INTERNATIONALEN STEUERRECHTS ALS PROBLEM DER STEUERPLANUNG IN DER MULTINATIONALEN UNTERNEHMUNG

By Horst Rieger. Berlin, Erich Schmidt Verlag, 1978. Steuerberatung — Betriebsprüfung — Unternehmensbesteuerung, Band 4. 352 pp.
Survey of the principles of international tax law, particularly with respect to tax planning of multinational companies, from both the theoretical and practical points of view. (B. 101.593)

### STEUERÖKONOMISCHE ANALYSE DER VERRECHNUNGSPREISE INTERNATIONALER UNTERNEHMUNGEN

By Horst Krüger. Berlin, Erich Schmidt Verlag, 1978. Steuerberatung — Betriebsprüfung — Unternehmensbesteuerung, Band 5. 183 pp.
Survey of the tax aspects of intercompany pricing. The author discusses these aspects on the basis of the principles of international tax law in the Federal Republic of Germany, France and the United States and on the basis of other legal provisions and economic principles. An extensive index and bibliography are appended. (B. 101.556)

### TAX STRATEGY FOR GENERAL MANAGEMENT

Economic and social issues. By John Chown and John Humble. London, Foundation for Business Responsibilities, 1978. 25 pp.
Study recommending a regular taxation strategy audit and an action plan which asks searching questions on companies' tax operations. (B. 101.490)

## IRAQ

### A STUDY. THE WORKER — EMPLOYER AND LABOUR LAW NO. 151 OF 1970 (AS AMENDED)

Part 1. By Khalid Issa Taha. Baghdad, Khalid Issa Taha, 1977. Studies in Iraqi Laws and Regulations, Volume III, 1977. 117 pp.
Explanation of labour law in Iraq. (B. 51.199)

### A STUDY. THE WORKER — EMPLOYER AND LABOUR LAW NO. 151 OF 1970 (AS AMENDED)

Part 2. By Khalid Issa Taha. Baghdad, Khalid Issa Taha, 1977. Studies in Iraqi Laws and Regulations, Volume IV, 1977. 147 pp.
Explanation of conditions relating to employment of aliens and the Trade Union Organisation. Texts of relevant regulations are appended. (B. 51.201)

### KEY TO LIST OF LEGAL STUDIES

By Khalid Issa Taha. Baghdad, Khalid Issa Taha, 1978. Studies in Iraqi Laws and Regulations, Volume VI, 1978. 43 pp.
Sourcebook for studies in Iraqi laws and regulations. (B. 51.200)

## LATIN AMERICA

### THE ANDEAN LEGAL ORDER

A new Community Law. By F.V. García-Amador. New York, Oceana Publications, Inc., 1978. 423 pp., $ 30,—.
Study of the Cartagena Agreement and other treaty sources of the law of the Andean Group and competent subregional organs thereof. Texts of relevant documents are appended. (B. 15.842)

### MINING AND PETROLEUM LEGISLATION OF LATIN AMERICA AND THE CARIBBEAN

Compiled by the General Secretariat, Organization of American States. New York, Oceana Publications, Inc., 1978. 1 binder, $ 75,—.
Loose-leaf publication summarizing basic mining and petroleum laws for 24 Latin American and Caribbean member states of the Organization of American States. Each country is presented in accordance with a common outline for comparison purposes. (B. 15.846)

## MIDDLE EAST

### DOING BUSINESS IN SAUDI ARABIA AND THE ARAB GULF STATES

By Nancy A. Shilling. New York, Inter-Crescent Publishing & Information Corporation (IPIC), 1975. 455 pp.
Reference work providing information in a common outline for six countries in the Middle East: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (Abu Dhabi and Dubai). Covered are politics and administration, the economy, development, foreign investment and participation, banking and finance including taxation. (B. 51.272)

### DOING BUSINESS IN SAUDI ARABIA AND THE ARAB GULF STATES

1977 Supplement. By Nancy A. Shilling. New York, Inter-Crescent Publishing & Information Corporation (IPIC), 1977. 147 pp.
Supplementary information on the basic work updating the material on six countries in the Middle East: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (Abu Dhabi and Dubai). (B. 51.271)

## THE NETHERLANDS

### THE IMPACT OF THREE MAJOR SYSTEMS OF CORPORATE INCOME TAXATION WITHIN AN INTEGRAL MODEL OF FIRM BEHAVIOUR

By Piet W. Moerland. Rotterdam, Erasmus University, 1978. Discussion Paper Studies, No. 7801/P. 16 pp. (B. 101.423)

### HET NEDERLANDS-SPAANSE VERDRAG TER VOORKOMING VAN DUBBELE BELASTING

3e druk, januari 1978. By Th.J.F. Zeegers and P.E. Hollander. The Hague, Fenedex, 1978. 18 pp.
Consideration of the double taxation treaty of 1971 between the Netherlands and Spain with a summary of the Spanish tax system. (B. 101.641)

### PERSOONLIJKE VERPLICHTINGEN

Tweede druk 1978. By J.C.J. van Vucht. Deventer, Fed., 1978. Fed's Fiscale Brochures, IB: 2.2. 64 pp. 13.75 Dfl.
Second edition of mongraph explaining the special deduction allowance for expenses borne by individual taxpayers in computing their annual taxable income. (B. 101.650)

### TAX INCIDENCE AND INCOME DISTRIBUTION: TOWARDS AN OPERATIONAL GENERAL EQUILIBRIUM MODEL FOR THE NETHERLANDS

By Wouter J. Keller. Rotterdam, Erasmus University, 1978. Discussion Paper Series, No. 7802/P. 58 pp. (B. 101.424)

### DE WAARDEBEPALING BIJ OVERDRACHT EN OVERGANG VAN AANDELEN IN BESLOTEN VENNOOTSCHAPPEN

By Robbert Wessels. Deventer, Kluwer, 1979. 608 pp., 55.— Dfl.
Thesis on the determination of the value of shares in a private company (besloten vennootschap) in case of transfer and similar transactions. (B. 101.623)

### WET INVESTERINGSREKENING

Commentaar op WIR en SIR. By H.M.N. Schonis and J. Renes. Arnhem, Gouda Quint, 1978. 424 pp.
Monograph commenting on the Law on Investment Incentives (Wet Investeringsrekening — WIR) and on the Law on Selective Investment Levies (Wet Selectieve Investeringsrekening — SIR). In addition, the investment premium scheme (Investeringspremieregeling — IPR) is considered. Relevant texts of the statutes as well as explanatory notes to the bills are appended. (B. 101.638)

## NETHERLANDS ANTILLES

### BELASTINGEN IN DE NEDERLANDSE ANTILLEN

Belastingheffing en fiscale faciliteiten meer in het bijzonder ten aanzien van Antilliaanse naamloze vennootschappen. Derde, herziene en uitgebreide druk. By Irving C. Plantz and Karl F. Walboom. Deventer, Kluwer, 1978. 236 pp. 45.— Dfl.
Third revised and extended edition of monograph on taxes in the Netherlands Antilles with emphasis on the corporate income tax. Texts of important tax laws, by-laws and double taxation treaties are appended. (B. 101.658)

### THE NETHERLANDS ANTILLES AS A FINANCIAL CENTER

Willemstad, Pierson, Heldring & Pierson, 1978. 60 pp.
Study of the profit taxation of Netherlands Antilles corporations. English translation of the text of the Netherlands Antilles Profit Tax Ordinance as amended and the company law (articles 33 to 155 inclusive) of the Commercial Code of the Netherlands Antilles are appended. (B. 15.848)

### TRANSFER OF SEATS OF NETHERLANDS ANTILLES CORPORATIONS

Message to the 32nd congress of the International Fiscal Association, Sydney 1978. Bonaire, R.H.D. Debrot, 1978. 7 pp.
English translation of a bill concerning the transfer of corporate seats of the Netherlands Antilles and foreign corporations into or from the Netherlands Antilles. (B. 15.847)

## NEW CALEDONIA

### PRINCIPAUX TEXTES FISCAUX EN VIGUEUR EN NOUVELLE-CALEDONIE

Document No. 45, September 1976. Mis à jour en février 1977. Noumea, Centre de Productivité et d'Etudes Economiques, 1977. 155 p.
Text of tax statutes and relevant by-laws. Text of the investment law is appended. The material is updated as of February 1977. (B. 51.206)

## NEW ZEALAND

### NEW ZEALAND INCOME TAX LEGISLATION

5th Edition. Incorporating 1977 Amendments. Income Tax Act, Income Tax (Annual) Act, Land Tax (Annual) Act, Land Tax Act, Property Speculation Tax Act, Inland Revenue Department Act, Regulations and Orders. Auckland, Commerce Clearing House (New Zealand), 1978. ± 1100 pp.
Compilation of tax laws including related regulations and orders. Texts of comprehensive double taxation treaties are appended. (B. 101.655)

### NEW ZEALAND INCOME TAX TABLES 1977/78 AND 1978/79

Auckland, Commerce Clearing House (New Zealand), 1978. 246 pp. (B. 101.653)

### 1978 NEW ZEALAND MASTER TAX GUIDE

Auckland, Commerce Clearing House (New Zealand), 1978. 523 pp. Guide explaining the income tax system in New Zealand based on the Income Tax Act 1976 including all 1977 amendments. (B. 101.654)

## NORWAY

### COMPANY, TRADE AND TAX LAW IN NORWAY

By Andreas Arntzen, Jens Bugge and Ulf Underland. Oslo, Den Norske Creditbank, 1978. 502 pp.
Guide to provide information concerning Norwegian laws with

respect to the establishment of new business, types of company, registration of firms, taxation, concession rules, foreign exchange regulations and other business legislation. The material is updated as of December 31, 1977. It is probably the most detailed guide to Norwegian company, trade and tax regulations published in the English language. (B. 101.621)

### NØKKELEN TIL SELVANGIVELSEN FOR 1978

By Per Magnus, Svein Torre Nilsen and Kai Vareide. Oslo, Norsk Skattebetalerforening, 1978/79. 117 pp.
Book entitled 'Key to 1978 tax return', containing details of all relevant provisions of the income and net wealth tax law, to guide individual taxpayers filing their tax returns. (B. 101.620)

## SPAIN

### MITNAHME VON PKW'S UND SPORTBOOTEN BEI REISEN UND ÜBERSIEDLUNG NACH SPANIEN

(Automóviles extranjeros y embarcaciones deportivas en desplazamientos temporales o definitivos a España). 4. neubearbeitete Auflage, Stand Dezember 19, 1978. Barcelona, Deutsche Handelskammer für Spanien, 1978. 20 pp.
Brochure explaining the regulations in Spain with respect to motor vehicles and sportboats entering Spain on either a temporary or permanent basis. (B. 101.629)

### VESTIGING ALS BEDRIJF IN SPANJE

Zesde uitgave. By P.E. Hollander, L. Hooijer and G. van Kooten. The Hague, Fenedex, 1977. 67 pp.
"Establishing a business in Spain" explains company law, foreign investment law, taxation, financial institutions, labour law and the social security system of importance to companies as well as individuals establishing a business or residing in Spain. (B. 101.642)

## SWITZERLAND

### BEREINIGTE ERLÄUTERNDE SKIZZE FÜR DIE VERORDNUNG DES BUNDESRATES ÜBER DIE NEUE FORM DER UMSATZSTEUER

Bern, Eidgenössische Finanz- und Zolldepartement, 1977. 35 pp.
Explanation of the proposed VAT legislation. (B. 101.471)

### LA FRAUDE FISCALE EN SUISSE

By André Hofer. Geneva, Editions Grounauer, 1978. 170 pp.
Tax fraud in Switzerland and the possibilities of the tax administration to act against fraud. Proposals for more effective provisions to combat tax fraud. (B. 101.659)

### GESETZ ÜBER DIE DIREKTEN STEUERN DER KANTONE UND GEMEINDEN

Bundesgesetz über die direkte Bundessteuer. Entwurf der Koordinations-Kommission vom 3. August 1973/20. Juli 1976.
Bern, Eidgenössische Finanz- und Zolldepartement, 1978. 320 pp.
Bill for an act concerning a law for direct taxes in the cantons and municipalities as well as for a federal law concerning direct federal taxes, prepared by the Co-ordination Committee from August 3, 1973 to July 20, 1976. (B. 101.520)

### MESSAGE A L'APPUI DE LA REFORME DES FINANCES FEDERALES 1978, DU 15 MARS 1978

Bern, Eidgenössische Finanz- und Zolldepartement, 1978. 84 pp.
Missive of the Federal Council proposing to modify the turnover tax and the direct taxation. (B. 101.470)

## UNITED ARAB EMIRATES

### LEITFADEN FÜR GESCHÄFTE MIT DEN VEREINIGTEN ARABISCHEN EMIRATEN

By Hubert Lang. Stuttgart, Industrie- und Handelskammer Mittlerer Neckar, 1978. 53 pp., 20.— DM.
Guide providing information on doing business with the United Arab Emirates. Tax aspects and foreign exchange regulations are dealt with. (B. 51.236)

## UNITED KINGDOM

### CAPITAL TRANSFER TAX

Issued by the Board of Inland Revenue. London, November 1977. 146 pp.
Book explaining the capital transfer tax provisions of the Finance Act 1975 and the succeeding Finance Acts. (B. 101.634)

### DEVELOPMENT LAND TAX

Issued by the Board of Inland Revenue. London, 1978. 94 pp.
Book explaining the provisions of the Development Land Tax Law of 1976 as amended by the Finance Act 1977. (B. 101.635)

### TAX REFORM AND CONSERVATION

By Richard Lecomber and Jonathan Fisher. London, Institute for Fiscal Studies, 1978. IFS Lecture Series, No. 9. 47 pp. (B. 101.644)

## U.S.A.

### DISTRIBUTIONAL ASPECTS OF TAX REFORM DURING THE PAST FIFTEEN YEARS

By Benjamin A. Okner. Washington, Office of Tax Analysis, U.S. Treasury Department, 1978. OTA Paper No. 35, October 1978. 50 pp. (B. 101.555)

### STOCK VALUES AND DIVIDENDS FOR 1979 TAX PURPOSES

Market values, par values and dividends of listed or regularly quoted stocks for 1979 federal, state and local tax purposes. Chicago, Commerce Clearing House, 1979. 160 pp., $ 5.50 (B. 101.647)

### 1979 TAX ANGLES IN SPECIAL AREAS

Chicago, Commerce Clearing House, Inc., 1978. 344 pp.
Special areas include: corporate executives, professional persons, retailers, manufacturers, wholesalers, builders, contractors, fiduciaries, investors, oil, gas, mines, farmers, salespersons, schoolteachers. (B. 101.586)

# Loose-Leaf Services

**Received between February 1 and February 28, 1979**

## AUSTRALIA

AUSTRALIAN INCOME TAX — LAW AND PRACTICE:

- — Bulletin
  releases 27-30
- — Cases
  releases 35-38
- — Replacement pages
  releases 21, 22 and 23

Butterworths, Ltd., Chatswood.

## BELGIUM

DOORLOPENDE DOCUMENTATIE INZAKE BTW/LE DOSSIER PERMANENT DE LA TVA

release 102
Editions Service, Brussels.

FISCALE DOCUMENTATIE VANDEWINCKELE

Tome II, release 32
CED-Samsom, Brussels.

GUIDE FISCAL PERMANENT

release 400
Editions Service, Brussels.

## CANADA

CANADA TAX LETTER

release 300
Richard de Boo, Ltd., Toronto.

CANADA TAX SERVICE — RELEASE

releases 224 and 225
Richard de Boo, Ltd., Toronto.

CANADIAN CURRENT TAX

releases 3-6
Butterworths, Ltd., Scarborough.

CANADIAN INCOME TAX:

- — Tax planning and management
  releases 32, 33 and 34
- — Revised
  releases 49 and 50

Butterworths, Ltd., Scarborough.

CANADIAN SALES TAX REPORTS

release 134
CCH Canadian, Ltd., Don Mills.

CANADIAN TAX REPORTS

releases 364-367
CCH Canadian, Ltd., Don Mills.

DOMINION TAX CASES

releases 3, 4 and 5
CCH Canadian, Ltd., Don Mills.

FOREIGN INVESTMENT IN CANADA

Report Bulletin
release 50
Prentice-Hall of Canada, Ltd., Scarborough.

PROVINCIAL TAXATION SERVICE

release 362
Richard de Boo, Ltd., Toronto.

## DENMARK

SKATTEBESTEMMELSER:

- — Skattenyt
  release 123
- — Skattebestemmelser
  release 116

A.S. Skattekartoteket Informationskontor, Copenhagen.

## FRANCE

BULLETIN DE DOCUMENTATION PRATIQUE DES TAXES SUR LE CHIFFRE D'AFFAIRES ET DES CONTRIBUTIONS INDIRECTES

release 1
Editions Francis Lefebvre, Levallois-Perret.

JURIS CLASSEUR — CHIFFRE D'AFFAIRES — COMMENTAIRES

release 6099
Editions Techniques, Paris.

## GERMAN FEDERAL REPUBLIC

DEUTSCHE STEUERPRAXIS — NACHSCHLAGWERK PRAKTISCHER STEUERFÄLLE

releases 64 and 65
Verlag Dr. Otto Schmidt, Cologne.

DOPPELBESTEUERUNG

Korn — Dietz — Debatin
release 37
Verlag C.H. Beck, Munich.

HANDBUCH DER GMBH

Wilke — Gottschling — Gaul — Berg
release 18
Verlag Dr. Otto Schmidt, Cologne.

KOMMENTAR ZUM ERBSCHAFTSTEUERGESETZ UND SCHENKUNGSTEUERGESETZ

R. Kapp.
release 12
Verlag Dr. Otto Schmidt, Cologne.

KOMMENTAR ZUR ABGABENORDNUNG UND FINANZGERICHTSORDNUNG

Hübschmann — Hepp — Spitaler
release 90
Verlag Dr. Otto Schmidt, Cologne.

KOMMENTAR ZUR EINKOMMENSTEUER

(Einschl. Lohnsteuer und Körperschaftsteuer)
release 124
Verlag Dr. Otto Schmidt, Cologne.

RECHTS- UND WIRTSCHAFTSPRAXIS STEUERRECHT

release 229
Forkel Verlag, Stuttgart.

STEUERERLASSE IN KARTEIFORM

releases 206-209
Verlag Dr. Otto Schmidt, Cologne.

STEUERRECHTSSPRECHUNG IN KARTEIFORM

releases 322-325
Verlag Dr. Otto Schmidt, Cologne.

STEUERTABELLEN

release 17
Verlag C.H. Beck, Munich.

UMSATZSTEUERGESETZ (MEHRWERTSTEUER)

G. Rau — E. Dürrwachter
release 29
Verlag Dr. Otto Schmidt, Cologne.

## INTERNATIONAL

JURA EUROPAE

— Droit d'établissement/Niederlassungsrecht
  release 6

Editions Techniques Juris Classeur, Paris.

## THE NETHERLANDS

DE BELASTINGGIDS

release 76
S. Gouda Quint — D. Brouwer, Arnhem.

BELASTINGWETGEVING:

— Vennootschapsbelasting
  release 20

Noorduijn, Arnhem.

CURSUS BELASTINGRECHT

release 38
S. Gouda Quint — D. Brouwer, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING:

— Suikeraccijns
  release 9
— Belastingen van Rechtsverkeer en Registratiewet
  release 25

Kluwer, Deventer.

FED LOSBLADIG FISCAAL WEEKBLAD

releases 1703-1706
FED, Deventer.

DE GEMEENTELIJKE BELASTINGEN

A.M. Dijk, G. Jansen, J.C. Schroot, F. Verstegen.

releases 265, 266 and 267
VUGA, The Hague.

HANDBOEK VOOR DE IN- EN UITVOER:

— Tarief voor invoerrechten
  releases 168 and 169

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK

releases 132 and 133
Kluwer, Deventer.

KLUWERS TARIEVENBOEK

releases 206, 207 and 208
Kluwer, Deventer.

NEDERLANDSE BELASTINGWETTEN

W.E.G. de Groot
release 154
Samsom, Alphen a.d. Rijn.

DE PARLEMENTAIRE BEHANDELING VAN DE NIEUWE BELASTINGONTWERPEN

release 55
Samsom, Alphen a.d. Rijn.

VAKSTUDIE — FISCALE ENCYCLOPEDIE:

— Inkomstenbelasting 1964
  releases 256-260
— Loonbelasting 1964
  releases 167 and 168
— Omzetbelasting 1968
  releases 64 and 65
— Vennootschaps belasting 1969
  release 59

Kluwer, Deventer.

## NORWAY

SKATTE-NYTT

A, release 1
Norsk Skattebetalersforening, Oslo.

## SWITZERLAND

DIE STEUERN DER SCHWEIZ/LES IMPOTS DE LA SUISSE

Tome IV, release 47
Verlag für Recht und Gesellschaft, Basel.

## UNITED KINGDOM

SIMON'S TAX CASES

releases 4 and 5
Butterworth & Co., London.

SIMON'S TAXES

release 33
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE

releases 3, 4 and 5
Butterworth & Co., London.

VALUE ADDED TAX — DE VOIL

release 67
Butterworth & Co., London.

## U.S.A.

FEDERAL TAXES — REPORT BULLETIN

releases 5 and 7
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE

releases 4-9
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE REPORTS

releases 17-20
Commerce Clearing House, Inc., Chicago.

FEDERAL TAX TREATIES — REPORT BULLETIN

release 12
Prentice-Hall, Inc., Englewood Cliffs.

STATE TAX GUIDE

releases 682 and 683
Commerce Clearing House, Inc., Chicago.

TAX HAVENS OF THE WORLD

Walter Diamond
release 18
Matthew Bender, New York.

TAX IDEAS — REPORT BULLETIN

releases 1 and 2
Prentice-Hall, Inc., Englewood Cliffs.

TAX TREATIES

release 324
Commerce Clearing House, Inc., Chicago.

U.S. TAXATION OF INTERNATIONAL OPERATIONS

releases 1 and 2
Prentice-Hall, Inc., Englewood Cliffs.

# Conference Diary

## MAY 1979

*Seminar Services International:* the 10th multi-choice International Tax Planning Symposium, Montreux (Switzerland), May 7-9 (English, French and German).

*Investment and Property Studies:* The Vienna Conference (including international tax planning), Vienna (Austria), May 16-18 (English).

*13th General Assembly of CIAT:* I. Development of Management Processes for Planning, Implementation and Control of the Resources of the Tax Administration; II. Taxpayer Control; III. Problems of Value Added Tax Administration; IV. Reports of CIAT Conferences and Courses; V. Minimum Legal Powers of a Tax Office; Quito (Ecuador), May 26-June 1 (English, Spanish).

## JUNE 1979

*The Taxation Institute of Australia:* First International Convention (including Fundamental Concept in Double Taxation Treaties, Guide to Estate Planning Far East locations), Hong Kong, June 10-16 (English).

*Management Centre Europe:* International Tax Management, Brussels (Belgium), June 21-22 (English).

*Marchmont Conferences:* Third International Tax Planning Conference, Washington D.C. (U.S.A.), June 27-29 (English).

## AUGUST 1979

*9th Congress of the Latin American Institute of Tax Law:* (a) Joint Ventures; (b) Bonded Warehouses, Free Ports and Free Zones, Asunción (Paraguay), August 20-24 (Portuguese, Spanish).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The taxation of transfers of family-held enterprises on death and inter-vivos; II. The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities. For the seminars the following subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark), September 3-7 (English, French, German, Spanish).

## FEBRUARY 1980

*Business Perspectives:* 6th International Tax Conference. Singapore, February 4-8 (English).

## SEPTEMBER 1980

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

**NOTE: The I.F.A. Conference at Copenhagen will be held from 3-7 September 1979 and not from 4-8 September as erroneously stated in preceding issues.**

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asociación Paraguaya de Estudios Administrativos y Fiscales, Yegros No. 837, Asunción (Paraguay).

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

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

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4A 1AB (U.K.).

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

Marchmont Conferences, Vogue House, 1 Hanover Square, London W1R 9RD (U.K.).

Seminar Services International, 1 Passage Perdonnet CH-1005, Lausanne (Switzerland).

The Taxation Institute of Australia, 19th Floor, C.A.G.A. Building, 8 Bent Street, Sydney, 2000, Australia.

# CUMULATIVE INDEX 1979 ~ Nos.1-3

# Contents

of the May 1979 issue

## ERRATUM

Due to a printing error, a grievous mutilation of text occurred in the second paragraph of the right-hand column of the obituary of Dr. K.H. Dronkers, which should in fact read as follows:

*Dr. Dronkers became well-known in international tax circles through his membership of international commissions, and as Secretary-General of the International Fiscal Association (I.F.A.). Up until his death, he had also for many years been a member of the Board of Trustees of the International Bureau of Fiscal Documentation.*

**In next issues:**

Braxilian legislation on industrial development (Part II)
— by *Antonio Mendes*

Recent theoretical developments in public finance
— by *Nizar Jetha*

Tax consideration for investment and business decisions in Nigeria
— by *A.C. Ezejelue*

The system of indirect taxation in the Caribbean Common Market
— by *Roy T. Gobin*

Customs valuation principles and practices
— by *Luc de Wulf*

Taxation and savings: some new empirical evidence in the Indian economy, 1960-76
— by *N.R. Vasudeva Murthy*

A review of the Ethiopian fiscal system
— by *M. Fissehatsion*

Japan: the 1979 tax reform
— by *Makoto Miura*

# Mr. van Hoorn receives Silver Medal

## Speech of Burgomaster W. Polak on the occasion of the presentation of the Silver Medal of Honour of the City of Amsterdam, May 4, 1979

Burgomaster W. Polak

*Ladies and Gentlemen,*
*Mr. van Hoorn,*

*I am pleased that you allow me to be back in this august assembly of the Trustees of the International Bureau of Fiscal Documentation.*

*As most of you probably know, I have not only been a Trustee of this Bureau myself, but like all of you here, a positive and active Trustee, in the sense that I always regarded it as an honour to be a Trustee of this institution founded by one of our most respected professors, prof. Adriani. We went through very difficult times with the Bureau in those days when we were not at all sure that it could survive its, then, severe financial troubles.*

*Being here again, I actually feel tempted to participate once more in your discussions.*

*Yet, that is not the reason why I came.*

*Having been away now for some time, I think I can underline in a very objective way the importance of the Bureau for Amsterdam as an international city.*

*About one year ago the Amsterdam City Council accepted a statement on the international contacts of the city.*

*In this statement, the Bureau of Fiscal Documentation figured as an example of an Amsterdam based institution that provokes many international activities.*

*Of course it is very easy to illustrate this point: thanks to the Bureau we get many foreign visitors and researchers who come to stay, work or confer here.*

*I should, in particular, mention various seminars that have been held here in Amsterdam with, as I understood, much success.*

*The fact that E.S.C.A.P. asked the institute to organise seminars for Asia says something about the Bureau's international reputation.*

*This worldwide reputation of the Institute is partly attributable to the up to date documentation on the taxes levied in the African and Latin American, European and Middle East countries — documentation compiled on a comparable basis — while the same documentation will be shortly available on Asian countries as well if I am well informed.*

*I said the worldwide reputation of the Institute is partly attributable to the documentation prepared here in Amsterdam..... because I am sure the reputation is* *attributable as well to the enormous amount of knowledge and work done by you personally, Mr. van Hoorn.*

*I know, I am not the first one to speak about the things you have accomplished as not only has Her Majesty the Queen honoured you with the rank of Officer in the Order of Oranje Nassau, but the Italian government has honoured you as well.*

*It is also noteworthy that, at the request of the Dutch Government, you have assisted in many meetings in Latin America and Asia.*

*And then, you are not only a hard working director of an internationally renowned Institute, but you are a Professor as well, teaching at the University of Brussels and lecturing at the Europa College in Bruges and the Europa Institute of the University of Amsterdam.*

*Beside these many and diverse undertakings, you have also been an active inhabitant of Amsterdam.*

*As an example of one of your activities in a completely different field I should like to mention that for many years you have been a very active president of our public library-foundation.*

*Yet, 25 years ago, when Mr. van Hoorn was nominated director of the Bureau, none of this was evident.*

*In the beginning of my speech I reminded you of the difficult period we had to go through when I was a member of the Board of Trustees. I may safely say now that to a great extent it was through you and Mr. Antal's work that we managed to survive.*

Prof. J. van Hoorn Jr.

*You started as Director of the Bureau with just a handful of people, while now the permanent staff of the Bureau number 40 not counting several others who work on a temporary basis.*

*Perhaps you think I came here to say that I understand your problems in housing your Institute which, as you might guess, is a well known problem at the City Hall — to say the least.*

*Actually, I did not come to speak about the accommodation needs of the Bureau as I am afraid the discussion on this subject can continue for decades, as is the case with the plans for accommodating the City Council itself.*

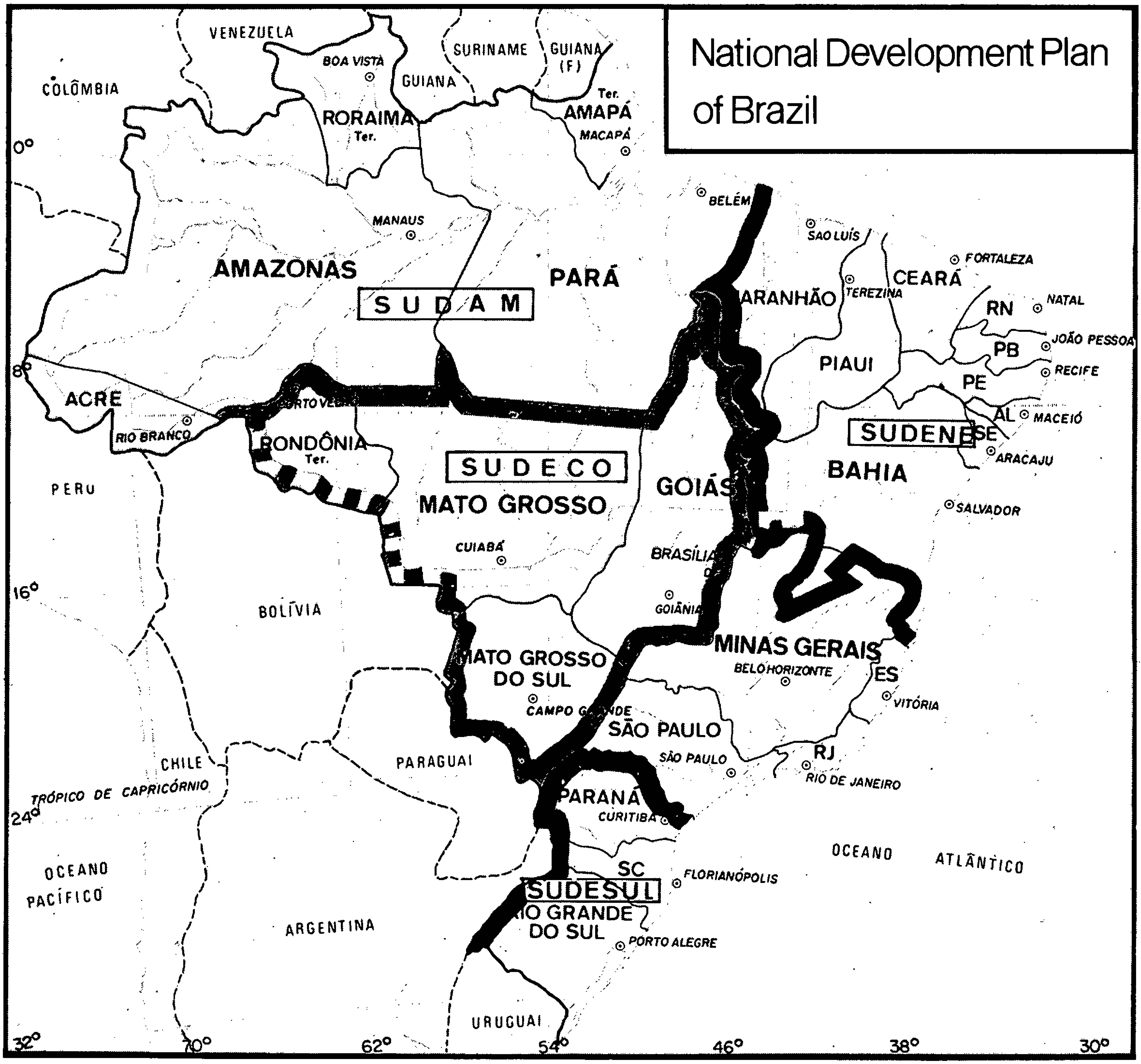
*I do want to inform you that the Board of Burgomaster and Aldermen has decided to award you, Mr. van Hoorn, the silver medal of honour of the city — our highest distinction awarded in these times.*

*Please allow me to congratulate you and the Trustees of your Institute with this award.*

# Brazilian Legislation on Industrial Development*

## By Antonio Mendes**

### Part One



## I. INTRODUCTION

The origin of the present Brazilian system of industrial development incentives lies in the creation of the Executive Group of the Automobile Industry (GEIA) by means of Decree No. 39,412 issued on June 16, 1956 during the Government of President Juscelino Kubitscheck. This Executive Group was formed to apply the guidelines established for the organization of the Brazilian automobile industry. The contribution of GEIA permitted the creation of an effective automobile industry in the country, the multiplying effects of which gave rise to the Brazilian automobile parts industry and resulted in considerable economic growth. After GEIA, other Executive Groups were also created for the development of other industrial areas of the country and all contributed decisively to the growth of their respective areas. [1]

The system that had been created was revised after the Revolution of March 31, 1964. On April 29, 1964 Decree No. 53,898 created the Industrial Development Commission (C.D.I.) within the Ministry of Industry and Commerce in order to provide for and direct the expansion of the country's industrial facilities. The C.D.I. was given the special task of establishing general criteria to govern the concession of governmental incentives.

Shortly afterwards, Decree No. 53,975 of June 19, 1964 subordinated the existing Executive Groups (some already reorganized) and the new Executive Groups created by the same Decree to the Industrial Development Commission. At the time there were seven Executive Groups:

(a) Executive Group of the Mechanical Industry (GEIMEC), which resulted from consolidation of the Executive Groups of the Automobile Industry (GEIA), the Agricultural and Highway Machinery Industry (GEIMAR) and the Heavy Mechanics Industry (GEIMAPE);

(b) Executive Group of the Metallurgic Industry (GEIMET);

(c) Executive Group of the Textile, Leather and Textile and Leather Articles Industry (GEITEC), which resulted from consolidation of the Executive Groups of the Textile Industry (GEITEC) and the Shoe Industry (GEICAL);

(d) Executive Group of the Chemical Industry (GEIQUIM), which resulted from consolidation of the Executive Groups of the Parmaceutical Industry (GEIFAR) and the Fertilizer Industry (GEIFERC);

(e) Executive Group of the Cinematographic Industry (GEICINE);

(f) Executive Group of the Electronic Materials and Telecommunications Industry (GEITEL); and

(g) Executive Group of the Food Products Industry (GEIPAL).

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* Study presented at the "Seminar on Industrial Development Legislation in Latin America", organized by INSTITUTO PARA LA INTEGRACION DE AMERICA LATINA (INTAL) together with the CONSEJO LATINO AMERICANO DE DERECHO Y DESAROLLO, held in Buenos Aires on October 5 and 6, 1977, revised and updated to August 1978.

** Law degree of the Law School of Franca, Franca, São Paulo, Brazil (1964), Master of Comparative Law degree of the Duke University, Durham, North Carolina, United States of America (1967), partner of the law firm Pinheiro Neto & Cia. — Advogados, São Paulo, Brazil.

1. Executive Group of the Cinematographic Industry (GEICINE), created by Decree No. 50,278, of February 17, 1961; Executive Group of the Agricultural and Highway Machinery Industry (GEIMAR), created by Decree No. 50,519, of May 2, 1961; Executive Group of the Heavy Mechanics Industry (GEIMAPE), created by Decree No. 50,522, of May 3, 1961; Executive Group of the Metallurgic Industry (GEIMET), created by Decree No. 50,521, of May 3, 1961; Executive Group of the Pharmaceutical Industry (GEIFAR), created by Decree No. 52,471, of September 13, 1963; Executive Group of the Fertilizer Industry (GEIFERC), created by Decree No. 52, 732, of October 23, 1963; Executive Group of Textile Industry (GEITEC), created by Decree No. 53,585, of February 21, 1964; Executive Group of the Shoe Industry (GEICAL), created by Decree No. 53,586, of February 21, 1964.

# Table of Contents

| | | |
|---|---|---|
| IV. Regional incentives<br>4.1. Incentives for investments in the Amazon<br>4.2. Incentives for investments in the Northeast<br>4.3. Incentives for investments in the Manaus Free Zone<br>V. Financing from the National Bank of Economic Development – BNDE<br>5.1. Basic Inputs Program<br>5.2. Basic Equipment Program | 5.3. Other programs<br>VI. Financing Fund of the Acquisition of Industrial Machinery and Equipment – FINAME<br>6.1. Small and Medium-Sized Company Program<br>6.2. Long Term Program<br>6.3. Special Program<br>6.4. Component Importation Financing Program<br>6.5. Enrolment of new products | manufactured by companies not controlled by national capital<br>VII. Risk investments: EMBRAMEC, FIBASE and IBRASA<br>VIII. Customs protection for the national industry<br>8.1. Similar national product<br>8.2. Increase of import duty rates<br>8.3. Import restrictions |

Decree No. 65,016 of August 18, 1969 created the Industrial Development Council (CDI) to be presided over by the Minister of Industry and Commerce and to replace the Industrial Development Comission. The internal organization of the Industrial Development Council (CDI) has suffered some changes since the date of its creation and the former Executive Groups have been replaced by Sectorial Groups. The CDI is today the authority competent to conduct the industrial development policy of the country.

**INDUSTRIAL DEVELOPMENT COUNCIL** [2]

| | |
|---|---|
| Sectorial Group I | – Capital Goods Industries |
| Sectorial Group II | – Basic Metallurgic and Intermediary Metal Products Industries |
| Sectorial Group III | – Chemical, Petrochemical and Pharmaceutical Industrial |
| Sectorial Group IV | – Intermediary Non-Metal Products Industries and Cement, Paper, and Cellulose Industries |
| Sectorial Group V | – Automotive and Automotive Components Industries |
| Sectorial Group VI | – Consumer Goods Industries |
| Sectorial Group VII | – War Materials Industries |

During this period of evolution of the CDI, other sectorial development bodies were also created. The special characteristics of their respective sectors have caused these bodies to remain separate to this day. They are the following:

(a) *Superintendency of Fishing Development (SUDEPE), created by Delegate-Law No. 10 of October 11, 1962;*
(b) *Brazilian Institute of Forest Development (IBFE), created by Decree-Law No. 289 of February 28, 1967;*
(c) *Brazilian Tourism Company (EMBRATUR), subordinate to the National Tourism Council, both created by Decree-Law No. 55 of November 18, 1966;*
(d) *Brazilian Aviation Company (EMBRAER), created by Decree-Law No. 770 of August 19, 1969;*
(e) *Executive Group of the Mining Industry (GEIMI), created by Decree No. 62,352 of March 5, 1968; and*
(f) *Commission for the Concession of Tax Incentives to Special Export Programs (BEFIEX), created by Decree-Law No. 1,219 of May 15, 1972.*

During the same period an incentive system was created for regional development and its application was attributed to several bodies organized specially for this purpose:

(a) *Superintendency of the Development of the Northeast (SUDENE), created by Law No. 3,692 of December 15, 1959;*
(b) *Superintendency of the Development of the Amazon (SUDAM), created by Law No. 5,173 of October 27, 1966;* [3]
(c) *Superintendency of the Development of the South Region (SUDESUL), created by Decree-Law No. 301 of February 28, 1967;* [4]
(d) *Superintendency of the Development of the Mid-West Region (SUDECO), created by Law No. 5,365 of December 1, 1967;*
(e) *Fund for the Recovery of the State of Espirito Santo (FUNRES), instituted by Decree-Law No. 880 of September 18, 1969;*
(f) *Superintendency of the São Francisco Valley (SUVALE), created by Decree-Law No. 292 of February 28, 1967; and*
(g) *Superintendency of the Free Zone of Manaus (SUFRAMA), instituted by Decree-Law No. 288 of February 28, 1967.*

**The incentives granted by the CDI and by the other bodies of sectorial development, as also those granted by the bodies of regional development, are examined in more detail below. At the beginning of this study it should, however, be mentioned that the incentives of the CDI and of the other industrial development bodies consist mainly of exemption or reduction of import duties for imports of equipment not produced in Brazil, together with credit and tax incentives, while the incentives of the bodies of regional development are represented mainly by contributions of non-voting risk capital.**

These two kinds of incentives are not exclusive; an industrial project enjoying regional development in-

2. Decree No. 81,651, of May 11, 1978, Art. 5.
3. SUDAM substituted the Superintendency of the Plan for the Economic Valorization of the Amazon (SPVEA), created by Law No. 1,806, of January 6, 1953.
4. See Decree-Law No. 576, of May 8, 1969.

centives can also obtain CDI incentives or incentives from other bodies of sectorial development, such an accumulation of incentives being normal. An examination of the history of sectorial and industrial incentives reveals that they contributed considerably to the growth of Brazilian industry, first by replacing imports and second by permitting the manufacture of export-oriented Brazilian products. Brazil is today practically self-sufficient as regards consumer goods. All efforts are now concentrated on the production of machinery and equipment, especially heavy machinery and equipment, and of basic inputs (in the sense of raw materials and basic products) in order to eliminate imports in these areas and encourage the exportation of manufactured products in general. [5]

Parallel to these incentives, Brazilian industries and particularly Brazilian entrepreneurs have received continuous support in the form of loans under favorable conditions. These loans are mostly granted by the National Bank of Economic Development (BNDE).

**NATIONAL BANK OF ECONOMIC DEVELOPMENT**

The BNDE has four subsidiaries:

FINAME – Special Agency of Industry Financing;
EMBRAMEC – Brazilian Mechanic Company:
FIBASE – Basic Inputs Company for Financing and Participation;
IBRASA – Brazilian Investment Company;

FINAME grants financing to the private sector of production of capital goods.

EMBRAMEC, FIBASE and IBRASA contribute risk capital to enterprises of interest to the economic development of the country.

## II. CONTROLLING BODIES

### 2.1. Economic Development Council – CDI

The Economic Development Council is a body of immediate assistance to the President of the Republic, presided over by the President himself and formed by the Ministers of Finance, Industry and Commerce, Agriculture, Interior, and the Secretariat of Planning of the Presidency of the Republic. [6] Other Ministers of State may be invited to attend CDE meetings, and these invitations are frequently made in view of the various matters to be discussed. [7]

Article 10 of Decree-Law No. 1,376 of December 12, 1974 granted the CDE the responsibility for proposing the Brazilian policies for the investment of regional and sectorial resources derived from the FINOR, FINAM and FISET funds, and for establishing the guidelines and priorities to be observed according to the general concept of national development plans. [8] The SUDENE, SUDAM, SUDEPE, IBDF and EMBRATUR agencies receiving the resources of these funds thus implement their respective programs according to the guidelines established by the CDE.

### 2.2. Industrial Development Council – CDI

The CDI is the body responsible for conducting the industrial development policy of the country under the guidance and direction of the Minister of Industry and Commerce. For such purposes the CDI establishes the programs and conditions for the implementation of this policy and provides for the regional plans to be compatible with the national policies of industrial development. [9]

The CDI is presided over by the Minister of Industry and Commerce and has the following members: the Minister in Charge of the Secretariat of Planning of the Presidency of the Republic, the Minister of Finance, the Minister of the Interior, the Minister of Mines and Energy, the Minister in Charge of the Armed Forces, the President of the Central Bank of Brazil, the President of the Banco do Brasil S.A., the President of the National Bank of Economic Development (BNDE), the President of the National Industry Confederation, and the President of the National Commerce Confederation. [10]

The CDI has an Executive Secretariat and the technical and administrative units defined in its Internal Regulations. [11] It should be explained that applications for CDI benefits involve two phases. The first consists of the presentation of a "Consultation Letter" in order to have the project qualified for the industrial policy of the country. Once the "Consultation Letter" has been accepted, an industrial project is prepared, the actual enjoyment of the requested benefits depending on its approval.

A Commission especially constituted by the Minister of Industry and Commerce examines the "Consultation Letters", and in the case of undertakings that are of major importance due to their dimensions or exceptional qualities, the conditions for classification of the respective "Consultation Letters" are submitted by the Minister of Industry and Commerce to the prior examination of the plenary session of the CDI. The approval of the project is the responsibility of the Minister of Industry and Commerce. [12]

The Executive Secretariat of the CDI is subordinate to the Minister of Industry and Commerce who appoints its Secretary General. The Executive Secretariat coordinates the studies and the implementation of the measures required to apply the industrial policy and to grant the incentives. [13]

There are seven Sectorial Groups, as listed in Section I, above, of this study. The industrial projects submitted to the CDI are analysed and appraised by the Sectorial Groups, which prepare a technical opinion on each

5. Law No. 6,151, of December 4, 1974, which approved the Second National Development Plan (PND) (1975-1979).
6. Law No. 6,036, of May 1, 1974, Arts. 1, 3 and 4.
7. Id., Art. 4, §1.
8. See 2.19, below.
9. Decree No. 81,651, Arts. 1 and 3.
10. Id., Art. 2.
11. Id., Arts. 5 and 9.
12. Id., Arts. 3, §1, 3, IV.
13. Id., Art. 7.

project, which opinion is then examined by the Executive Secretary of the CDI and, subsequently, submitted for final decision to the Minister of Industry and Commerce. The Sectorial Groups are also responsible for following up and controlling the implementation of the industrial projects approved by the Minister of Industry and Commerce and for analysing the fields of business affected by the project's activities, suggesting, where appropriate, changes in the economic policy instruments. [14]

## 2.3. Superintendency of Fishing Development – SUDEPE

SUDEPE is the body in charge of orienting and implementing the Brazilian fishing development policy. SUDEPE is a federal autonomous body and is thus an entity of indirect federal administration which has its own legal identity. [15] SUDEPE is administered by a Superintendent appointed by the President of the Republic and responsible for the Executive Unit of the entity. This Executive Unit has several administrative bodies which carry out the services and fulfill the purposes for which SUDEPE was created. [16] The Superintendent of SUDEPE has the authority to approve projects of investment or tax incentives in the fishing area, [17] and in addition controls the investment connected with the incentives granted, through a Department of Incentive Investment. [18] SUDEPE has a Deliberative Council composed of the Superintendent of SUDEPE, as its President, and of representatives of the following bodies: Ministry of Agriculture, Ministry of Finance, Ministry of Industry and Commerce, Ministry of the Navy, Ministry of Foreign Affairs, Ministry of Transportation, Ministry of the Interior, Secretariat of Planning of the Presidency of the Republic, and Banco do Brasil S.A. [19] The Deliberative Council basically has functions of orientation, although it approves financial operations, approves the National Plan of Fishing Development (PNDP) to be submitted to the Ministry of Agriculture, and gives its opinion on the matters submitted to it by the Superintendent of SUDEPE. [20]

## 2.4. Brazilian Institute of Forest Development – IBDF

The IBDF was created by Decree-Law No. 289 of February 28, 1967 and is the body responsible for setting the policy for the Brazilian forestation and reforestation policy. The IBDF is a federal autonomous body subordinate to the Ministry of Agriculture and is thus an entity of indirect federal administration. [21]

The IBDF has a Forest Policy Commission as its consulting and regulatory body. This Forest Policy Commission is composed of the President of the IBDF, who presides over the IBDF, and of technicians specifically familiar with forest problems who represent the Ministry of Agriculture, the Ministry of Industry and Commerce, the Secretariat of Planning of the Presidency of the Republic, the Administration Department in charge of the Coordination of the Regional Bodies, the Armed Forces, the National Bank of Economic Development (BNDE), Banco do Brasil S.A., the National Agriculture Confederation and the National Industry Confederation. [22]

The IBDF is administered by a President appointed by the President of the Republic upon the nomination of the Minister of Agriculture. [23]

The decisions on whether to grant tax incentives to forestation and reforestation projects are taken after deliberation by the President of the IBDF, such projects to be prepared in accordance with the rules periodically established in Rulings issued by the IBDF. [24]

## 2.5. National Tourism Council – CNTUR; Brazilian Tourism Company – EMBRATUR

The National Tourism Council and EMBRATUR were created by Decree-Law No. 55 of November 18, 1966 as the beginning of the Brazilian policy of tourism incentives.

The National Tourism Council is responsible for formulating, coordinating and directing the Brazilian tourism policy. It is presided over by the Minister of Industry and Commerce and composed of the following members: the President of EMBRATUR, the Delegate of the Ministry of Foreign Affairs, the Delegate of the Ministry of Transportation, the Delegate of the Ministry of the Air Force, the Delegate of the Management of the National Historic and Artistic Patrimony, the Representative of the Travel Agents, a Representative of Transportation, and a Representative of the Hotel Industry. [25]

In regard to the tax incentives offered to tourism, the National Tourism Council approves projects of investment in the construction or expansion of hotels or in works and services for tourism purposes. The projects are submitted to EMBRATUR, the supported opinion of which is essential for the decision of the National Tourism Council. [26] EMBRATUR is a "public company", i.e. it is a separate legal entity organized as a

14. Id., Art. 8.
15. Delegate-Law No. 10, of October 11, 1962, presently regulated by Decree No. 73,632, of February 13, 1974.
16. Delegate-Law No. 10, Art. 4; Decree No. 73,632, Art. 4. The Internal Regulations of SUDEPE were established by Portaria No. 105, of March 5, 1975, of the Minister of Agriculture.
17. Decree No. 73,632, Art 10, III.
18. Id., Art. 19.
19. Id., Art. 6.
20. Id., Art. 9.
21. Decree-Law No. 289, of February 28, 1967, Art. 1 and Decree No. 73,601, of February 8, 1974, Art. 1.
22. Decree-Law No. 289, Art. 8, Decree No. 62,018, of December 29, 1967, Art. 4, and Decree No. 73,601, Art. 3.
23. Decree-Law No. 289, Art. 9, Decree No. 62,018, Art. 4, and Decree No. 73,601, Art. 2.
24. Normative Portaria No. 08-DR, of IBDF, of February 1977.
25. Decree-Law No. 55, of November 18, 1966, Art. 5.
26. Decree-Law No. 1,191, of October 27, 1971, Art. 4, with the amendments of Decree-Law No. 1,439, of December 30, 1975 and Decree No. 78,379, of September 6, 1976.

company which indirectly serves federal administration purposes. [27]

EMBRATUR is administered by a Board of Directors composed of a President and three Directors. [28] The task of EMBRATUR is to further and encourage the development of the tourism industry. For this purpose, EMBRATUR is authorized to carry out the decisions of the National Tourism Council, to examine and issue technical opinions on tourism investment projects, and to manage the resources of the General Tourism Fund (FUNGETUR). [29] EMBRATUR controls, releases and supervises the investment of the resources derived from the amounts available under the tax incentive programs granted to tourism. [30]

### 2.6. Brazilian Aviation Company – EMBRAER

EMBRAER is a mixed-economy corporation (its operation being equivalent to that of a private entity) organized according to Decree-Law No. 770 of August 19, 1969. It is thus also an entity of indirect federal administration. Its purpose is to further and develop the Brazilian aviation industry by investing the funds at its disposal and designing and building its own airplanes.

EMBRAER is managed by a Managing Council of regulatory character and by an Executive Board of Directors. Since it is a mixed-economy corporation, its operational methods are the same as those of companies in general, with no particular peculiarities.

### 2.7. Executive Group of the Mining Industry – GEIMI

GEIMI was created by Decree No. 62,352 of March 5, 1968 in order to further the exploitation of the country's mineral resources, provide for the substitution of mineral imports and encourage the exportation of mineral products.

The President of GEIMI is appointed by the Minister of Mines and Energy and its members are representatives of the Ministry of Mines and Energy, the Secretariat of Planning of the Presidency of the Republic, the Ministry of Industry and Commerce, the Ministry of the Interior, the Ministry of Transportation, and the Armed Forces. [31] Its Internal Regulations were established by Portaria No. 356 of April 2, 1976.

GEIMI approves projects of implementation and expansion of mineral industries, proposes incentives and benefits for their expansion, including credit assistance, and coordinates the procedures for the performance of such projects. [32]

### 2.8. Commission for the Concession of Tax Benefits to Special Export Programs – BEFIEX

BEFIEX was created by Decree-Law No. 1,219 of May 15, 1972 to grant incentives for the exportation of manufactured products. BEFIEX was originally set up within the Ministry of Finance but was transferred to the Ministry of Industry and Commerce on June 21, 1974 by Decree No. 74,199.

BEFIEX is formed by the Secretary General of the CDI, who is its President and by representatives of the Secretariat of Planning of the Presidency of the Republic and of the Ministry of Finance. [33] Its current Internal Regulations were established by Portaria No. 212 of July 30, 1974 of the Minister of Industry and Commerce.

The rules for the preparation of applications for the benefits offered to Special Export Programs are contained in BEFIEX Resolution No. 1 of January 26, 1973, which sets forth the basic outline to be followed. Special export programs are approved by the Minister of Industry and Commerce based on the conclusive opinion of BEFIEX.

### 2.9. Commission of Company Consolidation and Merger – COFIE

COFIE was created by Decree-Law No. 1,182 of July 16, 1971 and is a collegiate body of the Ministry of Finance, directly subordinate to the Minister of Finance. COFIE was organized to control and examine projects of consolidation, merger or other forms of corporate combination or association for the purposes of obtaining tax incentives. [34]

COFIE is managed by a President, this position being held by the Secretary General of the Ministry of Finance. It is divided into a Plenary and an Executive Secretariat. [35] The Plenary of COFIE is composed of the Secretary General of the Ministry of Finance, as its President, and of representatives of the Secretariat of Planning of the Presidency of the Republic, the Ministry of Industry and Commerce, the Central Bank of Brazil and the Secretariat of Federal Revenue of the Ministry of Finance. [36]

COFIE's tasks relative to the concession of the benefits provided for in applicable legislation include: (i) formulation of the basic guidelines and definition of the priorities to be observed in the policy of consolidation and merger and of the opening of companies' capital; (ii) examination of projects of consolidation, merger and other kinds of combination or association of company interests; (iii) verification of the adequate utilization of the benefits granted and their application for the objectives of the approved projects; (iv) statements as to the revaluation of the assets and declaration of the

27. Decree-Law No. 55, Art. 11.
28. Law No. 6,253, of October 10, 1975, and Decree No. 78,549, of October 11, 1976.
29. Decree-Law No. 55, Arts. 6 and 14, Decree-Law No. 1,191, Art. 11, and Decree-Law No. 1,439, Art. 13.
30. Consolidation of Resolutions of the National Tourism Council, of October 4, 1972, Art. 65, II.
31. Decree No. 62,352, of March 5, 1968, Art. 30.
32. Id., Art. 2.
33. Decree No. 74,199, of June 21, 1974, Art. 1.
34. The Internal Regulations of COFIE were ratified by Portaria No. 170/76 of the Interim Minister of Finance, of May 18, 1976.
35. Decree-Law No. 1,182, of July 16, 1971, Art. 3, Portaria No. 170/76 of the Interim Minister of Finance, Arts. 2 and 4.
36. Decree-Law No. 1,182, Art. 3.

new values of the fixed assets of companies operating in the country. [37]

## 2.10. Superintendency of the Development of the Northeast – SUDENE

SUDENE is the body in charge of supervising, coordinating and controlling the implementation of investment projects for the development of the Northeast region of Brazil. It is managed by a Superintendency appointed by the President of the Republic and has an Executive Secretariat. [38]

SUDENE has a Deliberative Council composed of twenty-six members, as follows: the Superintendent of SUDENE, the General Director of the National Department of Drought Precaution Works, the President of CODEVASF, ten members appointed by the Governors of the Northeast States and by the Governor of the State of Minas Gerais, a representative of the Armed Forces and twelve representatives of the following bodies: Ministry of Mines and Energy, Ministry of Industry and Commerce, and the São Francisco Hydroelectric Company. [39]

The task of the Deliberative Council of SUDENE is to formulate the guidelines for the policy of developing the Northeast and to follow up its implementation according to the directive plan approved by the President of the Republic. [40] The Deliberative Council also approves projects of investment in the SUDENE region for purposes of enjoying the available tax benefits. [41]

The executive functions are carried out by the Superintendent of SUDENE through the Executive Secretariat. These functions include the preparation of supported opinions on the investment projects to be decided by the Deliberative Council.

It is important to note that the Banco do Nordeste do Brasil S.A. must give SUDENE all the technical cooperation it may request in order to analyse and control the projects of investment in the region. [42]

## 2.11. Superintendency of the Development of the Amazon – SUDAM

SUDAM is a federal autonomous body linked to the Ministry of the Interior. Its purpose is to direct federal action in the Amazon area. It was created by Law No. 5,173 of October 27, 1966 to replace the then extinct Superintendency of the Plan for the Economic Valorization of the Amazon (SPVEA). It is managed by a Superintendent appointed by the President of the Republic, who commands an Executive Secretariat. [43]

SUDAM has a Deliberative Council composed of the Superintendent of SUDAM, the President of Banco do Estado da Amazonia S.A., representatives of each of the States and Territories which belong to the Amazon region, and members of the following bodies: Armed Forces; Superintendency of the Free Zone of Manaus; National Bank of Economic Development (BNDE); National Institute of Agrarian Development; National Institute of Agrarian Reform; Foundation of Special Public Health Service; National Research Council; Ministry of Agriculture; Ministry of Communications; Ministry of Education and Culture; Ministry of Finance; Ministry of Mines and Energy; Secretariat of Planning of the Presidency of the Republic; Ministry of Foreign Affairs; Ministry of Health; Ministry of Industry and Commerce; Ministry of Labor; and Ministry of Transportation. [44]

The Deliberative Council of SUDAM has the authority to approve projects and programs utilizing tax funds to develop the Amazon region. [45] The Superintendent of SUDAM is, however, authorized to approve projects which are of interest to the development of the Amazon for purposes of concession of benefits. The projects thus approved are submitted to the Deliberative Council at the first meeting held after the approval of the Superintendent. [46]

The executive functions are in the hands of the Superintendent of SUDAM through an Executive Secretariat. These functions, which include the analysis of projects for purposes of concession of the tax incentive funds, [47] are carried out with the assistance of the Incentive Administration Department, which also controls the tax benefits granted. [48]

Banco da Amazonia S.A. (BASA) also participates in the implementation of SUDAM programs. BASA acts as the financial agent of SUDAM and also gives the cooperation requested in programs for the development of the Amazon region. [49]

In addition, one should also mention the Program of Agricultural and Agromineral Poles (POLAMAZONIA) which was created by Decree No. 74,607 of September 25, 1974 to provide for the integrated exploitation of the agricultural, agro-industrial, forestry and mineral resources in priority areas of the Amazon region. POLAMAZONIA has special resources for implementation through SUDAM, SUDECO and BASA. [50]

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37. Decree-Law No. 1,346, of September 25, 1974, Art. 3, §1, and Portaria No. 170/76 of the Interim Minister of Finance, Art. 7.
38. Law No. 3,692, of December 15, 1959, Arts. 3, 4, and 6, and Decree No. 52,346, of August 12, 1963.
39. Law No. 3,692, Art. 5, with the amendments introduced by Law No. 3,995, of December 14, 1961, Art. 20, Decree No. 76,962, of January 31, 1975, Art. 4.
40. Id., Art. 13.
41. Law No. 3,995, Art. 34; Decree No. 55,334, of December 31, 1964, Arts. 7, 14, §1, and §18.
42. Decree No. 55,334, Art. 14, §3.
43. Law No. 5,173, of October 27, 1966, Art. 11; Decree No. 73,630, of February 13, 1974, Art. 6.
44. Law No. 5,374, of December 7, 1967, Art. 16.
45. Decree-Law No. 756, of August 11, 1969, Art. 2, §4.
46. Law No. 5,734, Art. 5.
47. Decree-Law No. 756, Art. 2, §3; Decree No. 73,630, Art. 6.
48. Portaria No. 1,289, of August 8, 1975, of the Minister of the Interior, published in the Official Gazette of the Union, (I), page 10,661, Arts. 54 and 55.
49. Law No. 5,122, of September 28, 1966, Art. 1.
50. Decree No. 74,607, of September 25, 1974, Arts. 3 and 4.

## 2.12. Superintendency of the Development of the South Region – SUDESUL

SUDESUL is a federal autonomous body created by Decree-Law No. 301 of February 28, 1967, Article 9, to provide for the development of municipalities situated in the South region of Brazil. It is managed by a Superintendent chosen by the President of the Republic, who commands an Executive Secretariat. [51]

SUDESUL has a Deliberative Council formed by the Superintendent of SUDESUL, as its President, and by representatives of the following entities: Armed Forces; States of the South Region (one for each); National Institute of Development, Colonization and Agrarian Reform (INCRA); Banco Regional de Desenvolvimento do Extremo Sul S.A.; Ministry of Agriculture; Ministry of Communications; Ministry of Education and Culture; Ministry of Finance; Ministry of Mines and Energy; Ministry of Planning of the Presidency of the Republic; Ministry of Foreign Affairs; Ministry of Health; and Ministry of Transportation. [52]

SUDESUL is entrusted with the formulation of the guidelines for the policy of developing the area included in the southern region in which it operates. For this purpose, it is responsible for preparing the Development Plan for the region and coordinating and providing for its implementation. [53]

Like SUDECO, which is dealt with below, SUDESUL cannot count on funds derived from tax incentive schemes to carry out its programs. Its activity lies in the preparation of studies for the investment of federal funds in programs of interest to the region or of financial support for private investments in the area. This work is done by the Superintendent of SUDESUL with the assistance of the Deliberative Council which decides on the proposals presented by the Superintendent. [54]

## 2.13. Superintendency of the Development of the Mid-West Region – SUDECO

SUDECO is a federal autonomous body linked to the Ministry of the Interior with the objective of directing federal action in the Mid-West Region of Brazil. It was created by Law No. 5,365 of December 1, 1967. It is managed by a Superintendent apponted by the President of the Republic, who controls an Executive Secretariat. [55]

SUDECO has a Deliberative Council consisting of the Superintendent of SUDECO, as its President, and by representatives of the following entities: [56] Ministry of Agriculture, Ministry of Communications, Ministry of Education and Culture, Ministry of Finance, Ministry of Industry and Commerce, Ministry of Mines and Energy, Secretariat of Planning of the Presidency of the Republic, Ministry of Health, Ministry of Transportation, Ministry of Labor, Armed Forces, States of Goías and Mato Grosso, Federal Territory of Rondonia and SUDAM.

The task of SUDECO is to formulate the directives for the policy of development of the Mid-West region according to general guidelines of governmental planning and after consulting the Ministries and federal bodies acting in the affected areas. It must thus prepare the Directive Plans for the Development of the Mid-West Region.

As there are no tax incentives available for the development of the Mid-West region, SUDECO's activities are not the same as those of SUDENE and SUDAM. Besides making studies for the development of the region, SUDECO seeks the investment of federal funds in programs which favor the region and attempts to attract the participation of private groups in the projects outlined in its Directive Plans. These activities are carried out by the Superintendent of SUDECO under the guidance of the Deliberative Council which decides on each proposal presented by the Superintendent. [57]

## 2.14. Fund for the Economic Recovery of the State of Espirito Santo – FUNRES

FUNRES was instituted by Decree-Law No. 880 of September 18, 1969. [58] It is managed by the Executive Group for the Economic Recovery of the State of Espirito Santo (GERES), created by the same Decree-Law No. 880, article 7. FUNRES provides for the investment of funds in fishing, tourism, agricultural or industrial projects approved by GERES.

GERES is composed of two representatives of the Government of the State of Espirito Santo and of representatives of the following bodies: [59] Secretariat of Planning of the Presidency of the Republic, Ministry of the Interior, Ministry of Finance, National Bank of Economic Development (BNDE), SUDENE, EMBRATUR and the Executive Group of Coffee Plantation Rationalization (GERCA). The representative of the Secretariat of Planning of the Presidency of the Republic acts as the Coordinator of GERES. With the approval of the other members, the Coordinator appoints the Executive Secreatry of GERES, who performs the work of implementing the activities of GERES. [60]

GERES approves the projects which are to obtain the benefits of FUNRES, controls the investment of funds

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51. Decree-Law No. 301, of January 28, 1967, Art. 14. See also Decree No. 72,775, of September 11, 1973, which establishes the basic structure of SUDESUL.
52. Decree-Law No. 840, of September 8, 1969; Decree-Law No. 1,110, of July 9, 1970.
53. Decree-Law No. 301, Art. 10.
54. Id., Arts. 11, 15 and 17.
55. Law No. 5,365, of December 1, 1967, Art. 4; Decree No. 72,777, of September 11, 1973, Arts. 3, 4 and 5; Internal Regulations of SUDECO, Art. 2, published in the Official Gazette of the Union (I) (II), of May 13, 1968, page 1,032.
56. Law No. 5,365, Art. 6; Law No. 5,457, of June 20, 1968, Art. 1.
57. Law No. 5,365, Arts. 2 and 5; Internal Regulations of SUDECO, Art. 3.
58. The term for the investment options established by Decree-Law No. 880, of September 18, 1969, was extended up to and including the fiscal year 1978, by Decree-Law No. 1345, of September 19, 1974.
59. Decree No. 66,547, of May 11, 1970, Art. 18.
60. Id., Arts. 18(a) and 19.

and prepares studies for the economic recovery of the State of Espirito Santo. [61] The Bank for the Development of Espirito Santo (BANDES) acts as the financial agent of GERES in the implementation of the program entrusted to it. [62]

## 2.15. Company for the Development of the São Francisco Valley – CODEVASF

CODEVASF is a public company created by Law No. 6,088 of July 16, 1974 to replace the Superintendency of the São Francisco Valley (SUVALE). [63] Its purpose is to utilize the water and soil resources of the São Francisco Valley for agricultural, livestock and agro-industrial ends. [64] CODEVASF seeks to promote the integrated development of priority areas located in the region of the São Francisco Valley and to organize agro-industrial and farming districts. For this purpose, it provides infra-structure facilities, particularly water collection for irrigation and the building of channels, as well as basic sanitation, electricity and transportation facilities.

CODEVASF is directed by a Board of Directors consisting of a President and three Directors appointed by the President of the Republic. [65] It also has a Directive Council presided over by the President of the company and composed of representatives of the Secretariat of Planning of the Presidency of the Republic, the Ministry of Agriculture, the Ministry of Transports, the Ministry of Mines and Energy, and four members appointed by the Minister of the Interior. [66]

The funds of CODEVASF are formed by its capital paid up with the incorporation of personal and real property of SUVALE and supplemented by subscription by the National Treasury. CODEVASF is authorized to charge for water utilization in its area of administration and also for the services it renders. [67]

CODEVASF does not receive any funds from tax incentive schemes to grant to projects to be installed in the area under its control. The region of the São Francisco Valley is, however, situated in the Northeast region of Brazil and its projects can thus benefit from all the tax incentives administered by SUDENE.

## 2.16. Superintendency of the Development of the Free Zone of Manaus – SUFRAMA

SUFRAMA is an autonomous body with its own legal identity and its own assets. It is linked to the Ministry of the Interior and is responsible for administering the facilities and services of the Free Zone of Manaus. [68] The Free Zone of Manaus is an area of free import and export trade and of special tax incentives, which was established to create an industrial, commercial and agricultural center in the heart of the Amazon region, capable of economic development in spite of the local conditions and the great distance from the centers that consume its products. [69]

The responsibilities of SUFRAMA include: (a) preparing the Pluriannual Directive Plan of the Free Zone and coordinating or providing for its implementation, (b) organizing the preparation and implementation of the programs and projects which are of interest to the development of the Free Zone, (c) rendering technical assistance to public or private entities in the preparation or implementation of programs of interest to the Free Zone, (d) maintaining constant contact with SUDAM, with the Government of the State of Amazon and with the authorities of the municipalities located in the Free Zone and (e) carrying out and divulging research, studies and analyses to systematically determine the economic potential of the Free Zone. [70]

SUFRAMA is managed by a Superintendent, appointed by the President of the Republic, and who is assisted by an Executive Secretary and an Administrative Council and Administrative Units. [71] The funds of SUFRAMA are mainly derived from budget allocations and additional credits. [72]

## 2.17. National Intergration Program – PIN

PIN was created by Decree-Law No. 1,106 of June 16, 1970 for the specific purpose of financing the plan for basic utility works in the areas administered by SUDENE and SUDAM to permit a quicker integration of these areas into the national economy. PIN was initially established for the fiscal years 1971-1974, having later been extended to and including the fiscal year 1978. [73]

Due to its objectives as described above, PIN cannot be considered as a part of the industrial development programs examined in this study. Knowledge of its existence and organization is, however, important for a perfect understanding of pertinent Brazilian legislation.

In practice, this Program was to be implemented with funds derived from a credit to PIN of 30 percent of the total amounts deducted from income tax for investment in tax incentive programs. The amount available for use in incentive investment projects was thus reduced to 70 percent (see, however, also 2.18. below). [74]

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61. Id., Art. 17.
62. Id., Art. 2.
63. SUVALE was an autonomous body created by Decree-Law No. 292, of February 28, 1967, to promote the development of an area named "Bacia do São Francisco" as a replacement for the former "Vale do São Francisco" Commission. It was abolished by Decree No. 76,962, of December 31, 1975.
64. Law No. 6,088, Art. 4.
65. Id., Art. 5.
66. Id., Art. 5, and Decree No. 74,744, of October 22, 1974, Art. 17.
67. Law No. 6,088, Arts. 6, 7 and 8.
68. Decree-Law No. 288, of February 28, 1967, Art. 10, and Decree No. 61,244, of August 28, 1967, Art. 23.
69. Decree No. 61,244, Art. 1.
70. Decree No. 61,244, Art. 24, and Decree No. 76,991, of January 7, 1976, Art. 3.
71. Decree No. 76,991, Arts. 4 and 6.
72. Decree No. 61,244, Art. 59.
73. Decree-Law No. 1,106, of June 16, 1970, Art. 1, and Decree-Law No. 1,243, of October 30, 1972, Art. 1, sole paragraph.
74. Decree-Law No. 1,106, Art. 5.

Note that under the Brazilian investment incentive programs the amount of the investment, or part thereof, may be deducted from income *tax*, i.e. the system resembles an investment credit system.

The rules for the investment of PIN funds are established by the Minister of Finance, the Minister in Charge of the Secretariat of Planning of the Presidency of the Republic and the Minister of the Interior, subject to the approval of the President of the Republic. [75]

The first PIN phase is aimed at building the Transamazon and Cuiabá-Santarém highways and initiating a plan for the irrigation of the Northeast.

## 2.18. Program for the Redistribution of Land and for the Furtherance of the Agricultural Industry of the North and Northeast – PROTERRA

PROTERRA was instituted by Decree-Law No. 1,179 of July 6, 1971 in order to permit man to have easier access to land, to create better conditions for the employment of labor and to encourage the agricultural industry in the areas administered by SUDAM and SUDENE. PROTERRA was initially organized for application up to the fiscal year 1976 but was then extended to and including the fiscal year 1978. [76]

Like PIN, PROTERRA is not actually an industrial development program but knowledge of its existence and organization is necessary for a full understanding of pertinent Brazilian legislation. In the case of PROTERRA there are, however, provisions which provide for funds to be invested in financing projects of expansion of agricultural industries, thus making this program more similar to the field discussed in this study. [77]

The investment of PROTERRA funds must comply with programs and criteria approved by the President of the Republic and prepared by a Council composed of the Minister of Finance, the Minister of Transportation, the Minister of Agriculture, the Minister of Mines and Energy, the Minister of Industry and Commerce, the Minister of the Interior and the Minister in Charge of the Secretariat of Planning of the Presidency of the Republic. [78] PROTERRA is to be implemented with funds derived from 20 percent of the total amounts deducted from income tax due, for investment in tax incentive programs. [79]

The PIN and PROTERRA programs have thus reduced the amount actually available for investment in tax incentive programs to half of the amount available before the organization of these two programs which jointly consume the other half.

## 2.19. Investment Funds – "Fundões"

The mechanism originally established for the investment in tax incentive programs was based on the direct investment in projects selected by the investor himself. The system worked well in the case of major investors. Serious difficulties arose, however, in the case of small and medium investors who had no project of their own and were sometimes not even in a position to choose a project. This situation gave rise to the organization of a great number of incentive investment offices which basically caused two different distortions: the investment cost increased and the funds were not always channelled to the better projects but to those which offered the investment offices higher earnings.

Decree-Law No. 1,304 of January 8, 1974 was issued to end this practice by transferring the administration of the tax incentive funds to the institutions of the National Financial System. The Central Bank of Brazil was given the duties of establishing the operational rules to be adopted and of controlling compliance with such rules. [80]

Decree-Law No. 1,376 of December 12, 1974 established an indirect system for the investment in tax incentive programs by organizing the Investment Funds which are commonly called "Fundões" (Big Funds), of which there are three: the Northeast Investment Fund (FINOR); the Amazon Investment Fund (FINAM); and the Sectorial Investment Fund (FISET). Obviously, FINOR and FINAM handle the investment of the tax incentive programs of SUDENE and SUDAM, respectively. FISET takes care of the investments of the funds for the fishing, forest and tourism development programs coordinated by SUDEPE, IBDF and EMBRATUR, respectively. [81]

The Investment Funds are operated by banks: FINOR by Banco do Nordeste do Brasil S.A.; FINAM by Banco da Amazonia S.A. (BASA); and FISET by Banco do Brasil S.A. In the case of FISET, Banco do Brasil S.A. must keep three separate accounts for the fishing, forest and tourism programs. [82] It is important to note that Article 22 of Decree-Law No. 1,376 established that Banco do Nordeste do Brazil S.A., Banco da Amazonia S.A. (BASA) and Banco do Brasil S.A. are the only financial agents of the regional and sectorial development agencies in all dealings with the Investment Funds.

The regional and sectorial development agencies are still directly responsible for the administration of the Investment Fund accounts and for analysing and approving the projects and thus authorizing the release of resources. The mentioned banks are only responsible for the operation of the Investment Fund accounts. [83]

### *Mechanics of the Investment Funds*

Upon filing their income tax returns, investors may choose the funds in which they intend to invest the allowable portion of their income tax. Based on these

75. Id., Arts. 2 and 3.
76. Decree-Law No. 1,179, of July 6, 1971, Art. 6, and Decree-Law No. 1,493, of December 7, 1976, Art. 11.
77. Decree-Law No. 1,179, Art. 3.
78. Id., Art. 4.
79. Decree-Law No. 1,179, Art. 6.
80. Resolution No. 281, of the Central Bank of Brazil, of February 19, 1974.
81. Decree-Law No. 1,376, of December 12, 1974, Art. 1.
82. Id., Arts. 5, 6 and 7.
83. Id., Art. 8.

choices, the Secretariat of Federal Revenue issues the certificates of investment in the Funds. [84] These certificates are nominative and untransferrable and are issued according to the income tax actually paid. They are called "Certificates of Investment in Tax Incentives" (CAIF), and the current model was approved by Normative Ruling SRF No. 018 of March 21, 1977.

The CAIFs are exchanged for quotas of the corresponding Investment Funds within one year after the date of their issuance and the value of any CAIFs not exchanged in this period is added to the corresponding Fund. The quotas are nominative and endorsable and are quoted daily by the respective operating banks. [85]

The Investment Funds, in turn, invest their incentive resources in approved projects against the receipt of securities representing such investments. [86] At the option of the investor, the Fund quotas may be converted into securities held by the Funds according to their respective quotation. [87]

The collection of the investment portion attributed to EMBRAER (see 2.6., above) also follows the same system, the Secretariat of Federal Revenue issuing the corresponding investment certificates. These certificates represent proper qualification for subscription to EMBRAER shares. [88]

In order to permit the practical implementation of the system, the proportionate participation of each Fund or Special Program is calculated with regard to the total amount collected under the incentive system. This calculation is published by means of a Portaria issued by the Minister of Finance. The current values were established by means of Portaria No. 781 of December 20, 1977 and are as follows:

| FUNDS AND SPECIAL PROGRAMS | PERCENTAGE IN TOTAL INCENTIVES |
|---|---|
| FINOR | 20.07 |
| FINAM | 7.07 |
| FISET - Fishing | 0.58 |
| FISET - Tourism | 0.89 |
| FISET - Reforestation | 15.71 |
| FUNRES | 0.59 |
| EMBRAER | 1.87 |
| MOBRAL | 2.54 |
| PIN - FINOR (BNB) | 12.04 |
| PIN - FINAM (BASA) | 4.20 |
| PIN - Others (BNB) | 14.21 |
| PROTERRA - FINOR | 8.03 |
| PROTERRA - FINAM | 2.80 |
| PROTERRA - Others | 9.47 |
| TOTAL | 100.00 |

Note that the table results from the selection made by the taxpayers each year, and consequently varies from year to year. It is used to facilitate the apportionment of funds upon actual collection of taxes.

The task of coordinating and harmonizing the procedures of the tax incentive system governed by Decree-Law No. 1,376 has now been attributed to the Tax Incentive Coordination Commission (COCIF), created by Decree No. 78,312 of August 27, 1976. COCIF is presided over by a representative of the Secretariat of Federal Revenue and composed of representatives of the agencies of regional and sectorial development and of the banks which operate the Investment Funds created by Decree-Law No. 1,376. The Internal Regulations of COCIF were established on June 15, 1977 by Portaria No. 291 of the Minister of Finance.

The companies which benefit from the resources of the Investment Funds created by Decree-Law No. 1,376 are obliged to obtain special registration with the Central Bank of Brazil, as required by the Regulations approved by Circular Letter No. 316 issued by the Central Bank on November 19, 1976.

### 2.20. National Bank of Economic Development – BNDE

The BNDE was created on June 20, 1952 to act as the agent of the Federal Government in its financial operations for the reequipment and furtherance of the national economy. [89] It was transformed into a public company by Law No. 5,562 of June 21, 1971, subordinate to the Secretariat of Planning of the Presidency of the Republic. Its basic purpose is to cover the financing requirements of private and public companies so as to further the economic development of the country. [90]

The BNDE has a Council composed of eleven members, including the President of the BNDE, the Secretary General of the Ministry of Finance and the Secretary General of the Ministry of Industry and Commerce. The Council is responsible for the higher management of the Bank which is administered by a Board of Directors composed of six members.

#### 2.20.1. Special Agency of Industrial Financing – FINAME

The FINAME Agency is a public enterprise, a subsidiary of the BNDE, charged with the administration of the Financing Fund for the Acquisition of Machinery and Industrial Equipment (FINAME), organized to meet the financial needs caused by increased sales of capital goods produced in Brazil, to contribute to the expan-

84. Id., Art. 15, Portaria No. 305, of August 14, 1975, of the Minister of Finance.
85. Decree-Law No. 1,376, Art. 15, §§1, 2 and 3, and Resolution No. 381, of June 24, 1976, of the Central Bank of Brazil.
86. Decree-Law No. 1,376, Art. 8.
87. Id., Art. 17.
88. Id., Arts. 1(f) and 17.
89. Law No. 1,628, of June 20, 1952, Art. 8.
90. Its By-Laws were approved by Decree No. 73,713, of March 1, 1974, with the amendments made by Decree No. 74,011, of May 6, 1974, and Decree No. 75,953, of July 8, 1975.

sion of the national production of capital goods, and to encourage their exportation. [91]

The FINAME Agency is administered by an Administrative Board composed of the President of the BNDE, who is its President, the Director-Superintendent of the BNDE and a Council member of the BNDE, in addition to representatives of the Mechanical Industry appointed by the Brazilian Association for the Development of the Base Industry, the Regional and State Development Banks, the Commercial Banks, the Financing Companies and the Private Investment Banks.

### 2.20.2. EMBRAMEC, FIBASE, IBRASA

The BNDE established three subsidiaries in 1964 in order to provide nationally-controlled companies with risk capital:

EMBRAMEC — Mecânica Brasileira S.A., to support the development of the national capital goods industry;

FIBASE — Insumos Básicos S.A. Financiamento e Participações, to contribute to expediting the production of the basic inputs required for the industrial development of the country;

IBRASA — Investimentos Brasileiros S.A., to support economic development projects in sectors not covered by the two other subsidiaries.

These companies operate as corporations and their action is subordinate to the general policy established by the BNDE.

### 2.21. Customs Policy Council – CPA

The CPA is the governmental body responsible for formulating the basic guidelines of tariff policies as regards imports, in order to adapt the customs mechanism to the requirements of economic development and national labor protection. It was instituted by Law No. 3,244 of August 14, 1957 (Article 21) and its composition and operation are now governed by Decree-Law No. 730 and by Decree No. 64,926, both of August 5, 1959.

The CPA is presided over by the Minister of Finance, or, in his absence, by the Minister in Charge of the Secretariat of Planning of the Presidency of the Republic. It is further composed of the Minister of Industry and Commerce, the Minister of Foreign Affairs, the Minister of Agriculture, the Minister of the Interior, the President of the Central Bank of Brazil, the President of the National Industry Confederation, the President of the National Commerce Confederation, the President of the National Agriculture Confederation and the President of the National Industry Workers Confederation.

The CPA has an Executive Secretary appointed by the Minister of Finance and an Executive Commission responsible for directing and coordinating the administration of the customs policy. This Executive Commission is presided over by the Minister of Finance or, in his absence, by the Executive Secretary of the CPA, and is composed of representatives of the Secretariat of Planning of the Presidency of the Republic, the Ministry of Industry and Commerce, the Ministry of the Interior, the Ministry of Foreign Affairs, Banco do Brasil S.A., the Foreign Trade Department (CACEX), the National Bank of Economic Development (BNDE), the National Industry Confederation, the National Commerce Confederation and the National Agriculture Confederation.

It should be pointed out that Brazilian imports are controlled by CACEX, which is the body charged with the issuance of import licenses. The CPA thus works closely with CACEX and even passes on some specific tasks to CACEX, as, for example, the responsibility for determining whether there are similar national products (see 8.1. below).

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91. The FINAME Agency was formed to be the financing fund of the BNDE, by Decree No. 55, 275, of December 22, 1964. It was transformed into an autonomous body by Decree No. 59,170, of September 2, 1966; Decree-Law No. 45, of November 18, 1966, permitted its transformation into a mixed-economy company. Its transformation into a public company was effected by Law No. 5,662, of June 21, 1971, Art. 10. Its By-Laws resulted from the applicable provisions of Decree No. 59,170 and Decree-Law No. 45.

[To be continued]

# The 1979 Income Tax Changes in the Republic of South Africa

## by Dr. Erwin Spiro

*The manoeuvrability afforded to him by the success of indirect taxation in the form of the sales tax and generally the excellent result of the disciplined approach to financial policy in recent years enabled Senator O.P.F. Horwood, the Minister of Finance, to propose in his budget speech a number of widely welcomed income tax concessions for 1979 which will be briefly considered.*

### I. COMPANIES

*Loan levy.* Conscious of the need for companies to improve their profitability and cash flows in times of lower turnovers and higher costs the Minister proposed to reduce, for all companies, the present loan levy of 15 percent to 10 percent. In the case of non-gold and non-diamond companies, due regard being had to the 5 percent surcharge which remains, there is thus a reduction in the 48 percent composite rate of tax and loan levies to 46 percent.

*Surcharge on gold and diamond mining companies.* The differential 2½ percent tax surcharge imposed on gold and diamond mining companies over and above the normal company surcharge is now to be removed.

### II. INDIVIDUAL TAXPAYERS

*Abatements and rates.* The amount of tax payable by individual taxpayers is in South Africa determined by two factors: abatements deducted from income to arrive at the taxable amount and the rate of tax.

The primary abatements will be increased from R 1,200 to R 1,500 in the case of a married person and from R 700 to R 1,000 in the case of an unmarried person. The additional abatement applicable to persons over the age of 60 years will be increased from R 700 to R 1,000. For the purpose of this report it is not necessary to deal with the various increases of the secondary abatements and the decrease in the rate of diminution of abatements.

The new rates of tax, which will be found in Table I and Table II annexed hereto, show the following features:

(a) The commencing rate for married persons is reduced from 9 percent to 7 percent and that for single taxpayers from 12 percent to 10 percent.

(b) The rate of progression is evened out, and, in the case of single taxpayers the acceleration in the progression on taxable amounts between R 4,000 and R 8,000 is reduced.

(c) A reduction from 60 percent to 55 percent is effected in the top marginal rate of tax, applicable to that portion of the taxable amount in excess of R 30,000 (previously R 28,000) in the case of married persons and in excess of R 22,000 in respect of unmarried persons.

It is true that the loan levy of 10 percent which is still payable is not a true tax because it is redeemable, but practically at least it is felt as a tax, and the maximal marginal tax rate may, therefore, well be regarded as being 60.5 percent.

*Retirement gratuities.* The maximum exemption from tax in respect of retirement gratuities paid to an employee will be increased from R 12,000 to R 15,000.

*Pension and retirement annuity funds.* The maximum amount allowable in respect of members' contributions to a pension fund will now be fixed at 7½ percent of the member's taxable income derived from his employment or R 1,750, whichever is the greater.

The maximum amount allowable in respect of contributions by a self-employed person to a retirement annuity fund will in turn be fixed at 15 percent of the member's taxable income derived from his business or profession, excluding investment income, or R 3,500, whichever is the greater.

*Married women.* The Minister proposed that for tax purposes the deduction of R 750 from the earnings of married women be increased to R 900.

*Divorced or separated persons.* A divorced or separated parent who wholly or mainly supports children of the dissolved marriage out of his or her own resources will no longer be restricted to an additional abatement of R 500, but will now be taxed as a married person.

#### Provisional taxpayers

Taxpayers with incomes of less than R 1,000 *per annum* from sources other than remuneration will be relieved of the duty of completing two provisional tax forms in addition to their annual income tax return.

#### Farmers

The rate to be applied to the taxable income derived by a farmer who has elected to be taxed under the system of five-year equalization of tax rates will in future be the lower of the equalized rate or the actual rate applicable to such taxable income.

#### Elimination of discriminations

*Taxation on Blacks.* With effect from the earliest possible date relief will be granted to Black income tax payers by raising the threshold from which liability for tax commences from R 361 to R 1,201, and by adjusting the tax rates to afford relief to all remaining taxpayers. Next, steps will be taken to achieve parity between the income tax payable by Black and other taxpayers. Finally the phasing in of these steps will be done with due regard to the costs involved and their administrative feasibility, the aim being to achieve parity within the next three years.

In order that tax relief be as widely based as possible, the governments of various Black States were duly consulted and have agreed to grant similar relief to their citizens, the government of the Republic having decided to compensate them.

*Workers' training allowances.* The present provision for Black workers' training allowances will be amended to embrace the training of all population groups.

## III. WALVIS BAY

Since September 1, 1977, Walvis Bay has again been administered as part of the Cape Province, and residents have become subject to the South African income tax laws which provide for higher tax rates. Therefore, a special temporary diminishing rebate on normal tax will be allowed to persons resident in Walvis Bay on the last day of the year of assessment, if they were so resident for a period of at least six months during such year. This rebate will commence from the year ended February 28, 1978, and will be calculated on a sliding scale of 100 percent of the difference between the South-West African and the South African tax for the first year, diminishing each year thereafter by 25 percent until phased out by 1981.

## IV. THE FUTURE

After proposing all these benefits the Minister turned to some "severities" (using an expression of Machiavelli), the first relating to the taxation of fringe benefits and the second to "a very limited and modest capital gains tax". The Minister intends to publish a report in respect of fringe benefits towards the middle of the year, and a draft bill on the capital gains tax will be published for comment in the second half of this year.

## V. RATES OF INCOME TAX (NORMAL TAX)

*Persons other than companies.* Persons other than companies are, in respect of the taxable income derived in the years of assessment ending on February 29, 1980, or June 30, 1980, subject to the tax at the rates contained in the two tables annexed hereto. These tables are based on taxable amounts remaining after deducting from taxable income as defined the abatement applicable. Provided the tax is R 150 or more, there is added a redeemable loan levy of 10 percent.

*Companies.* The rates for companies in respect of taxable income derived in the Republic of South Africa for the year of assessment, that is the financial year ending during the twelve-month period from April 1, 1979, to March 31, 1980, are as follows:

(i) *taxable income derived otherwise than from mining:* 40 cents per R 1. A surcharge of 5 percent of such tax and a loan portion of 10 percent thereof are to be added to such tax. The effective rate is thus 46 cents per R 1;

(ii) *taxable income derived from gold mining:*
  (a) on any mine other than a post-1966 gold mine an amount determined in accordance with one of the formulae laid down plus a surcharge which is not payable in respect of certain assisted gold mines equal to 5 percent of the said amount and a loan portion equal to 10 percent thereof;
  (b) on post-1966 gold mines an amount determined in accordance with one of the formulae laid down plus a surcharge of 5 percent of the said amount and a loan portion of 10 percent thereof;
  (c) in the form of excess recoupments over capital expenditure accruing to companies which are or have been gold mining companies the average rate of tax as determined in accordance with the Act or 35 cents per R 1 whichever is higher.

(iii) *taxable income derived from mining for diamonds:* 45 cents per R 1 plus a surcharge of 5 percent of such amount and a loan portion of 10 percent thereof;

(iv) *taxable income derived from mining operations other than mining for gold or diamonds (or natural oil):* the position is the same as in the case of a non-mining company (see (i) above);

(v) *taxable income derived from mining for natural oil:* in respect of taxable income derived from mining for natural oil (excluding gas) normal tax at the rate applying to non-mining income plus an amount equal to 40 percent of the balance remaining after deducting the normal tax and in respect of taxable income derived from mining for natural oil in the form of gas normal tax at the rate applying to non-mining income, the normal and additional taxes chargeable being subject to such a reduction as the Minister of Mines, in consultation with the Minister of Finance, may determine. Where sulphur, salt or any other mineral is won in the course of mining for natural oil, the income derived from the mining of sulphur, salt or other mineral is deemed to be derived from mining for natural oil.

## VI. RATE OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

*Non-resident shareholders' tax.* The non-resident shareholders' tax is 15 percent of the amount of the dividend or interim dividend in question.

*Undistributed profits tax.* The undistributed profits tax is $33^1/_3$ cents on every R 1 by which the distributable income as defined exceeds the amount of dividends distributed during the specified period as defined.

*Non-residents' tax on interest.* The non-residents' tax on interest is 10 percent on the amount of the interest in question.

*Donations tax.* The donations tax is at progressive block rates, the block exceeding R 90,000 being taxable at the rate of 25 percent.

## ANNEXURE ~ Table I

| Taxable amount | | Rates of tax in respect of married persons |
|---|---|---|
| Where the taxable amount — does not exceed R 1,000 | | 7 percent of each R 1 of the taxable amount; |
| exceeds | but does not exceed | |
| R 1,000 | R 2,000 | R 70 plus 8 percent of the amount by which the taxable amount exceeds R 1,000; |
| R 2,000 | R 3,000 | R 150 plus 9 percent of the amount by which the taxable amount exceeds R 2,000; |
| R 3,000 | R 4,000 | R 240 plus 10 percent of the amount by which the taxable amount exceeds R 3,000; |
| R 4,000 | R 5,000 | R 340 plus 11 percent of the amount by which the taxable amount exceeds R 4,000; |
| R 5,000 | R 6,000 | R 450 plus 12 percent of the amount by which the taxable amount exceeds R 5,000; |
| R 6,000 | R 7,000 | R 570 plus 14 percent of the amount by which the taxable amount exceeds R 6,000; |
| R 7,000 | R 8,000 | R 710 plus 16 percent of the amount by which the taxable amount exceeds R 7,000; |
| R 8,000 | R 9,000 | R 870 plus 18 percent of the amount by which the taxable amount exceeds R 8,000; |
| R 9,000 | R 10,000 | R 1,050 plus 20 percent of the amount by which the taxable amount exceeds R 9,000; |
| R 10,000 | R 11,000 | R 1,250 plus 22 percent of the amount by which the taxable amount exceeds R 10,000; |
| R 11,000 | R 12,000 | R 1,470 plus 24 percent of the amount by which the taxable amount exceeds R 11,000; |
| R 12,000 | R 13,000 | R 1,710 plus 26 percent of the amount by which the taxable amount exceeds R 12,000; |
| R 13,000 | R 14,000 | R 1,970 plus 28 percent of the amount by which the taxable amount exceeds R 13,000; |
| R 14,000 | R 15,000 | R 2,250 plus 30 percent of the amount by which the taxable amount exceeds R 14,000; |
| R 15,000 | R 16,000 | R 2,550 plus 33 percent of the amount by which the taxable amount exceeds R 15,000; |
| R 16,000 | R 18,000 | R 2,880 plus 36 percent of the amount by which the taxable amount exceeds R 16,000; |
| R 18,000 | R 20,000 | R 3,600 plus 39 percent of the amount by which the taxable amount exceeds R 18,000; |
| R 20,000 | R 22,000 | R 4,380 plus 42 percent of the amount by which the taxable amount exceeds R 20,000; |
| R 22,000 | R 24,000 | R 5,220 plus 45 percent of the amount by which the taxable amount exceeds R 22,000; |
| R 24,000 | R 26,000 | R 6,120 plus 48 percent of the amount by which the taxable amount exceeds R 24,000; |
| R 26,000 | R 28,000 | R 7,080 plus 51 percent of the amount by which the taxable amount exceeds R 26,000; |
| R 28,000 | R 30,000 | R 8,100 plus 54 percent of the amount by which the taxable amount exceeds R 28,000; |
| R 30,000 | | R 9,180 plus 55 percent of the amount by which the taxable amount exceeds R 30,000. |

## ANNEXURE ~ Table II

| Taxable amount | | Rates of tax in respect of persons who are not married persons |
|---|---|---|
| Where the taxable amount — does not exceed R 1,000 | | 10 percent of each R 1 of the taxable amount; |
| exceeds | but does not exceed | |
| R 1,000 | R 2,000 | R 100 plus 11 percent of the amount by which the taxable amount exceeds R 1,000; |
| R 2,000 | R 3,000 | R 210 plus 12 percent of the amount by which the taxable amount exceeds R 2,000; |
| R 3,000 | R 4,000 | R 330 plus 13 percent of the amount by which the taxable amount exceeds R 3,000; |
| R 4,000 | R 5,000 | R 460 plus 14 percent of the amount by which the taxable amount exceeds R 4,000; |
| R 5,000 | R 6,000 | R 600 plus 16 percent of the amount by which the taxable amount exceeds R 5,000; |
| R 6,000 | R 7,000 | R 760 plus 18 percent of the amount by which the taxable amount exceeds R 6,000; |
| R 7,000 | R 8,000 | R 940 plus 20 percent of the amount by which the taxable amount exceeds R 7,000; |
| R 8,000 | R 9,000 | R 1,140 plus 22 percent of the amount by which the taxable amount exceeds R 8,000. |
| R 9,000 | R 10,000 | R 1,360 plus 24 percent of the amount by which the taxable amount exceeds R 9,000; |
| R 10,000 | R 11,000 | R 1,600 plus 27 percent of the amount by which the taxable amount exceeds R 10,000; |
| R 11,000 | R 12,000 | R 1,870 plus 30 percent of the amount by which the taxable amount exceeds R 11,000; |
| R 12,000 | R 13,000 | R 2,170 plus 33 percent of the amount by which the taxable amount exceeds R 12,000; |
| R 13,000 | R 14,000 | R 2,500 plus 36 percent of the amount by which the taxable amount exceeds R 13,000; |
| R 14,000 | R 15,000 | R 2,860 plus 39 percent of the amount by which the taxable amount exceeds R 14,000; |
| R 15,000 | R 16,000 | R 3,250 plus 42 percent of the amount by which the taxable amount exceeds R 15,000; |
| R 16,000 | R 18,000 | R 3,670 plus 45 percent of the amount by which the taxable amount exceeds R 16,000; |
| R 18,000 | R 20,000 | R 4,570 plus 48 percent of the amount by which the taxable amount exceeds R 18,000; |
| R 20,000 | R 22,000 | R 5,530 plus 52 percent of the amount by which the taxable amount exceeds R 20,000; |
| R 22,000 | | R 6,570 plus 55 percent of the amount by which the taxable amount exceeds R 22,000. |

# South Africa: BUDGET SPEECH 1979

## What the Minister of Finance said...

On March 28, 1979 the Minister of Finance pronounced his Budget Speech the main tax features of which were discussed in the preceding article by Dr. Erwin Spiro. We reproduce below — as far as is relevant — those parts of the Finance Minister's Budget Speech which deal with taxation.

### I. INDIRECT TAXATION

#### A. *Surcharge on imports*

As I have said more than once, the import surcharge introduced in 1977 is a temporary fiscal measure which will be phased out as circumstances permit. I now wish to propose that the surcharge be reduced by 5% from 12.5 to 7.5%. This reduction must be passed on by the trader to the consumer in the form of reduced prices at the earliest possible opportunity. In most cases the price reduction to the final consumer should be more than 5%.
The cost to the Exchequer will amount to R160 million in 1979-'80.

#### B. *Motor cycles*

Because of the fuel situation I propose that the 5% *ad valorem* excise and customs duty on motor cycles, auto-cycles and cycles fitted with auxiliary engines with an engine capacity of less than 200 cc be abolished. The loss of revenue for 1979-'80 is estimated at R300 000.

#### C. *Wine and fermented apple, pear and orange beverages*

Last year the excise duty on unfortified wine was reduced by 3 cents per litre to 4 cents per litre because it became evident that the excise duty of 7 cents per litre tended to have a detrimental effect on the sale of natural wines.

Turnover in the wine industry as a whole still has not come up to expectations and although I do not think that the remaining 4 cents per litre is a material cost fact or, especially for the more expensive types, I nevertheless would like to propose, as a gesture, that the excise duty on unfortified, fortified as well as sparkling wines be reduced by 1 cent per litre. In order not to disturb the relative position of each in the overall picture, excise duty on unfortified, fortified and sparkling fermented apple, pear and orange beverages will also be reduced by 1 cent per litre.

I expect of the wine industry that the prices, particularly of the less expensive natural wines, will immediatley be adjusted downwards so as to pass on the benefit of the concession to the consumer. The loss of revenue for 1979-'80 is estimated at R2,2 million.

#### D. *Grain spirits*

The Board of Trade and Industries examined the position of grain spirits *vis-à-vis* that of cane and wine spirits. To give effect to the Board's recommendations I propose that the excise duty on grain spirits be increased from 74 579 cents to 80 612 cents per 100 litres absolute alcohol and that an effective duty of 79 222 cents per 100 litres absolute alcohol be payable when grain spirits are used in the production of gin.

The additional revenue from this source is estimated to amount to approximately R1 million.

#### E. *Diesel vehicles*

The necessity for South Africa to use fuel sparingly need not be stressed. My colleague the hon. Minister of Economic Affairs and of Environmental Planning and Energy has repeatedly warned that the tendency to change over to diesel-powered motor-cars and light goods vehicles results in an undesirable increase in the use of diesel fuel which in turn creates an imbalance in the optimum utilization of the country's oil supplies. Available diesel should rather be reserved for heavy goods vehicles and stationary engines.

I therefore propose that an additional *ad valorem* excise and customs duty of 10% be imposed on diesel-powered motor-cars, station wagons and similar dual-purpose motor vehicles, minibuses, light goods vehicles with a gross vehicle mass not exceeding 2 450 kg, and on certain of the lighter types of vehicles designed to negotiate unusual terrain.

The revenue from this source for 1979-'80 is estimated at R4 million.

Government Notices to give effect to the amendments in respect of the import surcharge, excise and *ad valorem* excise and customs duties will be published tomorrow. The amended and new duties will become effective on 29 March 1979 and be applicable to all the imported goods concerned which have not been entered for domestic consumption before tomorrow, and on all the excisable goods concerned which by tomorrow have not been removed from the premises of manufacturers and owners of warehouses licensed by the Department of Customs and Excise.

The net loss of customs and excise revenue as a result of all these proposals will amount to R157,5 million in 1979-'80.

### II. TAX REFORM

In introducing the Sales Tax Bill last year, I stated that it was the most comprehensive tax measure to be applied in South Africa since the introduction of the Income Tax Act in 1914 and that it heralded the start of what could be termed a major tax reform programme. I explained that it was the intention to bring about a gradual shift from direct to indirect taxation in order to achieve a more balanced distribution of the tax burden over the whole population and a stabilization of the tax flow, which would ensure that shortfalls in one type of tax would not necessarily give rise to tax increases in the years to come.

This year I hope to take another major step forward on this road thanks, chiefly, to the manoeuvrability afforded me by this major new source of revenue, namely the general sales tax, and the underlying position of strength from which we are proceeding as a result of our disciplined approach to financial policy in recent years.

Before I spell out what I have in mind here, I want to refer to two aspects of taxation which are being closely studied at present, and also to deal with what might be called a few "housekeeping" items aimed at tax relief. Machiavelli once said "Severities should be dealt out all at once, that by their suddenness they may give less offence; benefits should be handed out drop by drop that they may be relished the more". (Interjections.) I shall start with two "severities".

#### A. *Fringe benefits*

The first relates to fringe benefits. These are generally resorted to more and more as a method of avoiding taxation and as substitutes for cash payments. The employee is often nowadays more interested in what fringe benefits are offered him than in his cash remuneration. This tendency is not unexpected in any country with a progressive income tax system and a relatively high rate of inflation but by the same token is not a particularly healthy phenomenon. Both benefits are taxable, but whereas cash payments are readily ascertainable and are fully taxed, fringe benefits as a type of remuneration are not always as clearly identifiable or reported, resulting in many instances in them either escaping tax or not being taxed at a value commensurate with the benefit enjoyed by the recipient.

Both the Standing Commission on Taxation and the Department of Inland Revenue have been studying this problem for some time and a report on the matter is expected any time now. The Chairman of the Commission has, meanwhile, given me an outline of the findings and recommendations. I intend publishing this report towards the middle of the year so that comments on the practical application of the proposals can be submitted and considered before any decisions are taken. I want to stress that the Government has not in any way committed itself to any kind of decision here.

B. *Capital gains tax*

The second "severity" I wish to refer to is due to the constant search for new sources of revenue to broaden the tax base and thereby, to a meaningful extent, to alleviate the burden of some existing forms of taxation. The Department of Inland Revenue has submitted proposals for a very limited and modest capital gains tax to the Standing Commission. These were considered by the Commission some time ago already.

Many misconceptions and even fears have arisen as to the form such a tax would take. Its inhibiting nature has been exaggerated out of all proportion, its place in the tax "mixture" is not always appreciated, and sight is quite often lost of the fact that while normal earnings are fully taxed, capital gains which also do add to the wealth of the recipient, escape tax completely. This to me is not altogether fair. I feel we should seek a just balance. As a result I have requested the Secretary for Inland Revenue to publish for comment a draft Bill on this matter in the second half of this year. I am encouraged to invite public debate on these measures because of the good results obtained by the Department of Inland Revenue in the course of its consultations on the general sales tax last year. Once again I want to stress that the Government has not committed itself to this kind of tax in any shape or form.

## III. HOUSEKEEPING ITEMS

And now for the "housekeeping" items:

A. *Walvis Bay*

Since 1 September 1977 Walvis Bay has again been administered as part of the Cape Province and residents have become subject to the South African income tax laws. South West African income tax rates are lower with the result that residents of Walvis Bay have since been faced with certain transitional problems.

The potential depopulation of the area is viewed with concern by the Government and although taxation is not the only factor in the new situation, I wish to propose that a special temporary diminishing rebate on normal tax be allowed to persons resident in Walvis Bay on the last day of the year of assessment, if they were so resident for a period of at least six months during such year. This rebate will commence from the year ended 28 February 1978, and will be calculated on a sliding scale of 100% of the difference between the South West African and the South African tax for the first year, dimishing each year thereafter by 25% until phased out by 1981.

B. *Provisional tax*

I wish to propose, next, that the threshold at which provisional tax becomes payable be increased from R500 to R1 000. The effect will be that taxpayers with incomes of less than R1 000 per annum from sources other than remunerations will be relieved of the duty of completing two provisional tax forms in addition to their annual income tax return. Of course, all income from whatever source must still be reflected in the annual tax returns and the tax thereon will be reflected in the assessments.

Although this measure does not entail the sacrifice of any revenue, an amount of R10 million in tax and loan levy receipts will be deferred to the following year when it will again be collected on assessment.

C. *Tax rate: Equalization for farmers*

A farmer's income is all too often subject to the vagaries of nature. The problem of increased taxation caused by inordinately high incomes in exceptionally good years has been catered for ever since 1968 by the introduction of a system of five-year equalization of tax rates. However, it could have the effect, for example, that when four good years are succeeded by a bad one, the bad years's taxable income could be taxed at a higher rate than that which would have applied had the actual rate applicable to such income been used.

I have considered the representation of organized agriculture in this regard and would, therefore, like to propose that, with effect from the tax year ending on 29 February or 30 June 1980, as the case may be, the rate to be applied to the taxable income derived by a farmer who has elected to be taxed at equalized rates should be the lower of the equalized rate or the actual rate applicable to such taxable income.

This proposal does not involve any sacrifice of tax revenue for 1979-'80 although for a full year the loss is expected to amount to R3 million.

D. *Estate duty*

Substantial concessions have been made in recent years to minimize the impact of inflation on the taxable values of estates, but the problem remains, as someone reminded me the other day, that "where there's a will there are relatives". [Interjections.]

I now wish to propose that the primary rebate and the rebates applicable to children and the surviving spouse of a deceased be increased by R5 000 each. This means, for example, that where a deceased is survived by a wife and two children his estate must have a dutiable value in excess of R140 000 before it will be liable for estate duty.

In addition, I wish to propose that the maximum allowable deduction from the total value of an estate in respect of insurance policy proceeds, local registered stock and Land Bank debentures be increased from R70 000 to R80 000, of which not more than R40 000 may be in the form of insurance policy proceeds. This will enabel a testator to provide for the payment of estate duty on an estate of up to R532 000 without the need for disposal of any other assets to meet the tax.

The increased abatements and this enhanced deduction will apply to the estates of persons dying on or after 1 April 1979. These concessions will entail a loss of R.1,5 million in 1979-'80 and R4 million in a full year.

E. *Retirement gratuities*

Remuneration, and consequently retirement benefits, have increased substantially in money terms during the past few years. I feel the time has arrived to increase the maximum exemption from tax at present allowed in respect of a gratuity paid to an employee by reason of his retirement or impending retirement, and I propose that the current amount of R12 000 be raised to R15 000.

The loss of revenue for 1979-'80 is estimated at R0,5 million and for a full year at R2 million.

F. *Pension and retirement annuity funds*

The Income Tax Act has for years included stipulations designed to encourage people to make provision for their retirement or for their dependants in the event of early death. Whereas the contributions of employees and employers to pension funds can, in most cases, provide for adequate retirement benefits, it is not always the case as far as self-employed persons are concerned.

Many businesses and professional partnerships have been converted into companies for the sole purpose of securing the tax advantages flowing from a pension fund, but this solution I know, is not possible for all professions. I have considered the alternative of resolving the problem by allowing partners in, or owners of, businesses and professional practices to become members of a pension fund established for the benefit of their own employees, but for a variety of reasons this solution is not considered practical in all cases.

I therefore wish to propse that the present limitation of R3 500 on contributions to a reitrement annuity fund by a self-employed person be amended to the effect that from the tax year ending on 29 February or 30 June 1980, allowable contributions to such a fund be restricted to 15% of the member's taxable income derived from his business or profession—excluding investment income—or R3 500, whichever is the greater.

In view of this new ceiling I also wish to propose that the maximum amount allowable in respect of members' contributions to a pension fund be fixed at 7½% of the member's taxable income derived from his employment or R1 750, whichever is the greater.

The loss of revenue—including consequential loan levy loss—for 1979-'80 is estimated at R5 million and for a full year at R10 million.

*G. Transactions in marketable securities*

In order to redress somewhat the present imbalance in costs between dealing in securities here and abroad and to induce the market to make greater use of local facilities, I am of the opinion that a measure of relief should be given. I feel, however, that the concession should be of a general nature so as to embrace transactions by both residents and non-residents.

I therefore wish to propose that the rate of stamp duty payable in respect of registration of transfers of marketable securities and the rate of marketable securities tax payable in respect of every purchase of such securities by a stockbroker on behalf of a client, be reduced by one-third from 1½ to 1% in respect of transactions in such securities concluded on or after 1 April 1979. The loss of revenue is estimated at R10 million.

While dealing with matters affecting the Johannesburg Stock Exchange, I am pleased to be able to announce that the Exchange will initiate and operate a market in Krugerrand. An open market where prices and turnovers are published daily ought to be to everybody's advantage.

H. *Workers' training allowances*

Flowing from the recommendations of the Naudé Committee, the Department of Labour undertook the implementation of an in-service training scheme similar to that at present enjoyed by Blacks, for all other workers, and I am happy to say that enabling legislation will be introduced by my colleague the hon. Minister of Labour during the current session of Parliament.

We need a more efficient and more highly skilled labour force in South Africa and I propose to contribute towards the achievement of this aim by amending the present provision for Black workers' training allowances in the Income Tax Act to embrace the training of all population groups once the enabling labour legislation has been approved by Parliament.

The concession will cost the Exchequer R3 million in 1979-'80 and R10 million in a full year.

I. *Income tax surcharge on gold and diamond mining companies*

A differential 2½ % tax surcharge imposed on gold and diamond mining companies over and above the normal company surcharge has been levied for many a year purely as a revenue-raising measure.

I think the time has now come for its removal, and I propose accordingly. It will apply in respect of all tax years ending during the 12-month period up to 31 March 1980.

The loss of revenue will amount to R22 million for the 1979-'80 financial year and R18 million for a full year. The higher loss next year is due to the recoupment of surcharge paid at the higher rate in 1978-'79.

J. *Loan levy*

Recently I have agreed to the earlier repayment of company loan levies for the 1973 and 1974 tax years. I am fully conscious of the need for companies to improve their profitability and cash flows in times of lower turnovers and higher costs. By now proposing to lower, for all companies, the present loan levy of 15% to 10% and thus, for example, effecting a reduction in the 48% composite rate of tax and loan levies for non-gold and non-diamond mining companies to 46%. I trust that companies will be encouraged to advance their investment and expansion plans wherever possible.

I propose that this reduction be granted in respect of all tax years ending during the 12 months up to 31 March 1980.

The cost to the Exchequer will be R111 million for 1979-'80 and R94 million for a full year. Once again, the higher loss for 1979-'80 is due to the recoupment of loan levy paid at the higher rate in 1978-'79.

K. *Divorced persons*

I have received representations from divorced or separated persons that they should be treated as married persons for income tax purposes. I am unable to agree to such a general change in the law. However, the position of the divorced or separated parent who wholly or mainly supports children of the dissolved marriage out of his care or her own resources deserves special consideration. At present such a parent is entitled to an additional abatement of R500 but is treated as unmarried for tax purposes. I now propose that he or she be taxed as a married person.

The loss of revenue for 1979-'80 is estimated at R1 million and for a full year at R3 million.

L. *Financing requirements*

Considering the substantial list of concessions I have announced thus far, it is necessary to return for a moment to the Exchequer accounts. Hon. members will recall that after allowing for the proposed increased expenditures, total Exchequer outlay for next year will amount to R11 190 million. Similarly, after allowing for the proposed concessions on the revenue side, customs and excise receipts are expected to total R1 282 million. In the case of Inland Revenue I have proposed various tax concessions amounting to R52 million, excluding consequential loan levy relief, which will reduce expected revenue from this source to R7 504 million.

In sum, the Exchequer can thus expect to collect a total of R.8 786 million, which leaves a deficit—before borrowing—of R2 404 million. After adding loan redemptions totalling R1 112 million the financing requirements at this stage amount to R3 516 million.

I propose that this amount be financed as follows:

| | R million |
|---|---|
| Public Debt Commissioners | 1 350 |
| Reinvestment of maturing stock | 856 |
| New stock issues | 550 |
| Non-marketable debt | 300 |
| Loan levies, adjusted for concessions | 444 |
| | R3 500 |

This leaves me with a deficit of only R16 million before allowing for foreign borrowing or the utilization of any available balances. Nietzsche once said: "Gentlemen, let us distrust our first reactions; they are invariably much too favourable." I invite you, therefore, to bear with me for another few minutes to see what the final position amounts to.

The healthy state of the Exchequer represents an achievement which I think the Republic can be justly proud of. It probably reflects at least as sound a position as is to be found in today's world and proves to me once again that in time of need South Africans, as a nation, are prepared to accept the yoke of increased taxation, of higher duties and imposts, and of disciplined expenditure and conservative financing.

I therefore feel duty bound when opportunity presents itself to propose meaningful concessions to the man who has been responsible for contributing so uncomplainingly to the State coffers. I am referring here to the individual income taxpayer. The relief I am anxious to give him is closely bound up with what I earlier called a major step forward in the reform of the tax system. The reform revolves around improvements in the system of taxation of Blacks, more liberal abatements, a more gradual run-down of the abatements themselves, and a reduction in marginal tax rates.

M. *Taxation on blacks*

In last year's Budget Speech, I mentioned that an Interdepartmental Committee was at that time studying the graduated income tax payable under the Black Taxation Act of 1969 and that attention would be given to the disparities which existed between the tax rates and taxes payable under this Act and under the Income Tax Act, 1962.

The Committee has concluded its work and the Commission for Plural Affairs, after consultation with the Department of Inland Revenue, has made certain recommendations to my colleague the hon. Minister of Plural Relations and Development. These include:

(a) that with effect from the earliest possible date relief be granted to Black income tax payers by raising the threshold from which liability for tax commences from R361 to R1 201, and by adjusting the tax rates to afford relief to all remaining taxpayers;

(b) that steps be taken to achieve parity between the income tax payable by Black and other taxpayers; and

(c) that the phasing in of these steps be done with due regard to the costs involved and their administrative feasibility, but that the aim must be to achieve parity within the next three years.

I am glad to be able to announce that these recommendations have been accepted by the Government and will be implemented with effect from 1 May 1979 in three phases. The Black States have taxing powers in terms of the Black States Constitution Act of 1971, *inter alia*, in regard to the income of their citizens wherever resident in the Republic. Approval by Parliament of these measures can affect only those Blacks who are not citizens of one or the other of the Black States. In order that tax relief be as widely based as possible, the Governments of the various Black States were duly consulted and have agreed to grant similar relief to their citizens. The Treasuries of the Black States are, however, unable to absorb this loss and the Government has decided to compensate them accordingly. The position will be reviewed annually in the light of circumstances prevailing at the time.

The loss of revenue to be borne in 1979-'80 is estimated at R33 million for this first phase.

N. *Individual income tax*

I now wish to deal with personal income tax. I think it was Browning who once said: "The best is yet to be . . ."! I shall, however, have to leave that to hon. members' judgement. The amount of tax payable is determined by two factors, abatements deducted from income to arrive at the taxable maount and the rate of tax.

The main abatements have remained fixed for some time now and I propose that they be increased as follows—

*Primary abatement*—from R1 200 to R1 500 in the case of a married person and R700 to R1 000 in the case of an unmarried person;

*Additional abatement*—applicable to persons over the age of 60 years—from R700 to R1 000;

*Child's abatement*—for each of the first two children—from R500 to R600, and for each of the third and successive children—from R600 to R700;

*Dependant's abatement*—from R250 to R350 and from R100 to R200 depending on the extent of maintenance provided; and

*Medical and insurance abatement*—from R1 000 to R1 200 in respect of married persons and from R750 to R950 in respect of unmarried persons.

At present the aggregate of these abatements is reduced by R2 for every R10 by which taxable income exceeds R5 000. I now propose, in addition to the higher abatements, that their rate of diminution be decreased to R1 for every R10 of the taxable income in excess of R5 000.

The introduction of these concessions alone entails a very considerable sacrifice of tax revenue but I deem it desirable to go one step further at this stage and announce substantial changes also in the tax rates—if only to disprove the saying that "taxes are a good investment because they always increase"! [Interjections]

The rates of tax which I now propose and which will be tabled in detail in the form of tax proposals, have the following features—

(a) the commencing rate for married persons is reduced from 9 to 7% and that for single taxpayers from 12 to 10%.

(b) the rate of progression is evened out and, in the case of single taxpayers the acceleration in the progression on taxable amounts between R4 000 and R8 000 is reduced; and

(c) a reduction from 60 to 55% is effected in the top marginal rate of tax, aplicable to that portion of the taxable amount in excess of R30 000—previously R28 000—in the case of married persons, and in excess of R22 000 in respect of unmarried persons.

The sum total of these concessions will afford considerable and, I feel, just tax relief to individual taxpayers. Normally one would have considered reducing loan levies on individuals before adjusting tax rates, but I feel it preferable to retain these levies for the time being and to grant relief in the form of abatements and rate concessions for two reasons: Firstly, it affords an opportunity to make substantial progress with our tax reform programme and, secondly, it provides the sort of fiscal flexibility which proved so useful last year in permitting earlier loan levy repayments for the purpose of stimulating consumption expenditure.

It is estimated that the expected yield of income tax from individuals will be reduced by as much as R394 million—including a consequential reduction of R36 million in loan levy—in 1979-'80 and by no less than R516 million—including R46 million in loan levy—in a full year.

Benchley once remarked that "there are several ways to apportion the family income, all of which are unsatisfactory". With due respect for him, however, I believe I may have succeeded in achieving a more just apportionment of earnings between the taxpayer and the tax collector.

Permit me to quote just a few examples to illustrate the effects of these proposals:

(1) The abatements for a married person with two children and with R500 in medical fees and insurance will henceforth only fall away entirely at the R37 000 income level as against the present R18 500 level.

(2) The total tax plus loan levy payable by married persons under the age of 60 years with two children will be as follows:

| *Taxable income* | *Present tax* | *Proposed tax* | *Decrease* | |
|---|---|---|---|---|
| R | R | R | R | % |
| 2 700 | 45 | — | 45 | (100) |
| 3 000 | 72 | 21 | 51 | ( 71) |
| 5 000 | 297 | 194 | 103 | ( 35) |
| 10 000 | 1 276 | 921 | 355 | ( 28) |
| 15 000 | 3 031 | 2 259 | 772 | ( 26) |
| 20 000 | 5 192 | 4 303 | 889 | ( 17) |
| 25 000 | 7 832 | 6 890 | 942 | ( 12) |
| 30 000 | 11 000 | 9 979 | 1 021 | ( 9) |
| 40 000 | 17 600 | 16 148 | 1 452 | ( 8) |

(3) In the case of married persons over the age of 60 years with no minor children, liability for income tax will commence at an income level of R2 501 as against the present R1 901.

These proposals will apply to tax years ending 29 February or 30 June 1980, as the case may be.

More needs to be done in the field of income tax reform but I feel further steps will have to wait for another day. There is an old English saying: "Always put off until tomorrow the things you should not do today."

### O. *Taxation of income of married women*

There is, nevertheless, one further concession which I feel should still be made today, one that will apply to the earnings of married women.

Hon. members will recall that in dealing with this matter in the House two years ago I said that I agreed with the conclusion of the Standing Commission on Taxation and the Department of Inland Revenue that the root of our problem is rather the high marginal rate of income tax on individuals and that it would be desirable to lower it as soon as the fiscal situation permitted.

I am therefore grateful that we have succeeded to an important extent in doing just that, but I feel I can go one step further. I wish to propose that for tax purposes the deduction of R750 from the earnings of married women be increased to R900 with effect from the tax years ending 29 February or 30 June 1980, as the case may be.

The estimated loss of revenue—including the loan levy—for 1979-'80 will be R13,5 million and for a full year R18 million.

### P. *Foreign loans and the stabilization account*

The effect of all the income tax concessions on individuals will be to reduce loan levy receipts by R38 million. If one adds to this the tax concessions totalling R403 million in respect of income tax, taxation on Blacks and the earnings of married women, the earlier deficit of R16 million will now increase to R457 million.

**COMPARATIVE SUMMARY OF THE STATE REVENUE ACCOUNT**

| | Rm | Revised figure 1978-'79 Rm | Budget figure 1979-'80 Rm | Percentage change % |
|---|---|---|---|---|
| **Expenditure:** | | | | |
| Printed Estimate (R.P. 2—1979; First print) | | | 11 034 | |
| *Plus:* Budget proposals in respect of: | | | | |
| Pension concessions | 59,8 | | | |
| Sasol II extension | 50,0 | | | |
| Assistance to farmers | 6,4 | | | |
| Consolidation of Black States | 20,0 | | | |
| Subsidy on bread | 20,0 | | | |
| | 156,2 | | say 156 | |
| Total Expenditure | | 10 000 | 11 190 | 11,9 |
| **Revenue:** | | | | |
| Inland Revenue at existing rates (excluding loan levies) | | | 7 556 | |
| *Less:* Taxation proposals in respect of: | | | | |
| Provisional taxpayers | 9,0 | | | |
| Estate duty | 1,5 | | | |
| Retirement gratuities | 0,5 | | | |
| Retirement annuities | 4,5 | | | |
| Stamp duty and marketable securities tax | 10,0 | | | |
| Training of workers | 3,0 | | | |
| Surcharge on gold and diamond mines | 22,0 | | | |
| Divorced persons | 1,0 | | | |
| Income tax on Blacks | 33,0 | | | |
| Income tax on individuals | 358,0 | | | |
| Married working women | 12,0 | | | |
| | 454,5 | | say 455 | |
| | | 6 591 | 7 101 | 7,7 |
| Customs and Excise at existing rates | | | 1 439 | |
| *Plus:* Taxation proposals in respect of: | | | | |
| Excise duty on grain spirits | 1,0 | | | |
| Excise duty on diesel vehicles | 4,0 | | | |
| | 5,0 | | 5 | |
| | | | 1 444 | |
| *Less:* Taxation proposals in respect of: | | | | |
| Surcharge on imports | 160 0 | | | |
| Excise duty on motor cycles | 0,3 | | | |
| Excise duty on wine | 2,2 | | | |
| | 162,5 | | say 162 | |
| | | 1 493 | 1 282 | −14,1 |
| Total revenue | | 8 084 | 8 383 | 3,7 |
| Deficit (before loans) | | 1 916 | 2 807 | 46,5 |
| Loan Redemptions: | | | | |
| Domestic loans | | 1 379 | 935 | |
| Foreign loans | | 234 | 136 | |
| Loan levies | | 266 | 10 | |
| IMF credits | | 271 | 31 | |
| | | 2 150 | 1 112 | −48,3 |
| Financing Requirements | | 4 066 | 3 919 | − 3,6 |

**(Continued on next page)**

| (Continued) | Rm | Revised figure 1978-'79 Rm | Budget figure 1979-'80 Rm | Percentage change % |
|---|---|---|---|---|
| Financing: | | | | |
| Domestic loans: | | | | |
| Public Debt Commissioners | | 1 400 | 1 350 | |
| Reinvestment of maturing stock | | | 856 | |
| New stock issues | | 2 047 | 550 | |
| Non-marketable debt: | | | 300 | |
| National Defence Bonds | 90 | | | |
| Bonus Bonds | 100 | | | |
| Treasury Bonds | 100 | | | |
| Other | 10 | | | |
| | 300 | | | |
| Foreign loans | | 110 | 200 | |
| Loan levies at existing rates | 556 | | | |
| *Less:* Concessions to companies and individuals | 150 | | | |
| | 406 | 516 | 406 | |
| Use of surplus of previous year | | 129 | 36 | |
| Transfer from Stabilization Account | | – | 221 | |
| | | 4 202 | 3 919 | |
| Balance: | | 136 | | |
| Disposal of 1978-'79 surplus: | | | | |
| Transfer to Special Defence Account | | 100 | | |
| Transfer to 1979-'80 financial year | | 36 | | |

A source of financing which I have not dealt with yet is foreign borrowing. South Africa's credit rating abroad has improved remarkably during the past year and the borrowing situation in the international market is better than it has been for quite some time. I should therefore like to propose that a portion of this deficit be financed by raising new loans abroad amounting to the equivalent of R200 million. Of this amount a substantial sum has already been secured, leaving only a small balance still to be found. By adding to this the surplus of R36 million carried over from 1978-'79, and by drawing an amount of R221 million as a balancing transfer from the Stabilization Account, I feel confident that we shall be able to achieve the targets we have set for ourselves in the coming year.

## IV. SUMMARY

As is customary, a summary of the Government's accounts is subjoined in the printed version of the Budget Speech (see chart).

## V. CONCLUSION

The Budget I have introduced today, like that of last year, contains elements of structural tax reform and elements of short-term economic policy.

The main elements of tax reform are the lowering of and adjustments to income tax scales, the increases in abatements, the decrease in the rate of diminution of abatements, and the initiation of a programme of phasing out the disparities between income taxes paid by Blacks and others.

Following upon the introduction of the general sales tax and the reductions in direct taxes announced in last year's Budget, these new steps should have the effect of shifting the burden of taxation somewhat further from direct towards indirect taxation, which remains one of the long-term objectives of tax reform in South Africa.

In regard to short-term policy, the Budget makes it clear that it is not our aim to stimulate the economy in the first instance through increased government spending. On the contrary, provision is made for an increase in government spending of less than 12%, which is not much more than the present rate of inflation. What our policy is aimed at, is the encouragement of expansion in the private sector. It is to this end that I have proposed net tax and loan levy concessions amounting to R762 million.

Taking the Budget as a whole, the main fiscal stimulus to the private sector will be imparted through the planned increase in the total deficit, excluding borrowing, of 46.5% to a figure of R2 807 million.

This increase amounts to about 2% of gross domestic product and represents a significant addition to the direct income generated by the Government's fiscal operations. It should have a substantial expansionary impact on private consumer and investment spending, and therefore on the rate of economic growth.

As part of the proposed financing of this deficit, provision is furthermore made for the transfer of the expected balance of R36 million at the end of the current financial year to the new year and a drawing on the Stabilization Account of R221 million. These financing methods should have the effect of moderately increasing the money supply and thereby also promoting economic expansion.

The overriding conclusion to be drawn from this Budget is, I believe, that financial discipline is the key to the success of economic policy. In difficult circumstances, South Africa has responded to the economic challenges confronting it with courage and determination. When the situation called for restrictive action, government spending was curbed, taxes were raised, bank credit and the money supply were restrained and interest rates were allowed to rise. Sacrifices were made by both the public and private sectors. Today we are reaping the benefits of these policies. There can be no question that it was our strategy of discipline and consolidation which laid the foundation for today's Budget and for our new co-ordinated fiscal and monetary policy of "growth from strength".

# FRANCE: A Re-Orientation of the Discussion on Capital Taxation - PART 2

by Jean-Loup Haÿ*

## A REASONED APPROACH: NO RECOURSE TO A NEW TAX BUT A REFORM OF EXISTING DUTIES

*In the first part of this article the efforts of the* Ventejol — Blot — Méraud Committee *were described which resulted in an extensive and in-depth study of the elements of various kinds of possible capital tax systems in order to demonstrate what sort of reform should be adopted in France to improve the French capital tax system. The members of the Committee, in the last part of their report, gave an extensive explanation organized along the following lines:*

1. *A summary of some of the reasons which justify capital taxation;*
2. *The weighing of the advantages and disadvantages connected with the adoption of an Annual Wealth Tax (A.W.T.), taking into account important factors such as fiscal equity and economic and administrative efficiency;*
3. *The justification of the capital transfer tax system (in the sense of an inheritance and gift tax system) from the social, economic and administrative points of view;*
4. *The presentation of the reform proposals of the Committee in relation to the aims set by it.*

The thought process of the Committee is characterized by an internal coherence which can only be understood if the presentation of its main logical arguments is followed in the same order as indicated under points 1 through 4 above. Any other method of analyzing the Committee's line of argument — which reaches its conclusion after a well-documented analysis of the technical and juridical aspects — would present the risk of doing injustice to the line of thought of the Committee and its reporter. Nevertheless the author of this article will venture to make some personal comments concerning the different points discussed by the Committee.

### A. WHY CAPITAL TAXATION?

The Committee's opinion is that there exist three primary justifications for he taxation of capital. In the first place, the possession of a certain amount of wealth increases the owner's taxable capacity. Secondly, it seems legitimate to discriminate for tax purposes between income from capital and income from work. Finally, the taxation of capital would normally serve to counteract the tendency towards an increase of inequalities in wealth distribution if not actually to reduce such inequalities.

In this connection it is interesting to recall that this line of argument was also used by the authors of the official documents published by the Irish and British governments, respectively, on February 28, 1974 ("Capital taxation") and in August 1974 ("Wealth tax"). [17]

In the first of these documents, a distinction is made between the arguments related to the problem of equity and the arguments connected with social justice. However, one can find once more the same motives as those of the French Committee, viz.:

> "Contribution in proportion to ability to pay was [formerly] considered solely in terms of the income of taxpayers. It is now generally recognised, however, that income of the taxpayer alone is not necessarily a complete test of taxable capacity or of ability to pay. Fair treatment in a taxation context requires that individual citizens in similar circumstances be treated on a basis of equality. Income, in the commonly accepted sense of the term, is not the sole measure of comparative circumstances." (§ 46, p. 23)
>
> "Wealth gives its possessor advantages even when no money income is derived from it. The enjoyment of the possession of works of art or of anitique furniture cannot be quantified or evaluated."
>
> "Capital also confers security. Income from capital is permanent and transmissible.... There are additional advantages in the ownership of capital which are not quantifiable in income terms, e.g. social status, prestige and influence." (§ 47 and 48, pp. 23-24)
>
> "The promotion of social justice requires that the tax system should contribute to the achievement of a more equitable distribution of wealth and income in the community. A proportionate or even a pro-

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17. *"Capital Taxation"*, laid by the Minister for Finance before each House of the Oireachtas, Government Publications Sale Office, Prl. 3688, Dublin, Eire. *"Wealth Tax"*, Green Paper presented to Parliament by the Chancellor of the Exchequer (Denis Healey) by command of Her Majesty, HMSO, Cmnd. 5704, London.

gressive income tax will not achieve this objective since it will have no effect on the distribution of existing accumulations of wealth. It can only to a very limited extent prevent the accumulation of new concentrations of wealth.... In the absence of a comprehensive system of capital taxation the bulk of this increase in wealth will accrue to those who are already wealthy. A tax system which is ineffective in distributing existing wealth cannot hope to develop a greater effectiveness in distributing the accretions of that wealth." (§ 50 and 52, p. 24)

In the second document, the emphasis is put on the necessity to seek out an equitable distribution of the public burden and to succeed in establishing a society characterized by fewer social and economic inequalities:

> "The fundamental purpose of the wealth tax is to make the distribution of the tax burden accord more closely with taxable capacities and thereby contribute to the creation of a more equitable society in which social divisions characterised by differences of wealth are reduced and in which social and economic power created by the possession of wealth is less concentrated than at present." (§ 71, p. 20)

This document was presented by the Chancellor of the Exchequer, D. HEALEY, with the following comments:

> "The Government is committed to use the taxation system to promote greater social and economic equality. This requires a redistribution of wealth as well as income. Thoroughgoing reforms are needed in the taxation of capital.... One of the main purposes of personal direct taxation is to share out the burden of taxation fairly in accordance with ability to pay. In this country [Great Britain] we have come to think of income as the main yardstick of taxable capacity and have sought to promote a greater equality through a progressive income tax. However, income by itself is not an adequate measure of taxable capacity. The ownership of wealth, whether it produces income or not, adds to the economic resources of a taxpayer so that the person who has wealth as well as income of a given size necessarily has a greater taxable capacity than one who has only income of that size. ... Once the additional taxable capacity represented by ownership of wealth is adequately brought into charge, excessive inequalities of wealth will in time be eroded, and it will be possible to reduce the high rates of tax on earned income." (Foreword, p. iii)

Therefore, one cannot be surprised to note that, except for Eire where the A.W.T. was experimented with for three years, [18] the acceptance of these arguments has led to a rejection of the A.W.T. and a thorough reform of the capital transfer tax system. However, it should be noted that in the particular case of France the adoption of the A.W.T. formula would have had at least two advantages which are not to be expected from even the best system of capital transfer tax. In the first place, it would be the best means to re-introduce a more just policy, from a social point of view, than the present one which has led since 1959 [19] to similar tax treatment of income derived from work ("earned income") and income derived from capital ("unearned income"). It will be easy to recognise that persons deriving the second sort of income have more means to take independent decisions and have more freedom of action than those who receive only the first kind. Since the taxation of capital would result in a higher tax burden on income from capital than on income from work, the difference between the two kinds of incomes would be taken into account. One could say that through the introduction of an A.W.T. the theoretical principle "à revenue connu égal, impôt égal" (equal incomes will be subject to equal tax) would be replaced by "à potentialités de dépenses égales, impôt égal" (equal potential to spend will be subject to equal tax). Secondly, the introduction of an A.W.T. in the French tax system would allow a remedy for the fiscal injustice caused by the introduction of the capital gains tax. Under this tax only gains which are *realized* through the sale or other disposal of assets are taxed, whereas under the A.W.T. the owner of assets whose value has increased over the years will be brought in the tax net, whether these assets are sold or not. This would be more equitable since the owner of an asset who is not forced to sell the asset will generally be financially stronger than a person who is forced to do so.

The preference of the Committee for the improvement of the current French inheritance and gift tax system over the introduction of an A.W.T. seems to be more justified if one takes into account the purpose of redistribution of wealth. Of course, it is possible to reach the conclusion that for this purpose the best conceivable method very likely consists in a limitation of the possibilities to transfer individual wealth by way of a gift or at death and to check the power to transfer wealth. Such action would have more chance to succeed if it were supplemented by an effective policy to stimulate saving and by a limitation of the power to accumulate wealth.

However, the effect of redistribution of wealth through an inheritance and gift tax will probably be more significant in a country where transfer of assets by way of gift or at death is firmly embedded in the social structure. The author is inclined to believe that this is indeed the case in France. A sample survey in 1970 carried out in France by the French Institute of Public Opinion (I.F.O.P.) shows that: "... the principle of transfer of wealth through inheritance is very broadly accepted: nine Frenchmen out of ten declare themselves favorable

18. In the Republic of Eire, the Wealth Tax Act adopted in 1975 constituted only a part of the general reform of the capital tax system. However, the wealth tax was abolished in 1978.

19. The Law No. 59-1472 of December 28, 1959 introduced a unitary income tax system in France, i.e. it introduced the single tax on the income of individual persons (impôt unique sur le revenu des personnes physiques or I.R.P.P.) which replaced the proportional (income) tax (taxe proportionnelle) and the progressive surtax (surtaxe progressive). For further details see: "*Aims and results of the Law of December 28, 1959, introducing the tax on the income of physical persons*", study presented by the Section of Finance, Credit and Taxation on the Report by Mr. *Michel Richard* of November 28, 1967, Economic and Social Council, Paris, 156 p.

to it."[20] In their book *La Richesse des Français*, *A. Baheau* and *D. Stauss-Kahn* write that — according to their computation — "during recent years more than 50 percent [of the wealth] possessed by households has been acquired through inheritance".[21]

The Committee has certainly paid attention to this aspect of the behavior of the French, but also pondered the fact that, as was correctly remarked by *L.C. Thurow* in the particular case of the United States:

> "... in theory, inheritance and gift taxes could reduce the concentration of wealth substantially. In practice, loopholes have become so large that inheritance taxes have virtually ceased to exist: collections amount to an annual wealth tax of less than 0.2 percent. For all practical purposes, gift and inheritance taxes do not exist in the United States. They do not stop wealth from being transferred from generation to generation."[22]

A similar opinion was expressed with respect to the British Estate Duty which was in 1974 replaced by the present Capital Transfer Tax: the Estate Duty was frequently considered as a voluntary tax!

The deficiencies of the present French legislation with respect to capital transfers lead to the conclusion that the French inheritance tax is currently not a good instrument for furthering an equitable distribution of wealth and for reducing current wealth inequalities. This opinion leads to a further conclusion, viz. that a reform of the French capital transfer tax system is at this moment more necessary than anything else. The latter conclusion is strongly supported by a critical analysis of the arguments brought forward by the advocates of an A.W.T.

## B. WHAT CAN BE EXPECTED FROM THE ADOPTION OF AN A.W.T.?

The Committee in its report reviews the various arguments presented by the supporters of the introduction of an A.W.T. in the French tax system, keeping in mind those purposes of a tax reform which it considers essential, i.e. social and economic justice, economic efficiency and net productivity of the tax (by considering the minimisation of the cost of collection and administration and maximisation of the financial yield).

These arguments and — where pertinent — their refutation are presented in Table VIII.

With a view to completing its refutation of the arguments most currently brought forward in favor of the introduction of an A.W.T., the Committee indicates some negative economic effects which might be expected if this method of taxation were introduced and if the tax were imposed — as is the case in the majority of foreign A.W.T. legislations — on real property, whether used for dwelling purposes or for professional use, on stocks and bonds and on all business assets.

Finally, the Committee even further justifies its rejection of the A.W.T. by stating that — according to a prudent estimate — the revenue to be expected from an A.W.T., were it to be introduced in 1979 in France at an average rate of 0.5 percent, would be very low, i.e. somewhere between 1,000,000,000 and 1,500,000,000 Fr.Frs., whereas the administrative cost as well as social psychic cost would not be negligible. The administrative cost is estimated to amount to approximately 10 percent of the yield of the A.W.T.

Before declaring itself in favor of an alternative solution to that of the introduction of an A.W.T. the Committee discusses the advantages which are inherent in the capital transfer tax system.

## C. THREE REASONS WHY A CAPITAL TRANSFER TAX IS SUPERIOR TO AN A.W.T.

According to the Committee a capital transfer tax can be justified on the grounds of (i) social efficiency, (ii) economic effects and (iii) the ease with which the administration can be accomplished.

In this part of the Committee's report the proposed reform begins to take shape. In the first place, the capital transfer tax to be introduced should become an effective instrument to control the factors which govern to a large degree economic inequality. It should also be a means to compensate inequalities inherent in birth. With a view to attaining this goal, it is necessary "to limit to a reasonable extent the amount of wealth which can be transferred to heirs and donees by very rich persons" and "to take into account in a simple and equitable manner the size of families, which is a fundamental factor with respect to the inequality of opportunities" and, finally, "to avoid by suitable exemption measures the taxation of small transfers and to facilitate the transfer of small and medium amounts of wealth..." (Report, p. 178).

A similar reform proposal was actually presented by another Committee — i.e. the Committee on Social Inequalities — whose main concern was "to complete the actions to break up the present structure of primary income distribution by a more efficient and equitable redistribution" (Report of this Committee, p. 54). The Committee Reporter wrote that in order to arrive at this result: "...the capital transfer tax system could be used in two ways to contribute to the reduction of inequalities of wealth between families". The first one was precisely: "... to take into account the resources — of capital and income — of heirs for the computation of [succes-

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20. See "*Attitude of the French towards capital transfers at death*", published in *Sondages — French review of public opinion*, 1970, No. 4, pp. 33-36. This is confirmed by a more recent sample survey in March 1976 by *Sofres* for the newspaper *Le Figaro*.
21. Published in 1977 by the *Presses Universitaires de France*, see p. 197. For further details and more information see the papers presented on "*Wealth accumulation and distribution*", Paris, 5-7, July 1978; more in particular the papers of *Dennis Kessler*: "*Wealth transmissions*" and of *André Masson* and *Dominique Stauss-Kahn*: "*Accumulation, transmission and wealth inequalities in France*".
22. See: "*Generating inequality*", MacMillan Press Ltd., London, 1975, p. 197. As we observed in the first part of this paper, the United States Federal capital transfer tax system was considered by the Committee as an example to follow.

## TABLE VIII

## THE PROS AND CONS OF THE A.W.T.

| | *Arguments in favor of an A.W.T.* | | *Observations of contrary opinions presented by the Committee* |
|---|---|---|---|
| | The A.W.T. is: | | |
| I A | A means to arrive at a higher degree of fiscal equity | I B | Fiscal equity will also be increased by certain improvements of existing taxes so that there is no need to introduce a new tax which would lead to a fundamental change in individual customs and uses and in the relationship between taxpayers and the tax administration |
| II A | A tool for the reduction of inequalities in wealth and consequently also for the reduction of social inequalities | II B | A substantial reduction of inequalities in wealth would require a relatively high tax rate (confiscatory rate). In such a case the taxpayer would not be able to pay the A.W.T. out of his income |
| III A | A means to improve the tax administration's possibilities to check on wealth and incomes | III B | The tax administration generally receives sufficient information regarding taxpayers but lacks the means to make adequate use of them and to check on them, both with respect to their quality and to their credibility |
| IV A | An instrument to compensate for too low tax assessments because of incorrect tax declarations | IV B | In France, the Land Tax (impôt foncier) partially fulfills this function. However, the argument has only a theoretical value since in practice it would be necessary to find a perfect method to estimate income from various sources |
| V A | A means to correct the situation in which non-monetary (psychic) income is not subject to tax | V B | It will only be possible to take a relatively small number of such benefits into account for tax purposes. For instance, the Tax on Improved Real Property (impôt sur le "foncier bâti") can be supplemented by a tax on presumed rentals. Other elements of wealth, like jewelry, would not be so easy to spot and to value, so that the psychic income resulting from their possession would escape taxation |
| VI A | A means to tax capital gains on an accrual basis and thus to supplement taxation of realised capital gains | VI B | Potential capital gains are eventually only temporary. Taxing realised gains is more realistic. Anyway, the A.W.T. should only tax on a permanent basis the increased value, i.e. the newly created ability to pay tax. A capital gains tax has the advantage that it is an ad hoc penalty on speculative gains. |
| VII A | An incentive (i) to dispose of assets which are not sufficiently productive; (ii) to select the best investments; (iii) to increase the mobility of productive assets; and (iv) to use them in an optimal manner | VII B | This implies that everyone acts rationally and always serves his own interest. However, certain decisions are often taken for purely sentimental reasons which show little rationality. There is one risk: an A.W.T. could be an incentive to invest in assets which can easily be hidden from the fisc and it could stimulate a capital flow to foreign countries where capital is treated more favorably. |
| VIII A | An incentive for enterprises to invest in labor rather than in taxed capital | VIII B | This argument is not sufficiently realistic and moreover it is erroneous. It may be true that man and machine are in competition in the short run and at a micro-economic level, however, they supplement each other in the long run and at a macro-economic level |

sion] duties to be paid on every transfer in connection with death (with of course an exemption for a certain minimum amount)". [23]

Secondly, the various negative economic effects which are inherent in an A.W.T. — particularly in the case of taxation of industrial, commercial and agricultural businesses — would not manifest themselves in case of an improved capital transfer tax system. In particular, a succession tax is not shifted to other persons and does not lead to particular payment difficulties. Even if such taxation would present a risk for the survival or development of the business of which the owner — whether he is a sole proprietor or has a majority interest — was the decedent it would be possible, according to the Committee, "to find solutions to such problems connected with the transfer of property which are not economically prejudicial to the financial situation of the heirs or to the economic continuity of enterprises or businesses which the decedent possessed" (Report, p. 179).

The Report indicates that here lies a serious problem for small and medium-sized businesses which needs careful study. Probably the best way to approach this problem is in terms of business economics and not only in fiscal terms. On this matter *J. Boswell* has advocated a tougher inheritance tax system supplemented by financial aid from the government as follows: [24]

> "It is hard to resist the conclusion that the best point at which to secure changes — humanely as well as effectively — is when small firm bosses reach retirement or die. The method would be a combination of tougher inheritance taxation with public action to deal with transitional problems... If a private company sector is to be retained and indeed reinforced by new blood, ... then established wealth should be transferred from old sectors to new uses. Inheritance taxation, rather than taxes on annual wealth or income, is classically the best way of facilitating this. Coupled with other measures, a reduction of inheritance would help to prevent two great sources of waste: the decline of many good firms and the unhealthy survival of many bad ones."

Thirdly, the sole fact that the Legislature could introduce a reform of an existing tax (whose yield is already four times the expected yield of an A.W.T.) would make it possible to maintain if not even to increase fiscal productivity.

Moreover, since one would have to do with an "old" tax it would not be necessary to create new administrative services for the assessment and collection of the tax and the checking of the taxpayers. Thus it is hoped that administrative costs, which are estimated to be 10 percent of the gross yield under an A.W.T., can be reduced to only 2.5 percent as is currently the case for the succession tax.

This need to maintain the productivity of the succession tax at a high level is one of the five goals enunciated by the Committee for the tax reform whose essential elements are described in the next section.

## D. THE STRUCTURE OF THE PROPOSED REFORM AND ITS PURPOSES

In order to understand better the Committee's recommendations with respect to a reform of the capital transfer taxes it is useful to show the relations which exist between the aims and the means of the proposed reform. This is the main purpose of Table IX.

## E. CONCLUSION

The Committee's Report has a threefold merit, i.e.: (i) it proposes new and feasible solutions, (ii) it demonstrates the numerous difficulties which must be solved in order to reconcile various goals set, and (iii) it meets the wishes of President *Giscard d'Estaing*, [25] of the Committee Méraud [26] and of a large number of Frenchmen. Moreover the reform proposals it contains are very courageous. On the one hand, it is common knowledge that it is risky to propose an amendment of French inheritance tax since the French feel strongly about being able to transfer capital. Therefore, this attitude will present a serious handicap for any reform and it will certainly mobilise the taxpayers to oppose the proposals. On the other hand, it is impossible to ignore the fact that to abandon the idea of the introduction of an A.W.T. will be repugnant to those persons who are in favor of this tax. A recent sample survey shows that 60 percent of the French are for the introduction of an A.W.T. and that 47 percent consider the French capital transfer system to be completely unjust. [27]

A great number of amendments and improvements will certainly be presented when the reform proposals are discussed. One can be fairly certain that two very important points will emerge:

(i) it will be argued that the surtax is inequitable in those cases where the inheritor's or donee's wealth stems from his own efforts rather than from donations or inheritances received by him; and

(ii) many persons will object to the principle of taxation on a lifetime cumulative basis as is the case under the British capital transfer tax system.

It is also true that the Report already goes very far by proposing the surtax and the revision of rates and exemptions and that no reform of any part of the French tax system will be easily accepted by the French taxpayers, even if these would only affect a very small category.

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23. See: "*Report of the Committee on 'Social inequalities'* ", La Documentation Française, Paris, 1975, p. 59.
24. See: "*The rise and decline of small firms*", London, G. Allen and Unwin, 1972, pp. 185 et seq.
25. See: "*Démocratie française*", Paris, Fayard, 1976, Chapter VII.
26. See note 23, supra.
27. *Le Nouvel Observateur*, November 30, 1976, pp. 59 et seq.

TABLE IX

| PURPOSES | | MEANS |
|---|---|---|
| 1. The re-establishment of a higher degree of progressivity | TRANSFER IN THE DIRECT LINE<br>Exemption | o Revaluation of the basis of the exemption accorded in 1959 (100,000 Fr.Frs.), taking into account economic development since 1959. Multiplication factors which could be used are:<br>– 3.09 (price increase since 1959); or<br>– 7 (increase of average wealth since 1959)<br>o Regular adjustment of the exemption to take into account monetary development |
| | Rates | o Ranging from 5 to 40 percent<br>o 40 percent rate applicable to gifts and inheritances exceeding 2,000,000 Fr.Frs.<br>o Regular adjustment of brackets to take into account monetary development |
| | Tax credit | o Minimum increase: to take into account price developments from 1952-1978, i.e. multiply the present credit of 2,000 Fr.Frs. by 4;<br>o Maximum increase: multiply the present credit by a multiplication factor higher than 4 in conformity with the Government's wish to increase the birth rate. |
| | OTHER TRANSFERS<br>Exemption | o Increase for brothers and sisters (150,000 Fr.Frs. in 1979)<br>o Increase of the minimum exemption (10,000 Fr.Frs. in 1970) |
| | Rate | o Uniform rate for all persons other than those in the direct line: 30 to 60 percent<br>o 60 percent rate applicable to gifts and inheritances exceeding 2,000,000 Fr.Frs. |
| | General measures | o Reduction of the tax burden for small and medium-sized transfers |
| 2. The reduction of the growth of private wealth through capital transfer | | o Imposition of a surtax which is a function of the wealth of the beneficiaries:<br>– full exemption if the inheritance or gift tax is less than 10,000 Fr.Frs.<br>– deduction allowed on the inheritor's or donee's wealth of 1,000,000 Fr.Frs.<br>– the "standard" inheritance or gift tax is multiplied by a coefficient which ranges from 1 if the inheritor's or donee's wealth is 1,000,000 Fr.Frs. to 1.5 if this wealth exceeds 10,000,000 or 12,000,000 Fr.Frs. |
| 3. The extension of the taxable base to total wealth of decedent, inheritor and donee | | o The inheritance and gift tax should be a function of total wealth of the decedent<br>o The surtax should be a function of total wealth of the inheritor or donee<br>o The existing exemptions and other favored treatment should be either abolished or revised |
| 4. The removal of opportunities to avoid tax | | o Revision of the gift tax system by introducing a degressive reduction of the tax which is a function of the age of the decedent (no reduction being available when the decedent reaches the age of 65)<br>o Taxation of important gifts which are directly handed over to the donee (such as cash amounts)<br>o After death, safe deposit boxes of the decedent should be inspected<br>o Control of any changes of a matrimonial contract<br>o Removal of possibilities to hide certain assets from the fisc |
| 5. The prevention of loss of revenue | | o Revision of the rates and exemptions which are applicable to substantial transfers (inheritances or gifts)<br>o Imposition of a surtax on wealthy inheritors or donees |

## Annual wealth tax and success on duties — A selected bibliography

In the first part of this bibliography, the reader will find the reports in which the problems and proposals concerning the A.W.T. and succession duties are presented in the same manner as in the Ventejol — Blot — Méraud Committee Report; in the second part, the major books and articles on the same subjects are listed. In those instances where only a portion is relevant to the questions treated in this article, the page numbers are indicated in parentheses.


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# ESCAP: Commonwealth Heads of Government Regional Meeting *

One of the efforts to enhance regional trade cooperation in the ESCAP region [1] was initiated by the commonwealth countries situated in the Asia and Pacific region. [2]

The first Commonwealth Heads of Government Regional Meeting was held in Sydney, Australia, from February 13 to 16, 1978.

The Commonwealth Heads of Government Regional Meeting in Sydney was only successful on relatively easy subjects where agreement was reached: cooperation on energy resources, solving problems of small states and fighting terrorism and drug trafficking. The really sticky subject was trade on which the conclusions were somewhat vague. The main economic argument of the meeting centred on protectionism and the ways in which the countries of the Asian and Pacific region could develop trade among themselves. [3]

During the meeting, Prime Minister Lee Kuan Yew of Singapore presented figures to show the insignificant proportion of inter regional trade of the 12 participating countries compared to their world trade. Their export to each other amounted to only 15 percent of their total world exports, while imports from other countries in the region were equally insignificant, apart from the Pacific countries' trade with Australia and New Zealand.

At present some of these nations have almost no trade with most of the 12 participating countries. For instance, India, which was one of the prime architects of the conference and which is to host the next meeting in 1979, sends only 5 percent of its exports to the region, of which half go to Australia and Singapore (See Table).

India provides a market for just under one percent of the region's exports. When Singapore is excluded, the rest of the region absorbs only about three percent of Malaysia's exports. Australia buys about five percent of Singapore's exports and Malaysia 16 percent.

The rest of the region buys only 4 percent. At the end of the meeting the Commonwealth Heads of Government of the Asian and Pacific Region produced a communique. They agreed to set up a Commonwealth Regional Consultative Group on Trade. This group will examine measures to facilitate travel within the region, to improve communications and reduce the cost of inter-regional transportation of goods. The group will also study ways and means of improving trading opportunities for the countries of the region in the major developed-country markets for goods produced by the developing countries in the region. [4]

* Note submitted by Jap Kim Siong.

1. The ESCAP region officially comprises the countries of Afghanistan, Australia, Bangladesh, Bhutan, Brunei, Burma, China, the Cook Islands, Democratic Kampuchea (Cambodia), Fiji, the Gilbert Islands, Hong Kong, India, Indonesia, Iran, Japan, Democratic People's Republic of Korea, Republic of Korea, Lao People's Democratic Republic, Malaysia, Mongolia, Nauru, Nepal, New Zeeland, the Pacific Islands, Pakistan, Papua New Guinea, the Philippines, Samoa, Singapore, Socialist Republic of Viet Nam, the Solomon Islands, Sri Lanka, Thailand and Tonga.
2. See: ASEAN: Recent Development in Trade Preferences and comprehensive Double Taxation Agreements, by Jap Kim Siong, Bulletin for International Fiscal Documentation 1978/4 at 146.
3. *Singapore Economic Bulletin*, March 1978 at page 17: Summary of Key-note Speech by The Prime Minister, Mr. Lee Kuan Yew, On Trade and Development at the Commonwealth Heads of Government Meeting of 12 Asian and Pacific Countries in Sydney (14 February 1978).
4. *Singapore Economic Bulletin*, March 1978 at page 3.

**TABLE**

**Exports to co-ordinate countries as percentage of exports to whole world 1976**

| Exports to | Australia | Bangladesh | Fiji | India | Malaysia | Nauru | New Zealand | Papua New Guinea | Singapore | Sri Lanka | Tonga | Western Samoa | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Exports from | | | | | | | | | | | | | |
| Australia | – | 0.1 | 0.6 | 1.5 | 1.8 | 0.1 | 4.9 | 1.6 | 1.7 | 0.3 | .. | .. | 12.8 |
| Bangladesh | 2.7 | – | .. | 1.8 | 0.2 | .. | 0.6 | 0.1 | 3.4 | 0.2 | .. | .. | 8.9 |
| Fiji | 18.2 | .. | – | .. | 2.7 | 0.1 | 10.2 | 0.4 | 5.0 | .. | 2.3 | 3.3 | 42.2 |
| India | 1.2 | 0.9 | 0.1 | – | 0.9 | .. | 0.4 | .. | 1.0 | 0.5 | .. | .. | 5.0 |
| Malaysia | 2.2 | 0.1 | .. | 0.6 | – | .. | 0.4 | .. | 18.3 | 0.1 | .. | .. | 21.7 |
| Nauru | 40.4 | .. | .. | .. | .. | – | 52.6 | .. | .. | .. | .. | .. | 95.1 |
| New Zealand | 12.2 | 0.1 | 1.3 | .. | 0.9 | .. | – | 0.3 | 1.9 | .. | 0.2 | 0.3 | 17.2 |
| Papua New Guinea | 14.0 | .. | .. | .. | .. | .. | 0.1 | – | 0.1 | .. | .. | .. | 15.4 |
| Singapore | 5.1 | 0.4 | 0.4 | 0.7 | 15.2 | .. | 1.0 | 0.8 | – | 0.2 | .. | .. | 24.0 |
| Sri Lanka | 2.9 | 0.2 | 0.1 | 0.1 | 0.2 | .. | 1.0 | 0.1 | 2.0 | – | .. | .. | 6.7 |
| Tonga | 3.2 | .. | 6.5 | .. | .. | .. | 29.0 | .. | .. | .. | – | .. | 38.7 |
| Western Samoa | 3.8 | .. | 0.4 | .. | .. | .. | 36.5 | .. | .. | .. | .. | – | 40.7 |
| Group Average (1) | | | | | | | | | | | | | 15.4 |
| Averages of Groups (2) | 4.5 | 0.30 | 0.42 | 0.97 | 4.4 | 0.05 | 2.5 | 0.80 | 4.7 | 0.25 | 0.02 | 0.04 | |

(1) The figure of 15.4% represents the proportion of intra-exports to world exports of the group as a whole.

(2) This row shows, at the bottom of each column, the proportion represented by exports to the country at the top of the column by the other countries in the group, compared with world exports of the same countries. Thus the figure of 4.5% at the bottom of the first column represents the share of the world exports, from Banglash through to Western Samoa as listed, going to Australia.

*Source:* Commonwealth Heads of Government Regional Meeting, Asia Research Bulletin, Singapore Part 6, March 31, 1978.

# Tax Changes in Zambia's Budget for 1979

BY A. A. DE SILVA

*The Hon. Minister of Finance proposed various revenue measures in his budget for 1979. Among these measures were changes relating to personal income tax and company tax.*

## Personal income tax

The existing and proposed tax structures are as follows:

| *Existing* | | | *Proposed* | | |
|---|---|---|---|---|---|
| *Taxable income (K)* | | *Rates (%)* | *Taxable income (K)* | | *Rates (%)* |
| First | 500 | 5 | First | 1,000 | 5 |
| Next | 1,500 | 10 | Next | 1,000 | 10 |
| Next | 2,000 | 25 | Next | 2,000 | 20 |
| Next | 2,000 | 35 | Next | 2,000 | 30 |
| Next | 2,000 | 45 | Next | 2,000 | 45 |
| Next | 2,000 | 55 | Next | 2,000 | 55 |
| Next | 2,000 | 65 | Next | 2,000 | 65 |
| | Balance | 75 | | Balance | 70 |

It will be seen that the changes from the existing structure are that the initial rate of 5 percent is now levied on the first K 1,000 of taxable income, the next rate of 10 percent is applied to the next K 1,000 of taxable income instead of to the next K 1,500, the rates applicable to the next two tax brackets of K 2,000 each have been reduced from 25 percent and 35 percent to 20 percent and 30 percent respectively and finally the maximum rate will now be 70 percent as against 75 percent.

The Minister indicated that as a result of the changes an average family of a working man, wife and three children earning K 4,000 per annum will pay K 215 in tax as against K 256 paid at present, a reduction of about 16 percent. Families of the same size earning K 10,000 and K 15,000 per annum will pay income tax reduced by approximately 9 percent and 5 percent respectively.

## Company tax

The rate has been reduced from 50 percent to 48 percent. The concessional rate of tax applicable to companies operating in the rural areas during the first five years of operation has been reduced from 35 percent to 30 percent.

The other changes are the exemption from tax of any profits earned from the export of goods manufactured from domestically produced agricultural raw materials and the system of incentives for manufacturing firms which create new jobs. The latter is in the form of a job credit system under which firms will receive a credit against assessed income tax of K 500 for each net addition to the number of full time employees.

The credit would continue for three years after the net addition so that the total benefit for a firm for each new job created will be a credit against income tax of K 1,500. Newly established companies will be entitled to credits only for new jobs created two years after the commissioning of their production. Non-liable companies which are not liable for a particular year or whose liability is insufficient to absorb the credit available will be allowed a carry over to subsequent tax years subject to a maximum of five years.

Some of the other significant revenue measures proposed are as follows:
(1) *Mineral tax* — The rate on cobalt has been increased from 10 percent to 20 percent.
(2) *Sales tax* — The rate on clothing and footwear has been reduced from 20 percent to 15 percent and the rate on furniture will now be 20 percent as against the previous rate of 30 percent.
(3) *Excise duty* — On beer there is an increase of 5 ngwee per bottle and on petrol and diesel fuel 2 ngwee per litre.
(4) With immediate effect the basic rate of interest on government loans has been raised from 7 percent to 10 percent.
(5) The fee on Government guarantees on loans from domestic or foreign sources has been raised to 2 percent from the existing fee of 1.25 percent. The fee was originally introduced on such loans guaranteed under the Loans and Guarantees (Authorisation) Act. The objectives in increasing the rate are to compensate the Government adequately in the risk taken in guaranteeing loans and to discourage borrowing unless it is absolutely essential.

## Comment

In dealing with the economic conditions which formed the background to the budget the Minister referred, among other matters, to mineral prices. He forecast poor prospects for major improvements in the price of copper which, as is well known, is the most important of the country's minerals. His view was based on the anticipated slow down of economic activity in industrial countries with the resultant depressing effect on the prices of all primary commodities. Even if world consumption of copper exceeded production there are large stocks sufficient to cover the excess. Although a small increase in price levels is expected it is not likely to be much in excess of the general level of inflation. (Since the budget was presented there has been an unexpectedly large increase in the price of copper and the upward trend is expected to continue for some time. Despite this the forecast is that the average increase in the price of copper in 1979 is not likely to be significant.) The prospects for the mining sector have nevertheless brightened as a result of the increasing prices fetched for cobalt. The price of cobalt increased threefold in 1978 from K 10,000 a ton at the beginning of the year to K 35,000 a ton by the end of the year. Production of cobalt is expected to increase rapidly in 1979 and at current price levels the economy as a whole will benefit substantially. The estimated revenue for the year from mineral tax on cobalt is estimated at K 9 million.

It is interesting to go back a few years and examine the role played by copper as a revenue earner. In 1969, 10 years ago, a third of the recurrent expenditure budgeted for was to be funded by mineral royalties and copper export tax. From then on the revenue from copper declined steadily and is not now budgeted for. The changing pattern is best illustrated by the table below which also includes revenue from income tax indicating that income tax has been steadily increasing in importance as a source of revenue.

| *Year* | *Revenue from copper* | *Income tax* |
|---|---|---|
| 1969 | 103 | 98 |
| 1970 | 114 | 122 |
| 1971 | 70 | 166 |
| 1974 | 62 | 144 |
| 1976 | 60 | 180 |
| 1978 | Nil | 200 |
| 1979 | Nil (Cobalt 9) | 216 |

*(The above figures are in millions)*

The other major source of increased revenue has been customs duties. This source is bound to play a less important role in future years in view of the policy of drastically reducing imports as a result of the severe shortage of foreign exchange. It is inevitable therefore that the much needed revenue has to be obtained in future from income tax. In presenting his budget in 1976 the then Minister of Finance stated: "I have referred to the need for the Government to raise more revenue in order to continue providing essential services to the people. It is necessary on this account to increase some taxes in order to raise the revenue required. Greater emphasis will have to be placed on income tax in the future."

A feature of the revenue pattern in Zambia is the relatively high proportion of income tax recovered from companies which together with the tax recovered under the PAYE scheme forms the bulk of the revenue from income tax. In 1969 of the K 98 million from income tax, K 68 million was from companies. In 1970 and 1971 income tax from companies amounted to K 91 million and K 129 million out of total income tax of K 122 million and K 166 million respectively. The pattern has not changed since and the burden of taxation has by and large fallen very lightly on the non-company business sector. This of course militates strongly against equity and justice in taxation and is also a contributory factor to the high rates of taxation.

It is against this background that one must view the budget proposals of 1979 in relation to income tax which in the Minister's words are "minor amendments to the tax structure". These amendments will result in an estimated total loss of about K 5.5 million and the total yield from income tax estimated at K 216 million is only marginally above the figure of K 200 million for 1978.

The changes in relation to personal income tax have been introduced with a view to relieving the burden cast on fixed income earners whose incomes have not risen in proportion to the increase in the cost of living and who have to part with a substantial part of whatever increases they get in their earnings in the form of higher taxation in the absence of adjustments to the tax rates. Another factor which influenced the Minister in introducing the changes, especially the reduction in the maximum rate, was the discouraging effect of high taxation on top managers and professional men. The extent of such a discouraging effect is dubious.

The reduction in the rate of company tax is intended to improve the liquidity position of companies and encourage investment as a means of stimulating production. The consequent saving in tax in the case of the larger companies would be substantial and should go a long way towards achieving the Minister's objective. The reduction of the concessional rate of tax applicable to companies operating in the rural areas in order to encourage more companies to invest in these areas is a positive step. This coupled with the incentives provided by the Industrial Development Act of 1977 to companies carrying on manufacturing enterprises in the rural areas, such as the eligibility for loans from the Development Bank of Zambia, should make investment in the rural areas more attractive and profitable. It is gratifying that the government has recognised the need for encouraging large scale investment in the rural areas as part of its rural development policy.

## Taxation in Zambia

The pre-Budget rates of the main taxes existing in Zambia are shown below:

*Individual income tax:*
5-75 percent (on income exceeding K12,000)

*Company income tax:*
50 percent

*Mineral tax:*
Rates vary viz: 51 percent on copper, 20 percent on lead and zinc, 15 percent on amethyst and beryl and 10 percent on gold, cobalt, silver, nickel, uranium and a number of other minerals.

*Selective employment tax:*
20 percent on the salary bills of employers of non-Zambians.

For further details of Zambian taxation see African Tax Systems (section B), a loose-leaf publication of the International Bureau of Fiscal Documentation.

The other proposals are the exemption from income tax of the profits earned from the export of goods made from domestically produced raw materials and the job credit system. The former is a move in the right direction but could encounter serious difficulties from an administrative point of view. The Department of Taxes will have to equip itself to ascertain whether the necessary conditions, such as that the products have in fact been made from domestic raw materials, are satisfied. Again the computation of the amount of profits attributable to such exports may prove complicated and the basis of computation will have to be worked out carefully. The job credit system is theoretically a real incentive and a departure from the traditional pattern. However the need for an increase in jobs arises only in the context of an expanding economy and the budget, viewed as a whole, in particular the reduction in government expenditure, does not hold out the prospect of an expanding economy.

On an overall assessment the amendments proposed by the Minister are commendable and welcome. But they have not been supported by administrative measures to ensure greater compliance. The collectible income tax arrears are substantial and are in fact about a third of the average total annual tax yield. If the reduction in tax had been accompanied by a greater administrative effort there would have been a revenue gain.

In the present context of the serious economic problems facing Zambia income tax must necessarily play an increasingly important role. Many countries which have thrown off the colonial yoke have resorted, in addition to income tax, to related taxes such as wealth and capital gains taxes not only as measures to generate much needed funds for economic development but also as instruments to effect sometimes radical social change. Up to now Zambia has not resorted to these measures but may have to very soon depend on this type of economic tool in its march towards the goal of socialism. With these in mind the government should give priority to a thorough examination of the existing tax structure and introduction of remedial and progressive measures in several areas in which the need for such measures is evident.

# TAX GLOSSARY

by H.W.T. PEPPER *

## L

**LAND TAX** — A tax based on the capital or annual (or rental) value of the land normally exclusive of any improvements. In Britain it is an ancient land tax, which originated in 1692 as a war tax charged initially at 20% of the annual value of land, but which also contained provisions whereby the tax could be "commuted", i.e. got rid of for a single once-for-all payment. This was finally abolished in 1963, having long survived early complaints that it discriminated against land owners in favour of merchants. (See also COMMUTATION OF TAX, LOCAL RATES AND TAXES, PROPERTY TAX.)

**LAND VALUES TAX** — A capital levy proposed in Britain by Lloyd George in 1909/1910 but not, in the end, actually imposed.

**LATE FILING PENALTIES** — Most countries have penalties for the neglect to render a tax declaration or return form by a statutory time limit, subject to a period of grace in the event of exceptional circumstances such as ill health or the absence of the taxpayer from his ordinary place of business or residence during the relevant period. In some countries, penalties are routinely imposed where the declaration is submitted after the time limit has expired (in the absence of special considerations) and penalties are almost always imposed where the date of rendering or filing the form has a direct bearing on the date of payment of the tax.

**LATE PAYMENT PENALTIES** — For reasons of tax equality or neutrality, tax legislation may contain provisions charging interest or penalties on late payment. Such provisions are necessary to deter the wilier taxpayers from using devices, such as appeals procedures, for delaying payment, or taking advantage of grace periods, or the time it takes to generate legal recovery processes, and then paying at the last possible moment. It is also desirable, however, to include some discretionary powers in legal provisions, so that where there is genuine hardship, instalment payments may be arranged without adding the burden of a penalty. (See also INTEREST ON UNPAID TAX.)

**LATIN AMERICAN FREE TRADE AREA (L.A.F.T.A.)** — An association of Latin American states (Argentina, Bolivia, Brazil, Chile, Columbia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela) formed with the general objective of removing tax barriers to trade between the members and broadly similar to other groupings such as the EUROPEAN ECONOMIC COMMUNITY (q.v.), COMECON (Council for Mutual Economic Assistance, a grouping of Bulgaria, Czechoslovakia, East Germany, Hungary, Outer Mongolia, Poland, Romania, and the USSR), EFTA (European Free Trade Association, of Austria, Finland, Norway, Portugal, Sweden, and Switzerland), CACM (Central American Common Market, of Costa Rica, Guatemala, El Salvador, Honduras, and Nicaragua), EAEC (East African Economic Community, a union of African countries, which presently includes Burundi, Ethiopia, Kenya, Malagasy, Malawi, Mauritius, Rwanda, Somalia, Tanzania, Uganda, and Zambia, with other countries possibly being included later).

**LEARNED SOCIETIES** — It is usual in tax legislation (a) to exempt from tax the income of learned societies which are non-profit-making and formed to encourage research and to regulate and preserve the ethics of particular professions, and (b) to authorise tax deductions in respect of membership fees payable by members of professions who exercise their skills in the course of earning their livings and who are usually compelled to maintain membership as a condition of being allowed to use those skills.

**LEASE** — See LEASE, LONG.

**LEASE-BACK** — (of LAND, ETC.) A business which owns real property (land, buildings, etc.) — or other assets — employed in its trade may decide that the capital represented by ownership would be better deployed in other business assets, and accordingly sell the property and lease it back from its new owner, the lease rent being deductible in computing the business profits. Such operations have, however, been used for tax avoidance purposes, e.g. by selling property or a relatively long lease thereon, to achieve a capital gain, and then leasing back on a shorter term at a high initial rent so as to obtain an artificially high current deduction for rent in computing profits. Legislation, e.g. in the U.K., of a fairly complex kind has been introduced to counter such devices, partly by taxing as income some of the sums received as "capital" on sale. (See also TADPOLE LEASES.)

**LEASE, LONG** — Because of the tax avoidance possibilities arising from the granting of leases for relatively short terms, regulatory legislation (see LEASE-BACK) defines what is a "long" lease, which will be outside the scope of the law. In the U.K. a lease of over 50 years avoids an income tax charge on any premium charged on the lease, and a lease of 50 years or more is not regarded as a WASTING ASSET (q.v.), while for the purpose of DEVELOPMENT LAND TAX, a long lease is one which exceeds 35 years at the time MATERIAL DEVELOPMENT (q.v.) is begun.

**LEASE, PREMIUM ON** — See PREMIUM ON LEASE.

**LEASE, SHORT** — May be defined as a lease which is not a LONG LEASE (q.v.).

**LEASING IMMOBILIER** — (Belgium, France) Hire-purchase of real property, also known as CREDIT BAIL.

**LEGACY DUTY** — A tax on bequests by way of legacy made in the will of a deceased person. The duty is usually related to the circumstances of the beneficiary rather than of the testator and may be levied in addition to estate duty on the total estate of the deceased. Legacy duty was imposed in Britain in 1780 on certain types of bequest and was abolished in 1949. (See also ESTATE DUTY, SUCCESSION DUTY.)

**LEISURE TAXES** — The term sometimes applied to taxes on entertainment and leisure activities, which can be defended in principle as taxes on "luxuries" rather than necessities. Items falling within the scope of leisure include ADMISSION and ENTERTAINMENT taxes on cinemas,

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

theatres, circuses, etc., TELEVISION ADVERTISING DUTY, taxes on hunting in the U.S.A. and Japan. There is usually a bias in favour of participation sports, and amateur as against professional sports, and also in favour of "live" theatre as against "canned" entertainment such as films, records, tapes, etc., which can be projected or played without the participation of performers. (See also GAMING DUTY.)

**LESS DEVELOPED COUNTRIES (LDCs)** — The distinction between developing countries and industrialised nations is to some extent recognised in tax legislation. Within CARIFTA (Caribbean Free Trade Area), for example, the larger countries (Barbados, Guyana, Jamaica, Trinidad) are labelled the MDCs (More Developed Countries) and the others the LDCs (Less Developed Countries) and in double taxation treaties between the members the MDCs allow more favourable treatment to the LDCs. Similarly, some of the industrialised countries have reduced their customs duties in favour of the goods exported to them by LDCs.

**LETTER BOX COMPANY** — A company registered in a TAX HAVEN, where it is usually free of income tax, and managed elsewhere. Also known as BRASS PLATE COMPANY. (See OFFSHORE COMPANY.)

**LEVY, EXCESS PROFITS** — See EXCESS PROFITS LEVY.

**LEVY, LOAN** — The principle of a loan levy is to take out of circulation money which might have been spent on consumption, particularly at a time of inflationary pressures, not by way of tax but by way of a loan which is to be refunded at a specified date. Examples of such levies have been the POST WAR CREDITS and POST WAR REFUNDS (q.v.) in Britain which were made in war time and the loan levies which have been made in South Africa and Israel in recent decades. In each of these examples the "loan" has been calculated as a percentage of the income tax payable, in the form of a supplementary, refundable, tax, but although the system still has potentialities there have been comparatively few examples of its use. (See also BUSINESS CYCLE EQUALISATION RESERVE.)

**LICENCE DUTIES AND TAXES** — Licence duties and taxes may take the form merely of a registration charge or fee for the privilege of carrying on a certain trade or profession, the charge made being more or less the amount required to defray the administrative cost of supervising or controlling the particular economic activity of the licensee. In some cases, however, the duty or tax is a source of revenue and substantial levies are often made on an activity such as the sale of liquor or tobacco, the running of a casino, and the provision of certain types of entertainment, particularly night clubs and cabarets. (See also LICENCE, TRADE, DEPRIVATION OF.)

**LICENCE FEES, RADIO** — Radio licence fees, usually a small annual charge, have been collected in some countries where the Sate supplies radio programmes for public enjoyment. With the invention of pocket-sized transistor radio sets the system has become increasingly difficult to operate, and the emphasis, with the coming of television, has passed to TELEVISION LICENCE FEES (q.v.). Some countries have instead made a once-for-all levy on the purchase of a new radio set, which may be collected, with less trouble, from dealers; elsewhere commercial advertisements on radio have provided revenue where programmes have been provided commercially, and taxes on such advertising have provided Government revenue where Government has remained involved in the provision of programmes. (See also TELEVISION ADVERTISEMENT LEVY.)

**LICENCE FEES, TELEVISION** — See TELEVISION LICENCE FEES.

**LICENCE, TRADE, DEPRIVATION OF** — The sanction of terminating a traders's licence is sometimes used as an extreme measure in the case of wilful neglect to pay tax, or in cases of serious tax evasion. The justification may be that where a trader, by virtue of his trade, is responsible, for example, for charging sales taxes on his turnover which is borne by consumers, and is responsible for paying these over to the tax department such that he has a form of "trustee" status on behalf of the government, the point may be reached where it is no longer justifiable to allow him to continue to hold this privilege.

**LIFE INSURANCE (ASSURANCE) RELIEF** — Although life assurance policies which provide for a lump sum "endownment" for the holder in return for his premiums, payable over a term of years, are merely one of a number of ways in which the "small man" may save for the future (see, e.g. S.A.Y.E.), it has long been customary in some countries, notably the U.K., to favour the saver with tax relief on his premiums. The typical policy assures a lump sum payment on death, if this occurs before the endownment term is completed; to prevent tax avoidance schemes, there are often restrictions on relief, by limiting the percentage premiums bear to the capital sum assured — e.g. to 15% — and the allowable premiums to a proportion of income for the tax year — typically the premiums are not to exceed 1/6 total income. The special treatment was justified in a Royal Commission on Taxation in the U.K. in 1920, which stressed that life insurance was the only manner of saving which assured a relatively large capital sum to the saver, in the event of untimely death, from the instant that the saving scheme commenced.

**LIFE INTEREST** — Assets may be given, or bequeathed, to one person for his or her lifetime use or benefit, with the stipulation that after that person's (the life tenant's) life time, the asset shall pass to another beneficiary. A typical transaction would be that of a man bequeathing his house to his widow to live in for the rest of her life (but with no power to dispose of it), the house to pass to his son on the death of the widow. In tax terms it is usual for less tax (or none at all) to be levied on the first transfer, but tax usually arises when the son inherits.

**L.I.F.O.** — The method ("Last In First Out") of valuing stock in trade or inventory whereby the supplies last purchased are regarded as those which are first sold. This system is more rarely used than the alternative system of F.I.F.O. (First in First Out).

**LIGHT DUES** — A levy made on shipping for the maintenance of light-houses and light-ships. In Britain such dues are collected by the Customs and Excise department on behalf of Trinity House.

**LIQUIDATION** — It is usual in corporation tax law to have special provision for the case where a company ceases to trade or goes into liquidation having undistributed income which would have been taxable on the shareholders, etc. if it had been distributed during the lifetime of the company. Such accumulations are usually "apportioned" to or deemed to have been distributed to the shareholder for the purpose of calculation tax.

**LIZENZGEBUEHREN** — (Germany) Patent royalties.

**LOAN LEVY** — See LEVY, LOAN.

**LOCAL AUTHORITY, EXEMPTION, TAXING POWERS** — it is usual for local authorities (states, provinces, counties, prefectures, cities, municipalities, etc.) to be exempted from taxes imposed by the Central, or Federal, Authority and also to be granted some taxing powers of their own (one reason for the latter being the desire of the Central authority not to monopolise the unpopularity that comes from the levying of taxes!). Where similar taxes are collected by authorities at different levels there may be scope for joint assessment and collection — as practised with income tax at national and local level in Sweden and with sales taxes in California, and New York. (See also REVENUE SHARING, LOCAL RATES AND TAXES.)

**LOCAL RATES AND TAXES** — Where in a country there is a central or federal government with separate levels of government at state, provincial, county or city levels, each level of government may have taxing powers. Taxes levied at the lower levels of government are commonly referred to as "local" taxes and most commonly include taxes on real property (or local "rates"), registration and licensing dues, but may also include sales taxes and, more exceptionally, income taxes. (See also RATES.)

**LOCATION OF ASSETS** — The location of an asset is relevant to the determination of whether it is within a taxing authority's jurisdiction. It is increasingly common to lay down rules on location in the tax legislation. For example, capital gains tax in the U.K. does not apply to a resident there if he is not domiciled there and the asset is located overseas. A shareholding in a limited company which gives rise to a capital gain would be regarded as an overseas asset if it were registered in a foreign share register. If there are no location or situs rules in the tax law, the general law applies; in the U.K. the common law applies in the case of CAPITAL TRANSFER TAX. (See also SOURCE RULE, re DOUBLE TAXATION TREATIES.)

**"LOCKED-IN"** — This term is used to refer to the situation where there is a capital gains tax and values have risen sharply so that substantial tax would be payable in the event of realisation of assets which have thus appreciated. Sometimes special tax relief is granted for a period to "unfreeze" the market, e.g. in land, where development is being hampered. Such action was taken, for example, in the U.S. in 1921 when the rate of tax on long-term gains was reduced to a flat 12½% of such "bunched" gains.

Where capital gains tax is not payable on the assets of a deceased person, i.e. where transmission on death is *not* regarded as a disposal for capital gains tax purposes, there may be a similar "locked-in" effect in that elderly persons may be unwilling to sell assets, particularly land which is ripe for development, so as to avoid capital gains tax which will be followed by death duties when they die.

**LOCOMOTION TAXES** — Taxes which were imposed in Britain at various times during the 19th century on certain forms of transport, e.g. coaches and horses, canals, and passengers in steamboats and railway trains. In the U.S., more recently, a 10% federal excise tax has been charged on transportation within the country.

**LODGERS, RETURN OF** — Taxation authorities usually maintain or have access to registers of those owning and occupying land and houses and can check whether those registered are also paying income or other taxes. No such check is available on those who neither own, nor occupy as tenants, real property, but instead live in hotels, pensions, boarding or lodging-houses. Some tax authorities, therefore, call for returns from such establishments of those who reside therein, other than for brief sojourns as transients.

**LONG LEASE** — See LEASE, LONG.

**LONG-TERM GAINS TAX** — A capital gains tax which applies only to gains where the realisation of the asset takes place after the lapse of a certain minimum period of time. Where the disposal takes place within the minimum period the surplus may be deemed to be income for income tax purposes, or taxed as a short-term gain at a rate higher than that applied to long-term gains. (See also CAPITAL GAINS TAX, SHORT-TERM GAINS TAX.)

**LOONBELASTING** — (Holland) Wage tax.

**LOSS, CASUALTY** — See CASUALTY LOSS.

**LOSS OF OFFICE OR EMPLOYMENT** — Where a director or employee loses his office or employment unexpectedly, e.g. on a "take-over" by one company of another, money may be paid to him in compensation. Such payments were traditionally regarded as not subject to income taxation. The exemption, however, led to proliferation of schemes of tax avoidance and thence to the passing of anti-avoidance laws. In the U.K., e.g., a ceiling is placed on the amount of compensation regarded as tax-free. (See also REDUNDANCY PAYMENTS.)

**LOSS RELIEF** — It is common for income tax laws to provide for relief for loss in a trade or profession, either by carrying forward the loss to offset it against profits made from the same source in subsequent years or to offset the loss against other income of the same taxpayer in the year in which the loss has been incurred. In some countries, e.g. Britain, the carry-forward is indefinite, in others losses may only be carried forward for a fixed period of years. (See also HOBBY FARMING and TAX-LOSS COMPANIES.) A refinement which is not so widely adopted is the provision, on the cessation of a business, for losses of the final year to be carried back for a year or two against previous profits. Although such relief is equitable (e.g. the U.S. allows losses to be carried forward for 5 years and back for 3 years, Japan allows 5 years forward and 1 year back), there is a budgetary cash flow drawback in that in a year of economic depression, not only will there be a decrease in current revenue from taxes on incomes, but the revenue fall will be exacerbated by refunds having to be made of previous years' taxes. (See also NET OPERATING LOSS.)

**LOTTERIES FOR CONSUMERS** — Some countries (e.g. Brazil, Chile) encourage consumers to demand receipts for their purchases from traders in order to compel the trader to keep fuller records of his transactions with the general idea that the result will be better tax compliance. The incentive to the consumer is that the receipts may be brought to a government office and exchanged for lottery tickets of a value proportionate to the receipts handed in, the lottery prizes being paid for out of government revenues. The receipts may then be "processed" by the tax department, which may make spot checks of selected receipts to ensure that the trader concerned has a record of the transaction in the books upon which his tax returns for sales tax and income tax are based.

**LOTTERY PRIZE TAX** — See LOTTERY TAX.

**LOTTERY TAX** — Taxation on lotteries is generally an ad valorem levy on the price of the tickets sold, or the amounts staked by punters (see also POOLS TAX). The alternative form of taxing lotteries is to levy a tax (sometimes at graduated rates) on the actual prizes. On the general grounds that all forms of betting are luxuries whether the punter wins or loses, a tax on the gross amounts wagered is preferable. Some countries combine a (sales) tax on the total sums wagered with income taxes or gains taxes on the prizewinners. Where a lottery is State-run the profit on the operation is a form of tax on the ticket buyers. (See also PARI-MUTUEL, TOTALISATOR.)

[to be continued]

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Guide explaining the Australian income tax law as of December 31, 1977. More detailed comment is contained in Australian Income Tax Law and Practice. (B. 101.089)

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### NIGERIAN TAX HANDBOOK 1978

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### BUDGET SPEECH 1979

Ronnie de Mel, Minister of Finance & Planning, November 15, 1978. Colombo, Government Printer, 1978. 58 pp.
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## SWITZERLAND

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## UNITED KINGDOM

### PINSON ON REVENUE LAW

Comprising income tax; capital gains tax; development land tax; corporation tax; capital transfer tax; value added tax; stamp duties; tax planning. By Barry Pinson. With sections on value added tax and development land tax by John Gardiner. Twelfth edition. London, Sweet & Maxwell, 1978. 647 pp., £ 18.—.
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### ROWLAND'S GUIDE TO THE TAXES ACTS & CTT

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Supplementary guide to Butterworth's Yellow and Orange Tax Handbooks which reproduce the actual legislation currently in force. This guide provides a practical explanation of the actual legislation. It includes a brief explanation of the Income Tax Acts, Corporation Tax Acts, Taxes Management Act 1970, Capital Gains Tax enactments, Development Land Tax enactments. References are made to Simon's Taxes, Foster Capital Taxes Encyclopaedia and the Land Development Encyclopaedia. (B. 101.680)

### THE THEORY AND PRACTICE OF INCOME TAX

By Richard A. Toby. London, Sweet & Maxwell, 1978. 210 pp.
Study describing from a socio-economic standpoint the principles and practice of income taxation as it has developed in the United Kingdom, with additional references to former British overseas territories. (B. 101.656)

### TOLLEY'S CAPITAL GAINS TAX 1978-79

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A Comprehensive detailed guide to capital gains tax including the 1978 Finance Act and relevant case law to November 30, 1978. (B. 101.681)

## U.S.A.

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### DOMESTIC INTERNATIONAL SALES CORPORATIONS

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### THE POLITICS OF RAISING STATE AND LOCAL REVENUE

By Richard D. Bingham, Brett W. Hawkins and Ted F. Hebert. New York, Praeger Publishers, 1978. 220 pp.
Collection of studies on taxation and the distribution of governmental, state and local revenues. (B. 101.684)

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# CUMULATIVE INDEX 1979 ~ Nos.1-4

# Conference Diary

## JUNE 1979

*The Taxation Institute of Australia:* First International Convention (including Fundamental Concept in Double Taxation Treaties, Guide to Estate Planning Far East locations), Hong Kong, June 10-16 (English).

*Management Centre Europe:* International Tax Management, Brussels (Belgium), June 21-22 (English).

*Marchmont Conferences:* Third International Tax Planning Conference, Washington D.C. (U.S.A.), June 27-29 (English).

## AUGUST 1979

*9th Congress of the Latin American Institute of Tax Law:* (a) Joint Ventures; (b) Bonded Warehouses, Free Ports and Free Zones, Asunción (Paraguay), August 20-24 (Portuguese, Spanish).

## SEPTEMBER 1979

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including Tax in international operations), Brussels (Belgium), September 3-5 (English).

*33rd Annual Congress of I.F.A.:* I. The taxation of transfers of family-held enterprises on death and inter-vivos; II. The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities. For the seminars the following subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark), September 3-7 (English, French, German, Spanish).

*Management Centre Europe:* International Tax Management, Copenhagen (Denmark), September 24-25 (English).

## FEBRUARY 1980

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

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asociación Paraguaya de Estudios Administrativos y Fiscales, Yegros No. 837, Asunción (Paraguay).

Business Perspectives, 11 Alexander Place, London, SW 7 2 SG (U.K.).

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

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

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

Marchmont Conferences, Vogue House, 1 Hanover Square, London W1R 9RD (U.K.).

The Taxation Institute of Australia, 19th Floor, C.A.G.A. Building, 8 Bent Street, Sydney, 2000, Australia.

# Contents

of the June 1979 issue

**In next issues:**

Recent theoretical developments in public finance
— by *Nizar Jetha*

Tax considerations for investment and business decisions in Nigeria
— by *A.C. Ezejelue*

Taxation and savings: some new empirical evidence in the Indian economy
— by *N.R. Vasudeva Murthi*

Integration of corporate and individual income taxes
— by *James R. Haney*

International and comparative aspects of corporate/shareholder integration
— by *Richard T. Esam*

General problems of intercompany transactions across the border
— by *Dr. Franz Helbich*

# Customs Valuation Principles and Practices

By Luc de Wulf*

*An adequate and uniform customs valuation system facilitates the analysis of national trade policy and international trade negotiations and fosters the interest of the trading community. This paper discusses in non-mathematical terms the need for generally accepted and uniform customs valuation principles and practices and briefly traces the international attempts for more standardized customs valuation procedures. The implications of differences in customs valuation practices on the value and comparability of international trade statistics are also briefly traced.*

## 1. NEED FOR AND BASIC REQUIREMENTS OF AN ADEQUATE VALUATION SYSTEM

Customs valuation practices and customs duties are to some extent interchangeable policy instruments in that several fiscal and trade objectives can be achieved through the manipulation of either one or both. For example, given the tariff structure, it is possible to alter the applicable valuation system so as to obtain higher import tax bases as well as higher revenues. Alternatively, these results can be obtained by changing the tariff schedule without altering the valuation system. However, the analysis of trade policy and its instruments is vastly complicated when both valuation principles and tariffs are used to foster particular objectives. Continued adherence to a theoretically sound valuation principle, along with the use of tariffs as trade policy instruments, presents analytical advantages that would permit a better trade policy.

Tariffs are comparable across countries. Differences in valuation systems, on the other hand, are more difficult to assess internationally. Such differences belong to the non-tariff trade barriers that complicate international trade negotiations. The manipulation of these valuation systems may sometimes nullify the effect of tariff concessions. Hence, an effective and universally adhered to valuation system would be highly advantageous.

Historically, each country has developed a customs valuation system of its own, in part to implement its national objectives. These systems took into account the interests of importers and of producers of products that compete with imports, as well as the capabilities of the customs administration, but they did not consider the interest of the foreign exporter, to whose business the great diversity and arbitrariness of valuation systems often cause an effective hindrance. This fact, together with the emergence of multinational enterprises with large intra-firm trade which presents special valuation problems, led to international efforts to foster the adoption of adequate and uniform valuation principles and practices.

A desirable valuation system would be based on the full economic value of the imported good and would be neutral vis-à-vis specific policy objectives. The concept of full customs value of imports will become clearer later in this article; for the moment it is sufficient to state that it includes both the cost of production and the cost of transportation to the importing country. This principle rules out f.o.b. valuation and administrative or minimum values. An adequate valuation system must also value the imports as if they were traded between unrelated parties (i.e. on the basis of open market prices). Sometimes adjustments must be made to the invoice price to arrive at open market prices. However, regulation should prevent arbitrary decisions on the part of the customs administration.

The choice of a c.i.f. valuation base has sometimes been challenged because it discriminates against the distant suppliers who incur larger insurance and freight costs than nearby suppliers.[1] This criticism seems to imply that global resource allocation would be improved if the production costs of various suppliers were equalized. However, this approach fails to recognize that efficient resource allocation among trade partners does not require the equalization of production costs, but it does require the equalization at the margin of the total amount of resources used to supply the importer's market. In fact, allocative efficiency requires c.i.f. valuation because, under the broadly valid assumption that like products sell for about the same price in the country of importation, the c.i.f. value base results in an equal tariff-price relation for all products irrespective of their origin. This guarantees that the directions of trade that would have existed in the absence of tariffs are not affected by the c.i.f. valuation. In addition, the protection policy of an importing country is also better served through c.i.f. customs valuation because this practice guarantees domestic producers the desired nominal protection, irrespective of the origin of the

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* The author is presently employed by the International Monetary Fund. The views expressed here do not necessarily represent those of his employer. Thanks go to Mr. Adrian Goorman, with whom I discussed many aspects of customs valuation.

1. For example, R.K. Pandey, Customs Valuation Systems (Indian Institute of Foreign Trade, New Delhi, 1970), p. 3.

product. From an administrative point of view, however, c.i.f. valuation has no particular advantage over f.o.b. valuation.

An important requirement of an adequate valuation system is its overall ease of administration. This aspect is important when it is recognized that a valuation system that does not meet some of the above-mentioned criteria may well achieve more adequate overall results than a fully adequate system if its implementation is beyond the capabilities of the customs administration. The administration of an adequate valuation system requires customs officers to be able to see the need for valuation inquiries and to request and use all the data needed to valuate the imports. This often requires the investigation of trade between related parties and may require post-clearance inspection, which depends in part for its success on the quality of the bookkeeping of the importer. Where demands for an adequate valuation system exceed local capabilities, the valuation principles and practices must be adjusted accordingly.

The next section presents the valuation principles that are binding on members of the General Agreement on Tariffs and Trade (GATT), the Brussels Definition of Value to be implemented by the countries that accede to that valuation convention, and the valuation principles applied by the United States, Mexico, and Brazil and the valuation system adhered to by Australia prior to its recent adoption of the Brussels Definition of Value. [2] A final section of this article provides an evaluation of these systems in light of the requirements spelled out above.

## 2. VALUATION PRINCIPLES

### a. The General Agreement on Tariffs and Trade (GATT)

In 1929 and 1930 the Economic Conference of the League of Nations addressed the problem of the use of multiple customs valuation standards. Although the participating countries agreed in principle on the need for action, none resulted. In 1947, when these issues were brought up again by the Contracting Parties to the General Agreement on Tariff and Trade (GATT), an agreement in principle was reached. The GATT Articles pertaining to customs valuation are included in Part II of the Agreement; they are now provisionally applied by about 80 GATT members and more than a dozen additional countries who apply the GATT rules *de facto*. The GATT Articles set forth broad principles that the member countries undertake to observe in their customs laws and administration. The pertinent Articles of the GATT contain the following commitment: (a) not to alter the method of determining the dutiable value so as to decrease any concession provided under the GATT; (b) to adhere to and administer uniformly a stable and published valuation method so as to enable importers to estimate, with a reasonable degree of certainty, the dutiable value of their goods; (c) to base the dutiable value on actual value, not on the value of merchandise of national origin or on arbitrary or fictitious value; (d) to define "actual value" as the price at which such or like merchandise is offered for sale in the ordinary course of trade under "fully competitive conditions"; [3] (e) in the absence of "actual value" to base the dutiable value on the nearest ascertainable equivalent of such value; (f) to use the exchange rates published by the IMF when prices expressed in foreign currencies are to be converted in domestic currencies.

### b. The Brussels Definition of Value

The GATT rules, however, do not set forth the elements of a complete valuation standard. Therefore, the European Customs Union Study Group, established in 1947, prepared its own valuation principles, which were to be consistent with those of the GATT that had just been agreed upon. In 1950, the resulting norms were agreed upon. At the same time, the Customs Cooperation Council (CCC) was established to supervise the implementation of these principles. Countries applying what became known as the Brussels Definition of Value (BDV) are estimated to account for 60 percent of 1976 world imports. [4] They include most Western European countries, Japan, many African countries, and most Latin American countries. The United States, Canada, and most Asian countries use different valuation principles.

The BDV is a notional standard in that the dutiable value of a product is the price at which goods would be sold under specific conditions. [5] As such it permits the customs officials to adjust the declared value of the product so as to conform to the standard, an adjustment for which alternative valuation criteria are available. The BDV states that:

> "For the purpose of levying ad valorem duties of customs the value of any goods imported for home

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2. Mexico and Brazil are undertaking the necessary studies to incorporate the Brussels Definition of Value in their legislation (Latin American Free Trade Association, *Newsletter* No. 36, May-June 1976, p. 2).
3. The use of "fully competitive conditions" was not intended to refer to the specific market structure of free competition. The authors of these regulations intended to refer to "open market prices", which are prices between unrelated parties. Such prices do not depend on the particular market structure.
4. In 1976, 80 countries were members of the Customs Co-operation Council, 30 of which were contracting parties to the Valuation Convention. In addition, some 65 countries are known to have valuation systems based on the BDV (Customs Cooperation Council, *The Activities of the Council*, Bulletin No. 21 (Brussels, 1976).
5. This "notional" standard contrasts with the "positive" standard according to which goods are to be valued in terms of the price at which goods *are* sold under specified conditions. The notional standard raises problems when imported goods are consigned for sale or imported on hire, when goods are sold between affiliates, in which case the price of like merchandise (which may not exist) must be used, and when fictitious invoice prices are used, in which case inquiries into the cost of production of these products is necessary. These problems arise from the fact that the positive notion calls for the ascertainment of that price as a question of fact, so that no other price or consideration is relevant to it (Customs Cooperations Council, *Explanatory Notes to the Brussels Definition of Value* (Brussels, 1971), pp. 16-18). In 1970 a positive standard was reportedly used in India, Libya, Iran, and Maldives (R.K. Pandey, *Customs Valuation Systems* (Indian Institute of Foreign Trade, New Delhi, 1970)). The U.S. valuation system is also basically positive.

use shall be taken to be the normal price, that is to say, the price which they would fetch at the time when the duty becomes payable on a sale in the open market between a buyer and a seller independent of each other." [6]

A brief discussion of the basic elements of this definition brings forth its salient features, as noted below.

*Time:* Goods are to be valued when they enter the country of importation. However, recognizing that there usually is some time between the placing of the order and the time of importation and that some goods are traded under forward contracts, a degree of tolerance is accorded in respect of this time element.

*Place:* Goods are valued on the assumption that all costs, charges, and expenses incidental to the sale and delivery to the place of introduction into the country of importation are included. This definition corresponds to the c.i.f. value. [7]

*Quantity and level of transaction:* The value of the imported product is the one that pertains to the quantity of the goods to be valued at the level (wholesale or other) at which that transaction is effected. Hence, quantity discounts and/or wholesale discounts reduce the dutiable value of the import.

*Open market conditions:* Dutiable value must be an open market price. An open market price presupposes that: (a) the price is the sole consideration; (b) the price is not influenced by any commercial, financial, or other special relationship between the buyer and the seller; and (c) no part of the proceeds of any subsequent resale or use of the goods will accrue to the seller or any person associated in business with him. In 1965, in response to traders who criticized this definition as being open to interpretation, the CCC recommended that if the transaction price is considerably lower than the price at which identical or similar products are available to other buyers, such price must be "uplifted" to obtain the dutiable or normal price. Such uplifts may be done on the basis of market price of the imported good in the importing country.

*Patents and foreign trademarks:* The value of goods manufactured in accordance with a patented invention or imported under a foreign trademark is established under the assumption that it includes the value of the right to use the patent, design, or trademark in respect of the goods.

*Currency conversion:* The official spot exchange rate is to be used to convert prices expressed in foreign currencies into prices expressed in local currencies. [8]

### c. Selected other valuation practices

**United States:** The multiplicity of customs valuation systems used in the United States makes this system difficult to comprehend and complex to administer. [9] However, some of this complexity is more apparent than real, as a large share of U.S. imports enters duty free (in 1970, 31.7 percent) or bears only specific rates (in 1970, 23.9 percent). Of those imports to which ad valorem or a combination of ad valorem and specific duties apply, some 98 percent is valued according to only two valuation systems. The U.S. valuation system is basically a positive one, although certain elements of some of the standards are of notional content. [10] Within the overall U.S. valuation system there are six different sub-systems for determining customs values. The system to be used is determined by the article to be valued. Each sub-system contains primary and alternate valuation standards. In all, there are nine such standards, some of which differ only slightly from each other. Seven standards are based on the value of the goods in the country of exportation, and two are based on the selling price in the United States of the domestic counterpart of the imported article (American selling price or ASP). Those standards that are based on the value of goods in the exporting country relate either to the value of goods sold for export to the United States or to the value of goods sold for domestic consumption. These values can be obtained in three ways: (a) actual sale price minus the insurance and freight elements, (b) through building up of foreign costs, or (c) the U.S. selling price of such or similar imports, minus the expenses of bringing such goods into the United States. These standards clearly opt for the f.o.b. basis. [11] The ASP standards base the dutiable value on the price of like or similar competing domestic articles in the U.S. market.

**Australia:** Until recently, the valuation system used by the Australian Customs Administration was as follows: dutiable value was the higher of either (a) the actual f.o.b. transaction price so adjusted to disallow any discount that would not be available to other domestic purchasers, or (b) the value of the same goods sold for domestic consumption in the country of exports, plus charges necessary for placing the goods free on board at the port of export. Most imports were valued under the latter alternative. Where problems arose in assessing the dutiable value according to the above standards, the customs authorities had considerable discretion in arriving at a "dutiable value".

Some products made in Australia are given a support price. On these products the importer is required to pay

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6. Customs Cooperation Council, *Customs Valuation Explanatory Notes*, Annex 1 to the Convention on the Valuation of Goods for Customs Purposes, Article 1 (Brussels, 1971), p. 103.
7. The CCC is at present considering the technical aspects of applying the BDV on an f.o.b. basis, permitting countries that apply such a valuation system to accede to the BDV convention (CCC, *The Activities of the Council*, Bulletin No. 21), p. 10.
8. Such a practice adds to the foreign exchange risk presently borne by the trading community as a result of fluctuating exchange rates.
9. This subsection is based on U.S. Tariff Commission, *Customs Valuation* (Washington, 1970), pp. 42-49. The complexity of the U.S. valuation system stems in part from the fact that initial recommendations of the Administration which were partly incorporated in the 1956 Customs Simplification Act were not retained for the goods for which the new valuation system would have caused the dutiable value to decrease by more than 5 percent. The old valuation system is used for these products.
10. For a discussion of this positive value concept, see footnote 4.
11. The f.o.b. basis was implicitly written into the U.S. Constitution, where it is recognized that tax levied on a c.i.f. basis might divert trade between ports, which at the time was considered an unequitable practice.

an additional import duty equal to 90 percent of the difference between the landed duty-paid cost and the support price, if the landed duty-paid cost is less than its support price. Although products for which such a support price is given constitute only a small share of total Australian imports, this practice has given rise to objections from exporters to Australia.

**Mexico:** Mexican ad valorem tariff rates are levied on the higher of (a) the f.o.b. invoice price, or (b) official prices established by the Mexican authorities. Since most official prices are higher than the invoice prices, this second basis is used in most cases. Official prices are established for protective purposes or when the f.o.b. price is unavailable or suspect. In the latter case, official prices are based on the wholesale price of the products in the country of origin or, if this is not possible, on the value of equal or similar merchandise in the national market. Official prices are also established when the foreign wholesale prices are notably less than those for similar merchandise in the domestic market or when they are less than the cost of production in Mexico. In these cases, the official price is based on the domestic wholesale price or on the cost of production. All official prices must be adjusted upward every time there is a change of 10 percent in the basis on which these prices were established.

**Brazil:** The dutiable value of Brazilian imports is determined on a c.i.f. basis and is the normal "open market" price of the goods to be valued or of similar goods at the time of importation. [12] The invoice price is generally taken as a basis for determining the normal price. However, about 10 percent of total Brazilian imports is valued according to either the minimum values or base prices. Minimum values are established to combat fraud and to value products whose normal value is difficult to determine, products that are the object of dumping, [13] and products whose prices fluctuate widely. In 1970 minimum prices existed for about 200 products, but this number has since decreased.

Base prices are used instead of the "normal value" in cases where import prices very widely among importers and where falling import prices cause prejudice, or might cause prejudice, to the domestic production of similar products. Import taxes on products whose c.i.f. import value is less than the base price are made up of a specific tax, equal to the difference between the c.i.f. price and the base price, and of the prevailing ad valorem tariff applied to the base price.

**Morocco:** The Moroccan customs code states that the import value to be used for customs purposes is the cash wholesale value of goods delivered at the customs office before payment of customs duties and assimilated taxes. In practice, however, importers state on their customs declaration both the invoice value of the imported item and the wholesale price at which they will sell those goods domestically. Import taxes paid, customs clearance expenses, and a profit rate established for specific groups of commodities at between 15 and 30 percent are then deducted from this domestic sale price to obtain the customs values.

## 3. CUSTOMS VALUATION AND INTERNATIONAL TRADE STATISTICS

The considerable diversity in valuation principles and practices applied by customs administrations around the world cast some doubt on the exactness of the import statistics and on their international comparability. The comparability of these statistics is further undermined by the faking of invoices by importers. Such practices can be used by importers as a mechanism to channel profits and capital abroad to reduce their profit tax or customs duty liability or to provide funds which can be sold on the domestic black market for foreign exchange. [14]

The customs valuation practices and the faking of invoices would not greatly affect the validity of import statistics if these statistics were gathered from other sources than the customs data. However, a survey based on the responses of 75 IMF member countries, which in 1973 accounted for 75 percent of world trade, found that, although more than 30 percent of the weighted replies reported a preference that the invoice price of the imports be used as the standard of reporting trade statistics, only one third of these replies showed that imports were actually recorded on such a basis. [15]

In those cases where administrative or minimum prices are used in lieu of actual import values for the determination of import duties, the bias can be quite serious. Correction for such biases is complicated by the fact that the importer is not required to report his invoice price. Where he is required to do so, he complies with the assurance that this figure will rarely be questioned as it has no repercussion on his import duty liability. Also, customs authorities often apply an upward adjustment to the prices charged on intra-firm trade. Such adjustments may take quite some time to be prepared by the customs authorities, challenged by the importer, and finally settled. In these cases, the valuation of such trade flows is often recorded by the statistics department at the original price rather than at the price that is later "uplifted" by the customs authorities. [16] The systematic biases in import statistics, therefore, cannot be determined without detailed analysis of the customs

12. The Brazilian legislation basically copies Article II of the BDV when defining "open market" conditions.
13. In this case some other countries use a tariff rate that is double the rate applied to goods not suspected of dumping.
14. Luc De Wulf, "Customs Valuation and the Faking of Invoices" (forthcoming). Obtainable from the author. Luc De Wulf, "Statistical Analysis of Under- and Overinvoicing of Imports", *Proceedings of the Social Statistics Section 1978*. Papers presented at the Annual Meeting of the American Statistical Association, San Diego, August 1978 (Washington, D.C., 1979).
15. International Monetary Fund, *Balance of Payments Manual* (Washington, 1977) p. 185.
16. Once such "uplifts" are made they are usually applied to all subsequent similar shipments. Hence this problem seems to occur only for the valuation of the original shipment. Without further research on this topic it is impossible to assess the quantitative importance of this problem.

valuation and invoice practices, while keeping in mind the share of trade that is likely to be affected by these practices.

## 4. EVALUATION

The above survey has shown that despite the fact that the BDV has received wide acceptance since its establishment, considerable diversity still exists in customs valuation systems. The fact that an increasing number of countries is adhering to the BDV Convention is a positive development. Compared with the other valuation principles surveyed, the BDV leads to greater certainty for traders with respect to the value that will be assigned to their goods and the duties that are to be paid. While some difficulties exist pertaining to the valuation of intra-firm trade, it must be admitted that the extreme complexity and diversity of such trade relations probably preclude completely satisfactory solutions to these valuation problems. The most that can be expected from any valuation principle is that it sets forth procedures that lead to less arbitrary decisions.

The complaint sometimes voiced by developing countries that the c.i.f. valuation discriminates against them is not acceptable from a theoretical point of view. The CCC's consideration of allowing countries that adhere to an f.o.b. valuation to accede to the BDV Convention certainly is welcome to developing country critics of the c.i.f. valuation. Yet, the access of developing countries to the export markets in the rest of the world would be better served through trade preference agreements. [17]

It is alleged that systems such as those used by the United States and, until recently, by Australia give discretion to the customs authorities. This can create a barrier to access to these markets, and *de facto* can discriminate against exporters from developing countries that are often new to these markets. However, such countries have a system of judicial review whose aim it is to prevent arbitrary applications of the valuation principles.

Administrative prices are often used by countries that are not members of the GATT Treaty, but not exclusively by them. [18] Such a practice is mostly followed for protective reasons, as in the cases of Mexico and Brazil. It reduces the information base of the tariff schedule and reduces the impact of multinational trade negotiations that deal with tariff concessions because changes in these administrative values occur more frequently than tariff changes, as such changes often require only administrative decisions. Thus, considerable uncertainly is added to the trade activity.

Administrative prices are often used by developing countries for reasons other than protection. Customs administration often draws up lists of such prices to guide officials in their valuation tasks. The need for such a list arose because customs officials often lacked the educational background and training to verify and, when the need arose, to challenge the invoice prices presented by the importer. Furthermore, post-inspection verification is often difficult because of the inadequate bookkeeping practices of traders. The desire to limit the margin of discretion available to the inspecting officer probably also contributed to the use of administrative values. Such a practice conflicts with BDV principles, but it must be understood in view of the administrative shortcomings of the customs administration in particular countries. Therefore, a limited use of administrative prices — periodically revised to follow price developments — may better achieve the objectives of the BDV than inadequate implementation of a full-fledged BDV.

## 5. THE TOKYO ROUND OF THE MULTILATERAL TRADE NEGOTIATIONS ON CUSTOMS VALUATION [18]

### Background

On April 12, 1979 the Tokyo Round of the Multilateral Trade Negotiations (MTN) came to a substantial conclusion, following five years of intensive negotiations. After discussing a wide area of tariff and non-tariff trade restrictions, the partners to the MTN presented a set of codes, declarations and decisions which Mr. Oliver Long, Director General of the GATT hailed as "an important boost to international trade in the coming years and a check on protectionism".

With respect to customs valuation the purpose of the MTN was to arrive at a fair and neutral system that is both operational and internationally agreed upon. Such an exercise was deemed necessary because it was realized that the 1947 GATT valuation principles do not provide all the elements of a complete valuation standard and that some provisions of the BDV (Brussels Definition of Value) not only remain open to different interpretations but, according to some, that the BDV is not an adquate instrument to deal with the present problems of international trade which is characterized by a large volume of trade between multinational companies.

During the course of the discussions several drafts of the Code of Valuation were prepared. Despite protracted negotiations, some aspects of the provisions on methods of valuation continued to present considerable difficulties for some countries. These countries — mainly the least developing countries — maintained that the draft Code of Valuation: (a) should have a special and differential treatment to developing countries, (b) is

17. For more on this issue, see Bahram Nowzad, "Differential Economic Treatment in Favor of Less Developed Countries", International Monetary Fund, Washington, D.C., July 15, 1977.

18. Using a clause of the BDV Convention that permits exceptional use of administrative prices, the European Economic Community (EEC) introduced such prices for steel imports during the first three months of 1978. The United States uses a basically similar approach to protect its steel production temporarily.

18. This section draws on GATT, The Tokyo Round of Multilateral Trade Negotiations. Report by the Director General of GATT, Geneva, April 1979, and Mark Allen, "Complex Conclusions of Tokyo Round Add Upto Framework for Future Trade", *IMF Survey*, May 7, 1979, pp. 133-37.

not neutral as between related and non-related traders, (c) favored firms and enterprises of developed countries and (d) did not deal adequately with the problem of price reduction not freely available or with the problem of sole agents or distributors.

The "procès-verbal" signed on April 12, 1979 by 23 of the 99 MTN participants reflected this disagreement between developed and developing countries. It contains two separate texts on customs valuation and governments could accept either one. Signature of the "procès-verbal" indicates no more than an "intention" to submit the relevant text, or legal instrument, to the national authorities for approval. The "procès-verbal" can be signed on a selective basis, thus limiting its effects to only some texts. Amongst the developing country partners of the MTN only Argentina signed. The existence of these parallel texts on customs valuation may create legal problems in the future and extensive consultations will probably be necessary to arrive at the uniform custom valuation procedure initially envisaged by the MTN.

## Main Features of the Texts of an Agreement

*a. Features common to both texts*

Five valuation methods are set out. These methods are arranged in a hierarchical order which is to be followed by customs officers in all cases. Only when no valid customs value can be found under the first method, can the second method be used, and so on.

*Under the first, and primary, method*, the transaction value as expressed by the invoice price should be accepted as accurate.[19]

If the transaction value is not acceptable because there is no invoice price and/or the sale does not take place under fully competitive conditions,[20] then Customs will use the *second method*, e.g., transaction value of identical goods sold under fully competitive conditions, for export to the same country of importation, and exported at or about the same time as the goods being valued.

If this method cannot be used, then *the next one provides* for determination of customs value on the basis of the transaction value of similar goods sold under the same conditions as described in the preceding paragraph.

If all three methods turn out to be inadequate, the importer can choose between *the fourth and fifth methods* to establish the value. If he does not exercise this option, then the hierarchical order will be maintained and the fourth method will be applied. Under this method, the imported goods' resale price will be used as a starting point, from which the estimated commission or profit and all necessary expenses and taxes incurred in the importing country and/or associated with the resale of the goods will be deducted. If the reslae price of the goods in question is not available, then the price of identical or similar imported goods can be used.

The *fifth method* is based on a computed value which consists of material and manufacturing costs, profits and general expenses for the goods being valued. The relevant information should be supplied by the producer and if he cannot or does not want to do this then the use of this standard will be virtually impossible.

If all the five methods turn out to be inapplicable then the customs value shall be determined using reasonable means consistent with the principles of the Agreement and of Article VII of the GATT, on the basis of data available in the country of importation.

Provision is made for the transaction value to be accepted by the Customs in sales between related persons when the importer demonstrates that this value closely approximates for instance the transaction value in sales between unrelated buyers of identical or similar goods for export to the same country.

Each party to the Agreement may choose whether it will apply it on an f.o.b. or c.i.f. basis.

*b. Provisions appearing in developing country text only*

These provisions should be applied to or by developing countries only and should have precedence and be applied as if other provisions of the Agreement were not existing or were accordingly modified. The main elements of these provisions are the following:

(1) a developing country accepting the Agreement may delay its application for a period of ten years;
(2) the burden of proof that a relationship between buyer and seller does not influence the price lies with the importer;
(3) an importer may exercise his option between the fourth and fifth method of valuation only if the Customs so agree;
(4) in addition to the elements specified in the Agreement the following may be included in the customs value:
    (a) any additional consideration which may influence the price (e.g. advertising costs);
    (b) any price reduction not freely available;
(5) definition of related person is more flexible, to cover, for example, sole agents or sole distributors;
(6) special derogations, if agreed by all parties, are envisaged in special cases (e.g. minimum prices).

19. This definition opts for the "positive" value standard. This implies that the burden of the proof that the invoice price is not an "open market price" rests with the customs authorities.

20. See note 3 above for the meaning of "fully competitive conditions".

# Singapore: 1979 BUDGET STATEMENT

The 1979 Budget Statement was presented on behalf of the Finance Minister by the Senior Minister of State (Finance), Mr. Goh Chok Tong, on March 5, 1979.* He said, inter alia, the following:

## SINGAPORE'S ECONOMY IN 1978

World economic performance in 1978 was lackadaisical. The industrialised countries grew at 3.5 per cent, a quarter of a percent lower than the previous year. The volume of world trade grew at 5 percent, marginally higher than the rate in 1977. The rate of inflation, however, eased slightly, and for the Organisation for Economic Cooperation and Development (OECD) countries, it was around 8 percent. Last year was the Year of the Horse and my confidence that Singapore would put on the extra gallop to challenge and beat the 1977 growth rate was not misplaced.

The Singapore economy grew by 8.6 percent, better than our expectation of a 6-8 percent growth, and higher than the 7.8 percent achieved in 1977. At current prices, growth was 9.7 percent. Growth was achieved amidst price stability as the GDP deflator rose by only 1.0 percent compared to 1.5 percent in 1977. However, as a result of rising food prices, particularly of rice, the Consumer Price Index rose by 4.8 percent against an increase of 3.2 percent in 1977. While our growth can be considered satisfactory, our workhorse was no match for the swifter stallions in Hong Kong, Taiwan and South Korea. Their economies raced along at between 10-13 percent last year. The engine of growth in Singapore last year was the transport and communications sector. It grew by 16 percent and accounted for 30 percent of the increase in GDP. The manufacturing sector came second, growing by 12 percent and contributing 28 percent of the incremental GDP. Especially heartening was the invigorating recovery in private investments in capital equipment. After 3 years of continuous decline following the oil crisis in 1974, private investments in plant and machinery increased by 20 percent in 1978. This augurs well for the manufacturing sector and the economy in the next few years. In 1978, 41,000 jobs were created, mostly in the manufacturing sector (21,000), and the commerce sector (12,000). As a result, unemployment fell to a record low of 3.6 percent.

Singapore's external trade rose by 15 percent to reach $52.6 billion in 1978. This was, however, lower than the rate of 18 percent achieved in 1977. Imports increased at a faster rate than exports thus widening the visible trade deficit by $1,183 million to $6.6 billion. This is a reversal of the trend since 1975. The main reason for this was the slower expansion of our exports, both domestic and re-exports. Notwithstanding this, Singapore's balance of payments continued to be in healthy surplus because of higher capital inflows. Visitor arrivals in the tourist sector exceeded 2 million during the year, registering a growth of 10 percent. Our financial and business services also continued to expand. Loans and advances of banks and ACUs increased by 20 percent and 21 percent respectively. Activity was much higher in the local stock market than the previous year's. All in all, 1978 was a satisfactory year for us.

## PROBLEMS AND PROSPECTS FOR 1979

I am not optimistic about the outlook for world economic growth in 1979. The present cautious growth policies of industrialised countries are not expected to generate growth of more than 3 percent in 1979. Many believe that the United States economy in the wake of recent stringent monetary policies will decelerate. It is hoped that there will be an offsetting expansion in Japan, West Germany and other smaller industrialised countries. Given our open economy, and our dependence on industrialised countries for export markets, any slowdown in the world economy will have an adverse effect on Singapore. An added depressant to the world economic outlook is the proposed 4-stage oil price increase totalling 14.5 percent in 1979 by OPEC. Even more sombre is the prospect of a world oil shortage following disruption of supply from Iran. The future supply and price of oil will determine the world economic performance. As for ourselves, we should step up efforts to economise on the consumption of oil and electricity.

Last year, I warned the House of the protectionist sentiments in the world. Protectionism has now been extended to the air. The new duopolistic end-to-end International Civil Aviation Policy initiated by Australia and apparently supported by other developed countries, will stifle the growth of airlines of intermediate developing countries and affect their tourist-related industries. Singapore stands to lose about 50 percent of the present number of Australian tourists, besides the loss of revenue for our national carrier. Singapore together with ASEAN and the Group of 77 developing countries must resist the protectionist tendencies of developed countries and help bring about an international economic order that will benefit the developing countries. In the light of the above problems, we must improve on our past efforts and performance if we wish to achieve the same growth rate in 1979 as in 1978. I would now like to examine in more detail the specific objectives that we will be pursuing in 1979.

## INDUSTRIAL DEVELOPMENT

1978 was the best year for the manufacturing investments since 1975. Investment commitments totalled $825 million, representing an increase of 100 percent over 1977. If a major petroleum project of $330 million was excluded, the increase was still a creditable 43 percent. Our major investors continued to be Japan and the United States. Expansions and diversifications of existing industries in 1978 as a percentage of total commitments rose to 56 percent, from the CPF Building and World Trade Centre by Ministries and Departments, and on the new Residents' Committees in Constituencies. Grants, Subsidies and Other Transfers, comprising largely grants for the recurrent expenditure of Statutory Boards, tertiary education institutions and aided schools will increase by $45 million or 12 percent over the current provision. This increase is to cater for normal salary increments, increase in CPF contributions and provision for new posts.

## REVENUE

The total estimated revenue for FY 79 at existing tax rates is $3,885 million, representing an increase of 5.6 percent over the revised estimate for FY 78. This increase compares favourable with the expected revenue growth of 3.4 percent for FY over FY 77. Income tax continues to account for the largest single source of revenue at 36 percent of total revenue receipts. For FY 79, income tax is expected to yield $1,400 million, an increase of 8 percent over the expected receipts in FY

* See also the article by Mr Lee Fook Hong: "Singapore's 1979 Budget" in the April 1979 issue of the Bulletin (p. 181).

78. The revenue estimate of $3,885 million covers the estimated recurrent expenditure of $3,374 million, leaving a surplus of $511 million available for transfer to the Development Fund. Despite this transfer, however, there is still a deficit of $1,186 million to finance the large development expenditure. This will be met by borrowings and a drawdown of the Development Fund. The question can be asked whether this deficit should not also be partially financed by additional taxes — which brings me to the bugbear of every Budget Session — tax changes.

## TAX CHANGES

For FY 79, I intend to introduce no new taxes. Instead, I intend to give the following tax concessions. It is our policy that effort, talent and skills at all levels should be equitably rewarded. Tax is a necessary evil of any good government but it must never be so high as to become a disincentive to work harder.

Last year, the burden of personal income tax was lightened. The tax reduction varied from 7.7 percent to 20.7 percent, depending on the tax bracket. The average tax cut was 14.8 percent. The tax cut last year has checked the rising trend of personal income tax expressed as a percentage of total revenue. In 1970, personal income tax represented 7.3 percent of total government revenue. It rose steadily every year until 1977 when it reached 13.8 percent. With the substantial revision to personal income tax last year, its proportion to total government revenue has been brought down to within 10 percent. I am satisfied that the general tax burden on individuals in Singapore is well within the international average. I shall therefore not make any changes to personal income tax rates this year but will periodically review them to ensure that both the marginal tax rates and the effective average tax rates of tax payers in various income brackets will never be so high as to deter them from wanting to strive for more rewards through excellence in performance and diligence in application of time and effort. The first three concessions which I intend to give are therefore aimed at rewarding hard work and encouraging saving for home ownership and old age security. First. Members will recall that after the general revision to personal income tax rates last year, the CPF contribution was raised from 15½ percent to 16½ percent in July 1978. The maximum allowable deduction for CPF contribution and life insurance premia remained at $4,000 per year. As a result, the benefits gained from the concession by the lower-middle income groups were eroded by their increased CPF contributions. Relatively most affected are those earning between $1,900 and $2,500 per month whose CPF contributions at the present rate of 16½ percent exceed $4,000 per year and those whose income brackets are in the ranges which did not benefit from the reduced tax rates last year, i.e., those with chargeable income between $20,000 and $35,000. To rectify this, I have decided to increase the allowable deduction for statutory CPF contributions to $5,000 per year. This will also benefit all other tax payers whose CPF contributions exceed $4,000 per year. This exemption applies equally to contributions to other approved pension and provident fund schemes in lieu of CPF. Where the statutory contributions exceed $4,000 a year, no tax relief will be given for life insurance premia and other voluntary contributions to super-annuation schemes. However, where the statutory contributions do not exceed $4,000 a year, the difference is allowable for tax deduction on contributions made to other approved pension and provident fund schemes and premia on life insurance policies. This concession will take effect from Year of Assessment 1980. The revenue loss is estimated at $4.9 million per year.

Second. At present, only half the pension received by resident pensioners is taxed. Out of the total number of 1,240 resident pensioners who paid income tax in 1977, 800, or 64.5 percent of them, had chargeable income, including pension income, of less than $7,500 per year. 412, or 33.2 percent, had chargeable income of $2,500 per year or less. For this group of pensioners, the pension income constitutes 82 percent of the chargeable income. For them, the pension is practically the only source of income and sustenance. Another 260 pensioners, or 21.0 percent of the total number of tax-paying pensioners, had chargeable income including pension of between $2,500 to $5,000 per year. Having considered this, and recognising both the past services rendered to the nation by pensioners and the ravages of inflation, I have decided to remove the tax burden on resident pensioners, even though as I have told the House on another occasion that there was nothing immoral in taxing pension which is income for past services. We have to be a hard-headed Government, but we are not hard-hearted. Wherever we can afford to we shall show in some tangible way that those who have served are not forgotten. With effect from Year of Assessment 1979, tax will be exempted on the whole of the pension income of resident pensioners. The largest group of pensioners who will benefit from this concession are those with chargeable income of less than $5,000 per year. The revenue loss as a result of this concession is estimated at $290,000 per annum.

Third. Rising prices of properties have had the effect of increasing the value of estates, at all levels. The present exemption ceiling of $100,000 for estate duty does not provide sufficient relief in many cases if the deceased had a house. Therefore, to further encourage home ownership and to relieve the hardship of those most affected by the escalation in property prices, I have decided to exempt from estate duty, any one house in a deceased's estate subject to a maximum value of $200,000. This concession is in addition to the existing exemption limit of $100,000 which will still apply regardless of the composition of the estate, but excluding houses. The effect of this concession will be that the existing exemption limit of $100,000 is being raised by $200,000 only if the deceased's estate includes 'one' house. For example, if the estate comprises a house assessed at $250,000 and other assets of $100,000, estate duty will be payable on $50,000 only, ie. on the value of the house above $200,000. If the $350,000 estate comprises entirely of assets other than a house, estate duty will be payable on $250,000, as at present. The exemption limit of $200,000 for the house will apply to the full share of any one house in a deceased's estate. This should cover most public and private flats, and terrace and semi-detached houses. If the deceased is a part owner of a house, the exemption will depend on his proportionate share of that house. For example, if the deceased owned one fourth of a house valued at $350,000, the maximum exemption granted to the estate for that house will be one-fourth of $200,000 or $50,000. A house which is given as an inter vivos gift will not qualify for the exemption, notwithstanding that the value of the house is included in the valuation of the estate if the gift is made within five years of the date of death. This concession will apply only to residential units. Houses which are registered in the names of companies will not be eligible for the concession. The concession, which will take effect from 1 April 1979, will ensure that in almost all cases, families will not lose their homes on account of estate duties. The revenue loss is estimated at $16-$17 million per year.

Fourth. In my 1977 Budget Statement I granted a 10 percent concessionary tax on income derived from offshore reinsurance business. To further encourage offshore insurance business in Singapore, I have decided to extend the 10 percent concessionary tax rate to income derived from general inward direct insurance business covering offshore risks. This concession will take effect from Year of Assessment 1980.

Fifth. Under the income tax legislation, the existing capital allowance allowed for company registered cars is restricted to a maximum of $15,000. With effect from 1 April 1979, I have decided to raise the ceiling of capital allowance for company-owned cars to $25,000 to take into account the higher present day prices of company cars.

## CONCLUSION

Mr. Speaker, Sir, this year's Budget Statement does not match the excitement of last year's. This is as it should be as we should take stock of the effects of the various tax changes made last year before we embark on further tax changes. It is a completely painless budget, and even mildly pleasurable. But there is a moral to this, and that is, to achieve nirvana you must first experience pain. We have all worked hard in the past. We have all made sacrifices. We have never flinched from the harsh realities of the world. We have had the perseverance and courage to overcome the many obstacles to our survival and gone on to achieve a higher standard of living. We have exercised prudence in our financial policy and we will continue to exercise careful restraint on government expenditure. Now we have a sound foundation for sustained growth. Provided we continue to be practical and realistic, adapting rapidly to changed circumstances and always prepared to work hard to earn and pay for oud needs we can face the uncertain and wintry economic climate without the fears and anxieties which plagued us from 1965-1969, and again from 1973-1974. The outlook for the world is sombre. Even before the cut-off of oil supplies in Iran the U.S. was expected to have a downturn in its economy later this year. Now there are all the imponderables of when and at what levels oil will be exported by Iran. The problems of unemployment and protectionism in the industrial countries are persisting. And the world is nervous over the dangers of further escalation and involvement in the conflicts caused by Vietnamese troops in Kampuchea and Chinese troops in Vietnam. For Singapore in 1979 as it has been from time to time in 1965, 1968 and 1973, it means, prepare for the worst and work to achieve the best. This is the philosophy of this budget. Sir, I beg to move.

# INDIA: SURVEY OF CURRENT INCOME AND WITHHOLDING TAX RATES ON INCOME DERIVED BY FOREIGN COMPANIES *

As may seem from this chart, income and withholding tax rates on foreign companies are relatively high in India. However, some authorities — e.g. Mr. E. Srinivasan, former Member of the Central Board of Direct Taxes — fe.: that the *effective* rate of tax is still low because of the numerous tax exemptions and reductions which are available.

It should also be kept in mind that foreign investment in India is at present negligible because of strict Government control and the introduction of the Foreign Exchange Regulations Act. Most of the collaboration agreements between Indian and foreign companies which currently receive Government approval entail only the use of foreign technical know-how and expertise and do not permit financial participation. In addition, except in the case of "core sector" industries, the subsidiaries of all foreign companies have been directed to reduce foreign participation to a maximum of 40 percent and this has now by and large been complied with. There are very few branches of foreign companies operating in India.

**Statement showing rates of income tax payable in India by foreign companies on profits and gains of business, dividends, royalties and technical know-know fees, etc.**

| *Nature of income* | *Rates of income tax including surcharge* |
|---|---|
| 1. Profits and gains of business derived by an Indian branch of a foreign company | 75.25 percent |
| 2. Dividends received by a foreign company on equity investment in a domestic company | 25 percent |
| 3. Income by way of royalty payable by an Indian concern to a foreign company: | |
| (a) in pursuance of an agreement made before April 1, 1976 | 53.75 percent of the gross amount less a maximum deduction of 20 percent of the amount for expenses. |
| (b) in pursuance of an agreement made after March 31, 1976 | 40 percent of gross amount. |
| (c) if the agreement is made after 1976, on so much of the royalty income as consists of lump-sum consideration for the transfer outside India of information in respect of any data, documentation, drawing, specification etc. | 20 percent of the gross income. |
| 4. Income by way of technical service fees payable to a foreign company: | |
| (a) in pursuance of an agreement made before April 1, 1976 | 53.75 percent of the gross amount less a maximum deduction of 20 percent of the amount for expenses. |
| (b) if the agreement is made after March 31, 1976 | 40 percent of gross amount. |

**Rates of income tax including surcharge payable by domestic companies**

| | | |
|---|---|---|
| i) | Widely-held company with income up to Rs. 100,000 | 48.37 percent |
| ii) | Other widely-held companies | 59.12 percent |
| iii) | Controlled industrial company with income up to Rs. 200,000 | 59.12 percent |
| iv) | Controlled industrial company | 64.5 percent |
| v) | Other controlled company | 69.87 percent |

**Tax on intercorporate dividends**

With the exception of about a score of priority companies which enjoy complete exemption from tax on intercorporate dividends, all other companies pay tax on 60 percent of the dividends received from another company even if the dividend-paying company is a wholly owned subsidiary — tax deductible at source at 24 percent.

* Compiled by Kailash C. Khanna.

Roy T. Gobin*:

# The System of Indirect Taxation in the Caribbean Common Market

CONTENTS



## I. INTRODUCTION

*In developing economies commodity or indirect taxation offers several advantages over direct taxation* [1] *and can be an important instrument in promoting developmental objectives if optimally designed.* [2] *This paper examines the design and operation of the sales tax systems of the 4 major countries in the Caribbean Common Market (CARICOM)* — Trinidad, Jamaica, Barbados *and* Guyana. *The common market consists of 12 English-speaking countries that perceive regional integration as a mechanism which may serve to mitigate the economic handicaps* [3] *which small, open economies experience. Consequent on the formation of the common market, commodity taxes need to be structured in a manner which not only promotes national objectives, but they also must be harmonized, i.e. contribute toward the achievement of regional goals.*

**THE CARIBBEAN COMMUNITY AND COMMON MARKET (CARICOM)**

The CARICOM was created by the Treaty of Chaguaranas in 1973 with a view towards unity in the Caribbean area. Its main purpose is the economic integration of its members by means of the Caribbean Common Market which superseded the former Caribbean Free Trade Association (CARIFTA). Its main organs are the Heads of Government Conference in which final authority is vested, the Common Market Council consisting of Government Ministers appointed by the member States and a Secretariat whose main divisions are (i) trade and integration and (ii) general services and administration. Some associate institutions are the Caribbean Development Bank, the Caribbean Investment Corporation, the Regional Shipping Council and the Universities of Guyana and the West Indies.

The member countries are:

| | |
|---|---|
| Antigua | Jamaica |
| Barbados | Montserrat |
| Belize | St. Christopher-Nevis-Anguilla |
| Dominica | St. Lucia |
| Grenada | St. Vincent |
| Guyana | Trinidad and Tobago |

The CARICOM's main functions are to co-ordination of development planning, the introduction of a common external tariff, the establishment of an integrated system of tax incentives to industry and the setting up of double taxation arrangements between the richer and poorer members of the Community.

## II. SYSTEM OF SALES TAXATION IN CARICOM

### 1. Structure of sales taxes

In terms of legislative design, a primitive variant of a manufacturers' sales tax was initially introduced in Trinidad in 1963 in the form of its Purchase Tax. The tax bore no resemblance to a wholesale sales tax as its label would suggest; rather it applied to the importation and manufacture of finished goods as does a manufacturers' tax. However, unlike a true manufacturers' sales tax, under which coverage is general, the Purchase Tax applied only to items which were regarded as luxuries. Hence, in practice the Purchase Tax could have been more accurately characterized as an extended indirect tax system. A similar tax was introduced shortly afterwards in Jamaica (the Consumption Duty, 1965). This tax represented an additional set of indirect taxes superimposed on those already placed upon domestic production. Rates were low initially — between 3 and 5 percent — and the apparent rationale for a separate set of excises seems to have been an attempt to construct a flexible element in the excise system, with a relatively uniform rate structure which would be readily adjusted to meet revenue needs. However, for almost 10 years the rates remain unchanged. Barbados had introduced a Consumption Tax before Trinidad, in 1962, but no more than 10 commodities were ever covered during the 1960's.

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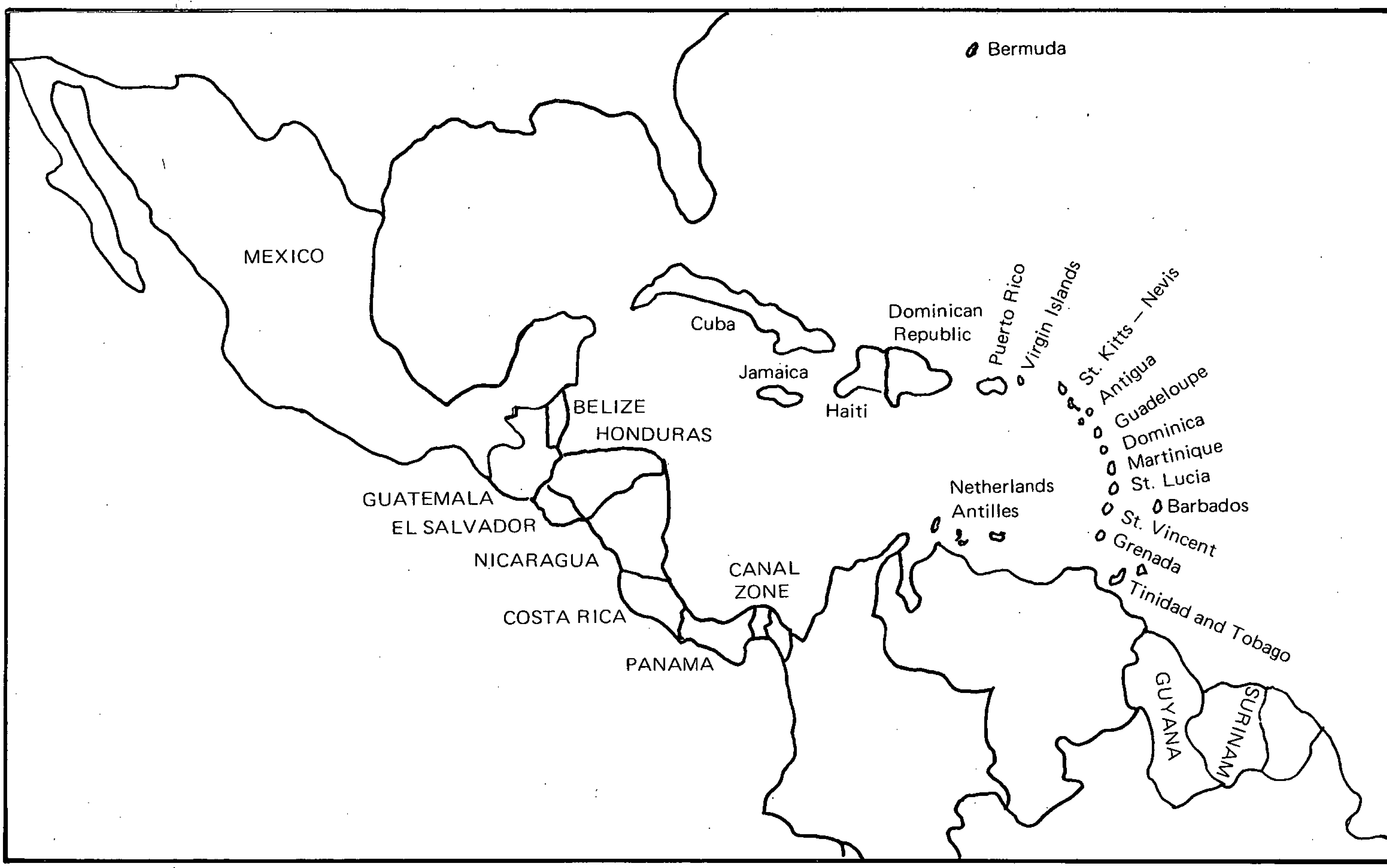
* Loyola University of Chicago. The author is grateful to John F. Due for helpful comments.

1. See Due, J.F., *Indirect Taxation in Developing Economies,* Ch.1 (Johns Hopkins University Press, 1970).
2. Due, J.F., *op. cit.*
3. Caribbean Community Secretariat, *The Caribbean Community: A Guide* (Georgetown, Guyana, 1974).




Interest in making greater use of commodity taxes arose largely in response to the need for additional revenue to supplement the sluggish growth of customs duties (see Table 3). In the early 1970's slower growth rates in import duties resulted not from a narrowing of the import base due to economic diversification as is usually implied by theories of tax structure development,[4] but rather from the freeing of intra-regional imports from tariffs under the Caribbean Free Trade Agreement (CARIFTA) and from an import substitution policy which made an increasing proportion of capital and intermediate imports non-dutable. As the administrative apparatus already existed under the Consumption taxes, coverage was extensively expanded between 1970 and 1974 to compensate for the slower growth in customs duties. All major domestic manufacturing activity and most finished imported goods were brought under the scope of these taxes. Hence with expanded coverage, from an analytical viewpoint, the consumption taxes bear closer resemblance to a true manufacturers' sales tax. The Consumption Tax introduced in Guyana in 1968 was from its inception a true manufacturers' sales tax, taxable items were based on the Brussels Tariff Nomenclature (BTN) classification. The extension of coverage and greater use of sales taxation is reflected in its increasing importance in the tax structure, as is evidenced by Table 1 below.

4. Hinricks, J., *A General Theory of Tax Structure Change During Economic Development* (Cambridge: The Harvard Law School, 1966).

**Table 1**

**REVENUE IMPORTANCE OF THE MANUFACTURERS' SALES TAX**

| | Jamaica | | Trinidad | | Guyana | | Barbados | |
|---|---|---|---|---|---|---|---|---|
| Year | % of Tax Revenue | % of Indirect Tax Revenue | % of Tax Revenue | % of Indirect Tax Revenue | % of Tax Revenue | % of Indirect Tax Revenue | % of Tax Revenue | % of Indirect Tax Revenue |
| 1965 | – a | – a | 3.6 | 7 | – a | – a | 4.9 | 8.2 |
| 1970 | 1 | 2 | 6.8 | 14 | 4.4 | 8.0 | 5.9 | 11.9 |
| 1973 | 7.8 | 15.3 | 9.5 | 20.6 | 12.4 | 22.6 | 5.3 | 11.3 |
| 1974 | 12.2 | 24.8 | 2.8 | 21.3 | 12.6 | 34.9 | 7.4 | 16.6 |
| 1975 | 18.0 | 35.8 | n.a. | n.a. | 9.6 | 35.8 | 5.9 | 13.9 |

*Source:* Computed from budget data on individual countries.
a = negligible.

Sales taxation now contributes about one-fifth of total indirect tax revenues in Jamaica, Trinidad and Guyana; in Barbados, its contribution is about 15 percent. In Jamaica and Guyana, it is presently the single most important indirect tax revenue source, while in Trinidad and Barbados it ranks behind import duties as the major contributor to indirect tax revenues. With the exception of Jamaica, the major proportion of revenue from this source is collected on imports in all the territories. The division between tax revenues collected at importation and that collected from the domestic base is shown in Table 2 below.

**Table 2**

**MANUFACTURERS' SALES TAX – COLLECTION BY BASE**

| Country | Year | % of Tax Collected at Importation | % of Tax Collected on Domestic Production |
|---|---|---|---|
| Jamaica | 1976 | 17 | 83 |
| Trinidad | 1976 | 50 | 50 |
| Guyana | 1976 | 65 | 35 |
| Barbados | 1975 | 60 | 40 |

*Source:* Unpublished data, Customs Departments in various countries.

## 2. Coverage and rate structure

As indirected, items subject to the sales tax in the Caribbean are restricted to locally manufactured goods and imports of finished products. The destination principle of taxation is applied both to intra-union trade and trade with the rest of the world, i.e. exports are tax exempt while imports, irrespective of source, are in general subject to the same rates of taxation as locally produced goods. The use of the alternative principle of taxation — the restricted origin principle — has never been considered in CARICOM. Under this principle exports are taxed in the originating country and intra-union imports are tax exempt; the destination principle is retained for trade with the rest of the world.

The tax is payable on a wide range of consumer goods, including alcoholic products. With the exception of a few specific rates, levied mainly on alcoholic products, the rate structure of the sales tax is characterized by *ad valorem* rates. Only in Jamaica do relatively uniform *ad valorem* rates prevail, 5 percent on all taxable consumer items; the major exceptions are refrigerators (10 percent) and stereo equipment (15 percent). These products, along with a few others in the same commodity class, are also subject to additional indirect taxes of 10 percent under the Retail Sales Act; rates of 52-57 percent are imposed on the purchase of motor vehicles. At the other extreme, in Guyana the rate structure is highly differentiated, with as many as 27 different *ad valorem* rates prevailing. Rates range from 2 percent on paints to 76 percent on motor spirits and lubricating oils. In addition, specific duties are levied on liquor, tobacco, cement, carbonated beverages and petroleum products. This wide variety of rates reflects an attempt to design the rate structure in a manner which would, by commodity class, recoup revenue that was lost as a result of the lowering of the customs tariff rate structure which was necessary when Guyana's tariff structure was brought into conformity with the common external tariff. Most consumer goods are subject to tax rates between 10 and 25 percent. There is a special tax (Purchase Tax) levied on the purchase of motor vehicles, with rates varying between 25 and 52 percent.

Unlike the case of Guyana, where the rate structure does not reflect any apparent tax criteria, the rate structure of the Purchase Tax in Trinidad is designed not only to generate revenues but also some consideration was given to equity criteria, as relatively higher rates of taxation are imposed on goods regarded as luxury items. Clothing and furniture were subject to low rates of taxation — 3 percent and 10 percent respectively, but since the beginning of 1977 the purchase tax has been removed from these items. Imported food and fruit are subject to a rate of 5 percent, while locally processed goods are exempt. On the other hand, refrigerators are subject to rates of 10-20 percent depending on cubic capacity, and other household durables, such as televisions, radios, electrical appliances, etc., to rates of 20-30 percent; duties on alcoholic beverages range from 10 to 25 percent. The rate structure is characterized also by a two-part column which distinguishes between domestic and common market products (Part 1) and non-CARICOM imports (Part 2). Rates in the Part 2 schedule are for some products (mainly processed food and fruit) discriminatory in order to offer additional protection to local industry. As is the case in Jamaica and Guyana a special levy (motor vehicle tax) is imposed on the purchase price of cars with rates varying between 15 and 50 percent.

The number of products covered under the tax in Barbados is not as extensive as in the other countries, partly reflecting a narrower manufacturing base. Prior to 1976, only 36 items were subject to the tax, but since the abolition of the retail sales tax in 1976 articles subject to tax have been expanded to about 85 items. In addition to specific rates on liquor, tobacco and cement, *ad valorem* rates are applied to products ranging from 15 percent on stoves, cookers and washing machines to 25-30 percent on water heaters and air-conditioning equipment. Generally, a rate of 15-20 percent is applied to most household appliances. Prior to the rate revision in 1976, rates were extremely low — about 5-10 percent on most items. The upward structuring of rates appears to be, as is the case in Trinidad, in accord with the principle of levying heavier taxes on the consumption of luxury items.

## 3. Exemptions

Unprocessed primary products — agricultural produce, fishing, etc. — are exempt from any form of indirect taxation in the region. In principle, there is no reason why the tax cannot be extended to primary products. In practice, however, because the marketing of these products is principally in the hands of small vendors, it is administratively difficult to levy a tax at this level, given the unorganized nature of distribution. Inasmuch as an increasing proportion of primary products is now being handled by government-owned marketing corporations and larger supermarkets, the force of this argument is reduced. Nevertheless, as will be argued later, the exemption of unprocessed primary products can be justified on the grounds of equity.

Services in the Caribbean are also outside the scope of sales taxation. A few services are taxed through the imposition of special levies. In Barbados and Jamaica, the services taxed are those usually associated with the tourist industry. In Barbados an 8 percent tax is levied on restaurant sales and on the cost of hotel rooms and food (Hotel and Restaurant Sales Tax); Jamaica imposes a tax of 5 percent (taxe de séjour) on hotel accommodations. Guyana levies a travel on the sale of airline tickets and financial services are indirectly reached by requiring commercial banks to purchase special operating licenses. Professionals — doctors, dentists, lawyers — need similar licenses. Tax treatment of most services remains limited in the region.

Throughout the region all industrial machinery and raw materials are exempt from any form of sales taxation. Administratively the suspension method is used in the granting of exemptions. Exports are also not subjected to sales taxation, thus avoiding any tax-induced reductions in competitiveness in foreign markets.

### 4. Sales tax administration

The basic tax administrative structure in CARICOM is typical of the British Commonwealth countries. The administration of the system of indirect taxes is the responsibility of the Customs and Excise departments (called the Comptroller General's Office in Jamaica) while direct taxes are administered by the Inland Revenue departments. In Jamaica, Guyana and Barbados, under the Consumption Tax Act, firms engaged in manufacturing must be registered with the Consumption Duty Division of the Customs departments. In Trinidad, manufacturers are not required to register specifically for the purpose of the tax; instead, use is made of the registry of approved industries (i.e. industries which seek to import capital goods and other inputs on concessionary terms) kept by the Industrial Development Corporation. There are no exemptions for small scale manufacturers except in Guyana where firms whose turnover sales are under G$10,000 (G$50,000 in the furniture and jewelry industries) are exempted. At present (1977), there are 1900 firms registered in Jamaica, 184 in Guyana and 93 in Barbados. In practice, most small scale manufacturing enterprises escape from the tax net in the countries in which they are not tax-exempt and are only brought within the tax when "caught" during field audits or "reported" by competitors.

With the exception of Barbados, the tax is applied to the duty-paid value of imports. On domestic production, firms file and meet their tax liability on a monthly basis. The taxable price is based on the factory value of the product. The system is one of self-assessment with a system of physical inspection and controls used in the enforcement and auditing of the tax. Firms are required to keep a record of their registered stock — materials, etc. — bought tax free. In addition, they are required to file returns of receipts and inventory balances of materials acquired tax free. Auditors are then in a position to carry out a crude "input-output" check, i.e. to verify whether reported sales plus final goods in stock approximate the level of production indicated by the use of tax free capital equipment and raw materials. In Jamaica, auditing of the consumption tax is linked to the administration of indirect taxes since the final level of production must be reported for indirect tax purposes. Trinidad attempts a more rigid, policing approach to the administration of its Purchase Tax. Manufacturers are required to keep raw materials in bond until released under the supervision of a customs officer. Claims for tax exemption are subject to greater control, thereby facilitating a more accurate estimate of the level of production. Given inventory in stock, the Purchase Tax division can then assess the accuracy of the value of sales reported.

The system of physical surveillance is likely to become increasingly ineffective — a concern already expressed by the indirect tax administrators — as the number of domestic establishments engaged in taxable activities increases. As will be argued later, the suspension method is inappropriate within a common market context as it is difficult under the system to guarantee the common tax treatment of inputs.

## III. EVALUATION OF THE SYSTEM OF SALES TAXATION

Given the present system of purchase and consumption taxes in CARICOM, the question arises as to whether this structure is the most optimal form of sales taxation for the region. An answer to this issue can be provided by evaluating the present structure using criteria which define an optimal sales tax structure.[5] The criteria which can be employed are the following: the contribution of the tax to total revenues; its impact in promoting a desired pattern of resource allocation and reducing inequalities in the distribution of income; and finally, the ease with which the tax can be administered.

In terms of its contribution to revenues, since the 1970's when coverage was expanded, not only have the consumption taxes become important revenue sources but they have recorded the highest growth rates among the major tax sources (see Table 3 below).

However, in spite of the high productivity in terms of revenue, the potential revenue yield can be increased since under the present tax neither the wholesale nor retail margins are included in the tax base.

For equal tax rates, tax yields will be higher under a sales tax levied closer to the retail level than at the manufacturing stage; or alternatively for equal revenue yields higher tax rates must be imposed under a manufacturers' sales tax than under a tax imposed at a later stage in the distribution process. In order to illustrate the magnitude of the excluded tax base, we compared

5. A detailed examination of the various criteria can be found in Due, J.F., *op. cit.*

## Table 3
### CONTRIBUTION AND GROWTH TRENDS OF MAJOR TAX SOURCES: 1970-1975

| Tax Sources | Jamaica | | Trinidad [a] | | Guyana | | Barbados | |
|---|---|---|---|---|---|---|---|---|
| | % of Total Revenue (average) | Growth Rate [b] (%) | % of Total Revenue (average) | Growth Rate [b] (%) | % of Total Revenue (average) | Growth Rate [b] (%) | % of Total Revenue (average) | Growth Rate [b] (%) |
| Total Direct Taxes | 48.6 | 18.8 | 64.6 | 36.1 | 59.2 [c] | 35.7 | 53.9 | 15.5 |
| Personal Income Taxes | 24.4 | 24.2 | 15.6 | 23.2 | 12.0 | 13.0 | 47.2 | 16.5 |
| Corporate Income Taxes | 22.2 | 10.4 | 45.7 | 41.5 | 20.0 | 14.9 | | |
| Wealth Taxes | 2.0 | 50.0 | 3.3 | 4.3 | 1.0 | — | 6.7 | 8.3 |
| Total Indirect Taxes | 51.4 | 15.3 | 35.4 | 9.2 | 40.8 | 10.4 | 46.1 | 10.4 |
| Excise Duties | 16.7 | 3.8 | 6.9 | 3.3 | 7.2 | 8.1 | 3.7 [d] | — |
| Sales Taxes (Consumption and Purchase Tax) | 4.0 | 86.0 | 6.3 | 17.4 | 9.5 | 41.8 | 6.1 | 13.3 |
| Import Duties | 17.2 | 6.7 | 15.4 | 7.4 | 17.5 | — | 24.9 | 6.2 |
| Other Taxes [e] | 8.5 | 17.3 | 6.8 | 11.4 | 6.6 | 7.6 | 11.4 [f] | 21.0 |
| Total Revenue | 100.0 | 17.0 | 100.0 | 27.4 | 100.0 | 24.8 | 100.0 | 13.1 |

a: Refers to period 1969-74

b: Annual average growth rates were computed using the formula: $r = [\sqrt[n]{\frac{T_t}{T_o}} - 1]\ 100$

where $T_t$ = tax value in final year

$T_o$ = tax value in initial year

n = number of years

c: The Export Levy introduced on sugar was considered to be a direct tax

d: Excludes Tax on Motor Sports

e: Also includes Tax on Motor Sports and Retail Sales Tax

f: Includes Stamp Duties, Betting and Entertainment Taxes, special retail sales taxes, Motor Vehicle and other licenses, etc.

the income originating in the distribution sector with that in the manufacturing sector in Table 4 below.

## Table 4
### INCOME IN THE MANUFACTURING AND DISTRIBUTION SECTORS (1974)
(in millions of dollars)

| | Jamaica | Trinidad | Guyana | Barbados |
|---|---|---|---|---|
| Manufacturing | 250.0 | 276.1 | 49.6 [a] | 42.3 |
| Distributive Trades | 274.0 | 300.6 | 80.8 | 121.7 |

*Source:* National Income Accounts of Individual countries
a = Excludes the processing of rice and sugar.

As indicated by the above table, the distribution sector (wholesale and retail) contributes more to GDP than the manufacturing sector — a structural feature of these economies which indicates that revenue gains are likely to be substantial if sales taxation is extended beyond the manufacturing level. The distribution sector in the Caribbean area is characterized by the coexistence of a large number of small vendors with larger established firms, [6] indicating that a tax at the wholesale/retail level with small vendors excluded may be feasibly implemented in the Caribbean. Reform of this nature may allow governments in the Caribbean to either widen the present narrow income tax brackets and/or reduce the steep effective marginal rates of taxation which may depress the level of capital formation, [7] and induce an out-migration of needed skills from the region.

Extending the tax beyond the manufacturing level can also reduce a major potential source of intra-union trade distortion. Under the destination principle of taxation, which is applied to intra-union trade in CARICOM with a manufacturers' sales tax, imported goods may be favored relative to domestically produced goods since the costs of advertising and other distributional activities are excluded from the taxable price of imports. Complete neutrality with respect to intra-union trade can be attained under a manufacturers' sales tax only if the origin principle of taxation is applied to intra-union trade and the rates of sales taxation within the union are equalized. [8] A switsch from the destination principle to the origin principle can only be justified if there are substantial administrative economies to be derived from the removal of fiscal frontiers. [9] At this stage in the evolution of the common market, however, intra-regional trade accounts for only a small proportion of total trade conducted by member countries (ranging from about 3 percent in the case of Trinidad to 20 percent for Guyana), making any significant administrative savings unlikely from a substitution of the origin for the desti-

6. Evidence on the nature of the distribution channels in CARICOM is provided in Gobin, R., *An Analysis of Indirect Taxation in the Caribbean Common Market: Its Impact on Tax Performance and Role in Tax Policy*, Ch. 6, unpublished Ph. D. dissertation, University of Illinois, Champaign.
7. Results from Gobin, R., *op. cit.*, Ch. 3.
8. Shown by Krauss, M., "Tax Harmonization in Economic Unions", *Public Finance*, No. 3, 1968.
9. Gillian, M., "Some Fiscal Aspects of the Latin American Free Trade Association", in Shoup, C.S. (editor), *Fiscal Harmonization in Common Markets*, Vol. II (Columbia University Press, 1967).

nation principle. In addition, the loss of fiscal autonomy as a result of rate equalization if the origin principle were introduced may not be politically acceptable at present. Since the retention of the destination principle appears reasonable, sales taxation on intra-union imports must be levied in a truly compensatory manner, i.e. the elements which enter into the taxable value of domestic production should be the same as those on intra-regional imports. This can only be achieved if a sales tax is imposed closer to the retail level.

Commodity taxes can also affect the sectoral allocation of resources within an economy. In CARICOM the general rates structure which prevails under the system of consumption taxes may encourage a flow of resources into desired lines of production. Production of non-luxury goods is subject to lower internal tax rates than luxury items. Rates of sales taxation vary between 20 and 30 percent on goods regarded as luxuries in Trinidad, Guyana and Barbados, while non-luxury goods are subject to rates between 5 and 20 percent. In Jamaica, in addition to the sales tax of 5 percent, luxury goods are subject to special retail levies (10 percent) and higher excise rates. Hence if demands are elastic, resources will tend to flow from high-taxed activities (production of luxury goods) into more desired productive activities. However, within this general structure, there appears to be an undue amount of rate differentiation which satisfies no apparent tax criteria under the Consumption Tax in Guyana and the extended system of excises in Jamaica. Consequently allocative inefficiencies (excess burdens) can result: in addition the highly differentiated rate structures complicate the administration of the indirect tax system.

From an equity viewpoint, the system of sales taxation is in general structured in a manner designed to redress inequities in the distribution of income. The tax burden on those in the lower income groups is alleviated to the extent that goods which are regarded as essential, such as food — both processed and unprocessed — housing, public transport, are tax-exempt while a relatively heavier burden is imposed on those in the higher income brackets, as higher rates of taxation are levied on those goods regarded as luxuries. However, two recent incidence studies in Guyana[10] and Jamaica[11] indicate that at best the incidence of sales taxation is proportional to income, suggesting that indirect taxation as an instrument may be only marginally effective in bringing about greater equality in the distribution of income.

## IV. CONCLUDING OBSERVATIONS

The present system of commodity taxation which prevails in CARICOM does not appear to be the most appropriate form of sales taxation for the region. An examination of the productive structures and the distributional channels in the four countries suggests that a sales tax extended beyond the manufacturing stage to the retail level, with small vendors exempted, may be feasibly implemented. Such a tax may allow some reduction in the heavy reliance on direct taxation that is now present in the region — a policy which may adversely affect the supply of effort and skills, and depress the level of real savings and capital formation in the region. From a common market perspective, the use of the value-added technique is preferred to a Honduras-type wholesale/retail hybrid tax in order to ensure the common tax treatment of inputs within the common market. In addition a value-added tax is likely to improve administrative efficiency as it entails the use of accounting audits rather than a system of inspection and physical controls which the suspension method necessitates. The cross-audit feature of VAT also reduces the danger of complete evasion from sales taxation. The successful operation of VAT usually necessitates a uniform rate structure. Therefore from an equity viewpoint, VAT will need to be supplemented by selected indirect taxes under which higher rates of taxation are applied to luxury goods; the present system of exemptions can be maintained. Reform of this nature is likely to increase the effectiveness of sales taxation as an instrument in promoting economic and regional growth in CARICOM.

10. Gobin, R., *op. cit.*, Ch. 5.
11. McClure, C., "The Incidence of Jamaican Taxes 1971-72", Faculty Working Paper, Rice University, 1974.

# Readers' Guide to the Treaty of Chaguaramas Establishing the Caribbean Community*

## INTRODUCTION

To those who are acquainted with the CARIFTA Agreement, the Treaty establishing the Caribbean Community will not be an entirely unfamiliar document. The Caribbean Community, in its economic aspects — the Caribbean Common Market — has evolved from the Caribbean Free Trade Association. It is no surprise, therefore, that many of the features of the CARIFTA Agreement have been carried over with modifications wherever necessary, into the new Treaty.

The framers of the Community Treaty have made it quite easy for us to see the connection between the Treaty and the CARIFTA Agreement. All the provisions relating to the evolution of CARIFTA have been placed in one section of the Treaty — the Common Market Annex. This Annex could be detached from the rest of the Treaty and, with minor changes, operated as a separate Agreement. In effect, it would amount to the CARIFTA Agreement adapted to correct the deficiencies and weaknesses that have manifested themselves in the operation of that Agreement as an instrument for the development of the Commonwealth Caribbean region. This should not, however, be taken as implying that what is left of the Treaty after extracting the Annex is entirely new. Outside of the Common Market arrangements, the Treaty covers cooperation in a number of fields, including foreign policy coordination — an important new development. In some of these areas, such as shipping, meteorology, health and education, the governments of the Region have for many years been operating projects or cooperating in other ways. It would be true to say, therefore, that the Community Treaty including the Annex does not represent a new departure in Caribbean cooperation. The Treaty more or less seeks to bring together within a single comprehensive and integrated arrangement the initiatives of the past, laying the foundation for further development in the future at the same time.

We shall begin our analysis of the Treaty by directing out attention, firstly, to that part which covers coordination of foreign policies and functional cooperation, that is, the Treaty excluding the Common Market Annex.

## THE TREATY
### (Excluding The Common Market Annex)

There are four Chapters in this part of the Treaty. The first deals with what is referred to as the "Principles" and covers among other matters the membership of the Community and its objectives. Chapter Two deals with the organs of the Community — the arrangements for its operation. Chapter Three contains the substantive provisions in the sense that it defines the programme of action for the Member States in the field of functional cooperation. Chapter IV deals with certain formal arrangements usually covered by all treaties.

### Membership of the Community

Under Article 2 of the Treaty, membership of the Community is open to the twelve Member Territories of the Caribbean Free Trade Association and the Bahamas. The Bahamas, though not a Member of CARIFTA, has been for many years an active participant in other areas of regional cooperation and, as a matter of fact, has been a contributor to the budget of the Commonwealth Caribbean Regional Secretariat, the administrative organ for CARIFTA as well as for other regional activities. It is important to note that the Community is not a closed arrangement in the sense of being confined to the twelve CARIFTA countries and the Bahamas. Participation in the Community is open to any other state in the Caribbean Region which is willing and able to exercise the rights and assume the obligations of membership under the Treaty (Article 2:1(b)). As provided for in the Treaty, any such state, upon application to the Conference for membership of the Community, may be admitted upon such conditions as the Conference may decide. Provision is also made for associate membership which is open to those countries eligible for full membership. Associate members will not participate fully in the Community arrangements.

Article 3 designates some of the Member States as "Less Developed Countries" and others as "More Developed Countries". Antigua, Belize, Dominica, Grenada, Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia and St. Vincent are designated as Less Developed Countries. Barbados, Guyana, Jamaica and Trinidad and Tobago are designated as More Developed Countries. This division reflects the wide disparities between the Member States designated as Less Developed and those designated as More Developed in population, geographical size, levels of development, income per head, etc. But the Treaty does not stop at the mere recognition of this fact. There are a number of special provisions relating to the Less Developed Countries in the Common Market Annex. These provisions will be discussed in the course of our examination of that part of the Treaty.

### Objectives of the Community

The specific objectives of the Community are set out in Article 4 of the Treaty. However, the Preamble is also of relevance in this connection in that it sets out the broader considerations which have motivated the establishment of the Community. The Preamble proclaims the determination of the Contracting Parties to strengthen the long standing ties which have existed among their peoples; their determination to eliminate unemployment; to improve standards of work and living; and their recognition that these objectives could be attained most rapidly "by the optimum utilisation of available human and natural resources, by accelerated, coordinated and sustained economic development, particularly through the exercise of permanent sovereignty over their natural resources; by the efficient operation of common services and functional cooperation in the social, cultural, educational and technological fields and by a common front in relation to the external world". It is against this background that we ought to consider the specific objectives set out in Article 4.

(a) the economic integration of Member States

(b) the coordination of Member States' policies towards the rest of the world; and

(c) functional cooperation "including the efficient running of certain common services and activities".

These objectives will be more fully appreciated after we have dealt with the provi-

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* *Source:* Caribbean Community Secretariat: *The Caribbean Community: A Guide.* Georgetown, Guyana, June 1973.

sions of the Treaty relating to their implementation.

### The Organs of the Community

Chapter Two of the Treaty is concerned with the Organs of the Community, the Institutions or bodies responsible for its administration and development. The Principal Organs of the Community are the Heads of Government Conference and the Common Market Council. There are also a number of other bodies referred to as "Institutions".

The Heads of Government Conference is comprised of the Heads of Government of the Member States (the Prime Ministers, Premiers and Chief Minister). It is the highest policy making body of the Community and may issue directions as to the policy to be pursued by the Common Market Council and other institutions of the Community. The Conference is the final authority for the conclusion of Treaties on behalf of the Community and for entering into relationships between the Community and other international organisations and states.

The Conference may consult with organisations within the Region and for this purpose may establish appropriate machinery. An example of such action, even before the establishment of the Community, is the creation of the Joint Consultative Group consisting of representatives of Industry, Labour and Consumers to consult with the CARIFTA Council of Ministers.

Below the Heads of Government Conference is the Common Market Council, the second most important Organ in terms of scope of responsibility. The Common Market Council is the successor to the CARIFTA Council and is directly responsible for the running of the Common Market. The composition of and procedures within the Council will be discussed in relation to the Common Market Annex.

### Institutions of the Community

Subject to the general direction of the Conference, the Institutions may formulate such policies and perform such functions as are necessary for the achievement of the objectives of the Community within their respective spheres of competence.

Seven Institutions are listed in Article 10, namely

The Conference of Ministers responsible for Health.
The Standing Committee of Ministers responsible for Education.
The Standing Committee of Ministers responsible for Labour.
The Standing Committee of Ministers responsible for Foreign Affairs.
The Standing Committee of Ministers responsible for Finance.
The Standing Committee of Ministers responsible for Agriculture.
The Standing Committee of Ministers responsible for Mines.

Provision is also made for the creation of additional Institutions by the Conference as the need arises.

Decisions and recommendations of the Conference have to be supported by all the Members. The same obtains for decisions of the Institutions, except that in their case abstentions are not considered as negative votes as long as at least three-quarters of the Members including at least two of the More Developed Countries vote in favour of such decisions.

Recommendations of an Institution shall be made by a two-thirds majority vote of all its Members including at least two of the More Developed Countries. Special voting procedures are laid down for the Standing Committee of Ministers responsible for Foreign Affairs and for the Common Market Council. These procedures will be described in the appropriate sections below.

### Associate Institution of the Community

There are certain other bodies in the Region, besides those listed, whose work is of great importance for the development of the Community. Some of these bodies, even though not in a strict legal sense within the Community arrangements, have been established by Governments of the Region in furtherance of the objectives of regional cooperation in the areas concerned. These bodies are referred to as Associate Institutions of which ten are listed in Article 14, namely,

the Caribbean Development Bank
the Caribbean Investment Corporation
the West Indies Associated States Council of Ministers
the Eastern Caribbean Common Market Council of Ministers
the Caribbean Examination Council
the Council of Legal Education
the University of Guyana
the University of the West Indies
the Caribbean Meteorological Council
the Regional Shipping Council.

The institutional arrangements of the Community do not represent any radical development. Meetings of Ministers of the Region in furtherance of common interests are nothing new. Moreover, the Heads of Government Conference already has a distinguished history.

The first Heads of Government Conference was held in Port-of-Spain as far back as 1963 and was attended by Barbados, Guyana (then British Guiana), Jamaica and Trinidad and Tobago. Up to April 1973, there have been eight such Conferences, the Windward and Leeward Islands, Belize and the Bahamas being represented for the first time at the Fourth Conference in Bridgetown in 1967.

In the past, the Heads of Government Conference met as a purely informal arrangement. It had no constitutional status, no direct authority in relation to any regional programme, and operated without formal rules of procedure. This does not mean, however, that the Conference was no more than a forum for the exchange of ideas. Over the years, the Conference has played a powerful role in regional affairs and has been the moving force behind many important developments including the establishment of the Caribbean Free Trade Association and now the Caribbean Community. Also, although there is no indication of this in the CARIFTA Agreement, the Heads of Government Conference has always functioned as the supreme policy-making body of CARIFTA. It would not be incorrect to say, therefore, that what the Community Treaty has done is to give formal recognition to the traditional role of the Heads of Government Conference. As a matter of fact, it would not be inaccurate to say that in the area of institution building, the Treaty has done more by way of consolidating existing arrangements than of creating new institutions.

### The Community Secretariat

The Commonwealth Caribbean Regional Secretariat, with a change in name to the Community Secretariat, will function as the principal administrative organ of the Community. In this regard, there will be no substantive change in the position of the Secretariat which since 1968 has been the administrative organ for CARIFTA and for other regional programmes. The functions of the Secretariat which are purely administrative and technical in scope are set out in Article 16 of the Treaty.

### Coordination and Functional Cooperation

Chapter Three of the Treaty deals with regional collaboration in the field of foreign policy, the operation of common services in a number of areas and the promotion of certain other activities. The Chapter is confined to three short articles, but this is in no way a measure of the scope of the operations covered.

Article 17 provides that Member States should aim at the fullest possible coordination of their foreign policies and should seek to adopt, as far as possible, common positions in major international issues. To this end the Article provides for the establishment of a Standing Committee of Ministers responsible for Foreign Affairs. It is important to note that the Committee does not have the power to make decisions that are binding on Member Governments. It can only make recommendations which, in all cases, must command unanimous support. In other words, a recommendation cannot be made if any one of the

Member States disagrees with the proposal.

With regard to functional cooperation (the running of common services and the promotion of other activities), Article 18 of the Treaty provides that Member States should make every effort to cooperate in certain specified areas listed in the Schedule to the Treaty. These are as follows:

1. Shipping
2. Air Transport
3. Meteorological Services and Hurricane Insurance
4. Health
5. Intra-Regional Technical Assistance and Public Service Arrangements
6. Education and Training
7. Broadcasting and Information
8. Culture
9. Harmonisation of the Law and Legal systems of Member States.
10. Position of Women in Caribbean Society
11. Travel within the Region
12. Labour Administration and Industrial Relations
13. Technological and Scientific Research
14. Social Security
15. Other Common Services and Areas of Functional Cooperation as may be from time to time determined by the Conference.

In many of the areas listed, there are already on-going regional arrangements some of which have been in existence for decades. Cooperation in shipping, for example, has continued from the days of the West Indies Federation and cooperation in Education in the form of the University of the West Indies goes back to the 1940's. The Treaty has integrated these and similar activities into the Caribbean Community System (apart from adding new ones) and provides a solid foundation for their continued development.

### Settlement of Disputes

Except for purposes of the Common Market, the Conference shall be the final authority for the settlement of disputes. Under the Common Market Annex disputes may be referred to the Common Market Council which may decide to submit the matter to a tribunal. Any Member State involved in a dispute may also request that the issue be referred to a tribunal.

### Legal Capacity of the Community

The Caribbean Community is endowed with full legal personality. It may enter into agreements with Member States, non-Member States and international organisations. The conclusion of such agreements is the function of the Conference, and will require the unanimous support of all Heads of Government.

### Withdrawal

Any Member State may withdraw from the Community by giving twelve months' notice in writing. A withdrawing Member will be required to meet any financial obligation assumed during its membership of the Community.

## THE COMMON MARKET ANNEX

The main provisions of the Common Market Annex can be put into five distinct groupings, corresponding more or less to five Chapters in the Annex. These groupings are as follows

(1) Trade liberalisation, that is, the removal of duties, quotas or licensing arrangements and other obstacles to the importation and exportation of goods between Member States (Chapter III).

(2) The Common Protective Policy which provides for the adoption by all Member States of the Common External Tariff (common rates of customs duties on imports from non-Member States) as well as the adoption over a period of time of a coordinated import policy in relation to non-Members (Chapter IV).

(3) The rights of persons or companies of one Member State to engage in economic activities in other Member States (Rights of Establishment); the movement of investment capital within the Common Market; and the rights of persons from one Member State to engage in self-employed activities in other Member States (Services) (Chapter V).

(4) The coordination of economic policies and development planning (Chapter VI).

(5) Special measures for the Less Developed Countries (Chapter VII).

The remaining Chapters deal with the questions of membership and objectives (Chapter I); Organs of the Common Market (Chapter II); and the General and Final Provisions (Chapter VIII).

### Membership and Objectives

As stated in Article 2, the membership of the Common Market is open to the twelve Member Territories of the Caribbean Free Trade Association. The Bahamas is therefore not included in the first instance. However, the Common market is also open to other states in the Caribbean Region and so the Bahamas may, at any time in the future, exercise the option of participating in the arrangements. Article 2 of the Annex, together with Article 2 of the Treaty does imply that the Bahamas can be a member of the Caribbean Community without participating in the Common Market. Provision is also made for Associate membership.

According to Article 3 of the Treaty, the Common Market shall have as its objectives

(a) the strengthening, coordination and regulation of the economic and trade relations among Member States in order to promote their accelerated, harmonious and balanced development;

(b) the sustained expansion and continuing integration of economic activities, the benefits of which shall be equitably shared taking into account the need to provide special for the Less Developed Countries;

(c) the achievement of a greater measure of economic independence and effectiveness of its Member States in dealing with states, groups of states and entities of whatever description.

The provision of special opportunities for the Less Developed Countries is part of the objectives of the Community Treaty. This is not so in the CARIFTA Agreement. In the Community Treaty this objective has been implemented in 18 of the 40 substantive provisions of the Annex (Chapters III to VII and Chapter VIII. Articles 56, 59 and 60, the other articles in Chapter VIII being merely references to earlier provisions).

### The Common Market Council

The Common Market Council is the principal Organ of the Common Market. Its membership comprises one Minister from each of the Member States. In the absence of the Minister, a Member State may designate "any person as an alternate to attend in his stead".

Except in specified cases, decisions and recommendations of the Council require the unanimous support of all its Members. However, their validity is not impaired by abstentions if at least three-quarters of the Members including at least two representatives of the More Developed Countries vote in favour. Generally speaking, decisions or recommendations requiring majority votes are those relating to disputes concerning the implementation or operation of the Treaty or derogations from its provisions.

### Trade Liberalisation

(a) *The Removal of Import Duties*

Article 15 of the Annex provides for the removal of import duties on all goods when imported from one Member State into another, subject to conditions described below. Temporary exceptions have been made for a list of commodities when imported into the Less Developed Countries. The list is commonly referred to as the Reserve List and is set out in Schedule III to the Treaty. There are thirty-five tariff items on the List. The Less Developed Countries have up to 1983 for the removal of duties from imports of these items from within the Common Market. Moreover, they are not bound to make their first reduction before 1st May, 1978 when the duties should be reduced to at least 50 percent of the levels existing immediately before the establishment of the Common Market. Also, they are not bound to make any further reductions before 1st May, 1983, when the duties are due to be eliminated altogether. Thus, the Less Developed Countries can maintain tariff protection on imports of the Reserve List commodities from their more developed partners for up to ten years. This is not the only provision under which the LDCs can maintain tariffs against the MDCs. Other instances will be given later. Also, a number of other exceptions applicable to all Member States will be referred to in due course.

Before an imported commodity can be entitled to duty-free treatment under the Treaty, it must satisfy one of three conditions. Goods meeting any of these requirements are said to be of Common Market origin. The first alternative is that it must not contain any raw materials imported from non-Member States, that is, it must be wholly produced within the Common Market region from materials obtained from one or more Member States. The second alternative is that the commodity where not wholly produced must be substantially manufactured in a Member State in the sense that materials imported from outside the Region and used in its manufacture must not exceed in value more than 50 percent of the export price of the goods (40 percent in the case of the Less Developed Countries) that is, the price received by the exporter excluding cost of transportation between the territories. This criterion is relaxed somewhat by the Basic Materials List which contains a number of commodities, the value of which if imported from outside the Region will not count as foreign value when used in the manufacture of other goods. This additional facility recognises the fact that most of the countries of the Common Market depend to a considerable extent on raw materials imported from outside the Region for their industries. The third alternative is the Process Criterion which states that if a product is manufactured by a specified process in a Member State, it will qualify without any further requirement for duty exemption. Provision was made for a process criterion under the CARIFTA Agreement, but the list of processes was never drawn up due largely to the unavailability of persons with the expert knowledge to undertake the task. However, work has already commenced on a Process List for the Common Market and it is hoped that this criterion will be available to manufacturers and exporters in the near future. The criterion has the advantage of simplicity in that it eliminates the need for the accounting data necessary to establish the percentage of foreign or domestic value.

(b) *Removal of Export Duties*

Under Article 18 of the Annex, Member States are required to remove export duties on goods exported to other Member States. However, there are exemptions in respect of a specified list of commodities set out in Schedule V to the Annex.

There are very good reasons for the removal of export duties. In the case where an industry in one Member State depends on raw materials imported from another Member State, the imposition of high export duties by the raw material producing State could seriously disrupt production in the importing Member State. This device could be used by the raw material producing State to strengthen the position of a competitive industry in its own territory. Such actions would be completely contrary to the Common Market spirit of fair competition.

(c) *Revenue Duties*

While the Community Treaty requires Member States to remove import duties on exports from other Member States, it does not seek to interfere with the right of Member States to raise revenue by whatever means they consider appropriate, including revenue duties collected by customs authorities. The only requirement is that revenue duties on imports must not exceed the internal duties on like domestic production.

Article 17 of the Annex provides that, in any case where the revenue duties on imports exceed the revenue charges on like domestic production, the difference must be eliminated. A similar provision existed under the CARIFTA Agreement. All the Member States were given up to May 1, 1973, to eliminate such difference except that the Less Developed Countries were given ten years in respect of rum, later extended to fifteen years. So the position is that by the time the Common Market is established all the Member States will have already equalised the revenue duties while the Less Developed Countries would have another ten years to run (up to 1983) for rum. This privilege they will now enjoy under Article 52 of, and Schedule IV to, the Annex as Members States of the Caribbean Community.

(d) *Removal of Quantitative Restrictions (Quotas or Licensing Requirements)*

Under Article 21 of the Annex, Member States are required to remove quantitative restrictions (basically import licensing or quota requirements) on goods imported from Member States, provided these goods are of Common Market origin. This proviso did not exist under the CARIFTA Agreement. The obligation to remove quantitative restrictions will not, however, prevent Member States from taking action to counter evasion of any prohibitions or restrictions which they apply to imports from outside the Common Market. Such evasion could take the form of the importation from an outside country of prohibited goods, indirectly in the form of raw materials or semi-finished products, for final processing or manufacture in one Member State and shipment ultimately to another Member State which maintains import restrictions or prohibitions against that outside country.

Member States are also required to remove quantitative restrictions on exports to other Member States. As in the case of export duties, such restrictions could have a damaging effect on industries in other territories which are dependent on the raw materials.

(e) *Removal of Other Barriers to Trade*

Tariffs and quantitative restrictions are not the only barriers to the free movement of goods between countries. There are other practices which could have a similar effect on trade as tariffs or quantitative restrictions. Such non-tariff measures (including quantitative restrictions already dealt with) are generally referred to as non-tariff barriers to trade. The problem was recognised by the drafters of the Treaty and a number of provisions as explained below have been included to deal with these situations.

*(i) Government Aids*

Certain types of government aids, by subsidising the operations of export industries, could considerably strengthen their competitive position against industries in other Member States. To prevent such a situation developing, Article 25 of the Annex provides that any goods receiving such aid may be denied the benefits of free trade under the Treaty. An exception is made for exports from the Less Developed Countries to the More Developed Countries excluding such exports to Barbados.

*(ii) Public Undertakings*

Government organisations, including central government departments, public corporations and local government bodies could in their purchasing policies, favour local industries even though imports from other Member States might be available on better terms. This "buy local" policy is not quite appropriate in the context of regional economic integration. Article 26 has therefore made it a breach of the Treaty for this policy to be adopted by governments or public bodies. An exception is made, however, for trade in agricultural products until a Common Market policy with respect to production and marketing (including subsidies) of these products has been agreed.

*(iii) Restrictive Business Practices*
Restrictive business practices could also operate to distort intra-Common Market trade and competition and hinder the realisation of the benefits expected from the operation of the Annex. These practices include the operation of monopolies to take unfair advantage of consumers in the Common Market or arrangements between enterprises to carve up the market among themselves and to charge unfair prices. Article 30 of the Annex contains arrangements for dealing with these problems. The Article provides for the investigation of any complaints of restrictive business practices and for the Common Market Council to recommend appropriate action to deal with proven cases.

*(iv) Dumping*
Article 19 of the Annex provides for action in the event of dumping, both against imports from Member States as well as from outside the Region. Basically, an export industry engages in a dumping practice when the price at which its exports are sold to the importing country is significantly below that at which it sells to wholesalers in its own domestic market. Of course, a lower price in the export market could be justifiable on economic grounds and so the establishment of dumping requires careful investigation. By the employment of dumping practices an exporter in a Member State could cause considerable harm to an industry in the country in which the goods are dumped or to an industry in another Member State exporting to that market. This is obviously an unfair practice and cannot be allowed to take place.

*(v) Other Measures*
Measures adopted (or not adopted) in fields besides those mentioned above could also unintentionally hamper the free movement of goods within the Common Market. Thus differential or uncoordinated requirements imposed by laws or by practices with respect to trademarks, standards, labelling, plant and animal quarantine restrictions, etc. could present difficulties to exporters. In recognition of this, Article 42 makes provision for the harmonisation of laws and practices in the following fields

(a) companies
(b) trade marks
(c) patents
(d) designs and copyrights
(e) industrial standards
(f) marks of origin
(g) labelling of food and drugs
(h) plant and animal quarantine restrictions
(i) restrictive business practices
(j) dumping and subsidising of exports.

**Exceptions to Trade Liberalisation**

*(i) Exclusion from the Annex*
All CARIFTA countries have a policy of granting protection to domestic industries by maintaining protective tariffs against imports or by reducing imports through quotas or licensing arrangements. These measures are often the result of express agreements between the governments and the manufacturers concerned. It would be difficult for a government in liberalising its trade in a common market arrangement to decide suddenly to terminate protection before the end of the period for which it has been offered under a prior agreement with industry. The problem was solved under the CARIFTA Agreement by allowing special exemptions for the products covered under these arrangements and this provision is carried over into the Community Treaty (Article 13 of the Annex). The countries exercising this right and the products affected are set out in Schedule I to the Common Market Annex. Such countries are required under the Annex to take all reasonable steps open to them to come into line with the provisions of the Annex.

*(ii) Balance of Payments Difficulties*
Developing countries are very susceptible to balance of payments difficulties. A common cause of this is high spending on imports and lagging earnings from exports. This could be a result of ambitious efforts to promote economic development. In order to stop the outflow of foreign exchange resulting from an unfavourable trade position or from other causes, the country might have no alternative but to take direct action to reduce imports. One of the most effective means of achieving this is by quantitative restrictions (import licensing). The Common Market Annex (Article 28) has therefore provided that Member States may, for limited periods, impose quantitative restrictions in order to deal with balance of payments difficulties.

*(iii) General Exceptions*
Under Article 23 of the Annex, a country can impose quantitative restrictions for a number of special reasons including the protection of public morals, the prevention of disorder or crime, the protection of human, animal or plant life, the need to protect or relieve critical shortages of foodstuffs or to preserve exhaustible natural resources. All these and others are referred to under Article 23 as General Exceptions.

*(iv) Difficulties in Particular Sectors*
None of the Member States of the Common Market can afford to stand by and allow any of its industries to go out of existence as a result of increased competition from Common Market imports stimulated by the removal of tariffs and other barriers to trade. The Annex (Article 29) thus allows Member States to take action to protect their industries from such harm by the imposition of quantitative restrictions subject to certain conditions as to duration.

**Common Protective Policy**

*(i) The Common External Tariff (CET)*
A cardinal feature of a common market is the maintenance of a common customs tariff (a common external tariff in the language of the Community Treaty) by the Member States. Article 31 provides for the establishment and maintenance of a common external tariff on commodities imported from third countries. No details for the introduction of the tariff have been included in the Annex. The detailed arrangements will be set out in a special decision of the Conference to come into effect simultaneously with the Treaty.

The Common External Tariff will not be implemented immediately. The MDCs will implement the full CET in three years except that for certain items Barbados will have up to eight years.

There will be no change in the tariffs of the LDCs when they join the Common Market. In keeping with paragraph 9 of the Georgetown Accord and Article 31 of the Annex, these countries (excluding Belize) will be free to continue until 1977 to apply the Customs Tariff of the East Caribbean Common Market. Belize is free to continue applying its national customs tariff until 1977 at which time it will begin to move towards the CARIFTA Common External Tariff. Article 31 provides for annual reviews of the tariffs of both the East Caribbean Common Market and the Caribbean Common Market for the purpose of determining appropriate arrangements for implementation by the LDCs of the Common External Tariff of the Caribbean Common Market. In these reviews, the economic situation of the LDCs will be taken into account. The longer period for the LDCs is designed to enable them to move towards the CET with the least possible difficulty.

*(ii) External Trade Policy*
During the period to 1981, Member States undertake to pursue policies with respect to quantitative restrictions on imports from third countries as would facilitate the implementation of a common policy for the protection of industries in the Region as soon as practicable after this transitional period. Article 34 also provides that Member States should seek progressively to coordinate their trade relations with third countries or groups of third countries. This is an important pre-requisite for the coordinated planning of the national economies and finds a parallel in other integration groupings such as the Central American Common Market and the European Economic Community where the provi-

sions go even further than the Caribbean Community Treaty.

### Establishment, Services and Capital

*(i) Rights of Establishment*
The question of rights of establishment could have been dealt with under non-tariff barriers because the denial of such rights could affect the development of trade within the Common Market; in other words, it could constitute a barrier to trade. Freedom of establishment includes the right of nationals of one Member State to enter another Member State to set up or manage commercial or manufacturing enterprises.

Article 39 of the Treaty provides that Member States should not impose restrictions on such activities by nationals of other Member States by discriminating against them vis-a-vis their own nationals to the extent that such discrimination prevents the nationals of other Member States from exploiting the opportunities created by the integration of national markets.

*(ii) Services*
Article 36 of the Annex provides that in relation to the provision of services Member States should, as far as practicable, give preferential treatment to nationals or persons belonging to other Member States over persons belonging to states outside of the Common Market. The services referred to include, in particular, commercial or industrial activities, professional activities, and the work of tradesmen, provided that such work is not done for wages or salaries.

*(iii) Capital*
Most common markets aim at promoting the movement of investment capital from one partner state to another. In the present circumstances of the Caribbean Common Market countries, the complete liberalisation of capital movements may do more harm than good in that investment capital may move from the less advanced Member States to other Member States more highly developed and offering greater opportunities for investment. Member States have acknowledged, however, that the flow of investments to the Less Developed Countries could contribute to a more balanced development of the Region. Article 37 of the Annex therefore provides that Member States should examine ways and means of introducing a scheme for the regulated movement of capital within the Common Market, particularly to the Less Developed Countries.

### Freedom of Movement Not Covered by Treaty

As a general note, it should be made clear that the Common Market Annex does not place Member States under any obligation to permit unrestricted entry of nationals, or of persons belonging to, other Member States into their Territories. However, this does not prevent individual Member States from entering into arrangements with other Member States for greater freedom of movement between their Territories.

### Coordination of Economic Policies and Development Planning

*(i) Economic Policies*
A cardinal feature of the Caribbean Common Market is its concern with the whole question of economic development. In this regard, the Common Market represents a significant advance from CARIFTA. At a general level, Member States agree to pursue their economic and financial policies in a manner to promote the objectives of the Common Market. To this end, they have agreed to arrange for collaboration between appropriate ministries, administrative departments and agencies, to coordinate their statistical services in areas affecting the operation of the Common Market and to consult and collaborate in connection with international conferences dealing with trade, economic and financial matters.

*(ii) Fiscal Incentives*
Member States have also agreed (Article 40 of the Annex) to harmonise their fiscal incentive laws under which tax concessions are granted to pioneer industries and, to this end a separate regional agreement on fiscal harmonisation has already been worked out. In this agreement, the Less Developed Countries are free to offer more favourable terms to investors than the More Developed Countries.

*(iii) Intra-Regional and Extra-Regional Double Taxation*
Under Article 41 of the Annex, Member States agree to adopt common principles in negotiating double taxation treaties with third countries. The basic objective in negotiating these treaties is that the non-member country would grant relief from taxation in respect of income earned by its citizens from investments in the countries of the Region. Such agreements would be an inducement to investors from third countries to establish industries in the Region, and would reduce the basis for discrimination between Member States.

With a view to encouraging the flow of capital within the Common Market, particularly to the Less Developed Countries, Member States agree to adopt similar double taxation schemes among themselves. One such scheme, between the Less Developed countries on the one hand and the More Developed Countries on the other, has already been worked out.

*(iv) Monetary, Payments and Exchange Rate Policies*
The provisions relating to the free movement of goods would be completely ineffective if importers do not have the freedom to finance their trading activities including the payment for goods imported from Partner States. Article 43 of the Annex therefore provides that these payments should not be subject to any restrictions. The Annex goes even further and requires that all current account payments (payments other than for investment purposes) should be free from restrictions. Member States have agreed also to permit payments on capital account, that is, for investment purposes, to the extent that such payments are necessary to further the objectives of the Treaty.

The harmonisation of monetary policies is also an objective towards which Member States have agreed to work. These policies include such matters as exchange rates and foreign exchange payments and will call for close collaboration between Ministries of Finance, Central Banks and other monetary authorities.

*(v) Ownership and Control of Regional Resources*
The Annex to the Treaty deals with the question of the ownership and control of the natural resources of the Region by providing in Article 44 that Member States keep the matter under constant review with the aim of increasing the degree of national participation in the economies and working towards the adoption, as far as possible, of a common policy on foreign investments.

*(vi) Development Planning*
Article 45 of the Annex provides for the preparation of a long term economic plan for the Common Market to serve as a framework for the development of the Region. It also provides for regular consultations among Member States in drawing up their medium term operational plans.

*(vii) Industrial Programming*
The rapid industrialisation of the Region will depend, to a great extent, on the cooperation of Member States in exploiting the possibilities of the wider regional market. To this end, the Common Market Annex (Article 46) has provided for a process of industrial planning within a regional perspective aimed at achieving the following objectives:

(a) the greater utilisation of the raw materials of the Common Market;

(b) the creation of production linkages both within and between the national economies of the Common Market;

(c) minimising product differentiation and achieving economies of large scale production consistent with the limitations of market size;

(d) the encouragement of greater efficiency in industrial production;

(e) the promotion of exports to markets

both within and outside the Common Market; and

(f) the equitable distribution of the benefits of industrialisation paying particular attention to the need to locate more industries in the Less Developed Countries.

Member States also agree (Article 47) to work towards the development of joint projects for the increased utilisation of the natural resources of the Region and to collaborate in promoting research and the exchange of information.

*(viii) Agricultural Development*

The Common Market Annex (Article 48) provides for the adoption of arrangements for the marketing of certain selected agricultural products. In fact, two separate arrangements have already been worked out, one covering certain selected agricultural products and the other covering oils and fats products. These two arrangements which are set out in Schedules VII and VIII respectively to the Common Market Annex are in fact the old Agricultural Marketing Protocol and the Oils and Fats Agreement appropriately modified.

The Schedule VII arrangements cover a selection of 22 agricultural commodities. Under this scheme, the surpluses of exporting countries are allocated to the importing countries and Member States are required to trade within these arrangements. Imports of the 22 commodities from countries outside the Region are not allowed unless all available supplies within the Common Market are absorbed. In practice, the surpluses of the LDCs are allocated before those of the MDCs are taken into account. Schedule VIII makes similar arrangements for trading in copra and coconut oil.

The Common Market Treaty does not stop at agricultural marketing. It also makes provision for the development of agricultural production. Article 49 of the Annex provides for the adoption of a scheme for the rationalisation of agriculture within the Common Market. It is a well-known fact that the Member States are competitive producers of a wide range of agricultural crops while there are many commodities in great demand in the Region which are not produced at all or are available only in small quantities. The aim of the rationalisation programme is to reduce uneconomical duplication in agricultural development giving particular attention to the need to increase agricultural production and trade in the LDCs. The rationalisation scheme will have the following basic objectives.

(a) the development of a regional plan for the integration of agricultural development in the Common Market;

(b) the achievement of the optimum utilisation of agricultural resources;

(c) the improvement of the efficiency of agricultural production in order to increase the supply of agricultural products for

(i) domestic consumption;
(ii) export to regional as well as extra-regional markets; and
(iii) inputs for agro-based industries

(d) replacement of imports on a regional basis;

(e) increasing the income and standard of living of the rural population;

(f) contributing to the achievement of full employment for the peoples of the Common Market;

(g) the provision of greater opportunities to the Less Developed Countries for the expansion of agricultural production for exports to markets within and outside the Common Market.

### Tourism

Article 50 of the annex provides that Member States should cooperate in the promotion and development of the tourist industry. Such collaboration could improve the competitiveness of the Caribbean tourist industry to the benefit of all Member States.

### Special Regime for the LDCs

Chapter VII of the Treaty provides a series of measures specifically designed to further the development of the LDCs and to reduce the disparities between them and the MDCs. In this Chapter, six of the eleven Articles refer to earlier provisions of the Annex. Three additional measures have been provided.

Under Article 56, the Less Developed Countries can, with the approval of the Common Market Council introduce tariffs or quantitative restrictions on imports from the MDCs in order to encourage the development of an industry in any one of their territories. The exercise of this privilege does not affect the rights of access of the LDCs to the markets of the More Developed Countries, except in the case of Barbados which may impose tariffs or quantitative restrictions on exports from the LDCs of goods similar to those of its exports against which the LDCs have taken action.

Article 58 of the Annex makes provision for the encouragement of the flow of investment from the More Developed Countries to the Less Developed. Among the means contemplated are joint ventures between investors from the MDCs and investors from the LDCs, double taxation agreements, already referred to, and measures to facilitate the flow of loan capital. Article 58, also provides for the establishment of an "appropriate investment institution" — an objective which is near realisation with the conclusion of an agreement for the establishment of the Caribbean Investment Corporation to promote the establishment of industries in the Less Developed Countries.

Finally, the More Developed Countries have agreed (Article 60 of the Annex) to provide opportunities for the Less Developed Countries to make use of their technological and research facilities.

According to Article 62 of the Annex, the Common Market Council will review annually the need to strengthen the existing mechanisms or to introduce new ones to provide greater benefits to the Less Developed Countries.

The designation of Member States as Less Developed Countries and More Developed Countries for the purposes of the Treaty should not blur the fact that all the Member States are less developed in a world context and face, without exception, very serious problems of under-development. Viewed against this background, the measures adopted for the Less Developed Countries within the grouping represent a high degree of commitment to the cause of regionalism on the part of their four more developed partners. As a matter of fact, in no other integration arrangement is there such a wide range of measures in favour of the economically weaker members of the grouping. While these measures cannot by themselves guarantee the Less Developed Countries either economic development, or a high level of participation in intra-regional trade, they do in a way provide the kind of opportunities that would hardly be available to the Less Developed Countries outside of the context of Caribbean integration.

### The Status of CARIFTA

In accordance with Article 70, the four More Developed Countries have agreed to terminate their CARIFTA relations as between themselves from the day the Common Market Treaty enters into force (1st August, 1973). They have also given notice in accordance with Article 33 of the CARIFTA Agreement of their intention to withdraw from CARIFTA with effect from 1st May, 1974. Between 1st August, 1973 and 1st May, 1974, the operations of CARIFTA will not be affected because the CARIFTA relations among the More Developed Countries will be replaced by the corresponding relations under the Common Market Annex. But from 1st May, 1974, CARIFTA will diminish to an arrangement between the Less Developed Countries, provided that the LDCs themselves do not terminate this arrangement. In fact, it is expected that on May 1, 1974, the Less Developed Countries (or at least six of them) will formally leave CARIFTA and join the Caribbean Community and Common Market.

According to the terms of the Georgetown Accord, the Community Treaty will come into effect with the four More Developed

Countries on 1st August, 1973, with the six Less Developed Countries, Belize, Dominica, Grenada, St. Kitts-Nevis-Anguilla, St. Lucia and St. Vincent, joining on 1st May, 1974. With respect to the remaining two Less Developed Countries paragraph 5 of the Accord states as follows

"All Signatory Governments note the declared intention of the Governments of Antigua and Montserrat to give urgent consideration to joining in this Accord, signature of which by either Government at any time prior to 1st May, 1974, will constitute agreement and undertaking to sign and ratify the Community Treaty subject to and in accordance with its constitutional procedures so as to become a Contracting Party thereto on 1st May, 1974".

**Legal Capacity and External Relations**

The Common Market, as in the case of the Community, is endowed with international juridical personality. It may enter into agreements with Member States, non-Member States and international organisations in order to promote its objectives. Negotiations for this purpose will be carried out by the Council and shall be subject to ratification by the Heads of Government Conference.

**Withdrawal**

The conditions relating to the withdrawal of Member States from the Common Market are the same as those applying to withdrawal from the Community as stated above.

# Conference Diary

## AUGUST 1979

*9th Congress of the Latin American Institute of Tax Law:* (a) Joint Ventures; (b) Bonded Warehouses, Free Ports and Free Zones, Asunción (Paraguay), August 20-24 (Portuguese, Spanish).

*Institut für Finanzwirtschaft und Finanzrecht:* Unternehmungsbesteuerung (Taxation of an Enterprise), St. Gallen (Switzerland), August 27-28 (German).

## SEPTEMBER 1979

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including Tax in international operations), Brussels (Belgium), September 3-5 (English).

*33rd Annual Congress of I.F.A.:* I. The taxation of transfers of family-held enterprises on death and inter-vivos; II. The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities. For the seminars the following subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark), September 3-7 (English, French, German, Spanish).

*Management Centre Europe:* International Tax Management, Copenhagen (Denmark), September 24-25 (English).

## NOVEMBER 1979

*Tilburgse Fiscalistenvereniging "de Smeetskring":* Municipal Real Property Taxes, Tilburg (Netherlands), November 23 (English).

## FEBRUARY 1980

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

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asociación Paraguaya de Estudios Administrativos y Fiscales, Yegros No. 837, Asunción (Paraguay).

Business Perspectives, 11 Alexander Place, London, SW 7 2 SG (U.K.).

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

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

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen, Varnbüelstr. 19, 9000 St. Gallen (Switzerland).

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

Tilburgse Fiscalistenvereniging: Secretariat, Hogeschoollaan 225, Tilburg (Netherlands).

# Braz ian Leg s at on on ndustrial Development

## By Antonio Mendes

## Part Two

### III. SECTORIAL INCENTIVES

#### 3.1. Industrial development incentives

#### 3.1.1. Incentives granted by the Industrial Development Council – CDI

The incentives in favor of industrial development projects were systematized as of the issuance of Decree-Law No. 1,137 of December 7, 1970. This Decree-Law was regulated by Decree No. 67,707 issued on the same date.

The incentives established at that time and for which the CDI is responsible were listed in Article 1 of Decree-Law No. 1,137 as follows: 92

(a) exemption from import duties for equipment, machinery, devices and instruments, accessories and tools, not produced in the country, and for parts which supplement national production;
(b) exemption from the Tax on Industrialized Products (IPI) for the goods mentioned above;
(c) credit for the purchaser of domestically manufactured equipment of the IPI tax amount;
(d) accelerated depreciation on nationally-produced goods, for purposes of assessing income tax;
(e) preferred financial support from official credit entities; and
(f) priority in the Customs Policy Council's examination of changes of customs rates in order to support the national industry.

The incentives described in items (a) and (b) of the preceding paragraph were modified by Decree-Law No. 1,428 of December 2, 1975, which reserved the benefit of import duty and IPI tax exemption to undertakings of relevant national interest approved by the President of the Republic. As of then the CDI was authorized to grant only *reductions* of import duties and IPI tax.

The provisions of Decree-Law No. 1,428 were regulated by Decree No. 77,065 of January 20, 1976, which granted the CDI the authority to reduce import duties and IPI tax: (i) by 50 percent in favor of industrial projects in sectors contained in the list approved by the CDI; and (ii) by 80 percent in favor of sectors expressly listed in Article 1, Paragraph 1, item II, of Decree No. 77,065.

According to the provisions of Article 1, Paragraph 4, item VI, of Decree-Law No. 406 of December 31, 1968,

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92. Article 1(f) of Decree-Law No. 1,137, of December 7, 1970, also mentions an incentive represented by the "registration of foreign financing or investment, according to the regulations established by the monetary and exchange authorities". In practice, the regulations regarding the registration of financing or investment do not differ as a result of their referring or not referring to approved projects. There is, however, an exception: the importation of machines and equipment for projects favored by incentives, when financed abroad for a period of over five years, is exempt from the compulsory deposit required for importations in general. See Resolution No. 443 and Circular No. 371, issued by the Central Bank of Brazil on September 14, 1977 and April 5, 1978.

## Table of Contents

products imported with import duty exemption are also entitled to exemption from the Tax on the Circulation of Goods (ICM). This exemption thus represents an additional incentive. It is important to note, however, that in the case of mere import duty *reduction*, ICM tax will be fully due. [93]

As regards the importation of supplementary parts, benefits may be granted in consideration of the respective nationalization programs (in the sense that it is the Brazilian Government's intention to have as many products locally produced as possible). The enjoyment of the incentive benefits is thus subject to compliance with the pre-established nationalization indices. [94]

For example, in the case of tele-printing machines the following table was established with five-year benefits: [95]

| Nationalization index based on value of parts | Reduction of Import Duties |
|---|---|
| 30% | 30% |
| 50% | 70% |
| 75% | 100% |

This means, for instance, that if a company is capable of manufacturing a tele-printing machine with 75 percent locally manufactured parts it will receive a 100 percent import duty reduction (i.e. a full exemption).

There are other requirements to be met by companies interested in obtaining incentives. In Resolution No. 35 of December 12, 1974 the CDI established the following basic conditions for industrial projects:

" (i) they must be destined to replace imports;
(ii) they must be committed to export objectives in the appropriate sectors which have an existing availability;
(iii) they must contribute to industrial decentralization or reduction of regional unbalances;
(iv) they must be supported by an adequate financial structure as regards own capital in relation to third party capital;
(v) they must have sufficient fixed and working capital to meet the specific conditions of the undertaking;
(vi) they must provide for a more intense use of national resources;
(vii) they must provide for the adoption of technological processes suitable for sectorial and regional development;
(viii) they must be production scales compatible with the maintaining of competitive costs;
(ix) they must satisfy anti-pollution criteria."

The examination of the projects is further subject to the interested parties presenting a year-by-year performance forecast of the total proposed imports. When the projects are approved, maximum import values will be established for each fiscal year, the validity of the incentives being subject to the strict fulfillment of the established forecast. [96]

Industrial incentive legislation makes no distinction between national industries and foreign-controlled industries as regards the enjoyment of incentive benefits. A multitude of projects controlled by foreign groups have been approved. More recently, however, the CDI has established a new condition for the concession of tax incentives to Brazilian companies, namely that they commit themselves not to make any changes in their share control without first obtaining the consent of the CDI, any breach of this commitment resulting in the loss of the benefits received. This rule is intended to avoid the transfer of national companies which have received CDI incentives to foreign groups. This condition has also been applied in the case of official financing, particularly when granted by the National Bank of Economic Development (BNDE).

### 3.1.2. Other industrial development incentives

According to Decree-Law No. 1,136 of December 7, 1970, the Minister of Finance is authorized to grant industrial establishments the right to an IPI tax credit on nationally produced machinery, devices and equipment intended for installation, modernization and expansion and for incorporation into the fixed assets of the favored companies. On the basis of this authorization the Minister of Finance issued Portaria No. 665 on December 10, 1974 to list the machinery, devices and equipment for which the benefit of the IPI tax credit may be obtained. This list is still in effect with only a few additions. The machinery, devices and equipment covered by Portaria No. 665 of the Minister of Finance also enjoy exemption from ICM tax according to Convention AE-08/74 entered into by the Secretaries of Finance of all the Brazilian States, including the Federal District, on December 11, 1974.

The enjoyment of the benefits provided by Decree-Law No. 1,136 does not require approval of the projects but is automatically granted if the products acquired are covered by Portaria No. 665 of the Minister of Finance. [97]

93. The importation of products to be incorporated in the fixed assets of the importer is not subject to payment of ICM tax, even if no exemption from import duty has been granted (Summary No. 570 of the Federal Supreme Court).

94. For example, CDI Resolution No. 5-71 of July 7, 1971 requires a 75 percent national content for tele-printing machines and CDI Portaria No. 28-71 of July 19, 1971 requires a 75 percent national content for motor excavator carriers. There are several CDI Portarias setting national content percentages for different products. See also Decree-Law No. 1,428, of December 2, 1975, Art. 2.

95. Resolution No. 5-71, Arts. 2, 3 and 5.

96. CDE, Resolution of the Presidency of Republic No. 47-76, of December 22, 1976.

97. Decree-Law No. 1,428, Arts. 4 and 5, contains provisions aimed at substituting the incentives established by Decree-Law No. 1,136. They are the following:
(a) exemption from IPI tax for nationally produced equipment, machines, apparatus, instruments, accessories and tools, listed by the Minister of Finance according to a CDI proposal, with the right to maintain and utilize credits for raw material, intermediate products and packaging material used in the manufacture of the goods exempt from IPI tax as described above; and
(b) a tax credit of up to 15 percent calculated on the domestic market sales of equipment, machines, apparatus, instruments, accessories and tools, granted to industrial establishments listed by the Minister of Finance and proposed by the CDI.
These provisions are not in force, as the corresponding list has not yet been issued by the Minister of Finance.

## 3.2. Incentives for the exportation of manufactured products – Special Export Programs

Within the scope of this study, it is also important to examine the incentives offered for exports as in the case of Special Export Programs. Federal authorities have made the acceptance of an export commitment a condition for the approval of several projects of establishment or expansion of foreign-controlled companies. [98]

The concession of incentives for the exportation of manufactured products under Special Export Programs is covered by Decree-Law No. 1,219 of May 15, 1972, as amended by Decree-Law No. 1,428 of December 2, 1975 and by Decree No. 77,065 of January 20, 1976. These incentives consist of the following:

(a) a 70 percent to 90 percent reduction of import duties and IPI tax in the importation of the machinery, equipment, devices, instruments, accessories and tools required to implement the Program; [99]
(b) a 50 percent reduction of import duties and IPI tax in the importation of the raw materials, components and intermediary products relating to the Program; [100]
(c) the deduction from the taxable profit of the portion of profit represented by exports of manufactured products; [101] and
(d) the exemption from the compulsory deposit in the importation of the products covered by the Special Export Program. [102]

The benefits described in the preceding paragraph may not be enjoyed cumulatively with other tax incentives provided for in current law. [103] Full import duty and IPI tax exemption may be granted in the cases described in (a) and (b) above provided that the Program has also been approved by the President of the Republic upon being deemed to be of relevant economic interest to the country. [104]

Obtaining the benefits in question requires the interested company to sign an Export Program with BEFIEX (see 2.8., above) expressly establishing the export commitment assumed by the company and the benefits to be received in exchange. [105] Export Programs have been signed for ten-year periods and their value is normally around US$ 400,000,000, although one of the latest approved Programs provides for an export commitment in an amount exceeding US$ 1,000,000,000. There are also Programs for small and medium industries, establishing export commitments for substantially lesser amounts.

The exports are determined on the basis of the net amount of average yearly exports, understood as the FOB value of the total exports of manufactured products, less the value of any components imported by the exporter under any special ruling and incorporated into the exported manufactured products, divided by the years of duration of the Programs. Insurance and freight, when paid to a Brazilian insurance or transport company, are added to the export value. [106] The value of the goods imported in each year with the mentioned exemptions may not exceed one third of the net value of the average yearly exports of manufactured products. [107]

Experience has shown that only major companies, nearly always large international companies, have assumed the risk involved in signing a Special Export Commitment. So much so, that news has spread that the ruling may be broadened to permit export commitments for only five years and thus allow smaller national companies to have access to these incentives.

## 3.3. Company merger and consolidation incentives

The incentives for the merger and consolidation of companies are currently governed by Decree-Law No. 1,346 of September 25, 1974, as amended by Decree-Law No. 1,532 of March 30, 1977. [108]

The incentives, which are valid until December 31, 1979, are the following: [109]

(a) one single revaluation of the fixed assets in excess of the monetary correction limits indicated in tax law but up to the market value, with suspension of payment of income tax on the value increase resulting from the revaluation; [110]
(b) the suspension of payment of income tax on the capital increase resulting from the asset revaluation, such benefit extending to the corporate and indivi-

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98. There are separate regulations to encourage exports, which are not analysed in this study. The basic legislation relating to these incentives is Decree-Law No. 491, of March 5, 1969, regulated by Decree No. 64,833, of July 17, 1969, with the amendments introduced by Decree No. 78,986, of December 21, 1976.
99. Decree-Law No. 1,219, of May 15, 1972, Art. 1, §2, I; Decree No. 77,065, Art. 5.
100. Decree-Law No. 1,219, Art. 1, §2, II; Decree No. 77,065, Art. 5, sole paragraph.
101. Decree-Law No. 1,219, Art. 10.
102. Decree-Law No. 1,427, of December 2, 1975, established the compulsory deposit of an amount corresponding to the FOB value of the import license. This amount is returned after 360 days, during which no interest or monetary correction accrues. The application of Decree-Law No. 1,427 was regulated by Resolution No. 443, of the Central Bank of Brazil, of September 14, 1977. Exemption from the deposit for importations made under Special Export Programs approved by BEFIEX was authorized by item IV, item 20 of Resolution No. 443.
103. Decree-Law No. 1,219, Art. 15.
104. Decree-Law No. 1,428, Art. 1, §2.
105. Failure to carry out the export commitment subjects the participant companies to the payment of the taxes from which they were exempted, or which would otherwise be due, with monetary correction and a fine of up to 50 percent (Decree-Law No. 1,219, Art. 4).
106. Decree-Law No. 1,219, Art. 3, §2.
107. Id., Art. 3. According to the provisions of §1 of this Art. 3, the annual value of imports does not include the value of goods imported with the exemptions granted by Decree-Law No. 1,137.
108. The incentives were initially established by Decree-Law No. 1,182 of July 16, 1971, with the amendments introduced by Decree-Laws Nos. 1,253 and 1,300 of December 29, 1972 and December 28, 1973, respectively. Decree-Law No. 1,182 subjected the enjoyment of the benefits to a commitment for the interested company to open its capital (Art. 4, II). This condition was excluded from the present regulation.
109. Decree-Law No. 1,346, Art. 13.
110. Id., Art. 1.

dual partners or shareholders of the company which may effect a capital increase under the same conditions by incorporating the amounts distributed (i.e. stock dividends are exempt); [111]

(c) amortization in more than one financial year of the expenses and other charges resulting from the reorganization or modernization of companies with effects on the operational results extending beyond the financial year in which they were incurred, provided that such expenses and other charges are deductible from the taxable profit, such amortization being authorized by the National Monetary Council in the case of financial institutions, and by the Minister of Finance in all other cases, both subject to the prior opinion of COFIE (see 2.9., above) in cases of merger and consolidation. [112]

The suspension from payment of income tax, as mentioned in item (a) of the preceding paragraph, is transformed into exemption within three years, once the economic and financial objectives of the project approved by the Minister of Finance have been attained. It should be mentioned that the figure resulting from the revaluation must necessarily be used for a capital increase within 180 days of the date of approval by the Minister of Finance. [113]

These incentives are applicable to mergers, consolidations or other forms of company combination or association, when considered to be of interest to the national economy according to the criteria established in Article 1 of Decree No. 75,247 of January 21, 1975. They include associations for the main purpose of obtaining economy of scale, development of the competitive powers of companies, reinforcement of the national financial system, the penetration, expansion or maintenance of foreign markets, the installation or modernization of undertakings for the manufacture of products that are scarce in the country, installation or modernization of agricultural-industrial undertakings or of undertakings related to the agricultural industry, and installation or modernization of undertakings for the production of capital goods.

Decree-Law No. 1,532 extended these incentives up to June 30, 1978 to companies which have priority projects for the expansion of their activities under reorganization or modernization programs financed with their own resources or with those of official financial entities.

### 3.4. Mining incentives

All the industrial incentives established by Decree-Law No. 1,137 and discussed in 3.1. above were extended to mining activities by Decree-Law No. 1,287 of October 18, 1973. In addition to these incentives, mining companies also enjoy the following benefits:

(a) deduction from their real profit, for income tax purposes, of a mineral resources depletion quota equivalent to 20 percent of the gross income earned in the first ten years of exploitation of the mine. This incentive does not affect the company's right to depreciate its assets according to current law. The amount of this deduction should be incorporated in the capital of the company within twelve months; [114] and

(b) financial support for research and for investigation and development of mineral processing techniques, such support being provided in the form of loans in amounts of up to 80 percent of the total cost of the undertaking. The financial support may be given with or without participation in the risk of the undertaking. In the case of such participation in the risk a corresponding compensation is established and charged in the form of a risk quota. [115] The Mineral Resources Research Company (CPRM) is responsible for controlling the geological and technical progress of the undertaking. [116]

Incentives were also created for the exportation of minerals that are abundant in the country in processed form (e.g. pellets) by means of Decree-Law No. 1,240 of October 11, 1973. These incentives are to be maintained up to and including the year 1978 and are the following:

(a) deduction from the profit subject to income tax of the portion corresponding to the exportation of such minerals; [117]

(b) deposit of 50 percent of the tax levied on dividends paid to residents (both individuals and legal entities) of other countries (at the rate of 25 percent in a special blocked account with Banco do Brasil S.A. for later use in the payment of other federal taxes (except the Sole Tax on Minerals) or for investment in other mining projects in the manner approved by GEIMI. [118]

In order to enjoy the benefits described in the preceding paragraph, the company must be controlled by nationals; the undertaking must have had its financial structure approved by the Ministry of Finance and its technical and economic structure by the Ministry of Mines and Energy; the company must export at least half of its production as evidenced by confirmed contracts for the purchase of the product over a term of not less than ten years, the unit value of the processed mineral to be at least 50 percent greater than that of the same unprocessed mineral. [119]

In the specific case of the incentive described in (b) above, the legal entity domiciled abroad must acquire, for its own use or for the use of an industry abroad in which it holds a majority interest, a portion of the

111. Id., Art. 2.
112. Decree-Law No. 1,303, of December 31, 1973.
113. Decree-Law No. 1,346, Art. 6.
114. Decree-Law No. 1,096, of March 23, 1970, Art. 1.
115. Decree No. 66,522, of April 30, 1970, Arts. 1, 5, 6 and 10.
116. The CPRM was created on August 15, 1969, by Decree-Law No. 764, amended by Law No. 6,399, of December 10, 1976. Its present By-Laws were established on May 24, 1971, by Decree No. 68,672. The purpose of the CPRM is to encourage the discovery and intensify the exploitation of mineral and hydric resources, to guide and favor private enterprise in the field, and to supplement private enterprise in the strictly limited field of research of mineral and hydric resources.
117. Decree-Law No. 1,240, of October 11, 1973, Art. 1, I.
118. Id., Art. 1, II and Art. 2.
119. Id., Art. 3.

production not below the proportion of the capital it holds in the Brazilian company in question. [120]

### 3.5. Forestation and reforestation incentives

The origin of the current Brazilian legislation on tax incentives for forestation undertakings can be traced back to Law No. 5,106 of September 2, 1966, which granted incentives for investments made by both individuals and legal entities in projects of such kind. The system applied at the time was different as regards the investments made by individuals or by legal entities. In the case of individuals, the investments made in approved forestation projects during the base year could be deducted from the gross income up to the limit of 50 percent of such *gross income*. In the case of legal entities, the applicable system was the investment in approved forestation projects of up to 50 percent of the *income tax* due.

Several changes were introduced as time went by and the legislation that now governs the matter is quite complex. Today there are two basic systems which are known by the name of the main law that refers to each: the System of Law No. 5,106 and the System of Decree-Law No. 1,134.

*System of Law No. 5,106*

The basic system of Law No. 5,106 for investments made by individuals is still in force. In other words, individuals wishing to take advantages of the incentives should during the basic year make investments in forestation projects of their choice. The major change is that the amount so invested is treated as a credit against income tax, while under the initial system it was a deduction against gross income.

The limits have been altered and the general rule is a credit up to 20 percent of the income tax due by individuals, although up to 42 percent may be credited for investments made in projects situated in the SUDENE and SUDAM areas. [121]

*System of Decree-Law No. 1,134*

This is the system for investments made by legal entities. It derives from Decree-Law No. 1,134 of November 26, 1970 and permits companies to use part of the income tax they owe for investment in approved forestation projects.

The current procedure was established by Decree-Law No. 1,376 of December 12, 1974 [122] channelling the investments through the Sectorial Investment Fund (FISET — Forestation and Reforestation). In practice, legal entities which wish to invest part of their income tax in forestation projects make this option at the time of filing their income tax return. The funds allocated for this purpose are later invested in projects approved by the IBDF.

The investment may be made in a project of the company itself, provided that the investor, individually or jointly with other investors, controls at least 51 percent of the project's voting capital, the other investors being required to hold at least 5 percent each (FISET Own Projects). [123]

There are special rules for investment in forestation projects of third parties — FISET Open Projects — which rules are rather complex. One can briefly say that each project states the minimum investment it can receive, this minimum amount being determined on the basis of the costs and of the planting area, and subject to the approval of the IBDF. [124]

The limits established for investment by legal entities of part of the income tax due by them are the following: [125]

| | |
|---|---|
| Base-Year 1974 | up to 45% |
| Base-Year 1975 | up to 40% |
| Base-Year 1976 and next years | up to 35% |

At present PIN and Proterra receive one half of the above percentages, i.e. 30 percent and 20 percent, respectively, of the above proceeds. [126] The profits earned on investments made with portions of income tax may not be transferred abroad, neither directly nor indirectly, subject to the revocation of the tax incentives obtained and to a demand for the income tax not paid, plus a fine of 10 percent per annum, in addition to other specific sanctions for non-payment of income tax. This prohibiiton does not, however, apply to remittance abroad of the portion of the profit attributed to direct investments of foreign capital in the project. [127]

*Legal form of projects*

The projects must be organized either as (i) "sociedades anônimas" or, (ii) non-share companies with multiple participation. In the latter case, the company is actually a special partnership governed by Articles 325 to 328 of the Brazilian Commercial Code, in which the active partner is responsible for the forestation undertaking and for its representation before the IBDF. [128]

*Project areas*

It is important to note that as of the fiscal year 1977, forestation projects may only be implemented in Prioritary Forestation Regions or in Industrial Forestation Districts. The Prioritary Forestation Regions are

120. Id., Art. 3, §1.
121. Decree-Law No. 1,338, of July 23, 1974, Art. 2(i) and (p), and Decree No. 79,046, of December 27, Art. 20.
122. See discussion regarding FISET in Sub-section 2.19 of this study.
123. Decree-Law No. 1,376, Art. 18.
124. Normative Portaria No. 08-DR, of the IBDF.
125. Decree-Law No. 1,376, Art. 11, IV, amended by Decree-Law No. 1,478, of August 26, 1976.
126. See discussion regarding PIN and PROTERRA in Sub-sections 2.17 and 2.18 of this study.
127. Decree-Law No. 1,376, Art. 11; abd Decree-Law No. 1,563, of July 29, 1977.
128. Decree-Law No. 1,134, of December 23, 1970, Art. 1, §1; Decree No. 79,046, Art. 25, and Normative Portaria No. 08-DR, of the IBDF, Art. 5; and Portaria No. 153, of May 2, 1975, of the Minister of Finance.

determined by the IBDF after hearing the Forestation Policy Council. The Industrial Forestation Districts are determined by a decree of the President of the Republic based on a joint recommendation of the Ministers of Agriculture, Industry and Commerce, the Interior and the Secretary of Planning of the Presidency of the Republic. Exceptions are made only for projects for fruit trees and "palmito" (palm hearts) and for projects with eminently conservationist effects. [129]

### 3.6. Fishing incentives

The incentives for the fishing industry were established by Decree-Law No. 221 of February 28, 1967, initially valid up to the year 1972. This period was entended to 1977 by Decree-Law No. 1,217 of May 9, 1972, which also made some changes in the initial system, and then extended to 1982 by Decree-Law No. 1,594 of December 22, 1977.

The incentives available are the following: [130]

(a) exemption or reduction of import duty, of IPI tax and of import duties and other federal duties, for the importation of fishing boats, equipment, machinery, apparatus, instruments and respective spare parts, tools, appliances and devices for fishing in connection with projects by SUDEPE;
(b) exemption or reduction of IPI tax for nets and net parts intended exclusively for commercial fishing or fishing research;
(c) exemption or reduction of IPI tax on boats intended exclusively for commercial fishing or fishing research;
(d) exemption from federal taxes and duties for the fish caught, whether or not it is processed in the country, whether intended for local consumption or for exportation;
(e) exemption or reduction of import duties and other federal duties for importations favored by import duty and IPI tax exemption, when made by companies that manufacture fishing equipment and appliances intended for catching, processing, transporting and trading fish;
(f) exemption, at the discretion of the Minister of Finance based on the opinion of SUDEPE, from the income tax due on the financial results obtained from undertakings approved by SUDEPE. The amount of this exemption should be incorporated into the capital of the favored company up to the end of the financial year following that of the exemption;
(g) the amount of investment in fishing project approved by SUDEPE may be credited up to 25 percent against corporate income tax. This credit may reach up to 50 percent if the projects are located in the SUDENE or SUDAM areas. In practice, the benefit of the investment is actually reduced by half, since one half must be assigned to PIN and to PROTERRA. [131]

The importation benefits are subject to specific regulations and apply only to products that are not manufactured in Brazil. [132] Decree-Law No. 1,428 of December 2, 1975 reserved import duty and IPI tax exemption for undertakings of relevant national interest which are approved by the President of the Republic. Based on an opinion of SUDEPE, the Minister of Finance may grant the reduction of these taxes.

There are detailed rules for the preparation of the fishing projects to be submitted to the examination of SUDEPE, established in "Portarias" which are periodically issued by SUDEPE. The company must cover at least one third of the entire investment with its own funds. [133] SUDEPE established special rules which make the proportion of own funds vary according to priority criteria fixed in view of the purposes of the project and of the area in which it is to be implemented. For projects situated in the SUDENE or SUDAM areas, the own funds must represent a minimum of 25 percent of the total project.

The results of investments made with income tax allowances may not be directly or indirectly transferred abroad, subject to revocation of the tax incentives obtained and to a demand for the income tax not paid, plus a fine of 10 percent per year and the other specific sanctions for non-payment of income tax. This prohibition does not, however, apply to remittance abroad of the profit portion attributed to direct investments of foreign capital in the project. It also does not hinder the utilization of the profits or earnings derived from the tax incentive investments for the purchase of foreign equipment not produced in Brazil, provided that this purchase has been duly authorized. [134]

### 3.7. Tourism incentives

Decree-Law No. 1,439 of December 30, 1975 establishes the incentives which are at present available for tourism, [135] favoring hotels and other means of lodging, tourism restaurants and undertakings which support tourism activities. [136]

The incentives available are the following: [137]

(a) financial aid from the Sectorial Investment Fund (FISET – Tourism);
(b) financial aid from the General Tourism Fund (FUNGETUR);
(c) reduction of income tax and non-refundable additional charges; and

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129. Decree No. 79,046, Arts. 4, 5 and 6.
130. Decree-Law No. 221, of February 28, 1967, Arts. 73, 74, 77, 78, 80 and 81, with the amendments introduced by Decree-Law No. 1,217, of May 9, 1972, and Decree-Law No. 1,594.
131. See sub-sections 2.17 and 2.18 of this study on PIN and PROTERRA.
132. Decree-Law No. 221, Art. 75.
133. Id., Art. 81, §2.
134. Decree-Law No. 1,376, Art. 11; and Decree-Law No. 1,563.
135. The former regulation was established in Decree-Law No. 55, of November 18, 1966, with the substantial amendments introduced by Decree-Law No. 1,191.
136. Decree No. 78,379, Art. 1.
137. Decree-Law No. 1,439, Art. 3. FUNGETUR, created by Decree-Law No. 1,191, Art. 11, and presently regulated by Decree-Law No. 1,439, Art. 13 and following, is allotted mainly budget funds to support tourism activities which are: small and medium-sized; located in preferred areas; have medium prices and tariffs; or are engaged in local activities, particularly those destined to recreation or lodging of the low income class.

(d) financing by official credit establishments according to the rules they adopt.

The financial aid from FISET — Tourism and from FUNGETUR for capital investment is limited to 50 percent of the investment in a favored undertaking. This percentage may be increased to 75 percent by determination of the National Tourism Council, in accordance with the conditions of priority and superiority established by the Executive Power. [138]

The income tax reduction favors tourism undertakings which are being built or which are to be built on the basis of projects approved prior to December 31, 1985. This reduction, which may go as high as 70 percent, is granted for successive annual periods up to a total of ten years. [139] An identical benefit may be granted to undertakings which are expanded, according to the criteria and conditions established by the Executive Power, based on the expansion cost and on the total value of the undertaking. [140] In both cases, the amount of the reduction must be incorporated into the capital of the favored company in the year following that of the benefit, for direct investment in tourism activities.

Article 6 of Decree-Law No. 1,439 provides further that companies which own operating hotels for at least five years and which have not taken advantage of the benefits established in Decree-Law No. 1,191 of October 27, 1971 may up to the year 1978 pay their income tax with a reduction of up to 70 percent, provided that they prove that they have in each year invested an amount of at least twice the reduction in operational improvements during the corresponding base period.

Legal entities may deduct up to 12 percent of their income tax for investment in tourism projects approved by the National Tourism Council. [141] This reduction may reach up to 50 percent in the case of projects located in the SUDENE or SUDAM areas. In practice, this reduction is actually reduced to half, since the other half must be assigned to PIN and to PROTERRA. [142]

Up to and including the financial year 1985, individuals may deduct from their income tax an amount for subscription of shares of publicly held "sociedades anônimas" (companies) engaged in tourism undertakings approved by the National Tourism Council, this amount being limited to 20 percent of the income tax due. [143] The benefits granted to tourism projects may only be enjoyed by Brazilian companies registered with EMBRATUR, in which the majority of the voting capital is held by individuals resident and domiciled in Brazil or by national legal entities which satisfy the same requirements. [144]

The results of investments made with portions of income tax may not be transferred abroad directly or indirectly, subject to revocation of the tax benefits obtained and to a demand for the income tax not paid, plus a fine of 10 percent per year and the other specific sanctions for non-payment of income tax. This prohibition does not, however, apply to the remittance abroad of the profit portion attributed to direct investments of foreign capital in the project. It also does not hinder the profits or earnings derived from investments made with tax incentive funds from being utilized for the purchase of foreign equipment not produced in Brazil, provided that his purchase has been properly authorized. [145]

### 3.8. Aeronautics industry incentives

The incentives available for the formation of a Brazilian aeronautics industry were established by Decree-Law No. 770 of August 19, 1969, which created Empresa Brasileira de Aeronáutica S.A. (EMBRAER). The Republic must hold at least 51 percent of the capital of EMBRAER and the remainder may be subscribed by individuals or legal entities. Article 7 of this Decree-Law permitted legal entities to deduct 1 percent of their income tax for investment in shares of EMBRAER. [146]

The results of investments made with portions of income tax may not be transferred abroad, directly or indirectly, subject to revocation of the tax incentives obtained and to a demand for the income tax not paid, plus a fine of 10 percent per year and the specific sanctions for non-payment of income tax. [147] The EMBRAER funds must be invested in airplane design and construction and the company has to date developed a significant number of models. In addition, EMBRAER encourages private aviation projects and should for this purpose, whenever possible, resort to qualified private initiative by transferring construction tasks. [148]

## IV. REGIONAL INCENTIVES

### 4.1. Incentives for investments in the Amazon

For the purposes of the incentives in question, the Amazon includes the entire area formed by the States of Acre, Pará and Amazonas, by the Federal Territories of Amapá, Roraima and Rondonia and by the area of the State of Mato Grosso which lies north of the 16th parallel, of the State of Goiás north of the 13th parallel, and of the State of Maranhão to the west of the 44th meridian. [149]

The incentives available for investments in the Amazon region are currently regulated by Decree-Law No. 756 of August 11, 1969. They are intended for agricultural, livestock, industrial and basic service projects, which

138. Decree-Law No. 1,439, Art. 3, sole paragraph.
139. Id., Art. 4.
140. Id., Art. 5.
141. Id., Art. 9, and Decree-Law No. 1,514, of December 30, 1976.
142. See sub-sections 2.17 and 2.18 of this study on PIN and PROTERRA. The system initially established by Decree-Law No. 55 was more favorable, as it permitted a reduction of up to 50 percent of the tax due.
143. Decree-Law No. 1,338, Art. 2(m), with the amendment introduced by Decree-Law No. 1,439, Art. 12.
144. Decree-Law No. 1,439, Art. 2.
145. Decree-Law No. 1,376, Art. 11; and Decree-Law No. 1,563.
146. The term initially established by Decree-Law No. 770, of August 19, 1969, for the option to invest in EMBRAER (up to fiscal year 1975) was extended by Decree-Law No. 1,408, of July 7, 1975, up to and including the fiscal year 1980.
147. Decree-Law No. 1,376, Art. 11; and Decree-Law No. 1,563.
148. Decree-Law No. 770, Art. 2.
149. Law No. 5,173, Art. 2.

SUDAM has declared to be of interest to the development of the Amazon.[150] The incentives available are the following:

(a) funds from the Amazon Investment Fund (FINAM);[151]
(b) funds from the Fund of Private Investment in the Development of the Amazon (FIDAM);[152]
(c) 50 percent reduction of income tax and non-refundable additional charges, for the results obtained up to and including the financial year 1982, this reduction being granted to economic undertakings existing on the date of the enactment of Decree-Law No. 756;[153]
(d) exemption from income tax and from non-refundable additional charges, for industrial and agricultural undertakings in the SUDAM area, which are set up, modernized, expanded or diversified up to and including the fiscal year 1982. The period of validity of this exemption is ten years as from the financial year following that in which the undertaking starts operating normally at the discretion of SUDAM. The exemption period may be extended for another five years if the undertaking meets one of the following conditions: (i) it is located in under-developed microregions; (ii) it has, during the exemption period, a profitability of 12 percent or less of the average capital and reserves of the period; (iii) it absorbs raw materials and inputs produced in the region in an amount exceeding 50 percent of the production cost;[154]
(e) exemption or reduction of import duty, of IPI tax and of other federal duties for the importation of machinery and equipment not produced in Brazil, when intended to implement undertakings approved by SUDAM;[155]
(f) refund of 50 percent of the income tax due, for industrial, agricultural, livestock and basic service companies which invest an equivalent amount in the modernization, supplementation, expansion or diversification of their activities, under a project approved by SUDAM.[156]

The FINAM funds may represent up to 75 percent of the capital of a company engaged in an economic undertaking approved by SUDAM, the interested group contributing at least 25 percent of the company's capital.[157] The proportion between own funds and FINAM funds is determined by SUDAM at the time of approval of the project.

The amount of the income tax exemption or reduction enjoyed by a company located in the Amazon must be capitalized in the company up to 31 December of the year following that in which the benefit was taken.[158] Legal entities can deduct up to 50 percent of their income tax for investment in projects approved by SUDAM. In practice, the benefit of the investment is reduced by half, since one half must be assigned to PIN and to PROTERRA.[159]

The results of investments made with income tax portions may not be transferred abroad directly or indirectly, subject to revocation of the tax incentives obtained and to a demand for the income tax not paid, in addition to a fine of 10 percent per year and to the specific sanctions for non-payment of income tax. This prohibition does not, however, apply to the remittance abroad of the portion of the profits attributed to direct investments of foreign capital in the project. It also does not hinder the utilization of the profit or earnings derived from investments of tax incentive funds to purchase foreign equipment not produced in Brazil, provided that other authorizations for the purchase have been obtained.[160]

Individuals may reduce the income tax they owe on their annual income tax return by an amount used for subscription of shares of industrial or agricultural companies having projects approved by SUDAM, up to a limit of 42 percent of the income tax due.[161]

No requirement of national control of capital is made for tax incentives to be granted to projects in the Amazon region.

### 4.2. Incentives for investments in the Northeast

For the purposes of the incentives under discussion, the Northeast includes the entire area constituted by the States of Maranhao (except the area situated to the west of the 44th meridian, which is part of the Amazon), Piauí, Ceará, Rio de Grande do Norte, Paraíba, Pernambuco, Alagoas, Sergipe and Bahia, the region of the State of Minas Gerais situated in the Drought Polygon, and the Territory of Fernando de Noronha.[162]

The incentives now available for investments in industrial or agricultural projects approved by Sudene in the Northeast region were established by Law No. 4,239 of June 27, 1963, amended by Law No. 4,869 of December 1, 1965 and by Law No. 5,508 of October 11, 1968. These three laws were regulated by Decree No. 64,214 of March 18, 1969, which is still in effect.[163] The incentives available are the following:

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150. Decree-Law No. 756, of August 11, 1969, Art. 1. The basic services for the purposes concerned are those related to energy, transportation, communication, colonization, education, sanitation and public health.
151. Id., Art. 1.
152. FIDAM was created by Law No. 5,173. The funds available to FIDAM are specified in Art. 33 of Decree-Law No. 756, and are constituted mainly of budget allowances, being applied by BASA as financing or refinancing (Decree-Law No. 756, Art. 34).
153. Decree-Law No. 756, Art. 22.
154. Id., Art. 23; Decree-Law No. 1,328, of May 20, 1974, and Decree-Law No. 1,564, Art. 1.
155. Decree-Law No. 756, Art. 26.
156. Id., Art. 29, with the new wording established by Decree-Law No. 1,564, Art. 4.
157. Decree-Law No. 756, Art. 1, §3.
158. Id., Art. 24.
159. See sub-sections 2.17 and 2.18 of this study on PIN and PROTERRA.
160. Decree-Law No. 1,376, Art. 11, and Decree-Law No. 1,563.
161. Decree-Law No. 1,338, Art. 2(i).
162. Law No. 3,629, of December 15, 1959, Art. 1, and Decree No. 64,214, of March 18, 1969, Art. 4, §3.
163. The terms of validity of the incentives were extended successively by Decree-Law No. 1,196, of December 23, 1971; by Decree-Law No. 1,328; by Decree-Law No. 1,563; and by Decree-Law No. 1,624, of May 3, 1978.

(a) funds from the Northeast Research and Natural Resources Fund (FURENE); [164]
(b) funds from the Northeast Investment Fund; [165]
(c) a 50 percent reduction of income tax and non-refundable additional charges, for the results obtained up to December 31, 1982, this reduction being granted to companies that were in existence at the time of the issuance of Decree No. 64,124 and to companies having undertakings which do not meet the exemption conditions and which have operating industrial or agricultural establishments; [166]
(d) exemption from income tax and from non-refundable additional charges, for companies having new industrial or agricultural undertakings approved by SUDENE and which are installed, modernized, expanded or diversified up to and including the year 1982. The period of validity is ten years as from the financial year following the date of normal start-up of the undertaking, according to a statement of SUDENE. The exemption period may be increased to 15 years if the undertaking satisfies one of the following requirements: (i) it is located in underdeveloped microregions; (ii) it has a profitability, during the exemption period, of 12 percent or less of the average capital and reserves of the period; (iii) it absorbs raw materials and inputs produced in the region in an amount in excess of 50 percent of the production cost; [167]
(e) exemption or reduction of import duty, of IPI tax and of other federal duties, for the importation of machinery and equipment not produced in Brazil, when intended for the execution of projects approved by SUDENE; [168]
(f) refund of 50 percent of the income tax due, for industrial, agricultural, livestock and basic service companies that invest an equal amount in the modernization, supplementation, expansion or diversification of their activities, according to a project approved by SUDENE. [169]

The FINOR funds (see 2.19. above) may represent up to 75 percent of the capital of a company that has an industrial or agricultural project approved by SUDENE, the interested party contributing at least 25 percent of the company's capital. [170] In the case of a foreign capital investment, the proportion of own funds must be at least 50 percent. [171] The amount of income tax exemption or reduction, as mentioned above, must be capitalized in the company in the year following that in which the benefit was enjoyed. [172] Legal entities may deduct up to 50 percent of their income tax for investment in projects approved by SUDENE. In practice, the benefit of the investment is reduced by half, since one half must be assigned to PIN and to PROTERRA. [173]

The results of investments made with portions of income tax may not be directly or indirectly transferred abroad, subject to revocation of the tax incentives obtained and to a demand for the income tax not paid, plus a fine of 10 percent per year and the specific sanctions for non-payment of income tax. This prohibition does not, however, apply to the remittance abroad of the portion of the profits attributed to direct foreign capital investments in the project. It also does not hinder the profits or earnings derived from investments made with tax incentive funds from being used to purchase foreign equipment not produced in Brazil, provided that all authorizations are obtained for the purchase. [174]

Individuals may reduce the income tax they owe under their annual income tax return by an amount for subscription of shares of industrial or agricultural companies having projects approved by SUDENE, this reduction being limited to 42 percent of the income tax due. [175]

There are no requirements of national capital control for SUDENE projects to enjoy the tax incentives in question.

### 4.3. Incentives for investments in the Manaus Free Zone

The Manaus Free Zone is an area defined by Article 2 of Decree No. 61,244 of August 28, 1967, its main points of reference being the Port of Manaus, the left banks of the Negro and Amazonas Rivers, the Urubu River and the Cuieiras River.

The incentives available for investments in the Manaus Free Zone were established by Decree-Law No. 288 of February 28, 1967, regulated by Decree No. 61,244. They are the following:
(a) exemption from IPI tax for goods produced or processed in the Free Zone, wether for local consumption or for trade within the Brazilian territory; [176]
(b) exemption from IPI tax and ICM tax, for goods of national origin intended for consumption and processing in the Free Zone, or for reexportation abroad; [177]
(c) exemption from IPI tax and from import duty, for foreign goods entering the Free Zone for local consumption, any degree of industrial processing or improvement, agriculture, fishing, installation and operation of industries and services of any kind, or storage for reexportation; [178]

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164. FURENE was created by Law No. 5,508, of October 11, 1968, Art. 8. Its funds are mainly budget allowances to be applied in financing the research and development of technology adequate for the region and for the research of natural resources, like mining.
165. Law No. 4,239, of June 27, 1963, Art. 18(b), and Law No. 4,869, of December 1, 1965, Art. 18. These incentives are also available for telecommunication projects approved by SUDENE.
166. Decree No. 64,214, Arts. 1 and 3.
167. Id., Art. 2 and Art. 16, §2, and Decree-Law No. 1,564.
168. Law No. 3,692, Art. 18.
169. Law No. 5,508, Art. 23, with the new wording given by Decree-Law No. 1,564, Art. 4.
170. Decree No. 64,214, Art. 29, §1.
171. Id., Art. 37.
172. Id., Art. 9, §3.
173. See sub-sections 2.17 and 2.18 of this study on PIN and PROTERRA.
174. Decree-Law No. 1,376, Art. 11; Decree-Law No. 1,563.
175. Decree-Law No. 1,338, Art. 2(i).
176. Decree-Law No. 288, Art. 9.
177. Decree-Law No. 288, Art. 4; Law No. 4,502, of November 30, 1964, Art. 7, I; Federal Constitution, Art. 23, §7.
178. Decree-Law No. 288, Art. 3.

(d) reduction of the IPI tax rate for raw materials imported for industrial processing, at the time of sale of the processed product to other parts of Brazil, such reduction applying to the value added in the industrial processing in the Free Zone;[179]
(e) exemption from export duty for the exportation of goods from the Free Zone to other countries, regardless of the origin of the goods.[180]

The incentives described above are not available for arms, ammunition, perfume, tobacco, alcoholic drinks and passenger cars.[181]

Decree-Law No. 356 of August 15, 1968 extended the tax incentives granted under Decree-Law No. 288 to goods received, originating from, improved or manufactured in the Free Zone for local utilization and consumption in pioneer areas, frontier zones and other places of the West Amazon. The West Amazon consists of the area of the States of Amazonas and Acre and of the Federal Territories of Rondonia and Roraima, according to paragraph 4 of Article 1 of Decree-Law No. 291 of February 28, 1967.

It should finally be mentioned that the area of the Free Zone is included in the area of SUDAM (i.e. the Amazon region), so that all the tax incentives available for the SUDAM area are also available for the Manaus Free Zone.

## V. FINANCING FROM THE NATIONAL BANK OF ECONOMIC DEVELOPMENT – BNDE

BNDE financing is granted either directly or through previously accredited Financial Agents. The BNDE also engages in the following operations: the rendering of guarantees, corporate participation, underwriting operations and the rendering of guarantees to winners of international bids.[182]

The priority programs of the BNDE are the following:
I. Basic inputs (raw materials and basic products);
II. Basic equipment; and
III. Other programs.

### 5.1. Basic Inputs Program

The Basic Inputs Program is intended to meet the domestic demand for raw materials and basic industrial inputs in order to diminish the importation of these products. The Program is available to the following sectors: mining, steel industry, non-ferrous metals industry, chemical and petrochemical industry, fertilizer industry, cellulose and paper industry, and cement industry.

The term of BNDE financing reaches up to twenty years at interest rates of 3 to 5 percent per year. The principal is subject to readjustment according to the index applicable to Readjustable National Treasury Bonds (ORTNs).

### 5.2. Basic Equipment Program

The Basic Equipment Program is intended to expedite the development of the sector in order to improve the balance of payments of the country and permit the development of heavy equipment technology, thus consolidating the infra-structure of the national production industry.

In this area, financing is granted for terms of up to 15 years at interest rates of 3 to 5 percent per year, the principal being readjusted according to the ORTN index.

### 5.3. Other programs

These are divided in the following manner:
(a) Operations with agents;
(b) Modernization of companies;
(c) Infra-structure;
(d) Technological development; and
(e) Others.

#### 5.3.1. Operations with Agents – Joint Operations Program (POC)

This Program is an incentive for the economic development of the country by strengthening private national enterprises, in particular small and medium-sized companies. The financing is granted through Financial Agents which are previously accredited by the BNDE. These Financial Agents analyse and follow-up the operations for which they assume responsibility.

The POC funds are extended by means of the following operations: (i) Program Operations, (ii) Package Operations and (iii) Project Operations.

The *Program Operations* apply to similar, supplementary or interdependent projects for raw materials, goods or services, preferably for the expansion of production capacity in microregions or in sectors of activities of a significantly local vein.

The *Package Operations* are meant to cover the financing requirements of small and medium-sized companies for the development of their projects.

The *Project Operations* are aimed at major undertakings.

The repayment term of the financing is up to ten years for Program Operations and Project Operations and up to eight years for Package Operations. Working capital financing is granted for terms of up to three years.

The Interest rate is established according to certain criteria stipulated by the Board of Directors of the BNDE and ranges from 0.5 to 4 percent. The principal is readjusted according to the monetary correction of the ORTNs and a commission of 2 to 2.5 percent is due to the Financial Agent.

179. Id., Art. 7, with the amendments introduced by Decree-Law No. 1,435, of December 16, 1975.
180. Id., Art. 5.
181. Decree-Law No. 340, of December 22, 1967, amended by Decree-Law No. 355, of August 6, 1968.
182. The BNDE prepared several pamphlets which present a summary of each of its operational methods. These pamphlets are available at the BNDE and were used in composing this study.

### 5.3.2. Modernization of companies — Industry Modernization and Recovery Fund

This is a sub-program organized to reequip private national companies with funds derived from the Industry Modernization and Recovery Fund (FMRI).[183] The financing may cover 50 to 100 percent of the project for a term of up to ten years at interest of 4 to 8 percent per year. The principal is readjusted according to the ORTN index.

### 5.3.3. Infra-structure

This is another sub-program by which the BNDE gives governmental entities assistance in infra-structure projects for the improvement of the economy. The two priority sectors are railways and highways. The BNDE provides up to 50 percent of the investment for a term of up to 15 years at interest of 4 to 8 percent per year, the principal being readjusted according to the ORTN index.

### 5.3.4. Technological development

This sub-program offers highly subsidized financing (without monetary correction) to induce companies to invest in research and development projects. This financing is available to universities and research institutions for joint projects with private companies.

The financing may cover from 80 to 100 percent of the project, with terms of up to ten years and interest of 0 to 4 percent per annum, without monetary correction.

### 5.3.5. Capitalization of private enterprises

Among the non-priority programs of the BNDE, there are two recent programs organized to encourage the capitalization of private national enterprises: PROCAP and FINAC.

The Special Program of Support for the Capitalization of National Private Enterprises (PROCAP) favors the capitalization of mainly small and medium-sized companies through the capital market. The Program is thus implemented through investment banks. The second program of this kind — PROCAP II — was approved by BNDE Resolution No. 506/77.

The PROCAP funds are intended to permit a Brazilian shareholder to pay up only part of share issues under a guarantee given by the investment bank that carried out the operation. The financing limit is 50 percent of the value of the securities which have to be registered with the Central Bank of Brazil. The repayment term of this loan is five years subject to interest and charges established according to the region in which the company is located, and to monetary correction according to the ORTN index.

The Program of Shareholder Operations and Financing (FINAC) is intended to support the capitalization of mainly small and medium-sized companies by means of financing extended to the shareholders for investment in their own companies. This Program is to be implemented through development banks which, in the opinion of the BNDE, have a closer relationship with small and medium-sized companies. The second program of this kind — FINAC II — was approved by BNDE Resolution No. 507/77. The financing term is up to ten years, subject to interest and charges established according to the region in which the company is located, and to monetary correction according to the ORTN index.

During 1978 the financing granted by the BNDE and by other federal financing institutions to their financial agents under programs of support for the capitalization of private national enterprises shall enjoy a tax incentive in the form of the limitation of the applicable monetary correction to 20 percent during the same financial year and relative to the balances outstanding under the agreements.[184]

## VI. FINANCING FUND FOR THE ACQUISITION OF INDUSTRIAL MACHINERY AND EQUIPMENT — FINAME

FINAME was created by Decree No. 55,275 of December 22, 1964 in order to finance operations of purchase and sale, including exportation, of nationally produced machinery and equipment and of importation of supplementary parts and components. Its funds are held at BNDE. The FINAME Fund is managed by the Special Industrial Financing Agency (FINAME), this Agency and the Fund having the same name.

The operations of the Finame Agency are carried out through previously authorized public and private financial agents, namely: regional and state development banks, commercial banks, investment banks and financing companies. The FINAME Agency establishes the criteria to be adopted in the operations it supports, including criteria as regards the cost of the operations. This cost is represented by interest charged at more favorable rates, monetary correction and the remuneration of the Agent.

There are four kinds of operations:[185]
(a) Small and Medium-Sized Company Program;
(b) Long Term Program;
(c) Special Program;
(d) Component Importation Financing Program.

### 6.1. Small and Medium-Sized Company Program

The Small and Medium-Sized Company Program is regulated by FINAME Agency Circulars Nos. 26 and 34 and favors machine and equipment purchases made by

183. The FMRI is an accounting fund, created within the BNDE by Decree No. 67,323, of October 2, 1970.
184. Decree-Law No. 1,621, of April 13, 1978, Art. 1 and 3.
185. The Programs are regulated by Circulars issued by the FINAME Agency; copies can be obtained at the BNDE. The Programs listed herein were regulated by Circulars No. 26, 27 and 28, all dated November 1, 1976, Circular No. 32, of May 18, 1977, and Circular No. 34 of March 31, 1978. The Operational Rules of the Programs were established by Circulars Nos. 25, 29 and 30, all dated November 1, 1976.

small and medium-sized Brazilian companies which are controlled by national capital and which engage in predominantly industrial activities. The beneficiaries of the Program may not belong to an economic group having a net worth in excess of 1,000 ORTNs (see 5.1. above). This Program is available only for machinery and equipment manufactured in Brazil with a national content of more than 80 percent or with a progressive nationalization program approved by the CDI.

Under this Program the FINAME Agency finances 70 percent of the amount for a term of up to 60 months and with a grace period of 3 to 18 months. The monetary correction is established at 10 percent per year, the interest at 9 percent per year and the Agent's commission at 3 percent per year.

### 6.2. Long Term Program

The Long Term Program is regulated by FINAME Agency Circulars Nos. 27 and 34. It benefits Brazilian companies controlled by national capital which (a) use, (b) lease, (c) manufacture the machinery and equipment to be financed. The beneficiaries of the Program may not belong to an economic group having a net worth of more than 1,000 ORTNs. This Program may favor machinery and equipment produced in Brazil with a national content of at least 80 percent or a progressive nationalization plan approved by the CDI, when basically intended for the activities which FINAME deems to have priority. Under this Program the FINAME Agency finances 80 percent of the amount for a term of 36 or 72 months depending on the degree of priority of the activity.

Interest is charged at the rate of 3, 5 or 7 percent per annum, also depending on the degree of priority of the activity, monetary correction being applied according to the ORTN index and the Agent's commission being due at the rate of 3 percent per annum.

### 6.3. Special Program

The operational system of the Special Program was established by FINAME Agency Circular No. 28. It benefits Brazilian companies controlled by national capital, which use or manufacture the machinery and equipment to be financed. This Program is available for machinery and equipment produced in Brazil, which meet one of the following conditions specified in Circular No. 28, item II: 186

(a) they are produced to order and represent a relevant technology innovation or greater national content of value and weight, compared to those already manufactured in the country;
(b) they compete with imported similar products in international competition;
(c) they are produced to order and require special drawings for their design; or
(d) they are intended for projects of relevant interest to the national economy.

Under this Program the FINAME Agency finances the total value of the machinery and equipment having a national content of 80 percent or finances 80 percent when the national content is 60 to 80 percent. Interest is charged at the rate of 1 to 7 percent per year as established by the FINAME Agency in each case, monetary correction being applied according to the ORTN index and the Agent's commission being due at the rate of 2 percent per year.

### 6.4. Component Importation Financing Program

The Component Importation Financing Program is regulated by FINAME Agency Circular No. 32 and benefits companies which manufacture capital goods. As established in item II (2) of Circular No. 32, this Program is available for supplementary parts and components:

(a) which are covered by financing already contracted between the FINAME Agency and the credit institutions of the country of origin;
(b) which are not produced in the country;
(c) which are intended for incorporation into machinery and equipment to be produced by the capital goods manufacturers; and
(d) the importation of which is given priority by the FINAME Agency.

Under this Program the FINAME Agency finances 85 percent of the FOB import value. The term is established for each case based on the production program. The interest is also established for each case by the FINAME Agency, the limit being 7 percent. Monetary correction is charged according to the ORTN index and the Agent's commission is 2 percent.

### 6.5. Registration of new equipment manufactured by companies not controlled by national capital

FINAME issued on May 18, 1978 Circular No. 35 concerning the registration of new equipment manufactured by companies that are not controlled by national capital, i.e. control by Brazilian individuals or by Brazilian companies which are controlled by Brazilian individuals. Foreign nationals who reside permanently in Brazil may qualify as "Brazilians" for this purpose. Circular 35 sets forth the system and criteria to be observed for such purpose. It discusses the enrolment of the manufacturer itself and then the enrolment of the product.

For the manufacturer to be registered with FINAME he must supply information indicating, in his field of activity, (a) the kind of machinery and/or equipment already traditionally financed by FINAME and (b) the kind of machinery or equipment that he intends to manufac-

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186. Circular No. 27 of the FINAME Agency, item II, 2 as follows:
(a) industrial production of equipment and basic inputs;
(b) industrial production of other goods;
(c) rendering of basic services such as: generating and transmitting electric power, telecommunications and railway transportation;
(d) agricultural and livestock production;
(e) freight and passenger highway transportation, complying with the technical requirements established in the Circular;
(f) rendering of other services at the discretion of the FINAME Agency.

ture. Besides this, the manufacturer will have to indicate the other types of equipment that he already produces. Finally, the interested company has to declare that its facilities are in good working condition and adequate for the manufacture of the product to be registered by FINAME. A certified copy of the Certificate of approval of the interested company's project by the CDI and/or of the Certificate of Registered Product under Portaria No. 513 of February 2, 1978 of the CDI also have to be presented. These documents are not required in the case of small and medium-size companies, unless specifically requested by FINAME.

The interested company will not be accepted for enrolment in the event it maintains agreements still in effect with foreign concerns that provide for direct or indirect remittances for the payment of technology. The company making application for registration with FINAME will have to satisfy FINAME in all respects in regard to this point. FINAME may accept, however, if properly justified, agreements entered into by the interested company for additional technology, if these agreements are with companies with which the applicant has no direct or indirect relationship. Occasional payments for specialized technical services may also be accepted by FINAME.

Circular No. 35 treats separately the enrolment of serial products and the enrolment of equipment manufactured to order. Enrolment of serial products is possible when these products meet percentages of national content of value and weight equal to or higher than the minimum percentages provided for in Circular No. 30 or the highest percentage achieved in the country. It is only possible to enroll equipment manufactured to order when there are less than four manufacturers of the same equipment already enrolled with FINAME, and the percentages of national content of value and weight, calculated according to the criteria defined in Annex V of the Operational Norms of FINAME, are equal to or higher than the greatest of (a) the minimum percentage established in item I of Circular No. 30, or (b) 10 percentage points above the highest percentages achieved in the country.

Special treatment may be obtained when there is only one manufacturer of the same equipment already enrolled, in which case a reduction of the percentage mentioned in the preceding paragraph may be obtained. Only in exceptional situations will the enrolment be considered when there are already four or more manufacturers of the same equipment enrolled.

Finally, FINAME has discretion to consider the enrolment of a product, without regard to the restriction established in Circular No. 35, when the interested company is able to demonstrate that in the preceding year it exported at least 50 percent of its production of the equipment in question, observing, however, the minimum percentages of national content of value and weight calculated according to the applicable criteria.

## VII. RISK INVESTMENTS: EMBRAMEC, FIBASE AND IBRASA

These BNDE subsidiaries were incorporated in 1974 in order to support national industries in their expansion plans. These subsidiaries bring risk capital to companies by means of a minority participation in the subscription of shares or convertible debentures. Their participation is added to that of national entrepreneurs upon determining the nationality of the control of a company. It is thus possible for a Brazilian group to improve the proportion of own capital/third party capital under actual national control.

The risk investments are made after an examination of a project submitted by the company, the examination being based on internal criteria. Foreign groups may participate in the companies receiving such risk investments, although only in a minority position.

EMBRAMEC invests in the field of machinery and equipment, FIBASE in the area of basic inputs and IBRASA in other fields of business.

## VIII. CUSTOMS PROTECTION FOR THE NATIONAL INDUSTRY

The national industry is given customs protection by means of two basic mechanisms: the protection of similar national products and the increase of customs duty rates to favor the creation of a national market for products manufactured in Brazil.

### 8.1. Similar national product

The question of national similarity is particularly important since tax or exchange favors are usually not granted for the importation of products when there is a similar national product. In addition, public entities are obliged to prefer the purchase of nationally produced materials.[187] The matter is dealt with in Articles 17 to 21 of Decree-Law No. 37 of November 18, 1966, and is regulated by Decree No. 61,574 of October 20, 1967.[188] Article 1 of this Decree establishes the following:

"*Article 1* — A national product is deemed to be similar to the foreign product if it is capable of replacing an imported product and meets the following basic conditions:

I. equivalent quality and specifications adequate for its purpose;
II. a price not above the foreign currency cost of importation of the foreign product, such cost being calculated on the basis of the normal price plus the taxes levied on the importation and other equivalent charges;
III. a term of delivery which is normal or current for the same kind of product.

187. Decree No. 61,574 of October 20, 1967, Arts. 17 to 24.
188. See Decree No. 64,017, of January 22, 1969, which gave new wording to Art. 2 of Decree No. 61,574.

*Sole Paragraph* — The concept of similarity as established in this article shall not apply if it results in a fractioning of the part or machine to the detriment of its good operation or with the delay of its term of delivery or assembly."

The responsibility for determining such similarity was expressly given to CACEX by CPA Resolution No. 497 of November 14, 1967. This determination is made for each case prior to importation. [189]

In practice there are two basic situations. In the first, the national manufacturer provides for the CPA to give its products the "similar registration". This registration is made by means of a CPA resolution published in the Official Gazette of the Republic. Once the registration has been obtained, it represents definite evidence of the existence of a similar national product. The opposite occurs in the second case: if there is no "similar registration", the importer who wishes to enjoy importation favors must obtain a declaration of non-existence of a similar national product, issued by the Brazilian manufacturers of the field or by the association representing their class.

Decree No. 61,574 (Art. 23) also provides for the possibility of "Participation Agreements" in order to accommodate the interests of the manufacturer of a similar national product with those of setting up a project of relevant economic interest. The matter is dealt with in CPA Resolution No. 1,793 of August 29, 1973. The regulations for the execution of such Participation Agreements are contained in a CACEX Notice dated September 25, 1973. These regulations establish the information to be supplied and the course of action to be followed for the consideration of a Participation Agreement proposal, the proposal being previously submitted to CACEX for the determination of its feasibility. Once this feasibility has been established, CACEX appoints the categories of entities which are to participate in the negotiations and may also appoint an entity to assist CACEX in the coordination of the Participation Agreement. Once the Agreement has been signed and ratified by CACEX, the import licenses will be issued for the portion to be acquired abroad without any further examination as to the existence of similar national products.

## 8.2. Increase of import duty rates

The CPA is authorized to increase import duty rates by up to 30 percent ad valorem within the maximum and minimum limits established for the chapter in which the product is classified. Such increases may be applied to products for which it is of relevant interest to encourage their local production or to those for which a "similar registration" has been obtained. [190]

The CPA normally raises the import duty rates after receiving a request from a Brazilian manufacturer, usually made through the association representing its class. The CPA also has the authority to establish, for purposes of calculating import duties: [191]

(a) *the minimum tariff value*, which is the pre-established price of the goods and the basis for the calculation of import duties; [192] and
(b) *the reference price*, which is a price intended to protect national production of similar products in cases of great disparity of prices of importations from several origins and in cases of general fall of import prices.

## 8.3. Import restrictions

A difference should, however, be made between the incentives of a customs nature and the restrictions imposed on imports, the latter being temporarily established when the country is in a difficult balance of payments situation. Import restrictions were introduced recently to reduce the flow of convertible exchange to other countries. These restrictions obviously favor the national industry of similar or replacement products. The criterion adopted is, however, not aimed at the protection of the national industry itself but at hindering or hampering the importation of certain products until the country's convertible currency reserves have improved.

The two mechanisms currently used by the Brazilian authorities are the compulsory deposit and the temporary suspension of issuances of import licenses for non-essential goods.

The compulsory deposit was instituted by Decree-Law No. 1,427 of December 2, 1975 and regulated by Resolutions No. 354, 358, 387 and 422, of December 2, 1975, February 5, 1976, August 18, 1976 and March 28, 1977, respectively, and by Circular No. 340 of March 28, 1977, all issued by the Central Bank of Brazil. The compulsory deposit is a requirement for the importer to deposit a cruzeiro amount equivalent to the FOB price of imported goods as stated in the import license. The deposited amount is refunded to the importer after 365 days, without interest or monetary correction.

The suspension of issuances of import licenses was introduced by CACEX Communiqué No. 574 of December 20, 1976, whereby CACEX suspended up to December 31, 1977 the issuance of import licenses for products classified as superfluous by applicable law. The suspension was maintained in the year 1978 by means of Communiqué No. 78/2, of January 2, 1978, which extended it to December 31, 1978. There are exceptions to this legal rule, including drawback importations and products imported for the exclusive purpose of exportation or reexportation, subject to the prior approval of CACEX.

189. When applying for the Import License, the importer should declare whether he wishes to enjoy any tax or extra-fiscal benefit in the importation. If so, the import license will only be issued against evidence that there is no similar national product.

190. Law No. 3,244, of August 14, 1957, Arts. 3 and 22; Import duty is a federal tax, the Executive Power having the authority to fix the corresponding rates, according to the Federal Constitution, Arts. 21, I, and 153, §29.

191. Decree-Law No. 730, of August 5, 1959, and Decree-Law No. 1,111, of July 10, 1970.

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FED LOSBLADIG FISCAAL WEEKBLAD

releases 1712-1715
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DE GEMEENTELIJKE BELASTINGEN

A.M. Dijk, G. Jansen, J.C. Schroot, F. Verstegen
releases 268 and 269
VUGA, The Hague.

INKOMSTEN IN DE AGRARISCHE SECTOR

releases 50 and 51
Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK

release 136
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK

releases 6 and 7
Kluwer, Deventer.

LEIDRAAD BIJ DE BELASTINGSTUDIE

C. van Soest, A. Meering
release 46
S. Gouda Quint — D. Brouwer, Arnhem.

MODELLEN VOOR DE RECHTSPRAKTIJK

release 63
Kluwer, Deventer.

NEDERLANDSE BELASTINGWETTEN

W.E.G. de Groot
releases 155 and 156
Samsom, Alphen a.d. Rijn.

NEDERLANDSE WETBOEKEN

release 156
Kluwer, Deventer.

OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF

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Commerce Clearing House, Inc., Chicago.

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Prentice-Hall, Inc., Englewood Cliffs.

# TAX GLOSSARY

*by H.W.T. PEPPER**

**LUBRICANTS** — See CATALYSTS.

**LUNCHEON VOUCHERS** — Many businesses provide canteen facilities for their employees, who are usually able to obtain meals and refreshments therein at less than the commercial prices prevailing outside. Where a business has no canteen, it may provide employees with luncheon vouchers which may be used in part payment of meals, etc. taken in commercial restaurants. In the U.K., such vouchers, provided they do not exceed a certain value per day, are regarded as a non-taxable perquisite of the employee.

**(LUXURY TAXES)** — Indirect taxes on luxuries are traditionally the easiest forms of tax to justify. Unfortunately, governments are usually unable to obtain the whole of the revenue they require by taxing only luxury goods and services. Moreover, there is some difficulty in defining luxuries, since what are fairly regarded as luxuries at one time may become the necessities of a later age.

## M

**MACHINERY AND PLANT** — Machinery and plant employed in a business usually qualify for depreciation allowances, and these are at a higher rate than those on buildings and other assets.

The precise definition of machinery and plant thus has some importance and has been the subject of much case law to expand the concept of the words as used in ordinary speech, as well as being occasionally elaborated in statute law.

Machinery and plant for tax purposes include the cost of installation, and may also include fixtures and fittings, safety equipment, and anti-pollution devices. The modern tendency is for governments to be more generous in the interpretation of what constitutes machinery and plant and in relief for its depreciation. (See CAPITAL ALLOWANCES, DEPRECIATION, FREE and WRITING DOWN ALLOWANCES.)

**MAINSTREAM (CORPORATION) TAX** — A term used in the U.K. to refer to the liability of a company, under the Corporation Tax regime introduced in 1973, to tax on its income. ADVANCE CORPORATION TAX (q.v.) payments on dividends paid out of corporate income rank to be offset against "mainstream" tax.

**MANAGEMENT EXPENSES** — A company whose income is derived from investments, and which is not concerned in dealing in investments or in any other form of trade, will nevertheless incur expenses of management and administration.

Since income from investments may accrue without exertion on the part of the company there may be no general statutory provision under which the company could claim deductions from its investment income. Accordingly, specific clauses are inserted into the tax laws in some countries to allow deduction of such expenses for companies whose business consists wholly or mainly in the making and holding of investments.

**MANUFACTURERS' (SALES) TAX** — A single-stage sales tax on the sales or deliveries by a manufacturer of his products. The term "Manufacturers' Tax" is used in Canada, but the tax is broadly the same as the COMMODITY TAX in Japan, the old PURCHASE TAX in the U.K., and various WHOLESALE TAXES. The tax normally embodies BORDER ADJUSTMENTS, e.g., an equivalent charge is made on comparable imports from manufacturers in other countries, so as to assure TAX NEUTRALITY between local and foreign manufacturers.

**MARCHE COMMUN** — (France & Belgium) The EUROPEAN ECONOMIC COMMUNITY (q.v.).

**MARGINAL RELIEF** — Where income or capital is exempted from tax up to a certain figure, and above that figure the *whole* income or capital is taxable, it is usual to provide marginal relief for cases where the income or capital is only slightly above the exemption limit.

The same principle applies where a rate of tax is charged on income or capital up to a certain level and a higher tax rate applies above that level to the whole income or capital.

Usually the relief consists of granting the same treatment to the income or capital as if it were no greater than the limit which it exceeds. The excess, however, is then charged to tax at a much higher rate of tax than would otherwise apply — the result is that the benefit of the marginal relief diminishes as the income or capital gets further above the limit, until it finally disappears altogether.

Where personal relief, e.g. for a dependent relative, is subject to an income limit for the relative, a common expedient is to diminish the relief by deducting from it the amount by which the relative's income exceeds the relief (in effect, at this point the relative would not be regarded as "dependent"). (See, by contrast, TRANCHE SYSTEM.)

**MARKETING BOARDS** — In some countries marketing boards may be set up under regulatory laws, in particular to handle the marketing of agricultural produce. (Another such device is the Producers' Co-operative society, usually set up on the initiative of the producers, though normally subject to some statutory controls.)

Although the activities of such boards (and societies) will in general not be regarded as producing taxable "profits" (see MUTUALITY PRINCIPLE), they may achieve some deferment of tax for their members by setting up reserves.

In the U.K. the income tax law includes provisions dealing with Marketing Boards' reserves. Surpluses on operations are in any event statutorily required to be put to reserve which, in effect, confers "exemption" because sums paid to reserve are tax-deductible. Sums paid out of reserves are, however, to be treated as trading receipts unless distributed to members (to whom they will be taxable receipts) or handed over as levies to the Government. There are also provisions to ensure that reserves will not be built up, tax-free, to levels in excess of reasonable requirements.

**MARKET PRICE** — See VALUATION.

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

**MARK-UP** — The margin which a trader adds to the cost of the goods he buys in order to fix his selling price. The mark-up, or GROSS PROFIT (q.v.), roughly represents the value added by the trader, which is the subject of VALUE ADDED TAX. (See also UPLIFT.)

**MARRIED WOMAN** — In many countries the practice of requiring a husband to make a declaration of his wife's as well as his own income for income tax purposes has a long history. The tradition was formerly based on the fact that married women, or women in general, had more limited rights (partly for their own protection) under the law in financial matters.

In addition the tax on a married couple's joint income was often higher than it would have been had they had the same incomes as unmarried individuals.

Current trends are for married women to be given greater equality with single individuals, as well as greater responsibility, under tax laws. In the U.K. a married woman has long had a right to declare her own income and pay her own share of the joint tax (see SEPARATE ASSESSMENT) and is nowadays virtually taxed as a single woman on her EARNED INCOME (q.v.). In the U.S.A. discrimination against married couples for income tax has been largely eliminated by INCOME-SPLITTING (q.v.) provisions. (See also AGGREGATION.)

**MATCHING RELIEF** — In double taxation treaties or in unilateral provisions in tax laws to avoid double taxation, relief is sometimes given, e.g. by the country of residence, in respect of reliefs (such as tax holidays) which are provided in the country of source of the income which is taxable in both countries. (See also TAX SPARING and TAX SHADOWING.)

**MATERIAL OF CHIEF VALUE** — A concept used (e.g., in connection with Customs duty in Canada) with respect to a CATCH-ALL clause in which N.O.P.'s (goods not otherwise provided for) are grouped and charged a flat rate of duty. Where the main constituent by value of such an item is itself listed elsewhere in the tariff and charged at a higher duty rate there, the usual provision is that the whole value of the item in question shall be charged at the higher duty rate.

**MATURED SPIRITS** — Under British Law, whisky may not be sold until it has been matured (usually in a bonded warehouse) for 3 years. The duty on other spirits, such as gin, which are not required to be matured is slightly higher than on whisky. The maturing condition was imposed during World War I so as to slow down the sale (and consumption) of spirits in order to help the war effort.

**MAXIMUM TAX** — In some countries, although graduated tax rates may rise to a fairly high top rate, a maximum rate of overall tax may be applied as a kind of cut-off measure. For example, in the U.S.A. the maximum tax that may be levied on earned income is 50% of that income, although the top rate of tax is 0%. In the Solomon Islands the top rate of graduated tax on individuals was 35% but the total tax bill for an individual could not exceed 25% of his income prior to 1976.

**MCGOVERN'S FIRST LAW OF TAXATION** — "Money made by money should be taxed at the same rate as money made by men" (expounded during the 1972 U.S. Presidential Election Campaign).

**MCKENNA DUTIES** — The import duties imposed in 1915 in Britain on motor vehicles, musical instruments, clocks, watches and films, which heralded Britain's departure from the policy of free trade which had endured from 1860 to 1915. The McKenna duties, like Purchase Tax in the second World War, were, however, imposed to restrict consumption for reasons of war-time economy, not as protective duties.

**MEDIAN LINE** — See CONTINENTAL SHELF.

**MEDICAL EXPENSES** — Some countries (e.g., Australia, Japan, U.S.A.) permit deductions in computing individuals' income tax in respect of expenditure on medical fees, the cost of medicine, etc. Usually there is some restriction on the allowance mainly to limit the administrative work otherwise involved. For example, the allowance in the U.S.A. is in respect of medical expenses which exceed 3% of gross income and the cost of medicines and drugs when they exceed 1% of gross income.

**MEHRWERTSTEUER** — The value added tax in the Federal Republic of Germany.

**MERES ET FILIALES (REGIME DE SOCIETES)** — Term used regarding exemption granted from French corporation tax in respect of dividends received by a parent corporation from its subsidiary.

**METHODS OF CALCULATING DEPRECIATION** — The methods used in various countries include DECLINING BALANCE (see REDUCING BALANCE), STRAIGHT LINE (q.v.), and SUM OF THE YEARS' DIGITS (q.v.). (See also DEPRECIATION, FREE CAPITAL ALLOWANCES, MONETARY CORRECTION.)

**MILLS, FACTORIES, ALLOWANCE** — The old type of depreciation relief introduced in Britain in 1918 (of an amount equal to the difference between the gross and net annual value of the premises) for factories and other buildings which were subject to wear and tear, e.g., through the vibration of the machinery they contained. The allowances were eventually replaced by the Capital Allowances System inaugurated in 1945, and subsequently by WRITING DOWN ALLOWANCES (q.v.).

**MINERAL DEPLETION** — See DEPLETION.

**MINERAL RIGHTS DUTY** — A levy introduced in Britain in 1910 at a rate of 5% on the rental value of all rights to work minerals, other than clay, sand, chalk, limestone or gravel. The duty was abolished in 1967.

**MINERAL ROYALTIES** — Payments for the right to extract minerals, the payments being usually related to the quantity of minerals extracted, or in some cases to the area of land or volume of ores, etc. worked. Where the minerals are not owned by the state, there will normally be a tax on the royalties. The operator in computing his profits from mineral workings may deduct the royalties he pays. (See also EXPENSING OF ROYALTIES.)

**MINERS' FREE COAL** — It has been traditional in the U.K. for coalminers to receive a substantial FRINGE BENEFIT (q.v.) in the form of free coal for household use. This particular benefit has remained income tax free, partly no doubt because the miners' occupation was formerly low-paid and remains dangerous, earning popular sympathy and respect, and partly because of the political "pull" exercised by miners' trade unions.

**MINIMUM DISTRIBUTION** — In countries where the top personal income tax rates are higher than corporation tax rates, it is usual to require minimum levels of dividend distribution by CLOSE COMPANY (q.v.) which otherwise could leave profits undistributed to permit tax avoidance, or tax deferment, by the controlling shareholders.

# Contents

of the July 1979 issue

# CORPORATE/SHAREHOLDER TAX INTEGRATION

## National Meeting of the U.S.A. Branch of the International Fiscal Association (I.F.A.) on January 12, 1978, New York

# Introduction to Subject

BY RICHARD M. HAMMER*

### I. INTRODUCTION

*The U.S. tax system, embodying a complete separation for tax purposes of corporations and their shareholders, with the resulting double taxation of corporate income, has been labeled the classical system. Why? Perhaps this is because our system has always been that way and thus it is classical. However, if you were to look back at the history of older tax systems, you might find that the partnership, or conduit, approach to the taxation of corporations and their shareholders, at least in part, is more classical than our separate entity approach.*

*For example, the U.K. system, in the days before their 1965 tax reforms, taxed corporations on their net income, but allowed shareholders to receive their dividend income free of further tax, except for the surtax which was imposed at higher income levels. The technique used by the U.K. was to require a U.K. individual shareholder to* gross up *his actual dividend received by the standard rate of income tax prevailing in the year of distribution. The gross amount thus constituted dividend income subject to the individual tax at the standard rate, with a credit for the same standard rate tax. Thus, in theory, the credit eliminated the individual tax and no tax was payable on dividends received by shareholders. This then was an integrated system, providing for a single tax on corporate income. Some of you I am sure remember the pre-1966 U.K. system.*

*The issue of effecting some form of integration in the U.S. has been over the last year or so in the forefront of U.S. tax reform discussions. With a U.S. corporate tax of 48 percent (which could be reduced to 45 or 46 percent next year[1]) and personal taxes reaching levels of 70 percent, the* proponents *of integration point to the inherent tax* disincentives *to corporate equity investment for U.S. investors, as compared, say, with business in the partnership or sole proprietorship form. The structure of the corporate tax system is not only a factor influencing domestic investment decisions, but also affects crossborder investments. Many countries have in recent years changed their systems, not only for domestic reasons, but also to encourage or discourage inward or outward investment and flows of capital.*

*The principal systems in use today around the globe include the classical system (ours), imputation systems (i.e., partial or full), the split rate systems and dividend deduction systems. The classical system results in complete double taxation of corporate income. A partial imputation system allows the individual shareholder, upon receipt of a dividend, a credit for some portion of the corporate tax attributable thereto, and is in use today in Canada, France and the U.K. A full imputation system allows the shareholder a credit upon the receipt of a dividend for all the corporate tax attributable thereto — this is in use only in Germany, to the best of my knowledge, with its 1977 reformed system. The "split-rate" system provides for a lower rate of corporate tax on distributed earnings and is used in Germany and Japan (Germany having a combination system since January 1, 1977). The dividend deduction system (similar to the split-rate concept) allows a deduction for dividends paid, whereby the corporation pays tax only on current retained earnings and the shareholder pays a full tax on dividends received. This is used in Norway, Finland and Greece.*

*The international aspects of these systems depend on*

* Vice-President of IFA, former President of the USA Branch of IFA.

1. In 1979 the rate of corporate income tax is 46 percent.

*how the receipt and redistribution of foreign earnings is treated, how the system interacts with the territorial method, where used, whether domestic shareholders are allowed imputation credits with respect to foreign corporate earnings, whether foreign shareholders are allowed imputation credits and whether there are withholding taxes on dividends distributed to foreign shareholders. There are treaty considerations as well.*

*These are questions we face in considering integration.*

## II. IMPUTATION SYSTEMS

*Of the systems which can be described as integrated in part or in whole, the imputation systems, although more complex, seem to be finding more current favor among the developed countries than the split-rate or dividend deduction methods. As I already mentioned, an imputation system permits a* domestic individual *shareholder to receive a tax credit for some portion (or all) of the domestic corporate tax paid on the corporation's income. The U.K., after a brief flirtation with the classical system (1965 to 1973), has reverted to an imputation system. France adopted it in 1965, Canada in 1972, Germany in 1977 and other Common Market countries have adopted it (Belgium) or plan to do so. The Dutch are against. While imputation systems of various countries may have broadly similar consequences for domestic shareholders with respect to domestic income, there are many variations among them in their relationship to foreign investors and foreign investment. The U.S. in particular has had difficulties in accommodating its tax treaty negotiating posture to these systems. Before the signing of the still unratified 1975 U.S.-U.K. treaty, only one major country, France, had concluded a treaty protocol with the U.S. incorporating the imputation credit, but only for U.S. portfolio investors (less than 10 percent). The discriminatory aspects of these systems have been stumbling blocks to the renegotiation of important tax treaties with France, Canada and Germany.*

*The U.K., for example, has been willing to extend, to a material extent, its imputation credit to both U.S. portfolio shareholders (100 percent) and U.S. direct investors (50 percent). France may be willing to extend some portion of its avoir fiscal to direct investors (new protocol not yet released). Germany and Canada, however, appear to be more reluctant to accommodate us in this regard.*

## III. SPLIT-RATE SYSTEMS

*A split-rate system imposes a higher rate of tax on undistributed income than on distributed income, thus providing the corporation with an incentive to pay dividends, particularly if the difference in rates is substantial. Where the split-rate applies to foreign shareholders as well as domestic shareholders, the system tends to favor foreign investors, unlike imputation systems which tend to discriminate against them. Germany and Japan are two countries which use the split-rate system, although the differential is more marked in Germany than Japan, even subsequent to the 1977 German reform.*

*Allowing for the fact that there are many computational factors and other circumstances which make the statutory rates diverge from the true effective rates (i.e., the tax as a percentage of pre-tax book income), it is nevertheless apparent that the imputation system countries today retain a higher tax on corporate profits paid to foreign shareholders when compared to the old German split-rate system. The combined rates of corporate and withholding taxes in Canada, France and Germany (under its new system) exceed the U.S. corporate rate of 48 percent. Thus, U.S. parent companies of subsidiaries in those countries are likely to have excess foreign tax credits with respect to dividends received from them, which can be exacerbated by the 1.861-8 regs.*

## IV. DIVIDEND DEDUCTION METHOD

*Under the dividend deduction method, some or all of a corporate dividend is deductible in arriving at taxable corporate income. A number of countries use this system, which is another method of integrating personal and corporate income taxes at corporate level and bears considerable resemblance to the split-rate system, since the rate of tax depends on distributions. Norway, Finland and Greece use this system.*

## V. U.S. PROPOSALS

*In 1975, then Secretary of Treasury Simon set forth in testimony to the Ways & Means Committee a U.S. proposal for integration, a proposal which was a combination of a dividend deduction system and an imputation credit system. It got little reaction from the public and Congress at that time. It was complex.*

*However, the Carter Administration has since its election endorsed the integration concept. By now, we would have expected to have the current Administration proposals, but you all know what has happened on that score. With primarily stimulus tax cuts to be presented by the Administration, structural reform (including any integration proposals) will doubtless wait a year or so before being exposed to the public by the Administration, although Al Ullman has stated that he thinks the integration area should be studied this year.*

## VI. HAS INTEGRATION ACCOMPLISHED ITS GOALS?

*The primary focus today of government financial planners and economists is in the area of capital formation. Will the world, or the U.S.A., be able to develop or create the capital necessary to keep economic activity on the forward track? It has been felt that an integrated system, because it tilts the scale to favor equity investment relative to debt investment, is a necessary tool for coping with this capital shortage problem. It is questionable, however, whether countries which have used integrated systems have had any success in terms of additional capital formation, resulting from their adoption of an integrated method. Perhaps this is so because these other countries, which have a great deal more of a net inflow of capital than some, have generally discriminated against foreign capital.*

*What has been the European experience? In this regard, I refer you to an excellent piece prepared by Harry Gourevitch of the Library of Congress' Congressional Research Service, issued in May 1977. His conclusion can be summarized with this quotation from his survey:*

> **"The experience of France, Germany and the United Kingdom with their respective tax integration schemes suggests that partial tax integration *may not* be an effective mechanism for increasing the rate of capital accumulation by business."**

*Perhaps our speakers from these countries will disagree with Mr. Gourevitch.*

# International Aspects of Integration*

BY EMIL M. SUNLEY**

Contents



### Introduction

I am pleased to be here today and have the opportunity to participate in this discussion of the international aspects of integration of the corporate and individual income taxes. Over the past year we have looked closely at integration, and I would like to share with you some of our thoughts on the subject. This will include a review of the reasons for our interest in integration, an overview of the similarities we see in the available integration methods, and a discussion of the significant foreign issues with emphasis on what we have learned from foreign experience. I would like to close by restating the substance and rationale of our treaty position toward those countries that have an integration system.

### Reasons for integration

One of the most significant trends in tax policy in recent years has been the movement in national tax structures from classical systems of separate taxation of corporations and their shareholders toward some form of integration of corporate and shareholder taxation with respect to distributed corporate profits. This trend grows out of an increasing concern over the impact of the double tax burden which the classical system places on income from capital in the corporate sector. The double taxation of corporate profits, once at the corporate level and again at the shareholder level, creates three types of distortions which reduce the efficiency of capital markets. Integration of the individual and corporate taxes reduces these distortions and thereby increases economic efficiency. These distortions represent a misallocation or waste of resources. Their elimination would result in an increase in national income and output.

### 1. Distortion between corporate and non-corporate activities

Investors divide the available capital stock between corporate and non-corporate activities so as to equalize the after-tax rates of return. Heavier taxation of corporate income, as under the classical system, distorts the allocation of resources toward the non-corporate sector. The corporate tax, therefore, leads to the production of "too little" corporate output and "too much" non-corporate output. Transferring capital from the non-corporate to the corporate sector would increase national income. As a rough approximation, Arnold Harberger has estimated the cost of this distortion to be about 0.5 percent of national income or $7.5 billion. Integration would reduce the size of this distortion by reducing the tax burden on corporate source income.

* Speech delivered at the meeting of the U.S. Branch of the International Fiscal Association on January 12, 1978.

** Deputy Assistant Secretary for Tax Policy, United States Treasury Department.

## 2. Distortion between dividends and retained earnings

The classical tax system encourages corporations to retain their earnings in order to avoid the double taxation of dividends. This creates a capital market distortion, since established firms with access to a pool of retained earnings may finance projects that they would not undertake if they had to rely on external finance. Alternatively, embryonic firms may have to forego investment opportunities because of their need to rely on external finance rather than retained earnings. Integration would reduce the distortion between retained and distributed earnings.

## 3. Distortion between debt/equity finance

The classical system of taxation encourages the use of debt finance because interest payments are deductible for tax purposes and dividends are not. This distortion in favor of debt may increase the riskiness of a business as well as its probability of bankruptcy. Integration would tend to reduce this distortion by reducing the tax burden on dividends.

In short, advocates of integration stress that it improves the efficiency of capital markets and increases national income by reducing (or eliminating) the distortion between the form of business organization, the decision to retain or pay out earnings, and the method of finance.

## Methods of integration

There are a variety of methods for integrating the corporate and individual income taxes. One could simply treat the corporation as a partnership, much as we do under our Subchapter S. That is, all of a corporation's earnings, whether distributed or not, would be imputed to the shareholders. The corporation tax could remain in place as a withholding tax which would be creditable against the shareholders' tax liability.

A less complete or partial method would be to integrate the corporate and individual income taxes with respect only to dividends. This can be done by either a split rate or dividend deduction method or by an imputation or shareholder credit system. Under the former, relief is provided at the corporate level by taxing dividends at a reduced or zero rate. The imputation system provides relief at the shareholder level by allowing a credit for part or all of the corporate taxes paid on distributed earnings.

Compared to the pre-integration regime, if the corporation maintains the same level of distribution under the dividend deduction system, the entire increase in cash flow will accrue to the corporation. If it maintains the same cash dividend under a shareholder imputation system, the shareholder will receive the full benefit of integration. As shown by the following two examples, the two basic approaches to partial integration can be made identical with respect to their impact on corporate and shareholder cash flow as well as on foreign shareholders.

**Example I**
**Dividend deduction system**

| *Corporation* | | | *Shareholder* | *Tax rate* 20% | 60% |
|---|---|---|---|---|---|
| Income | | $100 | Cash dividend | $40 | $40 |
| Dividend | | 40 | Tax | 8 | 24 |
| Dividend deduction (50%) | | 20 | After-tax cash flow | 32 | 16 |
| Taxable income | | 80 | Total, corporate plus shareholder, tax | 48 | 64 |
| Tax (50%) | | 40 | | | |
| After-tax income | | 60 | | | |
| Retained Earnings | 20 | | | | |
| Dividend | 40 | | | | |

In this example, the corporation is entitled to a $20 dividend deduction, one-half of the actual dividend, pays $40 in tax, and is left with $20 in retained earnings. Shareholders are taxed at their individual rates on the dividend. A shareholder in the 20 percent bracket would be left with after-tax cash flow of $32 and a 60 percent shareholder with after-tax cash flow of $16.

**Example 2**
**Shareholder imputation system**

| *Corporation* | | *Shareholder* | *Tax rate* 20% | 60% |
|---|---|---|---|---|
| Income | $100 | Cash dividend | $30 | $30 |
| Corporate tax | 50 | Gross-up (1/3) | 10 | 10 |
| After-tax income | 50 | Gross dividend | 40 | 40 |
| Retained earnings | 20 | Tax | 8 | 24 |
| Dividend | 30 | Tax credit | 10 | 10 |
| | | After-tax cash flow | 32 | 16 |
| | | Total, corporate plus shareholder, tax | 48 | 64 |

In the second example, the corporation pays $50 in tax, distributes a dividend of $30, and is left with $20 in retained earnings. This imputation system provides for a shareholder gross-up and credit equal to one-third the cash dividend or $10. In effect, the corporation distributes a cash dividend of $30 and a shareholder credit of $10. A 20 percent shareholder is left with $32 in cash, a 60 percent shareholder with $16.

Examples 1 and 2 illustrate that the dividend deduction and shareholder imputation systems can be made identical with respect to corporate and shareholder cash flow as well as total taxes paid. The two systems differ in terms of the amount of dividends declared and the amount of corporate after-tax profits. The corporation's cash dividend is lower under the imputation system, but this is because it also is distributing the right to a shareholder credit. The corporation's after-tax profits (but not the corporation's retained earnings) are higher under the dividend deduction system.

## International issues in an integrated system

Most of the countries which have integrated their tax systems have opted for the shareholder imputation, rather than dividend deduction, system. This choice has presumably reflected a desire to exclude foreign shareholders from the benefits of integration. It is assumed that the dividend deduction system automatically extends the benefits of integration to foreign shareholders whereas they can be denied the benefits under the other system by not extending the imputation credit to foreign shareholders. However, this argument overlooks the fact that foreign shareholders also can be denied the benefits of a dividend deduction system through imposition of a withholding tax.

The movement of investment flows across international boundaries demands that the international aspects of an imputation system be considered. Two questions must be answered:

(1) Which corporate taxes are going to be integrated?
(2) Which shareholders are going to be entitled to the imputation credit?

The first question involves whether a foreign corporate tax is to be integrated with the domestic individual income tax in the shareholder's country of residence. Consider the treatment of domestic individual portfolio investment in foreign corporations. Should the foreign corporate tax be integrated into the shareholder's individual income tax by allowing a credit similar to that allowed for tax paid by domestic corporations? Or, if the individual's investment is through a domestic corporation which has foreign source income, should the individual shareholder receive a credit for the corporate taxes which the domestic corporation has paid to the foreign government? The second international question pertains to whether the country adopting the imputation system will extend the credit to non-resident shareholders in domestic corporations.

The resolution of these issues depends on a number of considerations. Some argue that "capital export neutrality" should be a basic principle underlying international tax policy. Capital export neutrality is achieved when an enterprise pays the same total rate of tax on foreign profits as on domestic profits. This would require the integration of foreign corporate and domestic individual income taxes. That is, an individual would receive credit for corporate taxes irrespective of whether they were paid to the home or host country. Others are mindful of revenue considerations and point out that allowing a shareholder credit for foreign corporate taxes can be a significant revenue drain on the home country's treasury.

Similarly, from the viewpoint of the host country, extending the credit to non-resident shareholders can be costly. But not extending it discriminates against foreign shareholders in comparison to domestic shareholders. Before discussing these issues with respect to the United States, it may be instructive to review how they have been handled by some of the countries which have adopted integration systems.

## Foreign experience

### *France*

France has a territorial system of taxation at the corporate level. Income earned in France is taxable, but income earned outside France, either by a foreign branch or a foreign subsidiary of a French corporation, is exempt from French taxation. The imputation system in France integrates one-half of the corporate income tax with the individual income tax by providing a gross-up and credit at the shareholder level equal to one-half of the dividend.

Since profits initially are taxed at 50 percent, a corporation with $100 in pre-tax income would have $50 left to distribute. The shareholder would gross-up the dividend by $25, one-half the dividend, and the $25 imputation credit would exactly offset the tax liability of a shareholder taxed at the 33 percent rate.

Under the French territorial system of taxation, a dividend can of course be paid out of foreign source income not taxed in France. To assure that the shareholder credit actually reflects tax paid to its treasury, France relies on an equalization tax, the *précompte.* Assuming no French tax has been paid, the *précompte* is levied at a rate of 50 percent on distributions not paid out of fully taxed profits.

In the above situation, if no corporate tax had been paid to the French treasury, $25 in *précompte* would have been due on the $50 cash dividend. The *précompte* is assessed even if foreign tax has been paid, either on the dividend or on the underlying earnings out of which the dividends are paid. The *précompte* assures that the tax creditable at the shareholder level has been collected by the French treasury at the corporate level. Thus, France does not integrate foreign corporate taxes with its individual income tax.

Two factors tend to ameliorate the impact of the *précompte.* (1) Foreign withholding taxes can under tax treaty provisions be credited against it and (2) France has a dividend ordering or stacking rule whereby dividends are deemed paid first from fully taxed earnings from the current and then four previous years. Only when this "pool" has been exhausted are dividends deemed paid out of foreign earnings and does the *précompte* become due.

French legislation does not extend the imputation credit to either direct or portfolio non-resident investors. France, however, has extended the credit to non-resident portfolio investors on a treaty basis. The United States has obtained the credit for its portfolio investors and is pursuing it for its direct investors (i.e. corporations having a subsidiary in the United States).

### *United Kingdom*

The United Kingdom uses a credit, rather than exemption, method to eliminate double taxation of foreign source income. Under the United Kingdom integration system, corporate income is taxed at a rate of 52 percent and the shareholder is entitled to a gross-up and credit equal to 35/65[1] of the cash dividend received. The United Kingdom charges an Advance Corporation Tax (ACT) on all distributions. The ACT is equal to 35/65[2] of the cash dividend, the same as the gross-up and credit, and is creditable against the distributing corporation's (pre-ACT) United Kingdom tax liability.

Because of the ACT, the United Kingdom treasury is sure to collect as much tax at the corporate level as it is liable to credit at the shareholder level. Since the United Kingdom eliminates double taxation of foreign source income at the corporate level through a foreign tax credit, without the ACT the United Kingdom could be crediting or refunding to the shareholder tax which it has not collected at the corporate level. To prevent this outcome, foreign taxes cannot be credited against the corporation's ACT payment, but only against the "mainstream tax", i.e. the United Kingdom corporate tax net of the ACT credit. That is, the ACT is not affected by the payment of foreign taxes. The United Kingdom system therefore does not provide for the integration of foreign corporate taxes with the individual income tax.

Like the French, the United Kingdom system treats dividends as being paid first out of domestic source income. Since retained profits are taxed at the full 52 percent rate, treating foreign income, to the maximum extent possible, as being the retained portion of the profits minimizes the loss of foreign tax credits.

The United Kingdom legislation does not extend the imputation credit to either direct or portfolio non-resident investors. The United Kingdom has been willing, however, to make the credit available to portfolio investors on a treaty basis and, in the case of the United States, had made one-half the credit available to direct investors in United Kingdom corporations.

### *Federal Republic of Germany*

Since January 1, 1977, Germany has had a hybrid system that combines split-rate corporate tax with an imputation credit. The rate on retained profits is 56 percent and distributed profits are taxed at 36 percent. Thus, if all income is distributed, the tax paid at the corporate level is equal to 36 percent of the corporation's pre-tax income. A shareholder is required to gross-up his dividend by the 36 percent corporate tax paid, and is eligible for a refundable credit of this amount. Unlike France and the United Kingdom, the German system provides for full integration of the corporate taxes on distributed earnings.

Germany avoids the double taxation of foreign source income by both the tax credit and exemption methods. Germany gives a tax-sparing credit, equal to the German taxes due, on income from less developed countries. Income from a treaty country is exempt from German taxation. Income from the relatively small number of non-treaty developed countries is subject to German taxes, but with a credit for foreign taxes actually paid.

Apart from its dividend ordering rules, Germany does not integrate foreign corporate taxes with its domestic individual income tax. The German statute divides corporate income into three classes:

(1) income which has been subject to the full corporate tax of 56 percent;
(2) income which has been subject to reduced corporate taxation of 36 percent; and
(3) increases in net worth which have not been subject to tax or are part of retained earnings from the period preceding the adoption of the new system.

Dividends are deemed distributed first from class one, then class two, and finally class three. Thus, foreign source income which is taxed in Germany either at a nil or low rate would be deemed distributed only when the higher taxed pool of retained earnings had been exhausted. Any distributions deemed made from these foreign earnings would be subject to an additional corporate tax so that the distribution bears the 36 percent rate in Germany. In this way the German treasury is sure to collect at the corporate level any tax it is obligated to credit or refund at the shareholder level.

Although the reduced rate of 36 percent is available on distributions to resident and non-resident shareholders alike, Germany has not extended, either by legislation or treaty, its imputation credit to non-resident shareholders.

### *Canada*

Prior to 1972 the Canadian tax system combined a classical system with a non-refundable shareholder credit equal to 20 percent of dividends received from domestic corporations. This was replaced by an imputation system providing for a gross-up and credit equal to one-third of the dividends received. Since the imputation system, unlike the previous 20 percent shareholder credit, required the credit to be included in the shareholder's taxable income, it reduced the tax liability for those shareholders below the 40 percent bracket and increased it for those at or above this tax rate.

At the corporate level, double taxation of foreign source income is moderated or eliminated by a combination of exemptions and tax credits. Unlike France, Germany and the United Kingdom, Canada assesses no equalization or compensatory tax on shareholder distributions. Moreover, the shareholder's gross-up and credit is invariant with respect to the source of income out of which the dividend is paid. Thus, if a dividend is paid out of foreign source income on which no Canadian tax has been paid, the shareholder credit may reflect foreign corporate or withholding taxes. This lack of discrimination against foreign earnings may reflect the comparatively low rate at which dividends are grossed up. It may also reflect the fact that, unlike the French, United Kingdom, and German systems, Canadian shareholders whose dividend credit exceeds their tax liability receive no refund of their excess credits. In effect, Canada has chosen to integrate foreign corporate taxes with its individual income tax. It has not, however, extended the imputation credit to non-resident shareholders.

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1. In 1979 33/67.
2. Id.

## European Economic Community model

Although there are differences in the integration systems which have been adopted, a couple of generalizations can be made. Except for Canada and the ameliorative impact of various dividend ordering or stacking rules, no country integrates foreign corporate taxes with its domestic individual income tax. In these countries foreign source income may therefore be taxed more heavily than domestic income. Except by treaty, no country extends its imputation credit to non-residents with the result that non-resident shareholders are taxed more heavily than residents. Both of those foreign investment policies probably reflect tax revenue concerns and desired investment discrimination on the part of the countries with integrated tax systems. That is, integration countries may wish to discourage foreign investment by their residents and domestic investment by non-residents. Accordingly, it may be appropriate to review the outlines of the solution suggested by the European Economic Community (EEC).

In 1975 the EEC issued a Draft Directive of a proposal for harmonizing the corporate tax systems of the Community through an imputation credit method. This directive called for each country to impose a corporate income tax at rates ranging from 45 to 55 percent and to provide a dividend gross-up and credit of between 45 and 55 percent of the corporate tax paid. To ensure that the shareholder credit has been paid at the corporate level, the Directive provides for the assessment of a *précompte* or ACT-type compensatory tax on distributions which have not borne sufficient corporate tax. It is readily apparent that the proposed system of a corporate tax of roughly 50 percent with half of that tax being returned to shareholders on distributions is similar to the systems adopted by France and the United Kingdom.

The EEC Directive provides that the imputation credit is to be extended to all Community residents subject to tax on the dividend distribution. This would include individual shareholders and corporate shareholders that were not in a parent-subsidiary relationship, distributions between a subsidiary and its parent being tax free. For individual investors, substantial international tax neutrality within the Community would be realized since investors would receive the dividend credit regardless of the country of incorporation of the Community corporation in which they invest.

Direct investment is treated somewhat differently. The receipt by a parent corporation of a dividend from a subsidiary organized in another EEC state would be tax-free to the parent and would not carry any imputation credit payment to the parent. However, when a parent redistributes the foreign profits to its individual shareholders, the compensatory tax which ordinarily would be levied on the distribution would be reduced or offset by the credit attached to the dividend received from the subsidiary. In effect, the foreign corporate tax is integrated with a domestic individual tax.

The country of the subsidiary is obligated to pay to the country of the parent's corporation, through a "clearing house" procedure, an amount equal to the tax credit attached to the dividends of the subsidiary. In contrast to the traditional method of dividing tax revenue, which gives the source jurisdiction the first "bite", the EEC Directive would leave the source jurisdiction with only the residual corporate tax on dividends distributed to non-resident shareholders. Since, however, the Directive anticipates an imputation credit of approximately 50 percent of the corporate tax, the source country would still be left with about 50 percent of the corporate revenue. If a country provided for full integration of its corporate taxes on distributions, as does Germany, it might collect no tax revenue on corporate earnings distributed to foreigners. The amount of tax would depend on the tax rate in the residence country.

I would conclude that the EEC model may provide a workable solution so long as countries only integrate about half of their corporate tax. It would not provide a workable solution in a world where countries in effect fully eliminate the corporate tax with respect to dividends.

## Integration for the United States

The Treasury Department devoted considerable resources this year to developing an integration proposal for possible inclusion in the Administration's tax program. President Carter has now decided *not* to propose an integration system for the United States. This decision is based on the complexity of the issues, the need for an immediate economic stimulus, and the understandably short time available for Congress to enact legislation in an election year. Still, I would like to share with you some observations on how integration might work in the United States.

In our study of integration it became clear to us that there is great merit in a system which gives the shareholder the same gross-up and credit irrespective of whether the dividend is paid out of domestic or foreign source income. This, of course, does not mean that foreign taxes must flow through to the shareholders resident in the imputation country. France and the United Kingdom, for example, rely on the *précompte* and the ACT to ensure that the credit available at the shareholder level has been paid at the corporate level.

To allow a full flow through of foreign taxes to our shareholders would entail a very significant revenue cost to the Treasury Department. Since, for example, the United States and many foreign corporate tax rates are about the same, and the average United States individual shareholder tax rate is below the United States corporate rate, full flow through of foreign taxes would place us in the untenable position of refunding taxes at the shareholder level which, in effect, had been collected by a foreign government.

Traditional practice within a classical system has given the source country the major portion of the tax revenue from foreign investment with only residual taxing rights accruing to the residence country. It is not clear how the tax revenue from foreign investment should be divided between the host and home countries within an integrated system. Whether the revenue split should be

"50-50" or something else is an open question. It is very clear, however, that giving more than 100 percent of the tax revenue to the host country is unacceptable. But this is precisely the effect that full flow through of foreign taxes to individual shareholders would often have.

There are a variety of possible solutions to this problem. Foreign corporate taxes could be allowed as a credit at the individual shareholder level, but limited to the individual shareholder's tax rate. This would avoid the refund of foreign taxes by the residence country, but would be administratively complex since each individual shareholder would be required to compute a foreign tax credit limit. We rejected this solution. Another possibility would be for the residence country to allow a full credit at the shareholder level for foreign corporate taxes, but require the source country to finance the credit. This would entail an EEC type "clearing house" payment. A third possibility would be for the residence country to deny the flow through of foreign taxes, but, like France, Germany, and the United Kingdom, soften the impact through favorable dividend ordering or tracing rules.

## Current United States position

Let me conclude by commenting on our current position with respect to the appropriate tax treatment of investment by U.S. residents in an imputation country. We continue to believe in capital export neutrality: that an enterprise should pay the same rate of tax on foreign profits as on domestic profits. In accordance with that belief we continue to allow a foreign tax credit up to the amount of U.S. tax due on foreign source income. But we also believe in the time-honored principles of non-discrimination and reciprocal withholding rates.

Pursuit of these principles argues that the country adopting an imputation system should be prepared to extend the shareholder credit to investment by United States residents. Failure to extend the credit means that a corporation owned by U.S. residents pays higher foreign taxes than one owned by residents of the imputation country. This is a clear violation of the principle of non-discrimination.

We have heard it argued that since an imputation system provides tax relief only at the shareholder level, it does not affect the true corporate tax rate and the issue of non-discrimination does not arise. If this is an accurate characterization of the imputation system it means that U.S. residents are subject to a very high withholding tax on their dividends from foreign investment. This is a violation of the principle of reciprocal withholding rates contained in nearly all our treaties.

We have had substantial success in securing the extension of imputation credits to our residents with foreign portfolio investments. Only with the United Kingdom have we been able to negotiate the credit for our residents with direct investment. Our recent treaty with the United Kingdom provides that when a dividend is paid by a U.K. corporation to a U.S. direct investor, a refund equal to one-half of the credit allowable to a U.K. domestic shareholder, i.e. one-half of the ACT, is paid to the U.S. investors. Using a rule of thumb that about one-half of U.S. corporate profits are paid out in dividends, agreement was reached by treaty to extend one-half of the credit to U.S. direct investors, on the assumption that this credit relates to that portion of the U.K. dividend which on average will eventually be passed through to U.S. shareholders. This resolution provides a measure of fairness for U.S. investors and is consistent with the theory of an imputation system that relief should be available with respect to distributed earnings.

Although the U.S. does not have an integrated system, it is resolute in its determination to achieve a United Kingdom type solution in its treaty negotiations with other imputation countries. This is not a view that is held solely within the Treasury Department. In submitting its report, a House Ways and Means Committee Task Force on Foreign Source Income made the following statement (123 Cong. Rec. H 1918-19, daily ed. March 9, 1977):

> **"Subsequent to the last meeting of the task force it came to our attention that the effect of the integrated tax system of certain foreign countries may be to discriminate against investment in those countries by United States persons as compared with similar investment by their own residents ....**
>
> **... The discrimination against American investment that results when an integrated system gives refunds or credits only to its resident shareholders can be quite substantial.**
>
> **...**
>
> **We are greatly concerned about this situation and will, unless a mutually satisfactory resolution is forthcoming, recommend that the committee consider legislation which would give the President authority, if he determines that a foreign country does not accord investment by United States residents treatment comparable to investment by residents of that country, to tax investment in the United States by nationals or residents of that country at comparable discriminatory rates."**

It is clear that some in Congress share the concern of the U.S. Treasury over the gravity of the non-discrimination issue. Like the Ways and Means Committee Task Force, we hope that our treaty partners will acknowledge our view that U.S. shareholders must be treated equitably and that a mutually satisfactory resolution of this issue can be negotiated by treaty.

# Integration of Corporate and Individual Income Taxes*

BY JAMES R. HANEY**

CONTENTS



## I. Introduction

The purpose of this paper is to focus on the implications of integration of corporate and individual income taxes under either a gross-up shareholder credit method or a corporate dividend deduction method.

Removal of the tax bias against corporate earnings by reducing the combined corporate/shareholder tax burden is the primary goal. The method by which this goal is achieved should not take on such importance so as to negate this primary objective.

The tax economic effect can be similar under either the gross-up shareholder credit method on dividends paid or the dividends-paid deduction method because both lead to similar reductions in the overall tax bias against corporate source income. Table 1 illustrates this point.

Each method has advantages and disadvantages in the implementation process. However, implementation problems under either method should not imply less creditability of the integration concept and should not delay its adoption in concept.

Any approach to integration of corporate/individual taxes should be directed toward:

1. elimination of the tax bias against corporate source income vis-à-vis other sources of income;
2. elimination of the tax bias against equity capital;
3. simplification of the administration of integration for corporations, shareholders, and government; and
4. recognition of the political realities of such a change in the overall tax system.

The basic difference in the two methods is that the gross-up credit method achieves the reduction by reducing the shareholder's tax, while the dividend deduction method achieves the reduction by reducing the tax paid by the corporation.

The revenue cost can be the same under either method, depending on the specifics. Revenue variances would occur, however, under either method depending on whether tax-exempts and foreign investors are allowed to participate.

The principal problems caused by separate taxation of personal and corporate income are generally:

1. All corporate income is subject to a flat rate of 48 percent (ignoring normal and surtax difference, investment credit, etc.).
2. Dividends paid are taxed at shareholder's marginal rate based upon his entire taxable income.
3. Retained earnings are subject to capital gains tax at a lesser rate in that:
   a. gains are taxed only when realized, and
   b. only one-half the gain is taxed.

The important effects of this three-tier corporate tax system are summarized below:

* Paper submitted to the meeting of the U.S. Branch of the International Fiscal Association on January 12, 1978.
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1. The effective tax rate on currently distributed corporate source income is higher than the rate ordinarily assessed on non-corporate source income.
2. Capital gains are taxed at lesser rates, thus, the effective tax rate on retained earnings is less than the rate on currently distributed earnings.
3. Low-income taxpayers pay greater effective tax rates on corporate dividend income; high-income taxpayers pay lower effective tax rates if earnings are not distributed.
4. Fast-growing firms with relatively low dividend payout ratios may find their overall tax position enhanced vis-à-vis non-corporate enterprises by the existence of a separate corporation income tax and preferential capital gains treatment.
5. Capital income carries a higher tax burden in the corporate sector — the result may be to misallocate capital to non-corporate income.
6. Corporate executives are often more concerned about the rate of return after corporate taxes on capital invested in their companies, than about personal taxes (and the total tax burden on corporate source income). Thus, a greater preference for debt financing may result.

Although there are many approaches to integration, this paper addresses itself to three variations:

1. Complete integration — a shareholder credit on dividends received *and* on retained earnings.
2. Partial integration — a shareholder credit on dividends received.
3. Partial integration — a dividend deduction at the corporate level.

**TABLE 1**
**Comparison of partial integration methods**

| Corporation | Present | Credit | Deduction |
|---|---|---|---|
| Tax computation | | | |
| Income | 400 | 400 | 400 |
| Dividends paid deduction | – | – | 200 |
| Taxable income | 400 | 400 | 200 |
| Tax @ 50 percent | 200 | 200 | 100 |
| Cash Effect | | | |
| Dividends paid | 100 | 100 | 200* |
| Net cash retained | 100 | 100 | 100 |
| Shareholder | | | |
| Tax computation | | | |
| Dividend cash | 100 | 100 | 200 |
| Gross-up | – | 100 | – |
| Taxable income | 100 | 200 | 200 |
| Tax @ 40 percent | 40 | 80 | 80 |
| Tax credit | – | (100) | – |
| Cash effect | | | |
| Dividends received | 100 | 100 | 200 |
| Tax (paid) or refund | (40) | 20 | (80) |
| Net cash retained | 60 | 120 | 120 |

* Deduction of dividends permits a greater dividend payout without a change in corporate retained earnings or a change in the shareholder's net aftertax cash retained.

## II. THREE FORMS

### A. Complete integration (shareholder credit method)

Complete integration would treat retained earnings as being constructively received by the shareholders. The shareholder's allocated retained earnings would be imputed to him and taxed at ordinary regular individual income tax rates similar to the treatment of dividends received. The corporation actually would continue to pay the corporate tax on shareholder earnings to the government, the effect of which would be a "withholding tax" on behalf of the shareholders.

Each shareholder would receive a statement indicating his pro rata share of retained earnings and dividends paid to him, together with the corporate tax withheld attributable to both. The total sum would be added to the shareholder's other taxable income for the year and his individual tax liability computed. The attributable corporation tax withheld would be deducted from the shareholder's total tax liability. If the shareholder had insufficient tax liability to absorb the tax credit, the excess would be refunded.

The shareholder's basis in his stock would be increased by his pro rata share of retained earnings included in his income. Otherwise, that income would be taxed once when it is earned by the corporation and a second time as a capital gain when the shareholder sells his stock. Distributions of these retained earnings in future years would be received tax-free. In terms of the order of distribution, a LIFO approach would probably be the most appropriate. This is similar to the present structure when distributions first originate from current earnings.

### B. Partial integration (shareholder credit method)

Under the partial integration method, the shareholder would gross-up his dividends received to include the corporate tax attributable thereto, add the grossed-up amount to his other taxable income, compute his individual regular tax, and use the gross-up factor as a credit against his regular tax liability. Any excess credit would be refunded. The primary difference between the partial credit method and complete credit method is that retained earnings would be taxed at the corporate level only.

### C. Partial integration (dividend deduction method)

Under this method, the corporation would be allowed to deduct dividends paid in computing its taxable income. Dividends would be taxed to shareholders like all other income, at the shareholder's marginal rates, as they are now.

In essence, the corporation income tax would become a tax on retained earnings at the corporation's effective tax rate.

From the standpoint of the corporation, dividends and interest would be treated similarly. This would reduce the penalty against equity financing but would not eliminate it. To the extent that earnings are not distributed, the corporate tax would not be made neutral as between debt and equity financing. We should keep in mind that the dividend paid is not necessarily a true cost of equity financing.

## III. TECHNICAL ISSUES

The following technical matters generally would be applicable to either a shareholder credit method or a dividend deduction method unless otherwise noted.

1. *Tax-exempt shareholders (wholly or partly exempt):* Under the credit method, it would be easier to exclude such tax-exempts by denying them the credit. Equity considerations are not clear. Some argue no credit should go to tax-exempts because they pay no initial tax. However, income of pension funds, while not taxed initially, is taxed when pension benefits are paid out. To achieve the full economic benefits of integration from the standpoint of increasing investment and improving the allocation of resources, it may be necessary to allow the credit to tax-exempts. If this is so, it has also been suggested that a mild tax on all investment income be placed on tax-exempts. Under the dividend deduction method, the integration benefits would be automatically extended to tax-exempt shareholders.

2. *Foreign dividends/shareholders:* The revenue effect may dictate allowing the integration benefits only to U.S. dividends paid to U.S. shareholders.

a. Foreign corporation dividends to U.S. investors — the question is whether such dividends should be considered tax-exempt for purposes of U.S. income tax integration or should they be grossed-up with a tax credit.

b. U.S. corporation dividends to foreign investors — integration relief could be denied to foreign investors who would look to their own governments for relief, or the U.S. could impose a withholding tax on U.S. corporated dividends paid to foreign investors and then allow the tax to be taken as a credit similar to that used by U.S. residents. Since the foreign resident would not owe any U.S. personal income tax, a refund would be received equal to the corporate tax withheld. Foreign shareholders would then be taxed on the U.S. corporate source income under the law of their home country. This treatment is automatic under the dividend deduction approach. The integrated tax system of the foreign countries would have some impact on what might be the preferable approach by the U.S.

3. *Intercorporate dividends:* Under the shareholder credit method, one approach might be to exempt from corporate tax 100 percent of intercorporate dividends received because the tax was paid by the dividend-paying corporation. Adoption of the dividend deduction method would carry with it the repeal of the existing dividend-received deduction (85 percent) allowed to corporate distributees because the dividends would be deducted by the corporation that pays the dividend.

4. *Preferred stock:* One approach would be to not allow the credit on the grounds that holders of common stock largely bear the burden of the corporate tax. Preferred stock would be treated as a debt with the dividend deducted as interest. This would also avoid an allocation of retained earnings between preferred and common stock under the complete integration method. Under the dividend deduction method, preferred dividends would automatically be treated similarly to debt.

5. *Gross-up factor (effective corporate tax rate):* This issue is present only in the credit approach, has caused much concern, and has almost infinite variations. The more finely tuned it is, the more complex it becomes. Absolute correctness within a corporation or within a specific time frame is perhaps impractical, if not impossibe, and perhaps unnecessary. Listed below are some proposals which have been mentioned:

a. *A flat 48 percent corporate tax,* notwithstanding that corporations pay tax at rates less than 48 percent because of tax exemptions, credits, and other tax provisions. This method encounters opposition from those who argue that no credit should be allowed in excess of the tax paid by a corporation in a given year.

b. *The "exact method"* has been suggested to satisfy the above argument. The "exact method" would require that the gross-up factor and the rate for the credit vary for each corporation (or industry) based on the actual rate of tax that it pays. For simplicity, it could be the effective rate shown in the annual report or 10-K. Corporations would report this tax rate to shareholders on Form 1099 along with the amount of dividend and/or allocable retained earnings depending on whether partial or complete integration was in effect. Changes in corporate taxes resulting from audits or amended returns could be treated as an adjustment in the year such change occurs for gross-up purposes. Or a reserve for such changes could be set up and the corporate rate could reflect such reserve in the current year's gross-up. The latter would not seem to satisfy those who do want a credit based on taxes actually paid in the current year.

c. *Uniform gross-up factor* — A uniform corporate rate would be set below 48 percent to recognize the fact that the average effective corporate tax rate is less than 48 percent. This may be less equitable as among shareholders of differently taxed corporations than the "exact method". The uniform rate could be based on the national average (perhaps by industry). Further, a separate uniform rate for small businesses with less than $50,000 taxable income could be established to reflect the impact of the tax exemption on small businesses.

d. *The gross-up earnings method* has been also suggested whereby preferential income would be adjusted to a gross amount which would produce the same tax as at a 48 percent full corporate rate. For example, if the corporate rate was 50 percent, a corporate capital gain of $100 would be adjusted to $60 so that a 50 percent corporate tax rate would produce a $30 tax (the same as $100 at 30 percent). Earnings and profits would also be adjusted, for shareholder credit purposes, so that distributions treated as dividends subject to the shareholder credit would be limited to such adjusted earnings and profits. The gross-up credit on such dividends would be at the flat corporate rate of 48 percent, and any distributions in excess of the adjusted earnings and profits account would be treated as a return of capital not subject to the shareholder credit. Also under this method, investment tax credits and foreign tax credits would be passed directly to the shareholders and would not be a part of the gross-up credit procedure.

6. *Prospective application:* The shareholder credit method or the dividend deduction method undoubtedly would be applicable to corporate profits earned after the effective date of the legislation. Earnings accumulated prior to this date would not qualify.

7. *State taxes:* Integration in any form would affect the various state mechanisms, but that effect should not be controlling in a decision to adopt integration at the federal level. An analysis, state by state, does not seem practical at this time.

8. *Tax credits:* In computing the amount of the credit for corporate taxes paid which would be passed to the shareholder, a problem is presented as to whether existing tax credits, such as the investment tax credit, foreign tax credit, etc., should be components in the effective tax rate (gross-up factor) or wether such existing tax credits should be passed directly to the shareholder and excluded from the effective tax rate computation. To a great extent, the investment tax credit is unrelated to earnings (the amount is based on qualified expenditures). To pass such credits directly to the shareholder may cause the system to be cumbersome if a partial integration is adopted since such credits would have to be allocated in some manner to earnings, and then allocated in some manner between dividends and retained earnings. Under complete integration, the pass through might be simpler since such credits might be assigned on some pro rata basis without the need to identify them to earnings distributed or retained. At the start-up of the system, folding such credits into the gross-up factor would be simpler and perhaps better accepted by the shareholder, notwithstanding its lack of complete accuracy.

9. *Net operating losses:* The dividend deduction would significantly increase the extent of the net operating losses or reduce the income against which such losses may be offset; therefore, an increase in the period during which net operating losses can be deducted would appear necessary.

10. *Dividends from preferentially taxed income:* Dividend distributions from a corporation which has tax-free and/or preferentially taxed income for the year raises the question of whether a deduction should be allowed for such dividends or whether the deduction should be reduced by the portion attributable to such tax-exempt or preferentially taxed income. As long as distributions do not exceed taxable income for the year, no adjustment seems necessary. If it does, then a carryback or carryforward provision could take care of the situation.

## IV. MAJOR POLICY ISSUES

### A. Revenue impact

Any form of integration will cause a revenue loss initially. The magnitude of the loss would depend mostly on whether tax-exempt shareholders and foreign shareholders could qualify for tax relief. The initial revenue impact of partial integration would range from a low of about $8 billion to a high of $20 billion in today's economy. A program could be phased in, of course, to minimize the initial revenue drain, and over time better economic performance could make up for much or all of the initial losses.

Many tax provisions have been noted for potential repeal or alteration to offset the revenue loss from integration; *i.e.*, ADR, investment tax credit, minimum tax, foreign source income treatment, etc.

Revenue "trade-off" is highly political and thus unpredictable; however, here are some broad observations. First, many of the potential offsets are candidates for revision notwithstanding the adoption of integration. Second, arguments for the adoption of integration should be made on the merits of integration and not simply as a vehicle to "close loopholes". Third, modification of existing tax law should be debatable only on its merits. If a shareholder credit is adopted, a better argument probably could be made that the "trade-off" should come from the non-business sector.

In the short term, integration in any form could cause some market jitters and capital shifts. However, in the long term, the market place should react to smooth out any disruptions.

The shareholder credit method might improve taxpayer compliance because the shareholder would need to report dividends to receive the credit. Perhaps the revenue loss from integration could be offset to some extent through such improved reporting of income.

### B. Debt and equity financing

The shareholder credit method would make dividends more attractive to the investor than interest because the taxpayer receiving dividend income would also receive a tax credit that would substantially offset the additional tax liability attributable to the inclusion in the gross-up amount (for low margin taxpayers and perhaps substantially more taxpayers if the maximum individual rate is lowered to 50 percent). The preference by the investor for dividend income over interest income should ease the preference for debt over equity financing.

However, because dividends would still not be deductible to the corporation, those in control of corporate policy would still be apt to lean toward debt and its accompanying interest deduction. Thus, the disparity between debt and equity investments would lessen under the gross-up credit method but perhaps not as dramatically as under the dividend deduction method.

### C. Cash shortfalls

Complete integration under the shareholder credit method could result in a cash shortfall to shareholders in high margin rate brackets who would have imputed income for undistributed retained earnings. The cash problem would swing the opposite direction for low marginal rate shareholders. This would not be a problem under partial integration.

To alleviate the cash shortfall problem above, it has been suggested that the complete integration method should be accompanied by a reduction of the maximum marginal individual tax rate to 48 percent (similar to the maximum corporate marginal rate of 48 percent). However, this reduction in the maximum individual rate to 48 percent would not eliminate the problem, particularly if the gross-up factor were based on the "exact method" or a uniform rate of less than 48 percent because there would continue to be a shortfall between the 48 percent rate and the lesser gross-up factor rate.

The reduction in the maximum individual rate to correspond to the maximum corporate rate of 48 percent has also been suggested as a means to improve implementation of the partial integration method, separate from the problem of retained earnings computations and resulting tax cash shortage.

Another alternative in rate adjustment would be to increase the corporate rate to 50 percent with a reduction in the individual rate to 50 percent. It does not seem necessary for the maximum rates to be exactly the same, but the spread should be decreased, and a 48 percent corporate rate, and 50 percent individual rate would be accomplished. There is precedent for a 50 percent maximum rate in individual taxes in present law. Its extension would seem relatively simple.

## D. Book and tax conformity

Reformers may argue for book and tax conformity allegedly to simplify the determination and the implementation thought to be involved in the gross-up factor (effective corporate tax rate) under the shareholder credit method. However, there would be no substantial difficulty in determining what the corporation's effective tax rate is. Undoubtedly, it would be less than the maximum corporate rate of 48 percent, but that is the result of desired effects of the entire tax system and not peculiar to an integration system. It would also undoubtedly be more or less than the marginal tax rate of the recipient shareholder, but that will be so until both the corporations and individuals have identical flat tax rates. In other words, the merits, or lack thereof, of conformity should be debated separately from the merits of integration and in the context of the overall desired economic effect within the entire tax system, not just within the corporate sector. After all, each taxpayer now probably has an "effective" tax rate less than the maximum tax which could be extracted from him if he had no preferential tax items.

Pressure for tax and book conformity, which might increase because of public exposure to the effect of various tax provisions on the gross-up factor, does not seem any more likely under a shareholder credit than under a dividend deduction.

Although corporate effective rates are most often discussed in regard to the shareholder credit, the deduction for dividends would be of some concern to some corporations because its effect would be to reduce the corporate effective tax rate unless dividends are allowed to reduce income for accounting purposes also. There has been very little, if any, discussion regarding a change in accounting treatment of dividends if the dividends are deductible for tax purposes.

## E. Capital control and dividend payouts

In order to encourage the return of dividend distributions back to the payor corporation, some form of reinvestment requirement has been mentioned. Such a reinvestment plan would minimize the capital outflow impact on the corporation and perhaps minimize the argument against the shareholder credit method by corporate management fearing loss of control by the corporation of its capital as compared to direct capital improvement via the dividend deduction route. There is also concern about the possibility that the shareholder receiving the credit would not invest the tax savings and/or dividends but rather will spend them. Precedent does not seem to indicate this.

The gross-up credit method has one important advantage over the dividend deduction method because of the effect on corporate accumulations. Since corporate income taxes must be paid whether profits are distributed or not, the incentive to distribute dividends to obtain a deduction would not be nearly as compelling. However, shareholders would certainly apply pressure on corporate management to account for dividend payout potential. Thus, even under the gross-up credit method, the corporate policy as to dividend distribution would have a definite impact on investment decisions at both the corporate management and shareholder levels. As to new and growth corporations (including small business or closely held corporations), the gross-up credit method would appear more desirable because of their desire for little or no dividend payout.

## F. Integration and tax "preferences"

Present corporate tax preferences ("tax expenditures") that affect the determination of corporate taxable income retain their significance under either complete or partial integration. Thus, accelerated depreciation, ADR, depletion, intangible development expenses, deferred foreign source income, partially or fully exempt income, etc., will still remain vital tax issues.

Some concern has been expressed about the effect of the gross-up credit method on the status of foreign source income "deferral". There is concern that the "conduit" integration concept applicable to domestic corporate net income passed through to the shareholder would result in a similar flow-through with respect to foreign subsidiary income. However, the underlying concepts of tax treatment for these two income sources are fundamentally different and continued differing tax treatment should prevail, based on the merit of present arguments for "deferral".

The present tax credits (investment and foreign), which lower the actual rate of tax but not the amount of corporate income allocable to shareholders, would have a different effect than accelerated depreciation which would lower both the amount of tax paid by the corporation and also the amount of corporate income allocable to shareholders (unless that amount would be determined by reference to corporate earnings and accelerated depreciation, et al. would not be allowed to reduce those earnings for such allocation purposes).

Some may feel that integration should put an end to these tax preferences. Integration itself would not, but it might place even greater stress on the survival of these preferences. Most examples which describe the mechanics of integration ignore the implications of the differences in corporate taxable income and corporate book income. In their effort to achieve simplicity of description, a key issue is swept aside. If the determination of corporate taxable income under integration methods is deemed irrelevant, this is erroneous. First, corporate taxable income determines, along with the effective rate, the amount of corporate tax to be paid to the government. Second, the corporate taxable income presumably also determines the amount of corporate profits which could be distributable as dividends to shareholders. (It may be that, instead of corporate taxable income, the amount of corporate book earnings and profits would determine the allocation.) Whether the dividend aspect or effective tax rate in the integration system would be linked to taxable income or to book income would be important in determining the credit treatment to shareholders.

Additionally, it has been suggested that the preferential treatment of capital gains should be eliminated if integration is adopted. The difference in capital gains rates and ordinary income rates has narrowed in recent years. This spread would be further diminished if the maximum individual tax were 50 percent and the minimum tax on capital gains were applicable to any given taxpayer.

### G. "Loopholes" and other arguments

It has been suggested that the credit method would be a "loophole" for high marginal rate taxpayers. However, these shareholders would get proportionately less reduction from integration than the low rate shareholders would receive. Additionally, the lower rate shareholders could get a refund for corporate taxes paid which exceed the shareholder's own tax rate on the dividend. The high marginal tax shareholders would still have additional tax to pay on their dividends received because the corporate rate paid would have been lower.

These taxpayers currently carry the burden of excessive taxation and should be entitled to the benefits of the reduction of the tax bias. Furthermore, more *absolute dollar relief* should not be misrepresented as proportionately higher relief.

Under the dividend deduction method, the fact that the corporation income tax would apply only to retained earnings means that it would be a differential tax on growing companies who need their profits for expansion. The differential tax burden would be onerous for companies too small to secure equity funds. However, management which is paying dividends would take the resulting lower corporate effective tax rate into account in financial decisions which might make otherwise marginal projects more feasible.

While an additional deduction at the corporate level initially appears to be the answer to corporate management's capital shortage, it could trigger other problems which would result in non-resolution of the capital problem. For example, the corporation must have sufficient taxable income to absorb the additional deduction; otherwise, such a deduction would have no immediate economic effect. Thus, companies with existing minimal taxable income would have minimal relief.

Also, an additional deduction, which could be viewed as a reduction in the effective corporate rate, could increase the demand for elimination of other corporate tax provisions.

Advocating the dividend deduction method involves the possible implication of business seeking additional preferential treatment or another "loophole" because the direct reduction of tax bias would occur at the corporate level. In explaining the economic effects of this method, extreme care must be taken to point out that the shareholder is the beneficiary through increased dividends or increased capital gain on his stock.

Advocating the shareholder credit method carries the taint that it is a "loophole" for the rich. Careful explanation is needed to point out that the shareholder would still pay his highest individual marginal rate on dividends received. It is the corporate tax applicable to dividends that would be eliminated, in effect. Such corporate tax would be eliminated for all shareholders at an equal percentage rate so that each shareholder would receive the same amount of credit dollars regardless of his own marginal tax rate, whether it is 14 percent or 70 percent.

It is true that proportionately more dividends are paid directly to higher income taxpayers, but it should also be recognized that this is not true when indirect dividend recipients are included such as participants in pension plans. This fact may justify the participation, at least, of tax-exempt pension trusts in any program of integration.

## V. RESULTS

### A. Complete integration by shareholder credit method

Complete integration would eliminate all tax bias for or against:

1. corporate source and non-corporate source income;
2. debt and equity financing;
3. dividends paid and earnings retained;
4. over-taxation of low marginal rate shareholders and under-taxation of high marginal rate shareholders.

Some people urge complete integration because they see the 48 percent corporate tax rate as a shelter for retained profits of shareholders with individual marginal tax rates of 48 percent to 70 percent. However, unless safeguards are adopted, complete integration could involve significant tax penalties and cash shortages for some taxpayers.

### B. Shareholder credit on dividends paid

A shareholder credit for corporate taxes paid on dividends would also move toward eliminating the tax bias described under complete integration, along with the following results:

1. The market price of dividend-paying corporate stock should increase in comparison with alternative investments. Thus, new equity financing could be obtained without diluting earnings with lower rates of pretax returns on the new capital.
2. There would be no higher differential tax at the corporate level on retained earnings. Thus, the incentive to distribute dividends would not be as compelling. This would be advantageous to new and growth companies.
3. Prospective tax relief on future dividends could increase the price of all corporate stock in comparison to other investments.
4. The shareholder credit might make dividends more attractive to certain shareholders further reducing retained earnings. However, gross dividends might be reduced (because there would be an increase in net after-tax dividends to shareholders) and with a resulting increase in retained earnings for the corporation. Most likely, the payout ratio would remain unchanged.
5. In terms of the equity, the result would parallel the dividend deduction method. Thus, vertical and horizontal tax equity would result for distributed profits but not for retained profits.
6. Dividends should become more attractive than interest because the shareholder would receive a tax credit that would more than offset the additional tax liability attributable to the inclusion of the gross-up amount. The preference toward dividend income should reduce the preference for debt over equity financing.

### C. Dividend deduction method

Partial integration under the dividends-paid deduction method would have the following results:

1. Reduction of the tax bias against equity financing because dividends and interest would be treated similarly at the corporate level. This method would not eliminate such tax bias unless all earnings are distributed.
2. Reduction of the tax bias against corporate source income.
3. elimination of the double taxation of earnings distributed as dividends.
4. Possible increase in dividend payouts and encouragement of greater use of equity market to raise capital. Whether capital from retained earnings would be increased depends on the dividend payout policy which presumably would change to reflect shareholder desires.
5. Probably would result in the simplest method of integration but would provide no direct tax reduction to shareholders. Shareholders should benefit indirectly by receiving more dividends and capital gains on their stockholdings.
6. Creation of fewer administrative problems for corporations, shareholders, or the government.
7. Possible penalty on growing firms that need funds for expansion and preference to mature firms that may not need such funds.
8. Places a premium on distributions (tax deductions) to shareholders. If corporations maximize the deduction, less is retained for capital spending. This shortage theoretically should be overcome by increased investor interest in equity securities.

## VI. CONCLUDING COMMENTS

Business groups urge integration because of prospective tax relief for earnings on corporate capital and so that corporate source investments can compete more effectively with non-corporate source investments in the capital market-place. Often, however, business groups talk in terms of a partial integration method which would provide tax relief for dividends, and, more particularly, a deduction for dividends so that the tax relief originates in the corporation. Such tax relief would then compete, within each corporation, between greater dividend payouts or greater corporate expenditures (not necessarily capital expenditures).

Integration should receive a broad view by all sectors which should realize that it increases the availability of capital initially because the effective combined corporate/shareholder tax rate would be reduced. Longer range, the lesser burden of taxation on corporate source income should lead to more corporate investment.

Within the corporate community, integration should cause a reassessment of the choice of investment between companies. Long range, that choice should be influenced by the effectiveness of corporate management to provide the investor a greater return on his invested capital after considering the combined corporate/shareholder after-tax income. That return on investment will, of course, be influenced by each corporation's effective tax rate (i.e., the mix of preferentially treated income and deductions) and by the top marginal tax rate of the investor (also influenced by the individual taxpayer's mix of preferentially treated income and deductions).

In the final analysis, the ability of the corporate business sector to attract capital depends upon its ability to generate a competitive rate return after combined corporate/shareholder taxes. Whether such a favorable competitive position can be attained, in turn, depends upon the individual's particular after-tax return on all his net income which includes many favorable preferences available only to individuals. No taxpayer is a purist when it comes to preferential tax treatment of his taxable income or his tax deductions — whether it be corporation, individual, tax-exempt, partnership, or any other taxpayer. The investor's confidence in the corporate equity marketplace must be restored and integration is a step in that direction. But of equal importance, the business sector's confidence in the free marketplace as a source of equity capital must be restored, and a step in that direction would be to express confidence in the shareholder's choice of capital investment in a free marketplace. Perhaps this is recognition of an often forgotten fact of our capitalistic system that the people are the true investors in the end.

* * *

The business community should endorse the concept of integration as a means to reduce the tax bias against corporate source income. The primary methods for removing this tax bias are to allow a credit to the shareholder for corporate taxes paid under a gross-up procedure or to allow a dividend paid deduction to the corporation. Either of these methods is acceptable.

Other methods may be acceptable provided fairness is achieved between the taxation of corporate and non-corporate source income to the shareholder.

Both of the above methods can achieve similar tax economic results. Each method has advantages and disadvantages in its implementation process. One method may be preferred over the other depending on personal preference. However, the problems of implementation should not over-shadow the fact that there is a need for the integration of corporate and personal income tax.

It is recognized that the dividend deduction method may be simpler administratively. However, administrative simplicity may have to yield to political practicalities as a necessary step toward acceptance of the integration concept. The climate for integration seems better now than it has in many years which may lead to resolution of differing viewpoints.

Endorsement of integration probably should be limited to partial integration at this time. Phasing-in of relief seems practical because of the initial revenue impact. However, what is important is the acceptance of the fact that there is excessive tax on the combined corporate/shareholder income.

If the shareholder credit method is adopted at the start, the gross-up factor should be kept as simple as possible conceptually with refinements following as better understanding of the methodology is attained. In this regard, a trade-off between the degree of accuracy and simplicity might be required. However, as long as there are differences in rates of tax on taxable income, fine tuning in the gross-up factor would only add to complexities. Such complexities would not be understood by the shareholders or the general public or perhaps even by the people charged with implementing the system. Understanding of the mechanics of the integration system by all parties to assure them of the fairness of the system is essential to its acceptability.

Finally, the business community should strive for a consistent position that is compatible with the interests of non-business groups. Otherwise, business will find itself outside the policy-making circle, and, more importantly, outside the implementation circle. For years, business had advocated relief from excessive taxation on corporate source income and has always advocated the free marketplace system. The question is whether business is willing to trust a free capital market system.

# Integration of the Corporate and Individual Income Taxes in the United States*

BY DR. BERNARD WOLFMAN **

*I am going to discuss with you today some of the legal questions affecting the possibilities of integration of the corporate and individual income taxes within the United States. The effect that any integration scheme may have on individuals and companies abroad, I leave to others. I am going to start with a little history, but when I conclude I will come back to something that Mike Boskin referred to earlier, and I may then suggest an area of possible debate.*

Historically, our system is referred to as the classic system. I want to suggest, however, that if it is classic in the sense that it is the oldest, then it would have to have antedated our first United States income tax. But our first, and in that sense classic, income tax system had complete integration. The Civil War income tax from 1861 to 1872 taxed corporations like partnerships. I do not know what revenue agents did; I do not know how they dealt with audit adjustments; but I do know that corporations were taxed as partnerships and that our doing so was sustained as constitutional by the United States Supreme Court.

Then came a 22 year gap followed by the short lived income tax of 1894. Not until 1909 did we again have a federal tax on income and that was a tax on corporate income only. In 1913 an individual income tax was added and right from the beginning there was a degree of integration. The normal tax — under the old personal income tax there was a normal tax and a surtax — was not imposed on corporate dividends. And for a number of years the rate of the corporate tax and the normal tax were the same. So dividends were taxed only once at the normal tax level.

For a number of years thereafter there was a great deal of backing and filling on the way these taxes were to interrelate. But there was always an interrelationship, a

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concern about integration, from 1913 to 1936. Indeed, from 1936 to 1953 there was no integration at all. Since 1953 we have had a small degree of integration. You may remember that in the 1954 Code Dan Throop Smith and his group were responsible for giving us a 4 percent credit and a $50 exclusion. In the Kennedy administration we eliminated the credit, but doubled the exclusion, and we have the doubled exclusion today. In 1958, now 20 years ago, we in a sense integrated what are defined as "small business corporations" through the enactment of Subchapter S, providing a right to election for certain corporations very closely held. Today, therefore, we see but a minimal degree of integration. For this discussion we can assume that we do not have any. Using figures of about a year and a half or two years ago, the corporate tax as such produced 15 percent of our federal revenues (about $38,000,000,000) and the individual income tax yields 3 times that amount or 45 percent of our revenue ($118,000,000,000). The second largest revenue raiser, much bigger than the corporate tax, of course, is the social security tax. We have problems with the corporate tax in addition to those discussed, i.e. problems of incidence, of not knowing for sure who bears it. There are schools of thought with respect to this. Mike Boskin speaks for one of them, but only for one of them.

We have problems with respect to progressivity. We know that the existence of the corporate tax defeats the progressivity scheme of section 1 of the Code because it overtaxes people who are below the corporate rate individually and it substantially undertaxes people whose marginal individual rates are greater than the corporate rate. The latter group enjoy the benefit of substantial deferral. This creates equity problems and there are problems of economic efficiency to which Mike Boskin referred.

The double tax structure is one which the majority of us corporate tax lawyers are most at home with. We make our living with it, we teach it and we complain about it. It is the area of complaint that at some stage makes some of us lawyers look to the possibilities of integration. Now what are some of the structural problems that give us some pause about the existing system. First of all we have the doctrine that prevents us from taxing unrealized appreciation. Clearly, if we were to tax unrealized gains as they accrued, and I am not suggesting that, a substantial area of complexity would go by the board. We have problems with stock dividends, the problems addressed by Sections 305 and 306 and then the *General Utilities* doctrine, codified in Sections 311 and 336, means that although we talk about a "double tax" structure, we lawyers know that for large numbers of corporations — primarily those in the close control of their shareholders — that the corporate tax is never paid with respect to asset appreciation. In one fasion or another appreciated assets are distributable to shareholders free of corporate tax and a step-up in basis is nevertheless possible for new owners of those assets. What this results in, of course, is great discrimination among corporations engaged in the same activity, some of which are ongoing and cannot take advantage of the tax-free step-up and other corporations which are able to do so. This is a complexity and inequity that would go if we had complete integration.

We have problems with tax-free exchange that, if not eliminated, would certainly blunt the problems, if there were a completely integrated system. Other difficulties like those of the collapsible corporation would certainly be eliminated if we had complete integration. But so much for the problem of "complexity". There is the other world of concern involving accumulations and deferral. We have a system that only taxes the individual shareholder when he receives a distribution. And yet we have a tension within the system because not all corporations can be used as accumulation vehicles for their high bracket shareholders. Only corporations that can avoid the reach of the tax on unreasonable accumulations of surplus under Section 531 and the personal holding company tax under 541 can be so used. The problem which Sections 531 and 541 address would be eliminated under complete integration.

If as a conjunct of integration the preferential rate on capital gains were eliminated, another complexity would go. The provisions on capital gain redemptions and attribution of stock ownership (Sections 302 and 318) would be repealed. Lawyers would no longer spend vast periods of time seeking to convert ordinary income into capital gain.

Finally, another seemingly intractible problem that would go by the board in a partnership type integration scheme is the one growing out of the need to clarify the capital of a corporation between debt and equity.

We have not been able to make the classification successfully, and I suspect part of the reason is that we are not sure why the classification is necessary. We know that investment in the form of debt produces deductible interest and that investment in equity stock produces non-deductible dividends. But we also know that except in the case of public utilities virtually all — that is a slight overstatement, but not much — public corporations are financed by way of debt and retained earnings and not by new capital stock investment.

There is a bias in our system encouraging new investment in the form of debt. The system also encourages the retention of corporate earnings. The result is that with interest deductible and earnings retained there has not been a substantial "double tax" because the corporate tax is largely only compensatory, i.e. a proxy for the shareholder's tax which is substantially deferred.

The pro-debt bias may have negative effects on corporate capital structures unrelated to taxation, however, since the bankruptcy potential is increased. And we do have the frustrating problem of trying to classify investment between debt and equity at the closely-held corporate level. There are many modes of partial integration all short of the partnership form which I will not discuss.

The Treasury's draft proposal, which Emil Sunley understandably did not refer to in specific detail, is the one I will speak about. I do not work for the Treasury. I have a copy of the leaked proposal, but it was not stolen — it was given to me in my role with the ABA Committee that is studying integration. And it is a very interesting draft proposal. In essence the Treasury's proposal is this. If you assume instead of a 48 a 46 percent corporate tax rate as the Treasury was assuming for this purpose last August, earnings distributed to shareholders would be effectively taxed at the corporate level at only 25 percent.

Shareholders would gross up and credit the amount of the corporate tax on distributed earnings and there would be a withholding tax which the corporation would collect from distributions to shareholders at, say 30 percent.

Subsequently the figures changed and the withholding rate was to have been 20 percent and the corporate rate on distributed earnings was to have gone up to 32 percent. But this was the basic scheme. It struck a number of people initially as complicated and difficult, but I think that was based on only a superficial reading. One may differ with the proposal, and I have my differences, but I think that one of its best attributes was its workability. Once most of us on the ABA committee got over the shock of something very different, we discovered that the proposal was thoughtfully projected and workable.

Before analyzing the Treasury report from a legal or structural perspective, I would like to put it aside and look at the horizon of full partnership-type integration, the type which alone among all the integration schemes would tax individuals on their corporate income at the rate provided by Section 1 of the Code. There are some people who suggest that it would be unconstitutional to tax corporate earnings to shareholders before distribution. That is not because they ignore the fact that the Civil War statute was sustained, but because they do know that in *Eisner v. Macomber* Justice Pitney, speaking for the majority of the Supreme Court, said that such a tax would be unconstitutional. It was only dictum, of course, but in effect he said that that Court in 1920 would overrule the decision of the Court that sustained the Civil War income tax, at least insofar as it permitted the taxation of shareholders on their shares of undistributed corporate income. Today, however, very few people would say that Pitney's dictum was good law. It seems to me that if Congress decided to tax corporate income to its owners, as it does in the case of partnerships, there is nothing in the Constitution which would lead today's Court to find the corporate veil sacrosanct. And if we had full partnership taxation, we would eliminate the problems of deferral through accumulations, we would eliminate the debt-equity problems, we would eliminate many of the problems resulting from distributions of appreciated property, and many of the ordinary income/capital gain conversion problems. However, the problems that remain and the new problems that develop with a complete integration scheme are serious.

The first question arises with publicly-held corporations, where shares change hands repeatedly. To which shareholder would we tax the income of a corporation and on what date? The Treasury's proposal, with only a partial integration scheme, had to meet that question. It suggested that the shareholder on the first day of a corporation's taxable year be chargeable with the income of the full year that follows, so that a shareholder who sold, say, in midyear would in one sense be chargeable with income of the corporation after he transferred his ownership. But if you will just take it on faith for now, when you read the proposals, which should be published eventually, you will see that the shareholder is not harmed since upward basis adjustments will equate precisely with the post-sale income with which the shareholder is charged. The result is to tax him only on income for the period of time that he held the stock. The government is the loser in that scheme since nobody will pay tax on the income past the date of sale for the balance of that year until the buyer of that stock sells. The income is reflected in the buyer's downward basis adjustment and is just not picked up until he sells. This may not be the only way of dealing with the problem but it is a simple way and one that, from the individual taxpayer's point of view, has a significant element of fairness.

On the other hand, we see that although we have just gone through a period in which Jerry Kurtz's rulings have shaken up and narrowed the tax shelter world, the Treasury's integration proposal would open up a new tax shelter area. If corporate losses like corporate income would pass through to shareholders, they would be able to set them off against their high bracket ordinary income from other activity. Tax shelters all over again unless new "at risk" type limitations were developed for corporations as the 1976 Act did for partnerships as some people have suggested.

New complexity to be sure, but I am certain that we lawyers can solve the problem in our typical way of taking a simple structure, seeing abuse potential and writing a complicated statute to deal with it. I suspect these kinds of new complexities to be among the reasons that complete integration is not on the horizon, but I think we need to look at complete integration to see why, apart from revenue loss, we have to back into partial integration if we are going to have any.

Problems of inter-corporate dividends must also be addressed. What is the proper tax treatment of inter-corporate distributions in a world of complete integration?

Another difficulty that would be aggravated in a world of complete integration is the problem of audit. Shares change hands. The revenue agent comes in two years after the corporate return is filed. The case in which a proposed adjustment is contested is decided by the United States Supreme Court 10 years after the years to which the adjustment refers. Which shareholders are to bear that deficiency? The Treasury's draft proposal says that it would be borne by those who are the shareholders in the year in which the decision becomes final, but assumes that the market would adjust in discounting stock values for potential tax deficiencies and refunds. Maybe. I think this is a serious problem. The Treasury also worries about this issue from another perspective, and that is whether shares might be transferred in order to shift income or loss in anticipation of an audit determiniation.

Another concern is that even without serious audit adjustments, there may be fiscal year problems. We are all accustomed to the fact that in Subchapter K, in the partnership area, partnerships for the most part must report on the same fiscal year as their principal partners. We certainly cannot request that corporations shift their fiscal year. One of the nice questions is in what year would the shareholder of General Motors pick up his portion of the General Motors income for the year ending June 30, 1978, for which it files its return after two extensions at the end of 1979. If there is an easy answer to that question, a lot of people would like to know it. It represents a serious impediment to a practical full integration scheme.

Some of my predecessors on the platform today have already referred to another problem that has been met abroad but still seems intractable to some people in this country. This is the question of how to deal with tax-exempt and foreign shareholders. The initial Treasury draft was not going to make the tax withheld at the corporate level refundable when dividends were paid to tax-exempt shareholders or foreigners.

One of the reasons for this was the extensive revenue loss that refundability would produce. Another was that integration was designed to eliminate double tax on corporate source income, not *all* tax. Since charities had always in effect paid tax through the corporations they owned, integration would not be utilized to give them a big bonanza that was unnecessary to relieve the double tax burden to which others are subject. But, however you might resolve that policy question, the remaining issue is whether you can effectively subject charities to a corporate tax once there is a partial integration system in effect.

One would suspect that if such a scheme were adapted, enormous portfolio shifts would occur and charities would sell their stocks to taxable shareholders who would be able to get the benefit of the refundable credit for withheld tax on dividends. Thus the revenue loss would be as extensive as the Treasury fears, and the charities would take their money and invest in bonds.

Of course, one of the questions is why do charities hold stocks now. Why don't they hold only bonds. Why do they hold an investment in an entity which pays a tax on income distributed to the charity? Maybe the answer is that the corporate tax was substantially discounted and capitalized long ago and that the school of thought to which Mike Boskin adheres is either not entirely right, or the charities just do not act rationally. In any event, I think there would be some behavioral shift even though we have the lingering question of why shifts have not occurred to a greater degree now.

The biggest problem with integration, bot complete and partial, at least in terms of the anguish that I understand has afflicted people in Treasury, people on the ABA committee and other places, has to do with the way so-called tax preferences would be handled under an integration scheme. By "tax preferences" people generally mean provisions for accelerated depreciation, investment tax credit, municipal bond interest and the like, items which reduce taxable income below what might be agreed upon as "economic" income.

The question is whether those preferences are to be passed through to shareholders in a complete integration scheme. Presumably they would be or they would be eliminated, and in a partial integration scheme such as the Treasury proposed. The Treasury's approach to the problem initially, and as far as I know until the proposal died, was to "stack them last". That meant that any distribution would be treated first as a distribution of taxable income and that no preference income would be treated as having been distributed until everything else had been distributed. There have been suggestions for prorating preference income between retained and distributed income. That would I think create an intolerable burden, forcing Congress and all of us to try to come upon an agreed definition, a consensus as to what is "economic" income. We have had enough trouble just agreeing on what is taxable income, and I think if we had to assume the additional burden of agreeing on what is "economic income", we or the system might come apart at the seams. The "stacking last" approach comes as close to a workable — if not the most equitable — system that I think we can devise.

And so where does this all leave us? One thing we know is that the Treasury proposal is dead. I think that within the Treasury the strongest proponent was Larry Woodworth. With his passing there is no strong proponent for partial integration or complete integration within Treasury. We have known for a long time that the Counsel of Economic Advisors does not favor it, and if it is to rise from the ashes in the immediate future it will only be as a result of internal pressures within the Ways and Means Committee. It does not mean that all of the discussion and analysis that have taken place in the past year have been lost, because I think we have thought about things that needed thinking, and we have an opportunity now, in an unrushed way, to do further analysis and research and engage in serious dialogue on an important matter.

I believe that in evaluating integration schemes for the long run we have to consider the equity question: should individuals be taxed on all of their income at the progressive rates set in Section 1, or should the intervention of a corporation justify overtaxation for some, and undertaxation for others?

A desire for complete integration must be balanced against the concern for the resulting revenue loss. How would it be made up? And who would bear the burden?

With respect to complexity my own view is that the partial integration schemes, even the well worked out Treasury proposal, in the end relieve virtually none of the complexity that we now have in the law, because they maintain the form and structure of the classic double tax system. Indeed they add some complexity, although the Treasury proposal itself is a workable one.

The partial integration schemes do not achieve vertical equity in the terms we like to think embodied in Section 1 of the Code. What the Treasury's partial integration scheme does come down to is a tax cut. And I think we are prepared for tax cuts. But I am not persuaded that partial integration is the best way to do it. It seems to me that a cut in the corporate rate greater than the 2 percent that was proposed — maybe 4 percent — would be more effective. If we are going to have integration I would rather see more time and effort devoted to a complete integration effort — to a partnership scheme that would tax corporate income to individuals like their other income.

There is now underway an American Law Institute project reconsidering all of Subchapter C of the Code.

That project, part of which has already been published as Tentative Draft No. 1, has another side of it under study and I do not know how it is going to come out. One of the items being considered is a scheme in which the corporate tax would be preserved but new equity investment would give rise to a corporate deduction for dividends in a percentage of such investment equal to the going interest rate, so this would substantially eliminate the debt equity problem. If the going interest rate is 7 percent, that is what you could get on your stock on a deductible basis. Retained earnings would be taxed because, contrary to the economic views expressed by Mike Boskin, they are seen merely as compensation for the deferral at the individual level and, old corporate equity, locked in, is not now a drag on any capital market. The corporate tax was capitalized and discounted when it was imposed. In effect the corporate tax is seen as a lump sum tax and so no deduction would be given on old equity.

Future investment would be in the form of debt or equity without deductibility skewing the judgment. Some of the economists who have stimulated some of this thinking are Mike Boskin's colleague at Stanford, Joseph Stiglitz, and David Bradford whom some of you know from his Treasury days, and who is now at Princeton. I think this is an important and interesting area to explore because it achieves a great deal of what we have been seeking to achieve in our exploration of integration and yet may do the job in a much less radical, more manageable way and, unless we go to complete integration, I think it is more workable than any of the partial integration schemes previously considered. None of this is inconsistent, however, with our moving towards a consumption tax.

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## THE NEXT ISSUE

The next issue of the **Bulletin** will be a double issue (August/September) which will be distributed at the 33rd Congress of I.F.A. in Copenhagen (September 3-7, 1979). It will contain, inter alia, the following articles:

– Taxation in Denmark by Anders Andersen, Minister for Economic Affairs and Minister of Taxes and Duties
– Danish rules for dealing at arm's length by J. Mazanti-Andersen
– Multinational convention for the avoidance of double taxation of copyright royalties by J. van Hoorn Jr.
– General problems of inter-company transactions across the border by Dr. Franz Helbich
– Japan: The 1979 tax reform by Makoto Miura
– Tax considerations for investment and business decisions in Nigeria by A.C. Ezejelue

# International and Comparative Aspects of Corporate/Shareholder Integration*

## A View from the United Kingdom

BY RICHARD T. ESAM **

Well, I think I will be able to deal with some of the points very briefly because the subject is repetitive to some extent. You have heard — it has been made most clear by the two other speakers — that the big problem, as you all know, in the imputation system in the international field is the discriminatory nature of the tax. We do not seem to be making a very good stab at removing the discrimination and until we do I really think it is quite a serious problem in the sphere of international investment.

In the pro forma which I produced for this talk I sketched out the history of the U.K. tax going back prior to 1966, not because I want to go into the detail of it but there are various factors of those years which I think are very relevant to this question of discrimination. Dick Hammer mentioned that we had the imputation system in the U.K. prior to our 1965 system. We had it, in fact, right from the introduction of income tax. Companies were, prior to the 1965 system, liable to income tax and quite a small rate of profits tax. We did not know corporation tax as such and the income tax element, which at the end of the day was about 41 percent, was fully imputed to the shareholder.

Now the interesting factor, I think, about the U.K. system at that stage was that the U.K. attempted to remove the discrimination by giving not only the imputation credit to the U.K. shareholder in respect of an investment in the U.K. company but also as a relief for indirect foreign tax — you might call it an imputation credit for foreign tax — in respect of the individual shareholder's investment in a foreign company. So the individual shareholder in the U.K. prior to 1965 could get some form of imputation credit whether he invested in the U.K. company or a foreign company and the U.K. left the foreign countries to sort out their own affairs for their own resident shareholders. That was an attempt to remove the discrimination — in fact that was one way which was discussed in the EEC proposals and discarded. The recommendation in the EEC directive which, as you have heard, has not so far been adopted is that this discrimination should be removed by the individual fiscal authorities and that the imputation credit should be given both to the resident shareholders and to the foreign shareholders. And this is of course where our problems arise.

It is also of interest, I think, in the pre-1965 legislation in the U.K. to note that we considered the problem, which was also considered in France and in other countries where the imputation system has been discussed, as to whether there should be a fixed or variable précompte (advance corporation tax), based on how high a rate of tax the foreign income had borne. And in the pre-1965 period again we went a different way in the U.K. We had this very complicated system which we called the "net United Kingdom rate" of tax, so that, although everybody notionally got an imputation credit of the same amount, if any actual repayment of tax was involved then the repayment was limited to the actual U.K. tax paid. Thus this discrimination factor or feature was tackled at that time and was solved in a rather unusual way.

The U.K. then went over, as you know, to the so-called classical system and that did not last for very long. It came in 1965 and we lost it in April 1973. I think the interesting feature about that period was that once again it was appreciated that there was going to be discrimination against overseas investment and, for a period of 7 years, companies with overseas investments actually received payment from the U.K. fisc to compensate for the reduction in tax credit relief. This reduction resulted because, prior to 1965, with the rate of tax on the companies of 41 percent income tax and another 15 percent profits tax there was a total rate of 56 percent and, of course, under the system in the U.K. of taxation of world-wide income the foreign tax up to that limit of 56 percent was available for tax credit. When we went over to the classical system the foreign tax credit was limited to the rate of classical tax which varied between 40 and 45 percent between these years and the companies concerned received payment from the U.K. fisc called "overspill relief" to compensate for the loss of tax credit.

The other interesting feature about the classical system which we had in those years was that under the treaty rules, as endorsed by the OECD, the rate of withholding tax on top of the corporation tax was limited to 15 percent in the case of individuals and 5 percent in the case of the parent companies so that under that regime the parent company is favored. This is one of the problems arising when we go over to the other basis of

*Transcript of a speech delivered at the meeting of the U.S. Branch of the International Fiscal Association on January 12, 1978.

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the imputation system, particularly, of course, as we have heard in the German context, where the parent companies find themselves pitchforked from a favorable situation to a very unfavorable situation. I think that this is one of the big problems.

In 1973 we changed again in the U.K. A political decision was made in 1971 that the classical system would be abandoned and that one of two other types of system would be adopted, either the split rate system or the imputation system. In fact the original proposals made by the government were that the split rate system should be adopted rather on the German model as it existed at that time. The U.K. House of Commons set up a Select Committee to consider the situation. The Committee were not called upon under their terms of reference to make a choice between the three types of tax — the classical, the imputation and the split rate — but only to make the choice between the imputation and the split rate. And they came to the conclusion — perhaps if time permits I will give more detail later — that the imputation system was the better one. They recommended, however, that the previous system adopted in the U.K. of trying to have an imputation credit subject to restrictions by reference to a variable "net United Kingdom rate" of tax, i.e. a situation where account was taken of the different rates of U.K. tax actually paid by the company, should be abandoned and that we would go for a so-called simple system under which there would be a fixed "précompte", or "advance corporation tax" as it was called in the U.K. Now one of the big fears of the Inland Revenue expressed in its evidence to the Select Committee was that this "advance corporation tax" would be "eroded", as they put it, by the pressures from international investors and in certain circumstances it might be reduced and foreign tax might be offset as a credit against it so that eventually the idea of every company paying a "précompte" at least equal to the imputation credit to the shareholders would disappear.

Of some interest was the fact that the overspill relief that I referred to when we went over to the classical system was continued when we had our new system for another four years in order to give the overseas company a further chance to put its house in order. This would really involve giving up some overseas investment and making sure there was the right mix of domestic and overseas investment to get the maximum benefit out of the new system. So for another four years overspill relief has been paid to companies with overseas investments and it has only finished just this last year. This was not an attempt to remove the discriminatory features but to give companies an opportunity to adjust to them.

It was with the introduction of this new imputation system that the discriminatory features first arose because under the pre-1965 imputation system, as I say, the problem was tackled by putting the U.K. shareholder in the same situation whether he invested in the U.K. company or foreign company. But by the time we came to the imputation system, the U.K. shareholder investing in a foreign company had been deprived of his relief for the indirect tax, and his imputation credit for the foreign tax which he had prior to 1965 — and

> There is this one very big difference between the French "précompte" and the British "advance corporation tax" in the sense that, as we have heard, there are circumstances in which the French "précompte" can be repaid under treaties where income has flowed through the country and the ultimate shareholder has not received any benefit from the imputation credit. Now that is not possible under the U.K. law, but we have this other unusual feature, that the "advance corporation tax" can be carried forward and set off against the company's liability. So we have cured, or partly cured, the additional burden at the company level, but we never repay the "advance corporation tax" to the shareholder.

which went away with the classical system — was not reintroduced. So for the first time under an imputation system we found the situation that the individual shareholder in the U.K. was penalized if he invested in a non-resident company. And this penalty on overseas investment was of course compounded if you had a U.K. company that was investing overseas and if that U.K. company had foreign shareholders, so that the income in fact was being channeled through the U.K. and out again to foreign shareholders. That is the situation where the maximum discrimination arises under the imputation system. And that is the situation which I have tried to illustrate in the examples which I have put in my paper. It might be a good thing to look at that briefly although you can consider the detailed figures a little more at your leisure.

I have set it out in example 1 and example 2 and I have assumed in example 1 that it is all domestic income and there is a resident shareholder whereas I have assumed in example 2 that it is all foreign income and there is a non-resident shareholder, so that income is being channeled through the U.K. Now you see that for example 1 the profit in the U.K. of 100 is subject to the U.K. rate of corporation tax which is 52 percent. Then, as you know, when we declare a dividend we have to pay this "advance corporation tax" which is really a "précompte" although it is not technically identical. It always has been the same and will remain the same as the basic rate of the U.K. income tax which at the moment is 34 percent. When the dividend is paid to the shareholder — a dividend of 20 is paid to the shareholder which is in effect grossed up as in France and in Germany to the 30.3 gross dividend — the "advance corporation tax" is offset against the company's U.K. liability of 52 so there is no additional tax to pay at all. The 52 just remains. Now if you come across to the column on the right, the company which has earned the same income abroad and has paid the same corporation tax abroad is called upon to pay the same corporation tax when the dividend is declared — the same amount of "advance corporation tax" of the 10.3 in this particular case — but it is specifically enacted in the U.K. legislation, and this in a way is a very illogical thing, that although the "advance corporation tax" is a corporation tax it is not regarded as a corporation tax for the purposes of the tax credit relief. So the tax credit relief is denied against it, the 10.3 remains payable whatever the rate of foreign tax which may have been paid, and we have immediately got discrimination.

The second part of the example is just to illustrate what happens if that dividend of the gross of 20 cash is paid first of all to a U.K. resident and in the second case to a foreign resident. In the case of the U.K. resident if the shareholder is liable at the basic rate of 34 percent he gets his dividend and he gets his credit — his imputation credit — with no further tax to pay. But in the case of the foreigner, if he is liable at 34 percent, he gets no imputation credit and presumably his tax in his home country is charged on the net cash dividend and he has a further liability.

So you have got at the end of the day on the profits of 100 the total liability in example 1 of 52 and the total liability in example 2 of 69.1 which is a tremendous discrimination against foreign investment.

Now I should perhaps mention the mitigating features with regard to the U.K. system which is slightly different from the French. But I just wanted to bring out first of all this discrimination of the imputation system which I think the U.K. has gone some little way towards tackling, although there is still a long way to go. To my way of thinking until some success is achieved in this field the imputation system really militates against international investment. You have seen how it causes problems at the corporate level and how it causes problems also at the shareholder level. The mitigating features in the U.K. are perhaps threefold.

First of all the system in the U.K. is that if the "advance corporation tax" cannot be offset against immediate corporation tax liabilities it can be carried forward indefinitely.

In the second place, although I have shown in my example the situation in which the "advance corporation tax" is payable and in which it is quite impossible for foreign tax credit to be set against it there are provisions in the U.K. tax law under which, in a group of companies, "advance corporation tax" can be surrendered from one company to another. So that if there is one company within the group with a lot of foreign income, which pays a dividend and has to pay "advance corporation tax" which displaces foreign tax credit relief and therefore threatens to be a complete loss, that company can surrender its "advance corporation tax" to a fellow member of the group — it has to be a 51 percent common share ownership — and that "advance corporation tax" can then be carried forward by the other member of the group. It is an indefinite carry forward so long as the company remains in the group. This is very helpful of course — it means that taking any one year the "advance corporation tax" should not be wasted by displacing foreign tax credit although the problem, of course, remains that in order to use the carry forward of "advance corporation tax" sooner or later you have got to have domestic income which is taxable and against which the carry forward can be set. If you are in the situation of having foreign income, and only foreign income, and say the total foreign tax rate is 52 percent, you may have a carry forward of "advance corporation tax" but you will not get any benefit from it because there will be no U.K. tax against which it can be offset. But that is quite a mitigating feature in the U.K. tax law.

The third mitigating characteristic inherent in the U.K. system is that the system in effect also permits the distribution to be made out of the most beneficial type of income. So if there is domestic income and foreign income the way the system works is that you could distribute your domestic income and gain the benefit of the offset of the "advance corporation tax" before there is any problem of displacing the tax credit relief.

The aims for the U.K. government in introducing the imputation system were much the same as we had outlined from the French point of view — the consideration of the shareholder, the feeling that the imputation system would encourage distributions. I am not altogether sure that this is borne out by economic facts but it was decided that the classical system should be abandoned. In dealing with the reasons for adopting the imputation system in the U.K. I would like to think that we were motivated by international feeling and a desire to encourage the harmonization of taxes but I am afraid that that was not true. The decision of the Select Committee was made solely on the grounds that the split rate system which was operating in Germany had a disadvantage of the so-called "foreigner effect" — that the reduced rate of corporation tax on distributions was given willy-nilly under a split rate system both to domestic shareholders and foreign shareholders, and the Select Committee, bearing this in mind, came to the conclusion that the imputation system would probably give the country a better bargaining situation when it came to the renegotiation of double taxation treaties, which I think is probably true. But it is not a very healthy situation unless that bargaining position is used to try to come to some agreement bilaterally to try to remove some of these discriminatory features.

So what has the U.K. done about this? Well, we have done the same as the French and particularly the same as the Germans will be prepared to do. The U.K. is normally prepared to provide under treaties for the full imputation credit — the equivalent of the 34 percent rate of U.K. income tax — to individual shareholders in the other country (in fact to any shareholder other than a company owning more than 10 percent of the shares) subject to a levy of tax of 15 percent on their dividends. The withholding tax in the U.K. as such has disappeared but the treaties provide that in order to get the imputation credit the foreign shareholder has to submit to a tax of 15 percent. As you know, particularly with regard to the U.S. treaty, but more concretely perhaps with the Netherlands treaty which has been fully ratified, the U.K. has also been prepared to offer half the imputation credit to corporate shareholders with 10 percent or more share holdings provided the corporate shareholder submits to a tax of 5 percent. That, of course, links into the 15 percent and 5 percent previously under the classical system. The half imputation credit is not a very logical figure. It is really based I

# Essentials of U.K. Dividend Taxation

## TAX ON WORLD-WIDE INCOME – SCHEDULAR BASIS

**Prior to April 1966: "Imputation system"**

Final rates 41.25% income tax and 15% profits tax.

Income tax only was imputed.

International aspects –

(i) U.K. company investing in U.K. or abroad
– subject to 56.25% with DTR: "net U.K. rate" system.

(ii) U.K. portfolio shareholder investing in U.K. company or foreign company
– subject to personal tax with offset for 41.25% or foreign tax which could be greater: bias towards overseas?

(iii) Foreign shareholder in U.K. companies
– no imputation credit passed on.

**April 1966 – April 1973: Classical system**

Corporation tax 40-45%.

(i) U.K. company investing in U.K. or abroad.
– subject to 40-45% with DTR: "overspill relief" transitionally.

(ii) U.K. portfolio shareholder investing in U.K. company or foreign company
– no imputation credit or DTR (except for direct taxes).

(iii) Foreign shareholder in U.K. companies
– subject to withholding tax 41.25-38.75% subject to treaty reduction to 15-50% : parent companies favoured.

**April 1973 to date: Partial imputation**

Report of Select Committee 1971.

Partial imputation: "advance corporation tax" equal to it.

(i) U.K. company investing in U.K. or abroad
– subject to full tax with ACT merely an acceleration: subject to full tax with DTR limited to mainstream tax.

(ii) U.K. portfolio shareholder investing in U.K. company or foreign company
– Shareholder in foreign company discriminated against for first time.

(iii) Foreign shareholder in U.K. companies
– Pre-1966 position virtually restored.
– Discrimination except for possible treaty relief.

**Discrimination**

*At company level*

| | |
|---|---|
| 100 @ 52% | 52.0 |
| *less* Advance Corporation Tax (paid at time of distribution) | 10.3 |
| | 41.7 |
| *less* DTR (balance of foreign tax 10.3 unrelieved) | 41.7 |
| "Mainstream" corporation tax | NIL |

Philosophy is no "imputation credit" without matching payment of "advance corporation tax"

*At shareholder level*

Discrimination is increased if shareholder is unable to gain "imputation credit".

Treaties cure this for shareholders provided:

(a) They are not company which controls 10% or more of voting power.

(b) They submit to U.K. tax of 15% on their dividends.

But unlike "précompte" the ACT is never refundable to company.

U.S. treaty is first to try to break impasse for corporate shareholder with more than 10% of voting power, i.e. 50% of imputation credit is given + U.K. tax of 5%.

*Inward and outward direct investment*

Outward
Discrimination because ACT restricts DTR.

Inward
Discrimination because ACT (although part of 52% Corporation tax) does not give rise to imputation credit (contrast proposed U.S. treaty).

*U.K. Government's reason for adopting imputation system*

Aim was to remove bias against distributed profits – "split rate" system as in Germany (old system) was originally favoured.

Imputation system was adopted largely because of "foreigner effect".

Revenue were apprehensive about the ACT being "eroded" and Select Committee specifically recommended an imputation system with a minimum corporation tax charge.

Overspill relief (as introduced in 1965) continued for some years to enable companies whose income is derived wholly or mainly from overseas "to adjust to the introduction of the new system".

*Mitigation of minimum levy*

U.K. system permits companies to treat distributions as coming primarily out of domestic income.

ACT can be "surrendered" to a subsidiary (51% or more) in which case it is treated as having been paid by that subsidiary and carried forward (not back) as appropriate.

*Aims for the future*

Foreign corporation taxes should be treated as pari passu with domestic taxes for purposes of tax credit relief and of taxes which can be attributed to shareholders as imputation credit.

Benefit of imputation credit should be enjoyed not only by shareholders investing in their own domestic companies but by shareholders investing directly or indirectly in overseas companies.

think on the assumption that the imputation credit should only be given when income reaches individual shareholders and the holding company tends on a rough and ready basis to distribute about half its income. One possibility which was considered, but which would obviously be administratively impossible, was to ask the foreign holding companies to make some return of distributions and then give imputation credit related to the amounts of profits distributed to ultimate shareholders. That would be absolutely impossible, I think. So the compromise is to offer half the imputation credit subject to a tax of 5 percent. This is very much a halfway house — it does not fully remove the discrimination but it helps.

I just put at the end of my synopsis what I felt might be the aims for the future. I think a lot of it is pretty idealistic because there are effects obviously on the national exchequers but we shall not completely remove the discriminatory features until we accept that foreign corporation taxes should be treated in the same way as domestic corporation taxes for the purposes of tax credit relief and for the purposes of imputation credit to shareholders. And this, I think, should really be our long-term aim. Now how we achieve this — whether we do it by being rather generous unilaterally and accepting the impact on the national exchequers individually or whether we do it in some form of setting up at the end of the day between the various fiscal authorities — I do not know. But I think that unless this problem is tackled these discriminatory features will remain and I think, as I have illustrated, they do produce a very considerable additional tax burden for international investment. For that reason, when you are considering your integration system over here these features should be clearly before you.

## ASSUMPTION: IMPUTATION SYSTEM

| | |
|---|---|
| Corporation tax rate (U.K. and foreign) | 52% |
| Tax imputed to shareholders | 34% |
| Shareholders (U.K. and foreign) liable to tax at | 34% |

Example 1 — Domestic income and resident shareholder.
Example 2 — Foreign income and non-resident shareholder.

**Example 1**

| | | |
|---|---|---|
| Company profit | | 100 |
| Corporation tax (U.K.) | | 52 |
| Net profit | | 48 |
| Dividend to shareholder = | | 20 |
| | (i.e. gross | 30.3) |
| Company's liability (U.K.) | | 52 |
| Shareholder's liability 30.3 at 34% = | | 10.3 |
| Less imputation credit | | 10.3 |
| | | NIL |
| Total liability | | 52 |

**Net result**

| | |
|---|---|
| Profits retained by company | 28 |
| Net dividend retained by shareholder | 20 |
| | 48 |

**Example 2**

| | | |
|---|---|---|
| Company profit | | 100 |
| Corporation tax (foreign) | | 52 |
| Net profit | | 48 |
| Dividend to shareholder = | | 20 |
| | (i.e. gross | 30.3) |
| Company's liability (foreign) | | 52 |
| + U.K. advance corporation tax on distribution | | 10.3 |
| | | 62.3 |
| Shareholder's liability 20 at 34% (foreign) = | | 6.8 |
| Total liability | | 69.1 |
| Profits retained by company | | 17.7 |
| Net dividend retained by shareholder | | 13.2 |
| | | 30.9 |

**Note:** For the purpose of Example 2, it is assumed that the non-resident shareholder is entitled to neither an imputation credit, under a treaty, nor for tax credit, in respect of the U.K. tax, against his foreign tax liability.

Although in France the "précompte" payable in Example 2 would be repayable on distribution being made to a non-resident shareholder in a treaty country, there is no question in the U.K. of any refund of advance corporation tax.

# The German Imputation System

# Model Computation of Tax Burden of a German Subsidiary or Branch*

BY DR. ALBERT J. RÄDLER

## 1. New imputation system

As of January 1, 1977, Germany introduced full imputation while the existing split rate system was retained in a somewhat different way: resident companies are subject to a corporation tax of 36 percent on distributed earnings and of 56 percent on retained earnings.[1] Since imputation is only available to resident shareholders, this reform substantially increased the overall tax burden of non-resident shareholders, especially of parent companies.

Only two other major changes should be mentioned here since they are of great interest to foreign parent companies:

- Constructive dividends now also benefit from the reduced rate of corporate income tax of 36 percent;
- There is currently no further need to distribute income since the lower 36 percent rate applies to all distributions whenever made. Distributions out of earnings originally retained and taxed at 56 percent thus entitle the distributing company to a refund of the difference of 20 percentage points.

## 2. Revision of tax treaties

Renegotiations of existing tax treaties especially with respect to the rate of withholding tax have not come very far. One of the reasons for this failure may be that the United States, which on account of substantial American investments in Germany was thought to be ready to negotiate a kind of model agreement, is itself contemplating a change-over to the imputation system. It is generally expected, however, that Germany will reduce its withholding tax rate on dividends from the prevailing 25 percent on intercorporate dividends to the general treaty rate of 15 percent. A further reduction has certainly been claimed by foreign investors and their governments, but it seems rather unlikely that this will be accepted by the German side, unless the other government offers similar concessions to German shareholders, such as, for example, extension of their own imputation system as already provided for in an earlier agreement with France.

## 3. 1978 reduction of net worth tax

As of January 1, 1978 Germany will reduce the rates of its net worth tax from 1 to 0.7 percent for corporations and 0.7 to 0.5 percent for individuals. Since net worth tax is a non-deductible expense the impact of this reduction is substantially higher than its nominal amount; under the new corporation tax it always has to be paid of out income taxed at 56 percent.

At the same time some tax concessions in the field of local trade tax will become effective. These reductions, however, are limited to small-sized businesses so they are not taken into account in the following computations.

Certain expense items, as for example interest on long-term loans, continue to be added back to taxable income for the purposes of trade tax and tend to increase substantially the impact of this tax. These additions and certain reductions also had to be disregarded in the computations.

## 4. 1978 net worth tax reduction and anticipated treaty rate largely compensate 1977 corporation tax increase

The model computations of tax burden have been prepared for a subsidiary company and a branch with a high return on equity of 20 percent before taxes and another one with a lower return of 10 percent before taxes (Tables 1 and 2).[2]

The model computations show the rather surprising result that in 1978, in the case of maximum distribution by a subsidiary with a 20 percent return on equity, the overall tax burden will be practically the same as it was in 1976 under the old system, assuming a revised withholding tax treaty rate of 15 percent. In case of a

*Paper presented at the meeting of the U.S. Branch of IFA on January 12, 1978, New York.

1. For a detailed analysis see: Ault: Germany: The New Corporation Tax System, INTERTAX 1976, p. 262; for a complete English translation see: Ault/Rädler: The German Corporation Tax Reform Law 1977, Deventer 1976, 118 p.

2. For the situation in 1972/74 see: Rädler: Model Computation of Tax Burden of a German Subsidiary, INTERTAX, 1974, p. 32.

company with a 10 percent return on equity the overall tax burden would even be slightly lower than in 1976. Obviously any higher before-tax return on equity than 20 percent would continue to be burdened by a higher tax than the one in 1976.

As far as branch operation is concerned the model computations show a slightly lower overall tax burden in 1978 than the one in 1976 under the old system (Table 3).

## 5. Repercussions in parents' home countries

The computations state the German tax burden. It is equal to the final overall tax burden where the parent's home country levies no further tax (exemption, possibly with progression). When the home country grants a direct and/or indirect tax credit the taxpayer's overall position is somewhat improved by the fact that German taxes of the non-creditable type (net worth tax) will be reduced from 1978 onwards whereas the increase concerns corporate income tax, which is eligible for the indirect tax credit up to the ceiling under a per-country or an overall limitation.

**TABLE 1.**

**TAX BURDEN OF A GERMAN SUBSIDIARY with a return of 20% on equity before taxes**

| | |
|---|---|
| Income before taxes | DM 1,000,000 |
| Equity capital | DM 5,000,000 |
| Standard value of net worth | DM 5,000,000 |
| Local multiplier of trade tax | 400 percent |

| | Maximum distribution | | | No distribution | | |
|---|---|---|---|---|---|---|
| | 1976 | 1977 | 1978 | 1976 | 1977 | 1978 |
| Income before taxes | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| 0.8 percent trade tax on capital | ./. 40 | ./. 40 | ./. 40 | ./. 40 | ./. 40 | ./. 40 |
| Subtotal | 960 | 960 | 960 | 960 | 960 | 960 |
| 16.66 percent trade tax on income | ./. 160 | ./. 160 | ./. 160 | ./. 160 | ./. 160 | ./. 160 |
| Sub-total | 800 | 800 | 800 | 800 | 800 | 800 |
| net worth tax (non-deductible)[1] 1976/77: 1%, 1978: 0.7% | ./. 50 | ./. 50 | ./. 35 | ./. 50 | ./. 50 | ./. 35 |
| Sub-total | 750 | 750 | 765 | 750 | 750 | 765 |
| Corporation Income tax | ./. 226[2] | ./. 311[3] | ./. 304[4] | ./. 420[5] | ./. 448[6] | ./. 448[6] |
| Sub-total | 524 | 439 | 461 | 330 | 302 | 317 |
| 25 percent withholding tax (normal treaty rate) | ./. 131 | ./. 110 | ./. 115 | ./. – | – | – |
| Income after German taxes | 393 | 329 | 346 | 330 | 302 | 317 |
| In case of a 15% withholding tax | | 373 | 392 | | | |

1. In addition to the company the non-resident shareholder may be subject to net worth tax on the value of his shares if he directly or indirectly owns more than 25% of the shares and he is not protected by a tax treaty.

2. Computation: DM 524,000 x 15.45% = DM 80,958
DM 276,000 x 52.53% = DM 144,983
DM 800,000 DM 225,941

3. Computation: DM 113,630 x 56% = DM 63,632
DM 686,370 x 36% = DM 247,093
DM 800,000 DM 310,725

4. Computation: DM 79,545 x 56% = DM 44,545
DM 720,455 x 36% = DM 259,363
DM 800,000 DM 303,908

5. Computation: DM 800,000 x 52.53% = DM 420,240

6. Computation: DM 800,000 x 56% = DM 448,000

## TABLE 2.

## TAX BURDEN OF A GERMAN SUBSIDIARY

**with a return of 10% of equity before taxes**

| | |
|---|---|
| Income before taxes | DM 1,000,000 |
| Equity capital | DM 10,000,000 |
| Standard value of net worth | DM 10,000,000 |

Local multiplier of trade tax 400 percent

| | Maximum distribution | | | No distribution | | |
|---|---|---|---|---|---|---|
| | 1976 | 1977 | 1978 | 1976 | 1977 | 1978 |
| Income before taxes | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| 0.8 percent trade tax on capital | ./. 80 | ./. 80 | ./. 80 | ./. 80 | ./. 80 | ./. 80 |
| | 920 | 920 | 920 | 920 | 920 | 920 |
| 16.66 percent trade tax on income | ./. 153 | ./. 153 | ./. 153 | ./. 153 | ./. 153 | ./. 153 |
| Sub-total | 767 | 767 | 767 | 767 | 767 | 767 |
| net worth tax (non-deductible)[1] 1976/77: 1%, 1978: 0.7% | ./. 100 | ./. 100 | ./. 70 | ./. 100 | ./. 100 | ./. 70 |
| Sub-total | 667 | 667 | 697 | 667 | 667 | 697 |
| Corporation income tax | ./. 247[2] | ./. 322[3] | ./. 308[4] | ./. 403[5] | ./. 429[6] | ./. 429[6] |
| Sub-total | 420 | 345 | 389 | 264 | 238 | 268 |
| 25 percent withholding tax (normal treaty rate) | ./. 105 | ./. 86 | ./. 97 | ./. – | – | – |
| Income after German taxes | 315 | 259 | 292 | 264 | 238 | 268 |
| In case of a 15% withholding tax | | 293 | 331 | | | |

1. In addition to the company the non-resident shareholder may be subject to net worth tax on the value of his shares if he directly or indirectly owns more than 25% of the shares and he is not protected by a tax treaty.

2. Computation: DM 420,000 x 15.45% = DM 64,890
DM 347,000 x 52.53% = DM 182,279
DM 767,000 DM 247,169

3. Computation: DM 227,270 x 56% = DM 127,271
DM 539,730 x 36% = DM 194,303
DM 767,000 DM 321,574

4. Computation: DM 159,089 x 56% = DM 89,089
DM 607,911 x 36% = DM 218,848
DM 767,000 DM 307,937

5. Computation: DM 767,000 x 52.53% = DM 402,905

6. Computation: DM 767,000 x 56% = DM 429,520

**TABLE 3.**

**TAX BURDEN OF A GERMAN BRANCH**

**with a return on equity before taxes of**

| | 20% | | | 10% | | |
|---|---|---|---|---|---|---|
| Income before taxes | DM 1,000,000 | | | DM 1,000,000 | | |
| Equity capital' | DM 5,000,000 | | | DM 10,000,000 | | |
| Standard value of net worth | DM 5,000,000 | | | DM 10,000,000 | | |
| Local multiplier of trade tax | 400 percent | | | 400 percent | | |
| | 1976 | 1977 | 1978 | 1976 | 1977 | 1978 |
| Income before taxes | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| 0.8 percent trade tax on capital | ./. 40 | ./. 40 | ./. 40 | ./. 80 | ./. 80 | ./. 80 |
| Sub-total | 960 | 960 | 960 | 920 | 920 | 920 |
| 16.66 percent trade tax on income | ./. 160 | ./. 160 | ./. 160 | ./. 153 | ./. 153 | ./. 153 |
| Sub-total | 800 | 800 | 800 | 767 | 767 | 767 |
| Net worth tax (non-deductible) 1976/77: 1%, 1978: 0.7% | ./. 50 | ./. 50 | ./. 35 | ./. 100 | ./. 100 | ./. 70 |
| Sub-total | 750 | 750 | 765 | 667 | 667 | 697 |
| Corporation income tax 1976: 50.47%, 1977/78: 50% | ./. 404 | ./. 400 | ./. 400 | ./. 388 | ./. 384 | 384 |
| Sub-total | 346 | 350 | 365 | 279 | 283 | 313 |
| Withholding tax | – | – | – | – | – | – |
| Income after German tax | 346 | 350 | 365 | 279 | 283 | 313 |

**At the Meeting of the U.S.A. Branch of I.F.A. Mr. Pierre Kerlan of the French Ministry of Economic Affairs and Finance discussed the French imputation system. To our regret his paper was not yet ready for the printer when this issue went to press. We hope, however, to be able to publish Mr. Kerlan's contribution in a next issue.**

# RECENT THEORETICAL DEVELOPMENTS IN PUBLIC FINANCE

**The Effects of Taxes on the Allocation of Resources and Distribution of Incomes**

by NIZAR JETHA *

*The growing use of general equilibrium models and the explicit incorporation of constraints in optimization models have resulted in a modification of traditional conclusions in many areas of economics. The former has highlighted the dangers of ignoring interrelationships between different factor and product markets, and the latter the irrelevance of the full (unconstrained) optimum in a situation where the optimization process must take account of certain unavoidable constraints. Recent theoretical advances in public finance, occurring concurrently with, or following closely upon, these methodological developments, have prompted a reevaluation of the effects of taxes on the allocation of resources, equity and growth. The development of a general equilibrium model of incidence by Harberger [1] and extension of Ramsey's [2] work on optimal taxation by Diamond and Mirrlees [3] have, in particular, exercised a profound effect on the nature of modern public finance. Since many recent contributions have been highly mathematical, there is a need to convey the flavor of some of the major developments in less technical terms.*

## OPTIMAL TAXATION

The proposition that an indirect tax levied at a single *ad valorem* rate on all goods will be neutral (i.e. it will not lead to any changes in resource allocation) is firmly entrenched in the public finance literature. Recent work on the optimal excise (which, in the context of optimal taxation is defined as a tax on any good or service) shows that this proposition will be valid only in exceptional circumstances. The crucial idea underlying the optimal excise theory is that some goods (e.g. leisure) cannot be taxed. Therefore, revenues cannot always be raised through neutral taxes; the best that can be done is to choose an indirect tax structure that will minimize the welfare loss associated with distortionary (non-neutral) taxation.

The mathematical formulation of the problem is fairly straightforward. Utility has to be maximized taking into account: first, that not all goods can be taxed; and second, that a specified amount of revenue must be collected. [4] Without the first constraint, the problem would be an unconstrained optimization problem and would yield the traditional conclusion (i.e. an identical ad valorem rate on all goods). The presence of the first constraint transforms the problem into a second-best problem (constrained maximization) and yields a solution that differs fundamentally from the traditional result.

The solution to the constrained maximization problem states that taxes should be set at levels that would result in an equal proportionate reduction of demand for each taxable good (from the demand that would have prevailed had prices equalled marginal costs). The intuition behind this result would be easier to grasp if it is recalled that taxes induce changes in the relative structure of demand by causing divergences between prices and marginal costs. The implication of the solution is, therefore, that the welfare loss will be minimized if the relative pattern of demand for the taxed goods is kept unchanged. Since the price elasticities of different goods will vary, the price increases (and consequently the tax rates) needed to secure an equal proportionate reduction in demand for each good will also vary. The required price increase for a good whose demand is not sensitive to price will be greater than that for a good whose demand is sensitive to price. Clearly, a single tax rate will not do the trick in general.

One special case where a uniform proportional rate of tax will be optimal is worth noting. When labor supply is completely inelastic (that is, labor supply does not respond to changes in net-of-tax wages), the tax which would cause the least distortions is a tax confined to labor income. Such a tax would not change relative prices among consumer goods, and the change between the relative price of consumer goods and leisure would not matter because the supply of labor (and consequently the consumption of leisure) could not be varied. The same effect would be obtained by taxing all consumer goods at a uniform rate. [5]

While optimal indirect taxes can be computed in the manner described above, they are difficult to visualize because they depend in a complicated way on own (direct) and cross price elasticities. Their implications in some simple cases are, however, of interest. First, where demands for different goods are independent (i.e. cross elasticities are zero), the optimal tax rates for a set of

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1. A.C. Harberger, "The Incidence of Corporate Income Tax", *Journal of Political Economy*, June 1962.
2. F. Ramsey, "A Contribution to the Theory of Taxation", *Economic Journal*, March 1927.
3. P. Diamond and J. Mirrlees, "Optimal Taxation and Public Production", *American Economic Review*, March and June 1971.
4. D. Bradford and H. Rosen, "The Optimal Taxation of Commodities and Income", *American Economic Review*, May 1976.
5. A. Sandmo, "Optimal Taxation: An Introduction to the Literature", *Journal of Public Economics*, July 1976.

goods turn out to be inversely proportional to the (own) price elasticities for those goods. [6] This is the well-known inverse elasticity or the Ramsey rule. Second, in a situation where there are two goods and labor, and leisure cannot be taxed directly, the prescription is to tax the good which is complementary with leisure at a higher rate than the good which is a substitute for leisure. In this way, leisure would be taxed indirectly.

Optimal indirect taxes that neglect distributional considerations will be regressive. The Ramsey rule highlights this: goods with a low price elasticity (i.e. those likely to be more important in the consumption pattern of the poor) must be taxed at a higher rate than goods with a high price elasticity (i.e. those more likely to be important in the consumption of the rich). Optimal indirect taxes must, therefore, incorporate distributional considerations if they are to have practical relevance. One way this has been done is to introduce distributional weights explicitly in the constrained optimization problem. Next, a distributional characteristic of a good is defined in such a way that the higher the income elasticity of a good (i.e. the greater the share of a good in consumption as income increases), the lower the value of the distributional characteristic. A simple operational measure of the distributional characteristic can be derived by assuming that: (i) income distribution can be approximated by a lognormal distribution; (ii) demand for each good has a constant income elasticity; and (iii) marginal social utility of income has constant elasticity. The solution to the problem then gives optimal excises that depend on distributional characteristics (which in turn depend on income elasticities and the value that society attaches to additional utility at various levels of income) as well as price elasticities. [7]

This development has great significance for policy purposes. Previously, the desirability of varying tax rates directly with income elasticities (for distributional reasons) and inversely with price elasticities (for allocative reasons) was understood, but it was not known how to combine information on price and income elasticities to derive tax rates. Now optimal indirect taxes that take account of both allocative and distributive factors can be determined by methods that do not make excessive statistical demands.

In contrast, the work on optimal income taxation has not yet progressed adequately to give policy guidance. Edgeworth's utilitarian approach implied that income tax should be sufficiently progressive to equalize incomes. This approach neglected the effects of taxation on the supply of effort, saving and willingness to bear risks. Recent approaches have sought to determine the optimal progressivity of income tax (on earned income) by allowing for the effect of taxation on the supply of labor.

Early studies using this framework did not give a very progressive income tax. Subsequent research, therefore, focused on the sensitivity of the results to underlying assumptions. [8] In this connection, the implications of a wide variety of social welfare functions, ranging from Edgeworth's additive function (where additional utility is of the same social value regardless of whether it accrues to a poor person or a rich person) to Rawls' maximin function (which maximizes the utility of the worst-off individual) were explored. [9] One of the interesting conclusions that has emerged is that if the elasticity of labor supply found in empirical studies can be trusted, then high marginal tax rates can be obtained without appealing to extreme (Rawlsian) social welfare functions. [10]

## TAX INCIDENCE

The major development concerning incidence has been the introduction of a general equilibrium framework for analyzing the effects of taxes on the distribution of income. The main conclusion of the traditional partial equilibrium approach is that the incidence of a tax depends on the elasticity of supply of the taxed commodity or service in relation to its elasticity of demand. [11] A major implication of this result is that a factor that can move to other sectors can partially or wholly avoid the burden of taxation. While the partial equilibrium framework is useful for dealing with certain problems and provides valuable intuition concerning the effects of taxes in the context of general equilibrium, it cannot tackle problems involving the incidence of general product and factor taxes or even major partial taxes.

The new methodology has helped to dissipate much of the confusion that had surrounded the subject. In

6. More precisely, in a two-good case, the (relative) optimal indirect tax rates would be:

$$\frac{t_1}{t_2} = \frac{E_{22}}{E_{11}}$$

where $t_1$, $t_2$ are optimal tax rates for goods 1 and 2 respectively; and $E_{11}$, $E_{22}$ are direct price elasticities (compensated for income effects) for goods 1 and 2 respectively. The absolute levels of tax rates can then be calculated by taking into account the revenue requirements.

7. M. Feldstein, "Distributional Equity and the Optimal Structure of Public Prices", *American Economic Review*, March 1972.

8. M. Feldstein, "On the Optimal Progressivity of the Income Tax", *Journal of Public Economics*, November 1973.

9. Consider a social welfare function of the type

$$W = (\Sigma U_i^v)^{1/v}$$

where $W$ = social welfare
$U_i$ = utility derived by the ith individual
$v$ = a parameter of egalitarian preference

The function will give the Edgeworth and Rawls functions as special cases by setting $v = 1$ and $v = -\infty$ respectively.

10. N. Stern, "On the Specification of Optimum Income Taxation", *Journal of Public Economics*, July 1976.

11. More precisely, the share of tax burden borne by the supplier of the taxed commodity is given by

$$\frac{dYs}{dT} = -\frac{1}{1 + Ns/Nd}$$

where Ys = suppliers' income
T = tax revenue
Ns = elasticity of supply of the taxed commodity
Nd = elasticity of demand for the taxed commodity

Thus, when the supply is completely inelastic (Ns = 0), the supplier bears the full burden, and when the supply is perfectly elastic (Ns = $\infty$), the consumer bears the full burden.

analyzing incidence, we are concerned only with changes in real prices leading to changes in real income, and only the long-term effects of taxes on income distribution are relevant. Moreover, since the price of one factor (or commodity) can be held constant and all other prices expressed in terms of that price, only relative prices matter. Viewed in this light, whether a tax has been shifted forward or backward becomes a matter of semantics.

Under the assumption of fixed factor supplies, some clear-cut propositions can be derived. A general tax on income or consumption will be borne in proportion to shares in income or consumption, regardless of the elasticities of supply and demand of the various commodities. And a general tax on all uses of one factor will be borne by that factor; this result holds independently of the values of various parameters.[12]

The second proposition has some far-reaching implications. It indicates, for instance, that the full burden of payroll taxes (including the employer's contributions) will be borne by labor. And the burden of a property tax will be borne by all owners of capital (and not just those who own real estate). These conclusions run contrary to the previous thinking on the subject. Before the development of the general equilibrium model, it was held that the burden of payroll taxes was divided equally between the employee and employer; and a tax on land was borne by the landowner, but that on improvements was borne by the occupier.

Incidence of partial taxes can also be handled in the context of the Harberger model. It was, in fact, to analyze the incidence of corporate taxation that Harberger developed his two-sector, two-factor general equilibrium model. Unlike the incidence of general taxes, the incidence of partial taxes will depend on the values of a number of parameters, including factor intensities, elasticities of substitution between factors and elasticities of substitution in demand. Choosing plausible values for these parameters, Harberger has shown that the burden of corporate tax in the United States will be borne by all owners of capital, in both the corporate and non-corporate sectors. A heuristic explanation for this result is that the tax induces capital to move from the corporate to the non-corporate sector, and during this process the net-of-tax returns to capital in both sectors are equalized at a lower level.

Of the many directions in which the Harberger model has been extended, two are of particular interest. An adaptation of the Scarf algorithm by Shoven and Whalley has greatly increased the flexibility of the Harberger model; the model can now be disaggregated to the desired extent and exact solutions (in contrast to the approximate solutions yielded by the Harberger model) obtained.[13] Another major development has been the relaxation of the assumption of fixed factor supplies. However, under the resulting more realistic model, the simplicity of the conclusions derived from the Harberger model is lost; even the incidence of general taxes comes to depend on a number of parameters.

The consequences of allowing factor supplies to respond to their net-of-tax rewards is best illustrated by some examples. Now, the incidence of a payroll tax (a tax on labor income) will depend on the nature of the production function (labor's initial share in national income and the elasticity of substitution between labor and capital) and the elasticities of supply of capital and labor. For given values of other parameters, the higher the elasticity of labor supply, the lower the tax burden borne by labor (that is, higher the proportion that is shifted to capital). For certain parameter values, the burden of a payroll tax would be divided between labor and capital in proportion to their initial shares in national income. In other words, the pattern of incidence would conform to that which is associated with an income tax under fixed factor supplies.[14] The incidence of a general tax on capital income in a dynamic model that explicitly allows for capital accumulation depends on the co-efficients of the production function and the elasticity of saving with respect to the net rate of return. The higher the interest elasticity of saving, the greater the ability of capital to shift the burden of taxation to labor. These models suggest that, under plausible parameter values, labor (capital) can shift a substantial fraction of the tax burden to capital (labor).[15] This result also casts doubts on the incidence of partial taxes indicated by the Harberger model. But it must be stressed that models that allow for variable factor supplies lack generality in one respect: they embody more aggregation (one sector, two factors) than the Harberger model.

The overall judgment at this juncture must be that while substantial progress has been made in the study of incidence, a great deal remains to be done both in the formulation of more general models and in empirical research. The findings of the burgeoning research on incidence in the context of two sector growth models could, for example, modify many of the results discussed here. Meanwhile, studies that allocate total tax burden by income groups under assumptions that bear little relation to theory must be treated with scepticism.

## IMPLICATIONS FOR TAX REFORM

These and other analytical developments have afforded valuable insights on the economic effects of taxation. Empirical work, which has increasingly focused on the parameters identified as critical by theoretical models (e.g. responsiveness of the supply of labor and savings to net-of-tax returns), has also contributed to a better understanding of the effects of taxation. Nevertheless, a wide gap between theory and its implications for tax

12. C. McClure, "General Equilibrium Incidence Analysis", *Journal of Public Economics*, February 1975.
13. J. Shoven and J. Whalley, "A General Equilibrium Calculation of the Effects of Differential Taxation of Income from Capital in the U.S.", *Journal of Public Economics*, November 1972; and J. Shoven, "The Incidence and Efficiency Effects of Taxes on Income from Capital", *Journal of Political Economy*, December 1976.
14. M. Feldstein, "Tax Incidence in a Growing Economy with Variable Factor Supply", *Quarterly Journal of Economics*, November 1974.
15. M. Feldstein, "Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates", *Review of Economic Studies*, October 1974.

reform remains. This is in part due to the concentration of tax literature on the design of a completely new tax structure rather than on tax reform, and inadequate consideration given to administrative costs associated with alternative tax systems.[16] The gap is, however, being narrowed, and future developments in public finance can be expected to have greater relevance for tax policy in both the developed and developing countries.

Some of the recent theoretical developments have already begun to influence proposals for tax reform in the United States. Thus, the implication of the Harberger model, that the higher taxation of the corporate sector in relation to the non-corporate sector not only reduces the net return to capital but also results in a substantial welfare loss (because capital shifts from the higher productivity corporate sector to the lower productivity non-corporate sector), have formed major elements in the case for a complete or partial integration of corporate and personal taxation.[17] Attitudes concerning property and social security taxes have also been affected, although there is less agreement on the future role of these taxes. If property taxes are mostly borne by capital, then the criticism that they are regressive is incorrect.[18] On the other hand, if the incidence of property taxes is not closely related to the consumption of services provided by a local authority, then the rationale for confining property taxes at the local level is weakened. Last, but not least, the implication of the Harberger model that social security taxes are primarily borne by labor suggests that these taxes are even more regressive than previously supposed, and that past estimates have overstated the rate of return to participants on their contributions.[19] These factors have had a substantial impact on the continuing debate on the reform of social security.

16. M. Feldstein, "On the Theory of Tax Reform", *Journal of Public Economics*, July 1976.
17. C. McClure, "Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals", *Harvard Law Review*, January 1975.
18. H.J. Aaron, *Who Pays the Property Tax?* (The Brookings Institution, 1975).
19. A.H. Munnell, *The Future of Social Security* (The Brookings Institution, 1977).

# Conference Diary

## AUGUST 1979

*9th Congress of the Latin American Institute of Tax Law:* (a) Joint Ventures; (b) Bonded Warehouses, Free Ports and Free Zones, Asunción (Paraguay), August 20-24 (Portuguese, Spanish).

*Institut für Finanzwirtschaft und Finanzrecht:* Unternehmungsbesteuerung (Taxation of an Enterprise), St. Gallen (Switzerland), August 27-28 (German).

## SEPTEMBER 1979

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including Tax in international operations), Brussels (Belgium), September 3-5 (English).

*33rd Annual Congress of I.F.A.:* I. The taxation of transfers of family-held enterprises on death and inter-vivos; II. The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities. For the seminars the following subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark), September 3-7 (English, French, German, Spanish).

*Management Centre Europe:* International Tax Management, Copenhagen (Denmark), September 24-25 (English).

## NOVEMBER 1979

*Tilburgse Fiscalistenvereniging "de Smeetskring":* Municipal Real Property Taxes, Tilburg (Netherlands), November 23 (English).

## FEBRUARY 1980

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

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asociación Paraguaya de Estudios Administrativos y Fiscales, Yegros No. 837, Asunción (Paraguay).

Business Perspectives, 11 Alexander Place, London, SW 7 2 SG (U.K.).

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

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

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen, Varnbüelstr. 19, 9000 St. Gallen (Switzerland).

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

Tilburgse Fiscalistenvereniging: Secretariat, Hogeschoollaan 225, Tilburg (Netherlands).

# United Kingdom: The Conservative Budget 1979/1980

On June 12, 1979 the Chancellor of the Exchequer, Mr. Howe, pronounced his Budget Speech, extracts of which, pertaining to taxation, are reproduced below.

## ONLY A FIRST STEP

"Before turning to the first of my tax proposals, I must make it clear that today's Budget will only be able to deal with a small part of the Government's tax agenda. Coming, as we do, to a Finance Bill at this late stage in the year, there is a physical limit to the amount of legislation that can be proposed and enacted.

"We have been unable to deal with many important matters. There will be other opportunities to consider those. At this stage, we have concentrated on tax changes of strategic importance. I now turn to the first of these.

## SWITCH TO TAX ON SPENDING

"We made it clear in our manifesto that we intended to switch some of the tax burden from taxes on earnings to taxes on spending. This is the only way that we can restore incentives and make it more worthwhile to work; and at the same time increase the freedom of choice of the individual. We must make a start now.

"I have reviewed the whole field of indirect taxation to decide where the increased revenue could best come from. There are many cogent arguments at this stage in favour of Value-Added Tax.

"First, large areas of consumer expenditure, in fact about half the total, are not chargeable to VAT. Food, children's clothes, heating and light, public transport, house prices and rents are all zero rated.

"Second, poorer households tend to spend proportionately more of their income on such zero-rated goods. This means that, unlike most indirect taxes, VAT is not regressive.

Third, by comparison with taxes such as those on alcohol and tobacco, VAT is much more broadly based.

"Fourthly, there is a real opportunity for simplifying the operation of the tax by having one rate instead of two.

"In his speech on May 22, the rt. hon. gentleman, the Member for Leeds East, seemed to favour increases in the surcharge on National Insurance contributions or in Advance Corporation Tax.

"The National Insurance Surcharge falls on the whole of British industry, including production for export, but not on imports. It is inferior in this respect to VAT, which falls on imports but not on exports. This is clearly significant in light of the latest trade figures.

"An increase in Advance Corporation Tax would damage the overall liquidity of industry at a particularly difficult time: by contrast an increase in VAT actually increases it.

## VAT TO 15%

"For all these reasons my choice must fall on VAT. Moreover, the increase I make must be sufficient to provide for substantial and worthwhile reductions in income tax. I propose, therefore, that, as from next Monday, VAT should be charged at a new unified rate of 15 percent.

"Allowing for the wide range of goods and services which are zero-rated — and which will stay zero-rated — the new rate I propose is equivalent to 8 percent, averaged over the whole of consumer expenditure. This is significantly less than the average in the European Community.

"The yield from the increase to 15 percent is estimated at £ 2.035bn in 1979-80 and £ 4.175bn in a full year. Thus it will provide scope for further direct tax reductions in later years. The relatively small size of the yield this year reflects the loss of over two months' revenue between April and the present, and the time lag allowed to traders before they pay over VAT receipts to the authorities — an average of over three months.

"I have referred to the helpful contribution this gap provides towards improving liquidity. For as these funds build up in traders' hands, they provide a substantial boost to the liquidity of the firms and companies concerned.

"Concern has been expressed that an increase in VAT could lead to some particular difficulties, for example in relation to telephone bills for calls made before the date of change. I am proposing transitional provisions to deal with this and some of the other problems in this field.

The increase in VAT will, of course, add significantly to the point of sale prices of drink and tobacco. For example, the VAT increase will mean about an extra 28p on a bottle of whisky, approximately 2p on a pint of beer and 6p on a typical packet of 20 cigarettes.

"In these circumstances, I do not think it would be justifiable to make a separate increase in the excise duty on drink and tobacco this year.

"I fully realise that this increase in Value-Added Tax will result in a rise in prices — in fact a rise of about 3½ percent in Retail Price Index. This is, of course, a once-for-all effect. But there never will be a time when it is easy to effect the switch from direct to indirect taxes and the present moment is no exception. This much-needed reform has been postponed too long already.

The House should bear in mind that, as I have already indicated, VAT does not fall on a wide range of necessities. This means that the increase will fall less heavily on people in the lower income groups. And, as will be apparent when I come to my income tax proposals, I shall be leaving people with more money in their pockets with which to pay the increased VAT."

The Chancellor further stated that he appreciated that those who are not liable to income tax, e.g. many living on retirement pensions, will not benefit from the income tax proposals. Therefore, a number of social security benefits will be increased.

## ENERGY SAVING

"I dealt earlier with the excise duties on tobacco and drink. The oil duties, however, raise wider issues. I have already mentioned the general case for measures which will help us to meet the growing and undoubted need to conserve oil.

"At a time when there is a worldwide shortage of crude oil it is essential that we should play our full part in achieving the 5 percent reduction in consumption to which the previous Government rightly committed us.

"I therefore propose to increase all the main oil duties this year. In the particular case of petrol, the VAT increase from 12½ percent to 15 percent will be smaller than for many other items. With this in mind I propose to increase the petrol duty by 7p a gallon — which will result in a total price change of about 10p a gallon.

"I also propose to increase the duty on derv by the same sum, 7p a gallon, and the duty on heavy oil other than derv, by ½p. I am not, however, increasing the duty for burning oil and for domestic paraffin, which is the oil used most commonly in the home, particularly by pensioners."

### NO INCREASE OF CAR TAX

"The yield from these excise duty changes is estimated at an additional £ 525m in a full year, £ 400m in 1979-80. The immediate increase in the RPI will be about one quarter of 1 percent.

"In view of the increase I am proposing in the road fuel duties I have decided to make no change in the rate of vehicle excise duty. Our predecessors announced their intention of abolishing the duty on petrol driven vehicles.

"As my Rt. Hon. Friend, the Minister of Transport, has already said, we are reviewing the future of this duty and we shall announce our conclusions in due course. For heavier goods vehicles, my Rt. Hon. Friend will be announcing plans for restructuring the form of this tax.

"Before I leave the subject of motor cars, there is a particular issue I need to deal with. There is a weakness in the present legislation on capital allowances which enables leased cars to avoid the special rules restricting allowances for business cars.

"This has resulted in a loss of tax which is currently running at about £ 175m a year; and which could well rise to £ 200m next year if I take no action. I propose to put this right with effect from today."

### PETROLEUM REVENUE TAX

"I turn next to petroleum revenue tax. The previous Government announced last August that they proposed to increase this tax from January 1, 1979. These proposals were discussed very fully by the last Government with the industry and we ourselves have had representations about them, which we have carefully considered.

"I have judged them now against the background of recent rises in the price of oil. On that basis, the original package of PRT proposals for giving the Government more revenue from the North Sea is now fully justified.

"There will accordingly be provisions in the Finance Bill to implement it. I also propose, however, to introduce some changes in the PRT expenditure rules for which the industry have been pressing for some time. And the British National Oil Corporation will no longer be exempted from PRT.

"These proposals will increase the Government's revenue from the North Sea (at 1978 prices) by about £ 100m this year, and by about £ 1,800m over the period to 1985."

### TAXATION OF CAPITAL
### REPEAL OF COMMUNITY LAND ACT

"We made it clear in our manifesto that we were determined to make the taxation of capital simpler and less oppressive. The objection to Capital Gains Tax in its present form is that most of the yield comes from paper gains arising from inflation.

"The tax is, therefore, a capricious and sometimes savage levy on the capital itself. The Capital Transfer Tax, despite the improvements secured in the last Parliament by constant pressure from the Conservative benches, is oppressive, harmful to business, and a real deterrent to initiative and enterprise.

"It is perfectly natural that people should want to build up capital of their own and pass it on to their children; this is particularly true of the small business proprietor.

"The issues involved in both of these taxes are difficult and complex. I have, therefore, decided that we should not attempt to deal with them in the coming Finance Bill — abbreviated as it is bound to be — but should press ahead with a thorough study, with a view to legislation on all these matters at an early date.

"There is, however, one specific issue on which legislation is required in order to hold the present position. I propose to extend for a further two years the period for CTT transitional relief for capital distributions from discretionary trusts and to defer for two years the introduction of the periodic charge.

"The Development Land Tax, however, is a very different matter and calls for immediate action. This tax has combined with the Community Land Act to prevent much worthwhile development and to increase unemployment in the construction industries. We have already said that we will repeal the Community Land Act.

"I propose now to deal with the Development Land Tax. In place of the present rates of 66²/₃ percent and 80 percent, which the previous Government intended should rise to 100 percent, I propose that Development Land Tax will in future be charged at a single rate of 60 percent.

"The amount of development value which can be realised in a financial year without liability to Development Land Tax will be raised from £ 10,000 to £ 50,000. Both these changes take effect for disposals made on or after today.

"I do not propose to make any further reductions in rate; and the generous increase in the exempt slice should mean that it will not need early revision.

"Owners of development land will, therefore, have no reason for holding back in the hope of further tax reductions. What I have said today should remove the major uncertainties which have been hanging over the market."

### TAXATION OF BUSINESS PROFITS

"I now turn to the taxation of profits. A vigorous, profitable and expanding company sector is essential if we are to rebuild this country's prosperity. Profitability has dropped sharply in recent years and the rate of return on capital employed is now far too low. This is especially true of manufacturing industry.

"Without higher profits we shall not see the new investment and jobs which are so urgently needed. Achieving those profits is very largely the task of management and workpeople. The Government can help or hinder them, and this is no time to add to the difficulties that they face by raising taxes on profits still further.

"Against that background I propose no change this year in the general system or in the rates of Corporation Tax. Nor would it be right to make any major changes in the system of company taxation without careful consultation in advance.

"Looking further ahead, however, it is important that the tax system should take account of the effects of inflation on businesses, and do so in a way that is reasonably objective, equitable and simple to administer.

"The Government will therefore be reviewing this matter along with the accountancy profession's latest proposals for current cost accounting. I am arranging for the Inland Revenue to consult the accountancy profession and business later in the year.

"I need however to deal now with the question of stock relief. The Finance Bill will include legislation to honour the undertaking which my predecessor gave last year, and which we supported, to write off the deferred tax liabilities arising from stock relief given for the first two years of the scheme — 1973-74 and 1974-75; and thereafter to write off these liabilities in respect of each subsequent year, after they have been outstanding for six years.

"In addition, following consultations which the Inland Revenue have had with industry, I am proposing two further changes in the stock relief scheme. I intend to reduce the profit restriction for unincorporated businesses from 15 percent to 10 percent; and all businesses will be given greater flexibility in the amount of relief they can claim. Both these changes will be of particular benefit to small businesses.

"Details of the stock relief and car leasing proposals will be given in Inland Revenue Notices which I am making available in the Vote Office.

"I now come to dividend control. If industry is to flourish it needs not only adequate profits but a vigorous capital market to provide funds for investment and expansion. The control of dividends has now outlived its purpose. The control will accordingly come to an end when the

existing legislation expires on July 31.
"We on this side of the House have consistently championed the cause of smaller businesses. So I also propose to raise this year the qualifying profit limits for the small companies rate of corporation tax — to the figures of £ 60,000 at the lower end and of £ 100,000 at the upper end. This will go some way further than is necessary to maintain their real value."

### MAJOR REDUCTION OF INCOME TAX

"In the tax field, however, there is one measure that will do more than anything else to encourage smaller businesses — indeed businesses of every size. That is a major reduction in the burden of income tax.
*"That brings me to the keystone of our policy. Excessive rates of income tax bear a heavy responsibility for the lack-lustre performance of the British economy. We need, therefore, to cut income tax at all levels.*
*"For the reasons I have already explained, I cannot do as much this year as I should have liked, and I cannot do as much as is needed. But, although it is only a first instalment, there should be no doubt in anyone's mind that this Budget marks a turning point.*
"I begin with the higher rates of tax. The upper rates no longer affect only those on very high incomes. They apply to senior executives and middle managers in industry and increasingly to skilled workers: as well as to professional people and the proprietors of small businesses. These are the people upon whom so many of our hopes for initiative, greater enterprise and national prosperity must depend.
"It is universally recognised that the present top rate of 83 percent on earned income is an absurdity. The rate of 98 percent on investment income is even worse. Such rates bring in very little revenue.
"But they kill incentive and are patently unjust. Some members of the previous Government recognised this. But they did nothing about it. I now propose an overdue measure of reform."

### REDUCTION OF TOP RATES

"The top rate on earned income will be cut from the present 83 percent to 60 percent. This new top rate will apply to taxable income over £ 25,000.
"At the other end of the higher rate scale, the present threshold of £ 8,000 is too low. I propose raising it to £ 10,000. Even at this figure the starting point for taxation at higher rates will be no higher in real terms than it was in 1973. Between £ 10,000 and £ 25,000 I propose a new scale of rates less steeply progressive than the old scale.
"The top rate of 60 percent on earned income I now propose fulfils our commitment to reduce the top rate to the European average. For example, the top rate in France is 60 percent. In Germany, it is 56 percent. In the United States, it is only 50 percent.
"The new top rate will still be reached at an income level which is lower and in some instances significantly lower than is common elsewhere. This is a matter to which we may meed to return on a future occasion.
"So, while the reductions I propose are substantial, they are no more than the circumstances require.
"They will still in general leave people in the top income groups more highly taxed than people in corresponding positions in other industrialised countries. We have to compete with such countries, not only in the sale of goods and services, but in attracting and retaining the talent required to run our industry efficiently and profitably and thereby provide employment opportunities that our people so desperately need.
"We have over the years spent too much time and effort trying to "level down." This is no good to anybody. It is much more important to have a successful and prosperous society. And we cannot have a successful and prosperous society without successful and prosperous individuals.
"But it is not only at the top of the income range that the burden of income tax is particularly oppressive. The same is true for those on the lowest taxable incomes, where the tax system can help to ensure that some people are actually better off out of work."

### INCREASE OF TAX THRESHOLDS

"That is the importance of the tax thresholds, to which I turn next. The increases proposed in the April Finance Act, which were not of course implemented, were plainly inadequate. I propose to double these increases. This means that the amount a single person can earn tax-free will go up, not by £ 90, but by £ 180.
"The married allowance will go up, not by £ 140, but by £ 280. A single person's tax-free earnings will thus go up by nearly £ 3.50 a week. The amount that a married man can earn tax-free will go up by £ 5.38 a week. And these increases in personal allowances are quite apart from the change that I have in mind for the basic rate of tax.
"I have in fact three other changes to propose before I come to that. First, to help the elderly, the age allowance will be raised by £ 240 for the single person and £ 380 for the married person.
"These again are double the figures proposed in the April Finance Act. Last year, the income limit for the full age allowance was £ 4,000. This year I propose raising it to £ 5,000, more than twice the increase proposed in the April Finance Act.
"Second, I propose raising the threshold for the investment income surcharge. The justification for retaining the surcharge is itself debatable. Certainly there can be no argument but that it bites at far too low a level of income. Almost half the surcharge is paid by people over 65.
"This is moreover a tax which falls with particular severity on those who have had to make provision for their retirement out of their savings and have no occupational pensions to fall back on.
"The undue severity of the tax was recognised by the previous Government. But they introduced no more than palliatives, in the form of a reduced rate applied to the first slice of income liable to the surcharge and a slightly higher threshold for those over 65.
"I propose instead to raise the threshold to £ 5,000 for everyone; the rate above that level will remain at 15 percent. This approach combines a considerable simplication of the tax with a measure of justice that is long overdue.
"Third, I propose to implement immediately our election pledge to war widows. Provision will be made in the Finance Bill to exempt their pensions entirely from tax.
"I come finally to the basic rate. For the great majority of taxpayers — some 21m in all — it is the basic rate which determines their tax liability. It is the basic rate (plus, of course, the National Insurance Contributions) which represent the deterrent effect of tax on additional earning — whether those extra earnings come from overtime, or greater productivity, or reflect greater skill or the rewards of promotion.
"Everywhere one meets complaint and criticism that income tax erodes differentials, reduces the rewards of skilled workers and discourages effort, initiative and responsibility. This year I propose taking a first and significant step to deal with these complaints by reducing the rate from 33 percent to 30 percent. Our long-term aim should surely be to reduce the basic rate of income tax to no more than 25 percent.
"The total cost of these income tax reductions, including the cost of increases in personal allowances proposed in April but not implemented at the time, will be £ 4.54bn in a full year. The lion's share, no less than £ 3.46bn or over three-quarters of the total, represents the cost of increasing the personal allowances and reducing the basic rate. The cost this year of all the income tax changes will be £ 3.5bn."

### MORE INCOME TO SPEND

"As a result of the increase in the tax thresholds 1.3m people who would otherwise have paid tax this year will not be required to do so. The number of people paying tax at the higher rates would have been 1.2m: this will be virtually halved, to 650,000.

"The number liable to the investment income surcharge will be reduced to about a third of what it would have been — from 850,000 to 300,000. All these changes will simplify administration and reduce the work load on the Inland Revenue.

"The changes in allowances will be implemented for most taxpayers on the first pay day after July 12. The reduction in the rates of tax will be given effect as soon as new tax tables are ready in October.

"A full year's income tax reductions will be received even though my Budget is being presented two months or more after the start of the year.

"On this basis the income tax changes mean that for the married couple where the husband earns £ 100 a week, which is close to average earnings, there will be an increase in take-home pay averaged over the remainder of the financial year of over £ 4 a week.

"The increases in VAT and petrol duty will increase average family expenditure by about £ 2.75. So that, taking both the direct and indirect tax changes into account, the average family will be about £ 1.30 per week better off.

"Similarly, where the husband earns £ 60 per week there will be a real gain of over 75p a week, while the position of the couple on £ 150 per week will improve by nearly £ 2 a week.

"These reductions in the burden of income tax, which are as substantial as they are unprecedented, mean that wage and salary earners will have more money in their pockets to buy the goods and services they help to produce.

"True, the prices of a good many of these goods and services will be increased by my tax proposals. But we have done everything we can to ensure that every family in the land will have more money coming in to pay the increased bills. And what is more, the choice of the way they spend their income will rest increasingly with people, and not with Government.

"These changes represent only the first stage in the major reduction in the burden of direct taxation that we are determined to make.

"I emphasise this point particularly for those who will be involved in pay bargaining in the year ahead.

"Take-home pay will be substantially increased by these unprecedented cuts in income tax. This will more than make good the price effects of higher spending taxes.

"Any further attempts to cover those price effects by higher pay claims will be utterly self-defeating. The money will simply not be there to finance higher pay as well as lower income tax.

"Any attempt to have it both ways will simply end up by threatening jobs and putting firms — on whom jobs depend — out of business."

## THE GOVERNMENT FINANCIAL STATEMENT

## INLAND REVENUE

### Income Tax

The Finance Act, 1979, increased the single person's allowance and the maximum wife's earned income relief from £ 985 to £ 1,075 and the married allowance from £ 1,535 to £ 1,675. It is now proposed that these allowances be further increased to £ 1,165 and £ 1,815, respectively.

The Finance Act, 1979, increased the additional personal allowance from £ 550 to £ 600. It is now proposed to increase it further to £ 650.

The Finance Act, 1979, also increased the age allowance for the single person from £ 1,300 to £ 1,420, for the married from £ 2,075 to £ 2,265, and the age allowance income limit from £ 4,000 to £ 4,400. It is now proposed that these levels be further increased to £ 1,540, £ 2,455 and £ 5,000, respectively.

It is proposed to extend the basic rate band by £ 2,000 to £ 9,250 (reduced, as appropriate, by any wife's earnings charged at the lower rate), and to reduce the basic rate of tax from 33 percent to 30 percent.

## EFFECTS OF THE BUDGET

The effects shown are direct effects: i.e. the difference between the yields of pre-Budget and post-Budget tax rates at the same levels of income and activity. The expenditure tax figures do, however, allow for the effects of relative price changes on the composition of consumers' expenditure.

| | Forecast for 1979-80 £m | Forecast for a full year £m |
|---|---|---|
| **INLAND REVENUE** | | |
| *Income tax* | | |
| Increase in single allowance by £ 180 and married allowance by £ 280 | – 1,541 (a) | – 1,845 (a) |
| Increase in additional personal allowance by £ 100 | – 11 (a) | – 13 (a) |
| Increase in age allowance by £ 240 (single) and £ 380 (married) and in income limit | – 168 (a) | – 210 (a) |
| Reduction of 3p in basic rate | – 1,288 | – 1,395 |
| Extension of basic rate band by £ 2,000 | – 158 | – 200 |
| Changes in higher rate thresholds and rates | – 305 | – 662 |
| Increase in investment income surcharge thresholds | – 22 | – 201 |
| Exemption of child dependency allowance | – 5 | – 6 |
| Exemption of war widows' pensions | – 4 | – 6 |
| Stock relief: reduction in profit restriction | Nil | – 30 (b) |
| *Income tax and corporation tax* | | |
| Stock relief: write-off | Nil | – 25 (c) |
| Stock relief: partial claims | Nil | Negligible |
| Capital allowances: leased cars | Nil | + 200 (d) |
| *Corporation tax* | | |
| Decrease in rate of ACT to 3/7ths of the amount of the dividend | – 190 | (e) |
| Increase in limits for small company relief | – 6 | – 11 |
| *Petroleum revenue tax* | | |
| Increase in rate and reduction of uplift | + 110 | + 130 (f) |
| Reduction of oil allowance | + 20 | + 20 (g) |
| Relief for certain expenditure incurred after the oil is landed | – 20 | – 11 (h) |
| Removal of exemption of British National Oil Corporation | Nil | Nil |
| *Development land tax* | | |
| Reduction in rate and increase in exempt amount | – 2 | – 10 (i) |
| *Capital transfer tax* | | |
| Extension of transitional period for discretionary trusts | Negligible | Nil (j) |
| TOTAL INLAND REVENUE | – 3,590 | – 4,275 |

| | | |
|---|---|---|
| **CUSTOMS AND EXCISE** | | |
| *Value added tax* | | |
| Unification of rate at 15 percent | + 2,035 (k) | + 4,175 (k) |
| *Excise duties* | | |
| Increase in rate of duty on light oil, etc. | + 280 (l) | + 375 (l) |
| Increase in rate of duty on heavy oil for use in road vehicles | + 80 | + 100 |
| Increase in effective rate of rebatable oil duty | + 40 | + 50 |
| Variations in rates of duty on cigarettes | Negligible | Negligible |
| TOTAL CUSTOMS AND EXCISE | + 2,435 | + 4,700 |
| *Total Changes in Taxation* | – 1,155 | + 425 |

(a) Costs include the cost of revalorisation of allowances in the finance Act 1979 (£ 866m in 1979-80 and £ 1,042m in a full year).
(b) The cost in 1980-81 will be £ 10m.
(c) The cost in 1980-81 will be £ 20m.
(d) The field in 1980-81 will be £ 175m.
(e) Increases subsequent liabilities to mainstream corporation tax.
(f) Petroleum revenue tax + £ 270m; corporation tax – £ 140m.
(g) Petroleum revenue tax + £ 40m; corporation tax – £ 20m.
(h) Petroleum revenue tax – £ 22m; corporation tax + £ 11m.
(i) DLT – £ 13m; capital gains tax and corporation tax + 83m; in addition, there will be a loss of benefit to net of tax bodies amounting to £ 1m in 1979-80 and £ 6m in a full year.
(j) The cost in 1980-81 will be £ 20m.
(k) VAT + £ 2,135m in 1979-80 and + £ 4,305m in a full year; excise duties and car tax – £ 100m in 1979-80 and – £ 130m in a full year.
(l) Oil duty + £ 265m in 1979-80 and + £ 345m in a full year; VAT + £ 15m in 1979-80 and + £ 30m in a full year.

It is proposed to abolish the higher rates of tax above 60 percent and to increase the width of the remaining higher rate bands. As a consequence of these changes, the structure of personal tax rates in operation in 1979-80 will be:

*Bands of Taxable Income*

| £ | Percent |
|---|---|
| 0 - 750 | 25 |
| 751 - 10,000 | 30 |
| 10,001 - 12,000 | 40 |
| 12,001 - 15,000 | 45 |
| 15,001 - 20,000 | 50 |
| 20,001 - 25,000 | 55 |
| over 25,000 | 60 |

It is proposed that the investment income surcharge for 1979-1980 should be charged at the single rate of 15 percent, and that the threshold should be £ 5,000 for all taxpayers.

Following the withdrawal of child tax allowances in the Finance Act, 1979, it is proposed to re-define the qualifying conditions for additional personal allowance and to repeal Section 13, Income and Corporation Taxes Act, 1970 (child-minder relief). It is also proposed that the child dependency allowance received by widows and certain other social security beneficiaries should be wholly exempt from income tax.

It is proposed that war widows' pension should be wholly exempt from income tax.

It is proposed to reduce the profit restriction in calculating the amount of stock relief from 15 percent to 10 percent.

### Income tax and corporation tax

It is proposed to write off the balance of stock relief still outstanding for 1973-74 and 1974-75 and to introduce provisions to write off so much of the relief for each subsequent year as has not been recovered after a period of six years.

It is proposed to allow businesses to claim less than the full amount of stock relief due.

It is proposed to introduce provisions under which expenditure incurred after June 12, 1979, on cars acquired for long-term leasing will generally cease to qualify for the 100 percent first year allowance.

### Corporation tax

It is proposed that advance corporation tax for 1979-80 should be payable at the rate of three-sevenths of the amount of the distribution.

It is proposed for the financial year 1978 to increase the lower and upper limits for the "small companies" rate of corporation tax from £ 50,000 and £ 85,000 to £ 60,000 and £ 100,000 respectively.

### Petroleum revenue tax

It is proposed to increase the rate of petroleum revenue tax (PRT) from 45 percent to 60 percent for chargeable periods ending after December 31, 1978. It is also proposed to reduce the uplift in respect of certain qualifying expenditure from 75 percent to 35 percent, subject to transitional provisions for expenditure under contracts entered into before January 1, 1979.

It is proposed to reduce the oil allowance for PRT from 1m long tons to ½m metric tonnes a year, and to reduce the cumulative limit of 10m tons per field to 5m metric tonnes.

It is proposed to extend relief for expenditure to allow relief for expenditure incurred beyond the point at which oil is first landed in the United Kingdom and up to the point at which oil is valued for the purposes of PRT. It is proposed to remove the British National Oil Corporation's exemption from PRT for chargeable periods ending after 30 June 1979.

### Development land tax

It is proposed that development value realised from the disposal of an interest in land on or after 12 June 1979 should be charged at 60 percent and that the amount of development value realised in a financial year which is exempt from development land tax should be increased from £ 10,000 to £ 50,000 as respects disposals from the same date.

### Capital transfer tax

It is proposed to extend for a further two years the period during which transitional relief is available for distributions from discretionary trusts, and to postpone for two years the introduction of the periodic charge on discretionary trusts.

## CUSTOMS AND EXCISE

### Surcharges and rebates in respect of excise duties

It is proposed to extend for a further year the existing powers under Section 1 of the Excise Duties (Surcharges or Rebates) Act 1979 which enable the Treasury by Order to impose a surcharge or allow a rebate in respect of those excise duties to which the Section applies.

### Value added tax

It is proposed that from 18 June 1979 the 8 percent rate of value added tax should be increased to 15 percent.

It is proposed that from 18 June 1979 the 12½ percent rate of value added tax should cease to have effect and that the goods and services subject to it should be chargeable at the 15 percent rate.

It is proposed to amend the law so that the 15 percent rate of value added tax tax will not apply in respect of charges to telephone subscribers on computer-produced tax invoices which include a rental charge for a rental quarter commencing before 1 November 1979.

It is proposed to amend the law so that goods and services supplied before the date of the increase in the rate of value added tax will not attract the increased rate of tax solely because the time of supply for VAT purposes is after the new rate of tax has come into effect.

### Hydrocabon oil duties

It is proposed, from 6 p.m. on 12 June 1979, to increase:

(a) the rate of duty on light hydrocarbon oil, petrol substitutes and spirits used for power methylated spirits by 1.5p a litre;

(b) the rate of duty on heavy hydrocarbon oil for use as road fuel by 1.5p a litre;

(c) the effective rate of duty borne by rebatable oils (except kerosene used other than as aviation fuel) by 0.11p a litre;

(d) the rate of duty on gas used as road fuel by 0.75p a litre.

**Tobacco**

It is proposed as from 13 August 1979 to vary the rate of tobacco products duty on cigarettes as follows:

(a) to increase the specific element in the duty by £ 2.77 per 1,000 cigarettes, and

(b) to reduce the *ad valorem* element from 30 percent to 21 percent of the retail price.

# CUMULATIVE INDEX 1979 ~ Nos.1-6



**(continued on page 336)**

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— Tarief voor invoerrechten
  release 171
— Algemene wetgeving
  releases 77 and 78

Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK

releases 137, 138 and 139
Kluwer, Deventer.

KLUWERS TARIEVENBOEK

release 211,
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C. van Soest, A. Meering
releases 47 and 48
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release 2
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## NORWAY

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FEDERAL TAX GUIDE REPORTS

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Commerce Clearing House, Inc., Chicago.

FEDERAL TAX TREATIES — REPORT BULLETIN

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Commerce Clearing House, Inc., Chicago.

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Prentice-Hall, Inc., Englewood Cliffs.

**CUMULATIVE INDEX** (continued from page 330)

# Contents

of the August/September 1979 issue

# Alun Davies on IFA Bulletin

**Alun G. Davies**
**President of IFA**

*It gives me great pleasure as President of IFA to see that the IFA BULLETIN is dedicating a special number to the IFA Congress at Copenhagen (as it did for the previous congresses of 1977 and 1978 in Vienna and Sydney, respectively), and that a copy of the BULLETIN is being included gratis in each congress kit.*

*It has always seemed to me a trifle strange that more members of IFA did not take out subscriptions for the BULLETIN, which is available to members at a very modest subscription. I very much recommend that all members should subscribe, if they do not already.*

*The British Branch of IFA supplied a modest capital contribution in 1976 towards the BULLETIN, so that it could more effectively serve as a publication directed towards the dissemination of articles and studies on the many facets of international taxation and fiscal policy which are the bread and butter of members of IFA.*

*I have been watching with the greatest interest how the BULLETIN has been developing as a publication devoted to the stimulation of research and discussion on international tax developments. Mr. van Waardenburg, as editor of the BULLETIN, has cast his net far and wide and has made available areas of tax information which are often difficult to find.*

*To mark the special occasion of the Congress at Copenhagen, the Danish minister for Economic Affairs and of Taxes and Duties, Mr. Anders Andersen, has contributed an article on fiscal policy. Mr. Mazanti-Andersen, who has played an important part in helping Mr. Spang-Hanssen in the organization of the Danish Congress, contributes an article on "Oil companies and transfer pricing" in which sphere he has high expertise.*

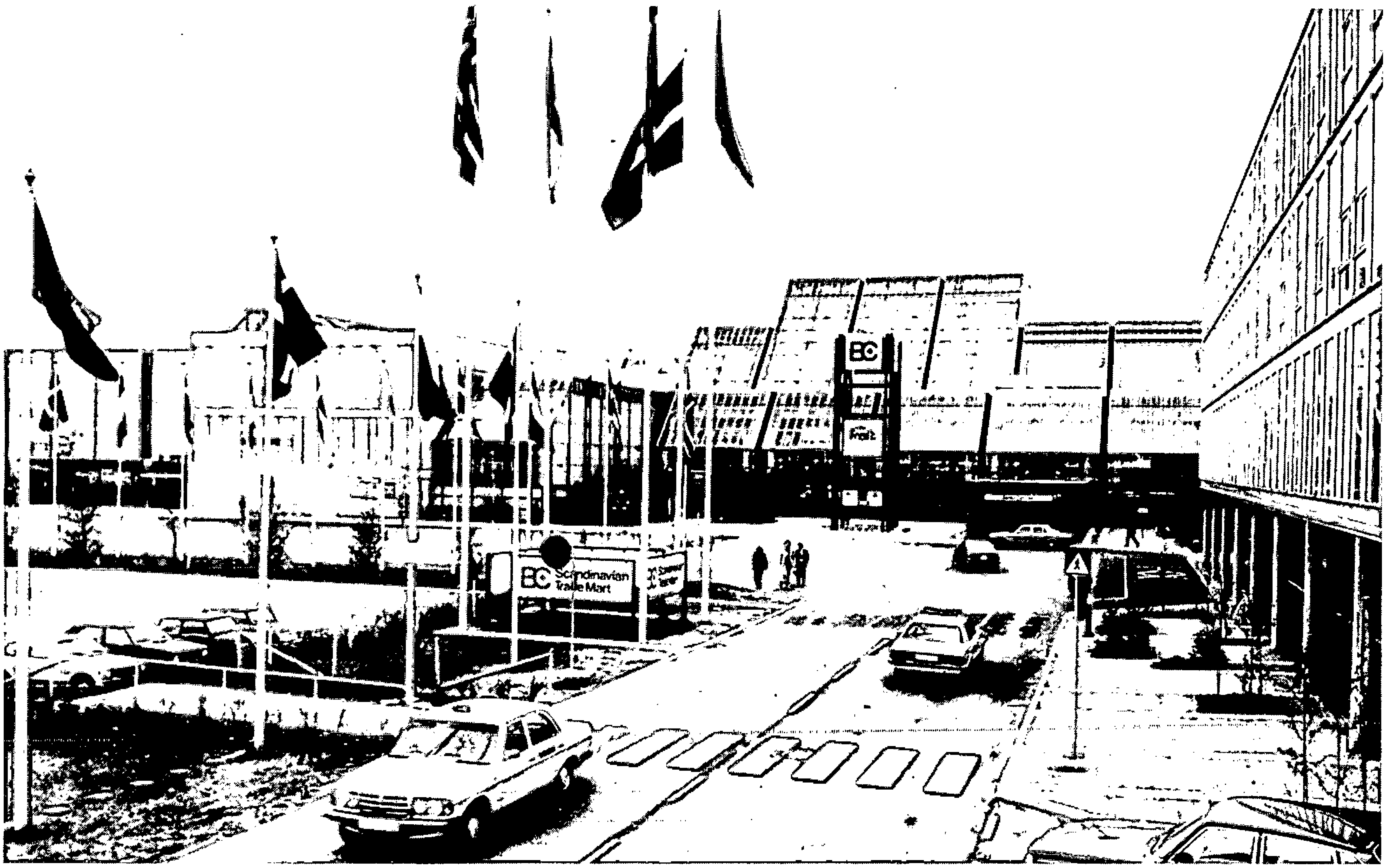
*This number of the BULLETIN also includes a comparative synopsis, prepared by members of the Bureau at Amsterdam, of taxation in the Scandinavian setting, which should be interesting and useful for Congress participants visiting Scandinavia for the first time.*

*Before the Congress is over, we should have learnt much more about taxation in Scandinavia and I hope that future numbers of the IFA BULLETIN will be able to publish further interesting articles on this subject.*

33rd congress IFA Copenhagen 1979

# 33rd International Congress of IFA

# Copenhagen



*Bella Center Copenhagen*
*Conference Center*

XXXIIIrd CONGRESS

*Subject I*

The taxation of transfers of family-held enterprises on death or inter vivos

*Subject II*

The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated enterprises engaged in international activities

*Bella Center Copenhague*
*Centre de Conférences*

XXXIIIe CONGRES

*Sujet I*

L'imposition du transfert des entreprises familiales par succession ou par donation

*Sujet II*

Les conséquences des déficits subis dans un pays pour une entreprise ou des entreprises associées ayant des activités internationales sur l'imposition des bénéfices dans d'autres pays

*Bella Center Kopenhagen*
*Kongresszentrum*

XXXIIIer KONGRESS

*Thema I*

Die Besteuerung der Übertragung von Familienunternehmen von Todes wegen oder durch Schenkung unter Lebenden

*Thema II*

Der Einfluss von Verlusten in einem Land auf die einkommen- order körperschaftsteuerliche Behandlung von international tätigen Unternehmen oder verbundenen Gesellschaften in anderen Ländern

# Welcome to Copenhagen

by Aage Spang-Hanssen

Let me start these introductory remarks by extending a warm and hearty welcome to all those who are going to attend the XXXIIIrd IFA congress in Copenhagen. Ever since our invitation to Copenhagen was accepted during the congress in Jerusalem, we in the Danish branch have devoted much time and enthusiasm in the preparation of the congress. We do hope that the participants will feel that the results do justice to our efforts.

I am using this opportunity to disclose our fundamental considerations on the congress.

First of all our invitation was based on using the only existing Danish congress center of the needed capacity, the Bella Center. The Bella Center is at one and the same time a center for congresses and exhibitions. You will find that the Bella Center is a 5 year old building with all modern facilities, including ample parking facilities, situated a little outside the central area of Copenhagen.

Consequently, our first worry was how we should arrange a congress without the impressive buildings and surroundings, which in previous congresses we have found in Sydney, Vienna and Jerusalem. Our solution was to make a virtue out of necessity. This means that we will emphasize and bring into focus the central aim of the congress — the scientific aspect.

Here we felt that this congress is favoured by the choice of the two subjects, each of far-reaching importance.

Subject I on family-held enterprises reflects the fundamental national interest in combining the fiscal interest with the interests of safeguarding the newly established enterprises and leaving the small enterprises the possibility of growing big — not being killed as infants by the combination of income tax, transfer taxes etc. This subject is especially fit for discussion in Denmark. It is often heard that Denmark is a socialized country, and it is true that our social security system is highly developed. But the Danish state does not — apart from public utilities — own one single share in any commercial company and our economy is totally dependent upon approximately 300,000 small family-held enterprises. As the national reports have shown the subject is, however, not only of interest for Denmark and the Scandinavian countries but it also has a far-reaching interest for the future development of all member-countries.

Subject II on deficits in subsidiaries in foreign countries reflects the tax problems of international or multinational companies and thereby problems of world-wide interest.

As for the seminars the world-wide aspect is covered by seminar 1 on tax treaties between developed and developing countries.

In chosing the theme for the "national" seminar, seminar 2, we turned to the Scandinavian aspect.

As the readers will know, Denmark is, since 1972, a member of the EEC. At the same time we maintain our close cooperation with the other nordic countries: Finland, Iceland, Norway and Sweden. The two following congresses will be held in EEC-countries, France in 1980 and Germany in 1981. Furthermore the only IFA congress previously held in Scandinavia was the Stockholm congress in 1967. We felt, therefore, that it would be of specific interest for the members to be informed of the present situation here in the Scandinavian countries.

However, in the Danish branch we have not forgotten what you may call the social side of the congress. First we want you to see and feel the easy charm of Copenhagen and the quiet melodic countryside which surrounds it. Secondly, but not less important, we have tried to establish the best possible facilities for developing new acquaintances and friendships and for renewing old friendships from previous congresses.

# TAXATION IN DENMARK

## *by Anders Andersen, Minister for Economic Affairs and Minister of Taxes and Duties*

At regular intervals surveys and tables by international organizations such as the O.E.C.D. and the E.E.C. are published, which show the burden of both direct and indirect taxation in different countries. Even though such surveys should be read with some caution, it must be admitted that, as far as Denmark is concerned, the trend is evident, viz. that Denmark is among the countries with the heaviest total burden of taxation.

I think that in order to facilitate the understanding of this position, it would be useful to look back for a moment at the historic development of taxation in Denmark. In this connection it would be natural, as our starting point to take a look at the background of the Fiscal Reform of 1903, which introduced for the first time a general taxation of income and capital in Denmark.

During the century prior to this Reform agriculture was by far the most important trade with the largest and most stable economic capacity. Therefore it was only natural that the State and the Municipalities, whose activities were, at that time, still rather modest as compared to the present-day scale, derived the bulk of their necessary revenue by the taxation of real property in addition to a few excise and customs duties.

Periods of recession in agriculture that coincided with the rapid rise of industry made it economically, politically, and psychologically inevitable that fiscal reform must be achieved in order to spread the burden of taxation so that the owners of real property would no longer bear the brunt of the government's taxing measures.

However, the introduction of the Fiscal Reform of 1903 did not immediately shift the major part of the burden from taxes on real property to income taxes. This start was modest, for tax was charged only on larger incomes and at low rates that were based on a slightly graduated scale.

In later years, however, the change in the method of taxation became more marked, which is evident from the fact that at the introduction of the Fiscal Reform the taxes on real property amounted to almost 2/3 of the total yield of the direct taxes, whereas today they amount to just under 5 percent.

The primary importance of the Fiscal Reform of 1903 was that it formed the basis upon which the government created an increase in the revenues of the State and the Municipalities that coincided with the expansion of the activities of the State and the Municipalities.

It must be said that the personal income tax has served this purpose well — some will no doubt hold the view that it has served it too well. A steady increase in the revenues from income tax has in any case been essential to the development of today's Welfare State, which was, I think, developed fastest in the Nordic countries. Gradually the State and the Municipalities have undertaken to perform an increasing number of tasks, so that — in addition to such traditional fields as military defence and the police — the State and the Municipalities today perform entirely or almost entirely the tasks that involve large expenditures, such as education, social security, health services, the sickness benefit system, national pension, roads, unemployment benefits, etc. The fact that the State and the Municipalities

**Mr. Anders Andersen**

*Anders Andersen, Minister for Economic Affairs and Minister of Taxes and Duties, was born October 1, 1912, at Voldby in Jutland. After a long practical and theoretical agricultural education he set up as an independent farmer in 1941, in 1954 taking over "Bensonslyst", his family's farm.*

*From early youth Anders Andersen has been a politically active member of the "Venstre" party (the Liberal-Democratic Party), for which he has been a member of the Folketinget (the Danish Parliament) continuously since April 21, 1953. His activities within the agricultural organizations led to a period during which he was the principal leader of Danish agriculture as President of the Agricultural Council of Denmark from 1960 to 1973.*

*As a member of the Assessment Tribunal in his Municipality of residence, as leading spokesman of the "Venstre" party in the Folketinget in matters of fiscal policy, and as a member of the Assessment Council, Anders Andersen has a long practical experience in the field of fiscal policy. He has, in the capacity of Minister, twice been responsible for taxation matters, first as Minister of Finance from December 1973 to February 1975, and since August 30, 1978 as Minister of Taxes and Duties.*

have undertaken these tasks has involved, of course, a substantial increase in the number of people employed in public service, which has resulted in proportionately heavy burdens of wages and pensions.

It is obvious that this whole development, which has involved large expenditures, could not be financed solely by means of direct income taxes. There seems to be an upper limit on this form of taxation too, which should for several reasons not be exceeded even in a country with a high taxpayer morality and a well-developed system of control.

The personal income tax includes State income tax, Municipal income tax, and County income tax, and also some small social security contributions. The State income tax is calculated according to a graduated scale, whereas the local taxes and the social security contributions are directly proportional to the taxable income. The percentages upon which the rate of the local taxes is calculated are fixed by the individual local authorities according to certain requirements.

The amounts of tax calculated in this manner are reduced by the "tax value" of the personal allowance. This "tax value" is calculated as the total amount of tax payable on an income of the same size as the personal allowance, assuming that the amount is charged to tax at the lowest rate of taxation on the National income tax scale. Husband and wife have a personal allowance each, and any amount of personal allowance which one of the spouses cannot utilize is transferred to the other spouse.

In a Municipality with an average Municipal income tax, the total income tax payable by a person under 67 years is in 1979 calculated according to the following scale:

**TABLE 1**

| *Taxable income (in DKr.)* * | | *Income tax before deduction of personal allowance (in DKr.)* |
|---|---|---|
| Not exceeding | 77,400 | 42.9 percent |
| Exceeding | 77,400 but | 33,204.60 on 77,400 and |
| Not exceeding | 139,400 | 57.3 percent on balance |
| Exceeding | 139,400 | 68,730.60 on 139,400 and 68.1 percent on balance |

* 1 DKr. as of April 17, 1979 equals 0.36 DM., 0.19 US$ and 0.09 £ .

The personal allowance is 14,500 DKr. and the "tax value" thereof is 6,220.50 DKr. in an average Municipality. The total personal income taxes will in 1979 amount to approximately 34 percent of the total taxable income.

As mentioned above personal income taxes are not the only ones levied to cover the revenue requirements of the State and the Municipalities. Among the other types of direct taxes that may be mentioned that are more or less important are, for instance, the corporation tax and the capital gains tax (see Table 2).

Neither should it be forgotten that *indirect taxation*, which in Denmark is characterized above all by very high excise duties imposed on a proportionately small number of products (motor vehicles, spirits, wine, beer, tobacco, etc.), and the value added tax, introduced in 1967, the rate of which is now 20.25 percent, are two other sources of revenue. The yield of the VAT and the rest of the excise duties is shown in Table 2, and this same table shows that these duties account for 38 percent of the total yield of direct and indirect taxes.

Up to now I have mentioned the effects of direct and indirect taxes on the Revenue. This function of taxes, of course, is important, but in a modern, economically controlled society, many other uses have been made of taxation.

In Denmark taxes and duties aggregate at present approximately 43 percent of the gross national product. It is self-evident that taxes and duties of such dimensions are certain to have an effect on major fields, especially on economic policy, on public as well as private investments, on demand for goods and services, on employment, and on the balance of payments. Thus taxes and duties have become an important instrument in the control of all the above fields in addition to several others.

By altering the rules of depreciation it is possible either to encourage or restrain investments, selectively from one trade to another, if so desired. Increase or reduction of direct taxes and duties may encourage or restrain the demand for home and foreign products and in this way affect the employment and the balance of payments. An increase in the duties on energy may cut down on the consumption of scarce resources, and duties and special rules of depreciation may serve environmental policy purposes.

The rule that establishes a lower limit of tax free income, and other deductions, particular rates of income tax, and graduated tax scales, etc. may contribute to a levelling of incomes and in this way serve social purposes. There are, of course, many other ways to achieve these objects, and in this connection I wish to emphasize that the best way to handle these things may possibly be through other channels than the tax system. Some years ago Denmark, for example, abandoned the system by which bread-winners were taxed in a different way than non-bread-winners, and it was replaced by cash payments of Government child subsidies to bread-winners with children. The separate taxation of a wife's income has also, to a great extent, been carried through, and equal personal allowances are granted to husband and wife.

Furthermore, in cases in which one of the spouses assists the other in a business that is carried on by the latter, a special taxation system is used. All this is part of the endeavour to consider everybody as an independent individual including for purposes of taxation.

An intensive utilization of the tax system to serve purposes other than the single one to procure revenues

## TABLE 2

| *(The year 1978)* *(1,000,000,000 DKr.)* | *The State* | *Municipalities/ Counties* | *Social Security* | *Total* | *In percentage of total yield (A+B)* |
|---|---|---|---|---|---|
| **Direct taxes** | | | | | |
| A. Personal income tax * | 26.9 | 33.5 | 5.9 | 66.3 | 51 |
| Special income tax | 0.6 | 0.3 | 0 | 0.9 | 1 |
| Wealth tax * | 0.7 | 0 | 0 | 0.7 | 1 |
| Duty on inheritance and gifts | 0.6 | 0 | 0 | 0.6 | 1 |
| Corporation tax | 3.4 | 0.6 | 0 | 4.0 | 3 |
| Tax on real property | 0 | 4.5 | 0 | 4.5 | 3 |
| Other taxes | 3.0 | 0.3 | 0 | 3.3 | 3 |
| Social Security contributions | 0 | 0 | 0.6 | 0.6 | 0 |
| Employer's contributions | 0 | 0 | 0.1 | 0.1 | 0 |
| Total | 35.2 | 39.2 | 6.6 | 81.0 | 62 |
| **Customs and excise duties** | | | | | |
| B. Value added tax | 27.0 | 0 | 0 | 27.0 | 21 |
| Tobacco | 4.0 | 0 | 0 | 4.0 | 3 |
| Beverages | 4.0 | 0 | 0 | 4.0 | 3 |
| Motor vehicles | 10.7 | 0 | 0 | 10.7 | 8 |
| Petroleum products | 0.4 | 0 | 0 | 0.4 | 0 |
| Customs | 0.8 | 0 | 0 | 0.8 | 1 |
| Other duties | 2.4 | 0 | 0 | 2.4 | 2 |
| Total | 49.3 | 0 | 0 | 49.3 | 38 |
| A + B in all | 84.5 | 39.2 | 6.6 | 130.3 | 100 |
| Gross national product | | | | 300 | |

* Estimated

has, of course, also some drawbacks. It is, for example, inevitable that the more demands made on the tax system the more complicated and confused it will be, and the greater the possibilities of unintentional loopholes or down-right evasion.

In recent years a more and more restrictive policy has been followed in this area and there has been an attempt to simplify the tax system in different areas. It is the Government's intention to continue these efforts.

Finally I wish to mention briefly the participation of Denmark in the area of international co-operation in the field of taxation. Co-operation in the field of taxation between the Nordic countries can be traced back many years and is reflected in the fact that in a number of areas covered by fiscal legislation we have practically uniform fiscal acts, applicable to all citizens in the Nordic countries, for example, the Seamen's Tax System. Furthermore, an extensive Nordic Agreement of Mutual Assistance regarding the exchange of information between taxation authorities, and assistance in the collection of taxes, etc. has been concluded. The next step in the Nordic co-operation will, according to expectation, be a mutual Double Taxation Agreement concluded between the five Nordic countries.
Since January 1, 1973, Denmark has been a member of the European Communities and has loyally participated in all efforts to harmonize taxation, where such harmonization would facilitate the free movement of labour, goods, services and capital, and also prevent discrimination in the area of taxation, i.e. prevent distortion of competition. It is, of course, a matter of vital importance for Denmark, a small country, the per capita foreign trade of which is among the largest in the world, that domestic production is not discriminatorily promoted through special favourable tax agreements and subsidies granted by way of taxation.

Denmark will likewise be among the states that will take an active share in combatting international tax evasion and tax avoidance. She realizes that such tax evasion and tax avoidance can only be combatted by means of widespread international co-operation, especially between taxation authorities, but as mentioned before, we are prepared to co-operate for that purpose.

**J. MAZANTI-ANDERSEN, M.C.J.**

*J. Mazanti-Andersen, born Copenhagen, Denmark, July 15, 1926; admitted to bar, 1953, Denmark. Legal education: Cambridge University, England; Faculty of Law, University of Copenhagen (Master of Law, 1950); New York University School of Law, U.S.A. (Master of Comparative Jurisprudence, 1956). Author: in English, The Doctrine of Consideration — A Comparative Analysis, 1957; in Danish, Taxation of Corporations, Stockholders, etc., (including Partnership and Partners), 1962 and Tax Problems Relating to the Activities of Foreign Enterprises in Denmark and Danish Enterprises Abroad, 1965. Private Tutor, Law of Contracts, 1949-1951. Member of the Committee for Dansk Skattevidenskabelige Forening (Danish Association for Scientific Tax Law Research), 1965. Member of the Committee appointed by the Government to draft and report on the Bill amending the Act governing Death Tax, etc., 1968. Member of the Committee appointed by the Government to draft and report on the Bill amending the Acts on Taxation of Corporations and Shareholders, etc. National Reporter to the XXVIIth Congress-International Fiscal Association, Lausanne (Switzerland) 1973 Subject II: "Partnerships and Joint Enterprises in International Tax Law." Member: Danish Bar Association; International Bar Association (Member, Business Section); International Fiscal Association (Danish Branch). Languages: Danish, English and German.*

# Danish Rules for Dealing at Arm's Length:

## A Special Case for Multi-national Oil Companies

by J. Mazanti-Andersen, M.C.J.

## I. INTRODUCTION

It was not until 1960 that a provision was enacted in Denmark authorising the tax authorities to adjust transactions which had not been contracted on an arm's length basis between "associated enterprises".

However, the introduction of this provision only constituted a codification of the practice relating to double taxation agreements (hereinafter referred to as "Convention") having as its object the bringing of domestic law into agreement with the various conventions concerned.

Until recently, the Danish tax authorities only applied this provision (section 12) to a rather limited extent. In 1978, however, the taxable income of a number of companies that were (are) resident in Denmark but were (are) owned or controlled by foreign oil companies was increased discretionary by the tax authorities.

## II. DEALING AT ARM'S LENGTH

Section 12(1) of the Danish Corporate Income Tax Act (1960) reads:

> *"If a company ... resident in Denmark, which is controlled by a foreign enterprise, is subject in its commercial or financial relations with the latter to conditions other than those which would apply in the case of an independent enterprise, the profits which it must be assumed that the company... would have received if it had been an independent enterprise dealing at arm's length with the foreign enterprise in question shall be included in the taxable income of the company ..."*

The provisions of subsection (2) hereof shall *mutatis mutandis* apply to branches of foreign enterprises with a permanent establishment in Denmark.

The explanatory statement which accompanied the Bill stated the following reasons for introducing the provision without which

> *"... it is to be feared that attempts could be made through manipulations of the accounts and arbitrary calculations to reduce the profits as shown in the accounts of the subsidiary or branch and, consequently, the taxable income in this country of such subsidiary or branch."*

Hence, the wording of the Act — "*If a company ...*" — places the burden of proof on the tax authorities to demonstrate that (a) the company concerned is controlled by a foreign enterprise, and (b) that it is subject to other conditions than would apply to an independent enterprise.

To the extent that they succeed in proving that the two conditions have been fulfilled, it is incumbent on the tax authorities to adjust the assessment of the company, with a corresponding adjustment to the taxable income.

In 1971 the Danish Minister of Finance stated, in a reply to a question put to him by a member of the Danish Parliament, that the criteria hitherto used by the Danish tax authorities do not, in principle, deviate from the general practice relating to "*concealed dividends*" from controlled companies or from subsidiaries of a Danish parent company trading or carrying on other forms of business with its principal shareholder or parent company, respectively.

In 1973 the Ombudsman (the Danish Parliamentary Commissioner) published an opinion interpreting section 12.

The Ombudsman established that the burden of proof for fulfilling the two conditions rests, in principle, on the tax authorities.

The Statement of the Ombudsman goes on to say:

> *"The first condition (a) implies that the tax authorities must demonstrate that the company's transactions are subject to instructions, etc., from a foreign enterprise to an extent which cannot be characterised as ordinary business relations only, cf.* Thøger Nielsen *at p. 195. et seq.*
>
> *The second condition (b) implies that the tax authorities must show that the company is subject to conditions which are, in a relevant way, cf. above, different from the conditions that would apply to an independent enterprise in such a way that these other terms will, among other things, influence the taxable income of the company."*

The Ombudsman further stated that independently of the rules regarding the burden of proof mentioned above, the general provisions of the tax law require that the companies give information to the authorities.

> *"Thus the companies must, possibly at the request of the tax authorities, inform the latter of the commercial and financial terms imposed upon them so that the tax authorities may evaluate whether the conditions (a) and (b) have been complied with . . . .*
>
> *The proof must particularly be based on the information provided by the company regarding the commercial and financial relations, and it is then for the tax authorities to prove that these relations are materially different from those existing between independent enterprises."*

If the two requisite conditions have been met, then the tax authorities must allocate to the taxable income of the company concerned the profits which are presumed to be those the company would have made had it been an independent company.

In respect to the exercise of such discretion the Ombudsman adds:

> *"Thus it is a question of making a discretionary evaluation, but this evaluation is limited in its scope as it can only aim at an adjustment of the declared income for distortions created by the above-mentioned dependence on the foreign enterprise."*

## III. THE 1978 CASES

As mentioned in the Introduction, the Danish tax authorities last year increased the taxable income of a number of subsidiaries resident in Denmark and owned or controlled by foreign oil companies.

The following is based on research material that was available to the present writer up to the moment of writing, chiefly concerned with one of the companies in question.

The arguments of the tax authorities may be summarised as follows:

By means of the accounting entries published throughout the years a conclusion was reached that the company had been subject to other conditions than those of an independent company. In particular, it was found that a justification cannot be made for an independent company to have accepted for a considerable number of years "such modest profits" as was shown in the accounts of the company.

In the case in point the arguments of the tax authorities for making the discretionary increase of the taxable income are as follows:

The increase is not founded on criticism of specific items of the accounts. The crucial point has been what must be assumed to be reasonable business profits considering the nature and scope of the activities of the company.

The argument goes on to say that the discretionary adjustment is based on a comparison of the profits of those companies in question with the results obtained by Danish subsidiaries of other multi-national oil companies, in addition to taking into account the limits laid down by the Monopolies Control Authority Board for the calculation of profit margins.

In reply to this argument, the companies primarily contend that the tax authorities have not proved that the companies have been subject to any "other conditions" than those which would apply to an independent enterprise. To put the matter in a different way, the companies maintain that the tax authorities have not been able to meet the condition regarding the burden of proof. To do so would require a clear demonstration that the "modest profits" were due to commercial conditions which do not conform to the criteria of arm's length business dealing. In addition they argue that the tax authorities increased the taxable income of the companies before any examination was made to show that the profits were unreasonable. In support of their view the companies also refer to the statement submitted by the Ombudsman (see Part II above).

Furthermore, the companies argue that the discretion has been exercised incorrectly. The requirements of the law cannot be considered to be fulfilled merely by "a comparison with the results obtained by Danish subsidiaries of other multi-national oil companies". If such a comparison were to have any relevance it would imply, among other things, that the tax authorities had in the first place made a close examination of the commercial conditions between the subsidiaries concerned and their controlling foreign parent companies. In addition, in the opinion of the companies, a comparison with the trading results of independent oil companies based in Denmark according to the criterion of "dealing at arm's length" would have been more natural.

In their arguments the companies also refer to the Commentary on Article 7 of the Model Convention (1977) which contains the following passage:

> *"It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce."*

As will be seen from the above, the Danish tax authorities' conception of the criterion "the real facts of the situation" apparently does not coincide with that of the companies concerned.

## IV. FURTHER COMMENTS ON THE INTERPRETATION OF SECTION 12 OF THE ACT

The unambiguous declaration of the tax authorities that "the increase is not founded on criticism of specific items of the accounts" seems remarkable considering that according to the statement accompanying the Bill (see Part II above), the reason for introducing section 12 was fear of attempts "through manipulations of the accounts . . . to reduce . . . the taxable income of (the) subsidiary".

In the light of this and taking into account the fact that the tax authorities have not provided clear cut decisive reasons for the increases, one cannot but think that in the opinion of the Danish tax authorities section 12 enables them, depending on the circumstances, to make discretionary increases of the taxable income in all cases where they consider the profits shown by a foreign-controlled enterprise to be too "modest".

When deciding whether the provision of the Act warrants such a wide interpretation, the corresponding provisions in various pertinent conventions must also be taken into consideration.

Thus the Convention concluded in *1948* between the United States and Denmark provides in Article IV:

> *"Where an enterprise of one of the contracting States, by reason of its participation in the management or the financial structure of an enterprise of the other contracting State, makes with or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise, any profits which would normally have accrued to one of the enterprises but by reason of conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

The corresponding provision in Article IV of the Convention concluded with the United Kingdom in *1950* contains the following provision:

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

Notwithstanding variations in wording the tenor of the two provisions is in actual fact the same.

In this connection it is important to note that the provision contained in the British Convention is identical with Article 9(1) of the O.E.C.D. Model Convention *1977*.

The Commentary (at p. 88) contains the following remarks regarding this latter provision:

> *"It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises."*

The words "special conditions" are a short reference to the criterion "conditions . . . which differ . . ." as used in Article 9(1) of the Model Convention 1977 and may therefore in real terms be compared to the criterion "other conditions" in section 12 of the Danish Act.

Consequently, it may be established:

*that* the requirement for proving "special conditions" was introduced several years prior to the adoption in 1960 of the provision in section 12; and

*that* the fulfilment of this requirement as a condition for the tax authorities to apply the arm's length rules is still considered relevant and important in international law.

In these circumstances the present writer is of the opinion that the mere fact that the Danish tax authorities consider the profits of a foreign-controlled enterprise too "modest" does not justify an adjustment under section 12. In support of this argument reference is also made to the statement by the Danish Ombudsman mentioned above; the arguments put forward by the tax authorities for the increases under section 12 (see II), do not seem to fulfil the requirements for proof and for exercise of discretionary evaluation regarding "distortions".

## V. ARTICLE 9(2) OF THE MODEL CONVENTION 1977

It is a well-known fact that the application of arm's length provisions may give rise to economic double taxation, i.e. taxation of the same income in the hands of different enterprises, as illustrated by the following example:

The profits of a Danish-owned subsidiary resident in State A are adjusted upwards with the consequence that the company in State A will be liable to tax on an amount of profit which has already been taxed in the hands of the Danish parent company.

In cases like this the new paragraph 2 of Article 9 provides that Denmark may make an appropriate adjustment to eliminate double taxation.

Article 9(2) of the O.E.C.D. Model Convention 1977 reads:

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

However, according to the Commentary to this Convention (at p. 88) Denmark is committed to make such adjustment only if it considers the adjustment made by State A justified both in principle and amount.

The Committee on Fiscal Affairs recommends that existing conventions should, as far as possible, be interpreted in the spirit of the new Commentaries, even though the provisions of existing conventions do not yet contain the more precise wording of the 1977 Model Convention.

This recommendation by the Committee further emphasises the importance, when interpreting domestic arm's length provisions, of taking account of the present conventions, including the opinion prevailing in "the other Contracting State" regarding "principle" and "amount".

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# TAXES IN SCANDINAVIA AFFECTING CORPORATIONS

## A Comparative Study

### DENMARK

## I. INCOME / NET WORTH TAX

## A. RESIDENT CORPORATIONS

SYSTEM: IMPUTATION OF APPROXIMATELY 50 PERCENT OF CORPORATE INCOME TAX

### 1. NATIONAL INCOME TAX

Danish: Indkomstskat af aktieselskaber

**Taxable base**

Annual world-wide income, after deduction of business expenses.

**Rate**

37 percent.

**Computation of taxable income**

*Depreciation of business assets*

Normal depreciation ("skattemæssige afskrivning") for buildings is generally permitted for all buildings used in a trade or business. No depreciation is allowed, however, for offices and dwelling houses unless, due to special circumstances, their value cannot be maintained through normal care and maintenance. For most types of buildings the rate of the depreciation allowance is 6 percent of cost during each of the first 10 years, and 2 percent of cost per annum thereafter. For new buildings including reconstructions and improvements, the construction of which is started between September 1, 1977 and December 31, 1980, the rate of 6 percent is increased to 10 percent for the year of acquisition and the next year. The 2 percent rate may be increased if it is shown that the building, in spite of proper care and maintenance will lose its entire value in less than 50 years.

For cinemas, theatres, hotels, restaurants, schools, garages and some other categories the rate is 4 percent of cost during each of the first 10 years and 1 percent of cost per annum thereafter, unless it is shown that the building, in spite of proper care and maintenance will lose its entire value in less than 100 years, in which case a higher rate may apply.

For installations in buildings (air-conditioning, elevators, central heating etc.) the rate of depreciation is usually 8 percent in each of the first 10 years and 4 percent per annum thereafter.

### FINLAND

## I. INCOME / NET WORTH TAX

## A. RESIDENT CORPORATIONS

SYSTEM: CLASSICAL

### 1. NATIONAL INCOME TAX

Finnish: Valtion tulovero
Swedish: Statlig inkomstskatt

**Taxable base**

Annual world-wide income, after deduction of business expenses.

**Rate**

43 percent. Reduced rates apply to corporations with annual profits below 50,000 FMk.

**Computation of taxable income**

*Depreciation of business assets*

Buildings may be depreciated only by the declining-balance method. Maximum rates varying with the main building material used and the type of the building are provided in the law. Some examples are as follows:

— 10 percent of remaining book value for wooden industrial buildings, power stations, workshops, warehouses, etc.
— 9 percent of remaining book value for similar buildings made of brick.
— 6 percent of remaining book value for wooden dwelling houses and offices.
— 5 percent of remaining book value for brick dwelling houses and offices.
— 20 percent of remaining book value for buildings used exclusively for research purposes.

For machinery and equipment normal depreciation is allowed on a collective basis, i.e. on the total book value of all assets at the end of the previous tax year, less the price of assets sold and plus the cost of assets acquired during the year. The maximum rate of depreciation is 30 percent. Different rules apply to motorcars.

Free depreciation during the years 1976 through 1979 applies to machinery and equipment purchased for use in factories and workshops to which the above free depreciation applies, provided that the machinery and equipment is ordered not later than October 31, 1978.

This study is based on the information published in SUPPLEMENTARY SERVICE TO EUROPEAN TAXATION, published by the International Bureau of Fiscal Documentation, Amsterdam, the Netherlands. This loose-leaf publication contains similar information on other major European countries

# NORWAY

## I. INCOME / NET WORTH TAX

## A. RESIDENT CORPORATIONS

SYSTEM: NO DOUBLE IMPOSITION OF CORPORATE DISTRIBUTIONS

### 1. NATIONAL INCOME TAX

Norwegian: Inntektsskatt til staten

**Taxable base**

Annual world-wide income, after deduction of business expenses. Dividends distributed are deductible for purposes of the national income tax.

**Rate**

27.8 percent.

**Computation of taxable income**

*Depreciation of business assets*

Normal depreciation is allowed according to the straight-line method. Depreciation is based on the historic cost of acquisition, including the investment tax. Guidelines for the expected useful life of assets are published by the tax authorities for most types of assets.

*Accelerated depreciation* is granted by one of the three main methods which will be distinguished below under their Norwegian names:

(i) "Tilleggsavskrivning" is granted to all assets falling under the normal depreciation allowances, with certain exceptions (e.g. motor vehicles, offices, shops, hotels). The rate amount to 50 percent of the normal annual depreciation allowance with a maximum of 5 percent of the cost price per annum, and is granted in the year of taking into use and the next four years. The total "tilleggsavskrivning" may not exceed 15 percent of cost.

(ii) "Åpningsavskrivning" may be chosen as an alternate to the "Tilleggsavskrivning" for
  (a) ships or aircraft ordered after January 1, 1962;
  (b) buildings and plant used in the production or storage of goods or the construction or overhaul of aircraft and ships; and
  (c) drilling rigs and drilling ships for underwater exploration of petroleum deposits.

For assets under (a) the allowance is 25 percent of the his-

# SWEDEN

## I. INCOME / NET WORTH TAX

## A. RESIDENT CORPORATIONS

SYSTEM: CLASSICAL

### 1. NATIONAL INCOME TAX

Swedish: Statlig inkomstskatt

**Taxable base**

Annual world-wide income, after deduction of business expenses.

**Rate**

40 percent.

**Computation of taxable income**

*Depreciation of business assets*

For buildings, only the straight-line method is permitted. In general, depreciation is based on the cost price and useful life. The rates generally vary between 2 percent and 6 percent per annum and are agreed upon by the taxpayer and the tax authorities.

For machinery and equipment, two forms are permitted: a straight-line method ("planned depreciation") and a declining-balance method ("accounting depreciation"). The straight-line method is based on the cost price and useful life of the asset. The declining-balance method is granted upon application if the taxpayer maintains adequate accounting records. This method is based on the total book value of all assets at the beginning of the tax year, plus the cost of the assets acquired less the assets sold during the year. The maximum rate of depreciation is 30 percent. However, should in any year the straight-line method of depreciation of 20 percent on all assets be more advantageous, then this depreciation is permitted.

At the discretion of the Government, an *accelerated depreciation allowance* of up to 30 percent may be granted for machinery and equipment in the first year of ownership, provided that the purchase of the assets has not been financed out of the business cycle equalization reserves (see below).

## DENMARK

The higher rates during the first 10 years apply only to acquisitions of buildings and installations on or after March 15, 1968. For acquisitions prior to that date only the normal rates of 2 percent, 1 percent, and 4 percent, respectively, apply, but in that case the taxpayer may continue depreciation under the rules previously in force.

For machinery and equipment used exclusively for business purposes, normal depreciation is allowed on a collective basis, i.e., on the total book value of all assets at the end of the previous tax year, less the price of assets sold during the year and plus the price of assets acquired during the first half of the year and one-half of the price of assets acquired during the second half of the year. The other half of the price of assets acquired during the second half of the year is added to the collective basis in the year following the year of acquisition.

The rate of depreciation is at the choice of the taxpayer but may not exceed 30 percent in any year.

However, for machinery and equipment acquired during 1975 and 1976, an additional depreciation of up to 15 percent of expenditure may be claimed by the taxpayer, which may be spread over the years 1975 through 1978. The additional depreciation is not available for assets eligible for the initial depreciation (forskudsafskrivning) discussed below.

Special rules apply to machinery and equipment used only partially for business purposes and to motorcars.

Items of machinery and equipment the cost of which does not exceed 1,800 DKr., or whose estimated useful life does not exceed three years may be written off completely in the year of acquisition. In the first two years of operation of the business, the complete write-off of items costing 1,800 DKr. or less is restricted to a total amount of 50,000 DKr.

An initial depreciation (forskudsafskrivning) applies to industrial buildings, machinery and equipment. The latter allowance applies only to that part of the total of contract prices during the year which exceeds 700,000 DKr. 30 percent of the excess may be written off during the first four years following the award of the contract, subject to a maximum of 15 percent in any one year.

For ships used for business purposes, a maximum 30 percent normal depreciation on a collective basis (but not grouped together with other machinery and equipment) is allowed. Initial depreciation for ships under construction with a contract price of 200,000 DKr. or more is allowed up to 30 percent of the contract price with a maximum of 15 percent in any one year before delivery.

### Investment incentives

*Investment allowance:* No investment allowance is normally granted. However, a temporary investment allowance applies to the construction of new buildings and to the reconstruction and improvement of existing buildings insofar as the expenditure exceeds 60,000 DKr., provided that the construction, reconstruction or improvement is begun during the period from April 1, 1975 to December 31, 1976, and provided further that the building is put to use within 2 years from the time the work is begun for purposes which make the building eligible for ordinary depreciation allowances. The investment allowance amounts to 5 percent for the year of the work's completion and the next following year.

## FINLAND

Items of machinery and equipment whose estimated useful life does not exceed 3 years may be fully written off in the year of acquisition.

Patent and other rights with a limited life may be written off under a straight-line method, over a period of 10 years, or so much less as their economic life.

Mines and quarries etc. may be written off over their estimated useful life, the annual allowance being related to the amount extracted.

Other assets, such as railways, bridges, quays and basins may be written off (straight-line) over their estimated useful life, with a maximum of 40 years.

*Accelerated depreciation* is available in the following cases:

For buildings to be used as factories or workshops, the construction of which is started between May 1, 1976 and December 31, 1977 and which are ready for use not later than October 31, 1978, free depreciation is granted during the years 1976 through 1979, i.e. the taxpayer may take the same depreciation for tax purposes as he takes for his commercial accounts.

For ships of at least 19 register tons ordered by shipping enterprises during the years 1978 through 1980 to be built in Finland, depreciation may start in the year the ships are ordered, but total depreciation for the time prior to the taking into use of such ships may not exceed 30 percent of their cost; this depreciation for tax purposes may also not exceed the depreciation taken in the taxpayer's commercial accounts.

Investments made during the years 1976-79 in legally designated development areas and being either new industrial or tourist undertakings or extensions of existing enterprises, or modernizations of machinery and equipment resulting in an increased capacity or in the ability to manufacture goods to a further stage of production, may be depreciated at will during the year the investments are put into service and the nine subsequent years. Similarl provisions applies in previous years.

### Investment incentives

*Investment allowance:* An investment allowance is granted for certain qualifying investments from 1976 to 1979 in "Zone 1" development areas (comprising, inter alia, Lappi, Oulu, Pohjois-Karjala and Kuopio). The investment allowance is 3 percent per year during a period of 10 years. Similar provisions applied in previous years.

An investment allowance of 3 percent per year for the year the ship is taken into use and the three following years applies to certain ships of at least 19 register tons ordered by shipping companies during the years 1978 through 1980.

An investment allowance of 3 percent during the years 1976 toric cost, and for assets under (b) and (c) 25 percent of that part of the cost price which exceeds 500,000 NKr. This allowance may be spread over a number of years, but the deduction in any one year may not exceed 50 percent of taxable income.

(iii) "Overprisavskrivning" applies only to assets used in the three northern provinces of Nordland, Tröms and Finmark. The types of assets eligible for this allowance are the same as those eligible for "Tilleggsavskrivning". Up to 50 percent of the cost may be depreciated in the first five years of use. Some other accelerated depreciation allowances are also available in those provinces.

**Investment incentives**

*Investment allowance:* No investment allowances are granted.

*Tax free reserves:* There are several provisions for the creation of tax free reserves, the most important of which are:

(i) Reserve for investment in capital assets

Taxpayers engaged in trade or business may deduct up to 25 percent of annual net taxable income (50 percent of that part of income which exceeds the average of the two preceding years) (with a minimum of 10,000 NKr.) to create a reserve for the investment in capital assets intended for the production, storage, transportation or turnover of goods or for the transportation of persons — excluding ordinary motor cars;

**Investment incentives**

*Investment allowances:* (a) At the discretion of the Government, an investment allowance of up to 10 percent may be granted on machinery and equipment in the first year of ownership, subject to the same restrictions as the accelerated depreciation referred to above;

(b) taxpayers engaged in business, agriculture, or forestry are entitled to a temporary investment allowance with respect to purchase and expenditures amounting to at least 10,000 SKr. of machinery and equipment which are intended for permanent use in their business, provided that the assets are purchased or produced during the period from October 15, 1975 to December 31, 1979. This investment allowance amounts to

Also, a temporary investment allowance applies with respect to purchases of machinery and equipment (except motorcars), depreciated on a collective basis, between September 20, 1975 and December 31, 1976. The allowance amounts to 20 percent of the difference between cost price of qualifying investments and the amount received on the disposition of old assets during the stated period. This investment allowance is extended to purchases during 1977 and 1978, at a reduced rate of 10 percent.

*Tax-free reserve:* Corporations engaged in trade or business may allocate up to 25 percent of annual profits with a minimum of 500 DKr. to a tax-free-investment reserve (investeringsfonds). An amount equal to one half of the reserve must be deposited in a blocked account. The reserve may be used as of the year following the year of allocation, but not earlier than three months after the date of the deposit, and not later than 12 years after the end of the year in which the allocation has taken place, for financing new industrial buildings, machinery, equipment and ships.

For the depreciation basis of such assets, the cost price or acquisition price is reduced by the amounts taken from the tax-free reserve as an advance depreciation allowance (forlods afskrivning).



through 1979 is also granted for new factories and workshops, the construction of which is started between May 1, 1976 and December 31, 1977 and which are ready for use not later than October 31, 1978. The same investment allowance applies to machinery and equipment purchased for use in the above buildings and ordered not later than October 31, 1978.

*Tax free reserves:* Under a new law of December 28, 1978, which replaces the former law of June 8, 1964 as of January 1, 1979, corporations may allocate up to 50 percent of profits (formerly up to 30 percent) to a tax-free investment reserve. The maximum allocation may be increased to 80 percent for any year by Government decree. A sum equal to at least 50 percent of the allocation must be deposited with the Bank of Finland. The reserve may only be used for qualifying investments in, inter alia, buildings, plant and machinery, research, development and export promotion in accordance with the Government's order or consent. If so used, the deposit is released. The assets acquired with reserve are not depreciable.

Shipping enterprises may create tax free reserves during the years 1978 through 1980 for future purchases of ships of at least 19 register tons to be built in Finland. In the case of companies, 58 percent, and in the case of other taxpayers 53 percent, of the reserves must be deposited at Finlands Bank. The amount of the reserve may be used for the acquisition of a qualifying ship and to the extent the acquisition is financed through the reserve, no depreciation is allowed.

With respect to new buildings to be used as factories or workshops, the construction of which starts between October 1, 1978 and June 30, 1979 and with respect to purchases of machinery and installations a special tax free investment reserve may be created or, alternatively, the expenditure on these buildings, machinery and installations may be depreciated at will. For further details, see under accelerated depreciation, above.

Taxpayers engaged in business, except banks, insurance companies and pension funds, may create, as of the year of income 1978, a business reserve. The annual allocation may not exceed 50 percent of pre-tax profits and the total reserve may not exceed 10 percent of the annual amount of wages paid, provided that during the years 1978 through 1981 the reserve must be gradually built up so as not to exceed 2 percent, 4 percent, 6 percent and 8 percent of annual wages, respectively. The deduction of up to 50 percent of the value of stock (see below) and the total amount of the business reserve may together not exceed the above limit, or the maximum 50 percent deduction of the value of stock, whichever is higher.

this sum must be deposited in a special account in the National Bank. Reserves are released after four years, for the purchase of new assets, or earlier if the Government so orders or consents. When the purchase of assets is wholly or partially financed out of the reserve, only 85 percent of the released reserve must be deducted from the purchase price in computing the depreciation base, thus leaving a benefit for the taxpayer equal to 15 percent of the reserve. No addition to this reserve is allowed as of the year of income 1973 (except that as of 1975 additions to the reserve were allowed for future investments to protect the environment).

(ii) Reserve for research and export promotion

Tax free reserves may be set aside
(a) to cover expenses of market development abroad and exports promotion, and
(b) to cover expenses of research related to the taxpayer's business.

Up to 20 percent of the annual net taxable income may be allocated to this reserve with an annual minimum of 10,000 NKr. The reserve may be released if the taxpayer has incurred qualified expenditures in subsequent years.

(iii) Further tax free reserves may be created by mining enterprises, enterprises just engaging in a business or investing in business facilities in northern Norway, and enterprises working in unemployment areas.
Total allocations to the various reserves may not exceed 50 percent of net profits in any year.

10 percent (later increased to 25 percent for investments between May 1, 1976 and December 31, 1979) of the purchase price or cost of production, and applies to the national income tax only.
The allowance taken in any year may not exceed gross income less other deductions from the appropriate source of income. As an alternative to the above investment allowance, a 4 percent investment subsidy from the Government is available for qualifying investments during the same period, applying to a maximum investment of 500,000 SKr. in each of the years 1975 through 1979. The subsidy is increased to 10 percent for investments between May 1, 1976 and December 31, 1979.
However, if delivery takes place between September 30, 1979 and December 31, 1979, the investment goods must have been ordered not later than September 30, 1979 in order to qualify for the allowance or subsidy.

This investment allowance and subsidy do not apply to
— machinery and equipment with an estimated useful life of three years or less;
— assets bought secondhand;
— ordinary motorcars;
— certain small boats;
— machinery and equipment made by the taxpayer himself, if the manufacture started before October 15, 1975;
— machinery and equipment already ordered before October 15, 1975;
— goods for the decoration of offices delivered after the year 1978;

(c) An investment allowance or alternative subsidy similar to those mentioned above is available with respect to the construction or reconstruction of buildings for use in the taxpayer's business (including agriculture and forestry), provided the construction or reconstruction is started during the period from October 1, 1978 to September 30, 1979. The investment allowance amounts to 10 percent of the expenditure incurred between October 1, 1978 and March 31, 1980 with respect to activities carried on and materials used during that period. The allowance may not exceed gross income less other deductions in the appropriate source of income. Expenditure of less than 10,000 SKr. in any year for any construction project does not qualify for the allowance. The following buildings are excluded from the allowance:
— buildings or parts of buildings used for dwelling purposes;
— petrol stations, parking facilities;
— shops, offices, banks, hotels and restaurants;
— meeting halls and similar buildings;
— sports buildings and other sporting facilities.
The investment subsidy which is available as an alternative to the allowance if the taxpayer cannot make use of the allowance amounts to 4 percent of qualifying investments. It may apply to a maximum investment of 1,000,000 SKr. in each tax year.

*Business cycle equalization reserves:* The "investeringsfonder för konjunkturutjämning" is a tax free reserve. For corporations, 40 percent of pretax income may be set aside tax free, and 46 percent of this amount must be deposited in a special blocked account in the Swedish National Bank to be used on approval by or at the request of the Government for the purchase of machinery, equipment, etc. Five years after the creation of the reserve, 30 percent may be withdrawn (without special permission) for expenditures for approved types of assets.

| DENMARK | FINLAND |
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## DENMARK

**Inventory valuation**

In general, inventory is valued at cost or market value, whichever is lower. The value may, for tax purposes, be reduced by up to 30 percent.

**Loss carry-over**

Losses may be carried forward to be set off against profits for five years. For losses incurred prior to the year of income 1976 the carry forward is restricted to two years. No carry-back is permitted. However, the tax payable for the year of income 1974-1975 may be reduced by 37 percent of losses incurred during the year of income 1975-1976. In computing the loss eligible for this relief, initial depreciation allowances, allocations to investment reserves and certain deductions in stock valuation are not taken into account.

*Deductibility of taxes paid*

The national income tax is not deductible. Indirect taxes, such as excises and import duties are deductible. However, VAT is not deductible since it can be recouped by the taxpayer. Foreign income taxes are not deductible.

**Affiliation privilege**

If a resident corporations owns at least 25 percent of the shares in any other corporation, the parent company's income tax on total income may be reduced by that part which is proportionally attributable to the dividends received from the subsidiary. This reduction, however, is limited to the tax paid by the subsidiaries on their profits so distributed. With respect to resident subsidiaries the dividends received by the parent company will be fully exempt to the extent that the dividends are paid out of income earned in 1977 (or substituted accounting period) and subsequent years.

*Deductibility of dividends distributed*

Dividends paid are not deductible in computing profits. However, resident shareholders are entitled to an imputed tax credit equal to 15 percent of the dividend, for dividends paid out of profits of the year 1977 (or substituted accounting period) and subsequent years.

*Relief for foreign source income*

In principle, foreign source income is taxable except that where a corporation derives income from a foreign permanent establishment, or from shipping between foreign ports, engineering and contracting business operations in a foreign country, the Danish corporation income tax on total income (including the income from the foreign business operations) is reduced by one half of the tax which is attributable proportionally to the gross income (before deduction of foreign tax) from the foreign business operations.

The exemption for intercorporate dividends received where

## FINLAND

**Inventory valuation**

In general inventory is valued at the lowest of actual cost price, current cost price or market value. The value so arrived may be further reduced, at the taxpayer's option, by up to 50 percent of that value.

**Loss carry-over**

Losses may be carried forward and set off against profits of the five subsequent years. Losses incurred during the first five years of operation may be set off against profits derived during the first 10 years, which means, for instance, that losses of the first year may be carried forward nine years.

*Deductibility of taxes paid*

In computing profits for purposes of the national income tax, the national income tax itself, the local income tax and the church tax are not deductible. Indirect taxes, such as the turnover tax, are deductible. Foreign income taxes paid are not deductible.

**Affiliation privilege**

No affiliation privilege as such exists but dividends from domestic sources received by a resident corporation which does not deal in securities are normally exempt from national and local income tax and church tax. As of 1969 this exemption does not normally apply to dividends from foreign sources, except that, as of 1975, dividends from non-resident companies are exempt to the extent that such non-resident companies have been subject to tax in Finland with respect to their profits.

*Deductibility of dividends distributed*

For purposes of the national income tax only, resident corporations may deduct 40 percent of the difference between dividends distributed and exempt dividends received. As a temporary measure, the entire dividend paid will be deductible for purposes of the national income tax, with respect to new shares issued and fully paid-in during 1969 through 1980. This full deductibility applies for the year of issue and the next five years. Dividends qualifying for the 100 percent deductibility may not exceed 20 percent of the relevant share capital per annum. In addition, the 100 percent deductibility does not apply to the extent that the dividend rate on the new shares exceeds the dividend rate on the old shares.

*Relief for foreign source income*

As of the year of income 1972, finally assessed or withheld foreign taxes imposed on certain types of foreign source income or on foreign situs property may be credited against the Finnish national income and net worth taxes. The credit is

| NORWAY | SWEDEN |
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## NORWAY

**Inventory valuation**

In general inventory is valued at historic cost price or market value, whichever is lower.

The FIFO system is permitted, LIFO is not.

**Loss carry-over**

Losses may be carried forward to be set off against profits for the next ten years. When a corporation liquidates, losses may be carried back to be set off against profits of the preceding two years.

*Deductibility of taxes paid*

Income and net worth taxes are not deductible except foreign taxes for which no other relief is available.

Indirect taxes paid (e.g. import duties, excise duties, etc.) are normally deductibly in computing the taxable income in the years in which they are paid, unless they constitute part of the cost of acquisition of business assets which are subject to depreciation allowances over their useful life. This applies, inter alia, to the investment tax on business assets (see below). The VAT does not normally affect the computation of business profits as this tax is recouped by the taxpayer.

**Affiliation privilege**

Domestic dividends received by a resident corporation are subject to national income tax but exempt from local income tax. Foreign-source dividends are subject to both national and local income tax.

*See for deductibility of distributed dividend for national income tax purposes, below. There is no double imposition of corporate income!*

*Deductibility of dividends distributed*

Dividends distributed are deductible in computing taxable income subject to the national income tax, so that henceforth the national income tax will apply to retained profits only. Dividends distributed are not deductible for purposes of the local income tax, but they are exempt from local tax in the hands of the shareholders.

*As a result of the above system corporate income is taxed only once and double taxation at the corporate and the shareholder level is avoided completely.*

*Relief for foreign source income*

In the absence of double taxation agreements, all income from foreign sources is included in taxable income except income from foreign immovable property and income attributable to a foreign permanent establishment, one half of which is exempt.

The same partial exemption may apply to dividends received from a foreign corporation, provided that the Norwegian company, together with not more than 9 other Norwegian residents, owns at least 95 percent of the shares in such foreign corporation.

## SWEDEN

**Inventory valuation**

The general rule is that the valuation of inventory may not be lower than 40 percent of the cost or market value, whichever is lower. The FIFO system is permitted.

**Loss carry-over**

Losses may be carried forward to be set off against profits for ten years. No carry-back is permitted.

*Deductibility of taxes paid*

The national income tax is not deductible. However, the local income tax may be deducted as a business expense.
Indirect taxes such as excises and import duties are also deductible. However VAT is not deductible since it can be recouped by the taxpayer. In addition, foreign taxes not covered under unilateral or treaty relief provisions are deductible.

**Affiliation privilege**

Domestic dividends received are generally exempt if the recipient is a company which owns or holds shares that represent at least 25 percent of the entire voting power of the distributing company. If the voting power of the shares owned or held is less than 25 percent, the dividends received may nevertheless be exempt if the recipient company proves that the shares are acquired for organizational reasons.
Special rules exist for closely-held companies, banks, insurance companies and other financial institutions, as well as for holding and investment companies.

*Deductibility of dividends distributed*

Dividends paid are, in principle, not deductible. However, a dividend of up to 5 percent paid on new shares is deductible from the gross income of the paying company during any 10 years falling within a period of 15 years after the shares have been paid up. This deduction is not granted if more than 50 percent of the shares of the paying company are held by other Swedish companies exempt from tax with respect to the dividends, or by foreign companies wholly exempt from the coupon tax for the dividends received by virtue of a tax treaty.

With respect to shares issued after December 31, 1978 the annual deduction is increased to a maximum of 10 percent available for a maximum period of 20 years, provided that the aggregate deduction over that period may not exceed 100 percent of the qualifying paid-in capital.

*Relief for foreign source income*

Foreign taxes may be deducted in computing taxable income.

one corporation owns 25 percent or more of the shares of another applies equally to holdings in foreign corporations.

In addition, a credit is granted for foreign taxes paid with respect to any type of foreign income.

## 2. LOCAL INCOME TAX

No local income tax is levied on corporations.

## 3. MISCELLANEOUS INCOME TAXES

No other income taxes are imposed on corporations.



available only for foreign taxes imposed by national governments. With respect to foreign-source income, the credit is available for: income and capital gains from immovable property, interest, royalties, income from international sea- and air transport, business and professional income derived through a permanent establishment abroad, including capital gains, income of performing artists and professional sportsmen from performances abroad, and income from employment and pensions received for duties performed abroad. Foreign tax on dividends also qualifies, provided that the Finnish shareholder owns at least 25 percent of the foreign company's share capital directly, or at least 40 percent together with other shareholders who are residents in Finland. Foreign income not qualifying for credit relief continues to be taxable in full, without even a deduction for foreign taxes paid.

## 2. LOCAL INCOME TAX

Finnish: Kunnallisvero
Swedish: Kommunalskatt

### Taxable base

Annual world-wide income, after deduction of business expenses.

Major factors which influence taxable income for the local income tax are the same as for the national income tax.

### Rate

The local income tax is imposed at a flat rate, varying between 13 percent and 18.5 percent, depending on the municipality. In Helsinki the rate is 15 percent.

*Relief for foreign-source income*

All income from foreign sources is included in taxable income with the exception of income derived from foreign immovable property and from business and liberal professions carried on abroad.
Dividends, patent royalties and interest wholly attributable to foreign business operations are exempt from local income tax and church tax.

## 3. MISCELLANEOUS INCOME TAXES

Church tax

Finnish: Kyrkollisvero
Swedish: Kyrkoskatt

### Taxable base

Annual world-wide income, after deduction of business expenses.

Major factors which influence taxable income for the church tax are the same as for the income tax.

### Rate

Between 1 percent and 2 percent.

NORWAY

With respect to income from employments and liberal professions, and income from international sea- and air transport, a credit is granted for any foreign income tax paid against the Norwegian national and local income tax. As in the case of the partial exemption mentioned above, this unilateral credit only applies in the absence of treaty provisions.

## 2. LOCAL INCOME TAX

Norwegian: Inntektsskatt til kommunen

**Taxable base**

Annual world-wide income after deduction of business expenses. Major factors which influence taxable income for the local income tax are the same as for the national income tax, except that domestic-source dividends received are exempt from local income tax, and that no deduction is granted for dividends distributed (see above). Local income taxes are imposed by county and municipal districts.

**Rate**

The rate imposed by the county districts may vary between 6 percent and 8 percent, and the rate imposed by municipal districts between 12 percent and 14 percent. In virtually all municipalities tax is imposed at the aggregate maximum rate of 22 percent.

## 3. MISCELLANEOUS INCOME TAXES

Common tax for the tax equalization fund

Norwegian: Fellesskatt til skattefordelingsfondet

**Taxable base**

Annual world-wide income after deduction of business expenses. Major factors which influence taxable income for this income tax are the same as for the local income tax.

**Rate**

The rate is 1 percent.

SWEDEN

In addition, foreign income taxes on foreign income may be credited against the National Income Tax. The amount of foreign tax which may be credited may not exceed the National Income Tax which would be payable on the same income before deduction of foreign tax. The amount of the credit is subsequently reduced by the amount of national and local income tax saved through the deductibility of the foreign tax. Dividends, interest and royalties from abroad are included in taxable income after deduction of foreign taxes.

## 2. LOCAL INCOME TAX

Swedish: Kommunal inkomstskatt

**Taxable base**

Annual world-wide income, after deduction of business expenses.

Major factors which influence taxable income for the local income tax are basically the same as for the national income tax. The national and local income taxes may not be deducted in computing income subject to the local tax, however.

**Rate**

A flat rate, usually about 25 percent, depending on the municipality.

*Relief for foreign source income*

There are no unilateral provisions for the avoidance of double taxation. Foreign taxes, however, may be deducted in computing taxable income. Dividends, interest and royalties from abroad are included in taxable income after deduction of foreign taxes.

## 3. MISCELLANEOUS INCOME TAXES

Undistributed profits tax

Swedish: Ersättningskatt

This tax is levied only upon those Swedish holding companies which fail to make adequate distributions of profits giving tax advantages to individuals ultimately entitled to the profits.

**Taxable base**

The amount of profits deemed to be unreasonably withheld.

**Rate**

The rate is 25 percent.

## DENMARK

### 4. NET WORTH TAX

No net worth tax is imposed on corporations.

## B. NON-RESIDENT CORPORATIONS

Non-resident corporations are subject to the corporation in-income tax, insofar as they carry on a business through, or derive income from, a permanent establishment in Denmark or receive income from immovable property in Denmark. The rate of the corporation income tax for non-resident corporations is 37 percent, the same rate as for resident corporations. Non-resident corporations are not subject either to a net worth tax or business tax. Dividends paid by resident corporations are subject to a dividends withholding tax (udbytteskat) of 30 percent, unless reduced by treaty provisions. For non-resident corporations and individuals this withholding tax is the final and only tax on the dividends received.

## FINLAND

**Relief for foreign-source income**

All income from foreign sources is included in taxable income with the exception of income derived from foreign immovable property and from business and liberal professions carried on abroad. Dividends, patent royalties and interest wholly attributable to foreign business operations are exempt from local income tax and church tax.

### 4. NET WORTH TAX

National net worth tax

Finnish: Varallisuusvero
Swedish: Statlig förmögenhetsskatt

Resident corporations whose shareholders are subject to net worth tax with respect to their shares in the corporation are not subject to the national net worth tax. Other legal entities will normally be subject to net worth tax.

The rate of the net worth tax for the year 1979: 1 percent. A reduction is granted if taxable net worth is less than 50,000 FMk.

## B. NON-RESIDENT CORPORATIONS

Non-resident corporations are, in principle, subject to the national income tax and local income tax — and in some cases church tax — with respect to all income from Finnish sources, with the exception of interest from bonds, bank accounts, foreign trade credits and from loans which are not an investment equivalent to the borrower's own capital.

However, as of the year 1973, many types of income derived from Finnish sources are subject to a single withholding tax, which is a final tax, and which replaces the national and local income tax as well as the net worth tax, infra. According to these new provisions, dividends are subject to a withholding tax of 25 percent, and royalties and interest (except certain exempt categories of interest, listed above) are subject to a withholding tax of 30 percent both computed on the gross amount received. Other types of income continue to be subject to national and local tax for their net amount after allowable deductions and at the normal rates which also apply to resident companies, i.e. 43 percent and between 13 percent and 18.5 percent, respectively. With respect to income not attributable to a certain municipality the local income tax is imposed by the national government at the (Helsinki) rate of 15 percent.

Non-resident corporations remain subject to the national net worth tax at a rate of currently 1 percent of taxable net worth, excluding, however, assets such as shares, bonds and patents, the income whereof is subject to the withholding tax of 25 percent or 30 percent or wholly exempt.

No net worth tax is due by companies resident in countries which have concluded a tax treaty with Finland containing a relevant non-discrimination clause, except for 1976, when the net worth tax is temporarily re-introduced for resident companies.

## NORWAY

#### Petroleum income tax

The Act of June 13, 1975 relating to the taxation of Submarine Petroleum Resources contains, inter alia, provisions for the imposition of a special tax of currently 25 percent for taxpayers engaged in production and pipeline transportation on the Continental Shelf. This tax is in addition to the income taxes imposed with respect to all activities in the area.

### 4. NET WORTH TAX

National net worth tax

Norwegian: Formuesskatt til staten

#### Taxable base

Net worth of corporate taxpayers.

#### Rate

The rate is 0.7 percent (0.4 percent for shipping companies).

## B. NON-RESIDENT CORPORATIONS

Non-resident corporations are liable to the same income taxes as resident corporations, if and insofar as they carry on business in Norway, participate in such a business, or derive income from tangible movable or immovable property located in Norway, subject to treaty provisions. Dividends from Norwegian corporations are subject to a coupon tax (kupongskatt) which is levied at a rate of 25 percent, unless a treaty provides otherwise.

Non-resident corporations are also subject to the national and local net worth taxes, if and insofar as they carry on a business in Norway, participate in a Norwegian business or own immovable or tangible movable property located in Norway. The national net worth tax is imposed at 0.7 percent. The local net worth tax is imposed at a flat rate, between 0.4 percent and 1 percent, depending on the municipality. In virtually all municipalities the tax is imposed at the maximum rate of 1 percent. This local net worth tax does not apply to corporations resident in countries which have concluded a treaty with Norway containing a relevant non-discrimination clause.

## SWEDEN

### 4. NET WORTH TAX

No net worth tax is imposed on resident corporations.

## B. NON-RESIDENT CORPORATIONS

Non-resident corporations are subject to the national income tax and the local income tax at the same rates as resident corporations, but only with respect to income attributable to a Swedish permanent establishment, income from immovable property located in Sweden, income from activities executed on a continued and repeated basis (even in the absence of a permanent establishment), income from royalties from Swedish sources and capital gains from the sale of real property or business assets located in Sweden. Dividends and interest paid to a non-resident company are not subject to income tax, unless they are attributable to a business carried on in Sweden through a permanent establishment or on a continued or repeated basis. However, dividends paid to non-residents are subject to a dividend withholding tax ("kupongskatt") of 30 percent, unless a treaty provides otherwise.

Non-resident corporations are, in addition, liable to the national net worth tax (Swedish: statlig förmögenhetsskatt).

#### Taxable base

The value of net worth (whether movable or immovable) invested in Sweden at the end of the year.

#### Rate

| | |
|---|---|
| on net worth up to 200,000 SKr. | nil |
| on the amount between 200,000 SKr. and 275,000 SKr. | 1 percent |
| on the amount between 275,000 SKr. and 400,000 SKr. | 1.5 percent |
| on the amount between 400,000 SKr. and 1,000,000 SKr. | 2 percent |
| on the amount exceeding 1,000,000 SKr. | 2.5 percent |

Non-resident corporations which derive Swedish income not attributable to a certain municipality are subject to local income tax at a special rate of 10 percent.

| DENMARK | FINLAND |
|---|---|

# DENMARK

## II. INDIRECT TAXES

### 1. VALUE-ADDED TAX

Danish: Almindelig omsætningsafgift (general turnover tax)

**Taxable persons**

Entrepreneurs selling goods and services in Denmark; importers.

**Taxable base**

Actual sales price (excluding the tax itself) of goods and certain services, payable by all entrepreneurs. They may deduct the tax paid on their own purchases.

**Rate**

18 percent.

### 2. EXCISE DUTIES

Danish: accise

The following products are subject to excise duties: tobacco, alcoholic beverages, sweets, cosmetics, textiles, matches, gasoline, gramophone records, radio and television sets.

### 3. OTHER INDIRECT TAXES

Other indirect taxes are levied, such as stamp duties, registration duties, motor vehicle tax, etc.

# FINLAND

## II. INDIRECT TAXES

### 1. TURNOVER TAX

Finnish: Liikevaihtovero
Swedish: Omsättningsskatt

**Taxable persons**

Entrepreneurs selling taxable goods and services in Finland; importers.

**Taxable base**

Domestic sale or lease of movable goods and rendering of certain related services (cleaning, repair, maintenance) by entrepreneurs and the value of imported goods. The tax is also levied on products which an entrepreneur uses for his own consumption. In computing their taxable turnover, entrepreneurs may deduct the purchase price of goods purchased or imported for the purpose of resale, so that in essence only the value added is taxed.

**Rate**

14 percent (on the consideration received including the tax itself, making the effective rate 16.28 percent).

16.28 percent on the value at importation (not including the tax itself).

### 2. EXCISE DUTIES

Finnish: Valmistevero
Swedish: Accis

The following products are subject to excise duties: tobacco, beer, sweets, mineral waters, tires, matches and liquid fuels.

### 3. OTHER INDIRECT TAXES

Other indirect taxes are levied, such as registration duties, stamp duties, motor vehicle tax, tax on certain insurance premiums, etc.

## NORWAY

## II. INDIRECT TAXES

### 1. VALUE ADDED TAX

Norwegian: Merverdafgift

**Taxable persons**

Registered entrepreneurs selling taxable goods and services in Norway; importers.

**Taxable base**

The taxable base is the consideration received for sales of taxable goods and services, and value at importation including import duties. In computing an entrepreneur's final turnover tax liability, the tax paid on his purchases and imports may be deducted, so that, in effect, only the value-added is taxed.

**Rate**

The rate is 20 percent of the consideration excluding the tax itself.

### 2. EXCISE DUTIES

Norwegian: Særavgifter

Many excise duties or luxury taxes are levied on domestic sales of certain consumer goods. Those on alcohol, tobacco, chocolate, sugar, confectionery and petrol (gasoline) are the most important.

### 3. INVESTMENT TAX

Norwegian: Avgift på investeringer m.v.

**Taxable base**

The taxable base is the value of fixed business assets purchased by entrepreneurs for lasting use in their business, the turnover tax on which is deductible. This tax, in fact, replaces the former single-stage turnover tax on such business assets.

**Rate**

The rate is 13 percent on the cost of acquisition excluding the turnover tax and the investment tax themselves. As of January 1, 1978, a reduced rate of 9 percent applies to qualifying investments in buildings, installations and other depreciable business assets by manufacturing and mining enterprises. As of September 1, 1978, the special rate is further reduced to 5 percent, and as of July 1, 1979 to nil.

## SWEDEN

## II. INDIRECT TAXES

### 1. VALUE-ADDED TAX

Swedish: Mervärdeskatt

**Taxable persons**

Entrepreneurs selling goods or services within Sweden: importers.

**Taxable base**

Consideration received for sales of goods and certain services rendered in relation to goods. At importation the value for purposes of customs duty, including the customs duty itself. In computing 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.

**Rate**

17.1 percent of the price including tax (effective rate: 20.63 percent). For certain goods and services, the above rate is applied to 60 percent or 20 percent of the price paid which implies effective rates of 10.26 and 3.42 percent of the price including tax (effective rates: 11.43 and 3.54 percent). There are two types of exemptions: full exemptions with a refund of the tax paid on purchases, and limited exemptions without such refund.

### 2. EXCISE DUTIES

Swedish: Accis

Confectionery and certain chemical products are subject to the special excise tax ("Särskild varuskatt").

### 3. OTHER INDIRECT TAXES

Other indirect taxes are levied such as taxes on tobacco, wine and spirits, registration duties, stamp and annual vehicle tax.

| DENMARK | FINLAND |
|---|---|
| **4. IMPORT DUTIES**<br><br>Danish: toldafgift<br><br>Import duties are levied on importation of products.<br><br>Note that Denmark is a member of the EC, so that the common EC tariff is applicable. | **4. IMPORT DUTIES**<br><br>Finnish: Tultikkuvero<br>Swedish: Tull<br><br>Import duties are levied on importation of products. |

# TRANSFER PRICING AND MULTINATIONAL ENTERPRISES

# A NEW OECD REPORT*

A large share of world trade is represented by transfers of goods, technology and services between various entities within multinational enterprises (MNEs) — its branches, affiliates, subsidiaries — situated in different countries. The question of prices applied to these transactions, in other words, "the transfer prices", has attracted general attention as a central feature of the operations of MNEs. The setting of acceptable price levels for tax determination purposes when such transactions take place is the subject of a report just published by the OECD, "Transfer Pricing and Multinational Enterprises", and of an OECD Council Recommendation to governments.

The basic premise of this work, accepted both by national tax administrations and MNEs, is that as far as possible these price levels should, for tax determination purposes, approximate to prices which woudl have been charged by unrelated enterprises in similar circumstances, the so-called "arm's length price".

The report notes that MNEs are in a position to apply artificial transfer prices in order to minimise tax, for example, by selling goods to a subsidiary in a tax haven country at less than a normal market price. Substantial amounts of revenue have been recouped by the tax authorities over recent years through the adjustment of such artificial prices. On the other hand, the report recognises that there are factors (e.g. the desire of subsidiaries to maximise their profits) militating against artificial transfer pricing and that it is not always easy for MNEs to calculate appropriate transfer prices especially if — as may happen — they are faced with conflicting requirements by different government administrations. Moreover, if national tax authorities differ in their approach towards transfer pricing, there is a danger that an MNE as a whole may be doubly taxed.

This report, which also takes into account the results of discussions with representatives of the largest MNEs, represents a first attempt to provide guidance on the methods and practices generally agreed by tax administrations for arriving at acceptable approximations of arm's length prices for intra-group transactions. It is thus hoped that it will not only help tax officials to approach more effectively the problems presented by the transfer prices of MNEs, but also the enterprises themselves by indicating ways in which mutually satisfactory solutions may be found to those tax problems.

It is on the basis of this report that the Council has adopted a Recommendation inviting the tax administrations of Member countries to take account of the methods of assessment proposed in this report in their audits of company accounts. The text of this Recommendation is annexed to this release (see next page).

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* "Transfer Pricing and Multinational Enterprises", 100 pages, OECD, Paris, 1979, (£4.40; $9.00; 36 Fr.Frs.) ISBN 92-64-11947-7. Available from OECD Sales Agents.

| NORWAY | SWEDEN |
|---|---|
| **4. OTHER INDIRECT TAXES**<br><br>Other indirect taxes, such as stamp duties and registration duties are levied. A luxury tax is levied on the sale of gold and silver goods, cosmetics and some other non-essential goods.<br><br>**5. IMPORT DUTIES**<br><br>Norwegian: Innførselstoll<br><br>Import duties are levied on importation of products. | **4. IMPORT DUTIES**<br><br>Swedish: Importtull<br><br>Import duties are levied on importation of products. |

# Recommendation of the Council

on the determination of transfer prices between associated enterprises
*(Adopted by the Council on 16th May, 1979)*

The Council,

Having regard to Article 5(b) of the Convention on the Organisation for Economic Co-operation and Development of 14th December, 1960;

Having regard to the Declaration of 21st June, 1976 adopted by the Governments of OECD Member countries on International Investment and Multinational Enterprises and the Guidelines annexed thereto;

Having regard to the Report of the Committee on Fiscal Affairs of 12th March 1979 on the determination of transfer prices between associated enterprises;

Considering that transactions between associated enterprises (i.e. between parent and subsidiary enterprises or enterprises under common control) may take place under conditions differing from those taking place between independent enterprises;

Considering that the prices charges in such transactions between associated enterprises (usually referred to as transfer prices) should, nevertheless, for tax purposes be in conformity with those which would be charged between independent enterprises (usually referred to as arm's length prices) as provided in Article 9(1) of the OECD Model Double Taxation Convention on Income and on Capital;

Considering that problems with regard to transfer prices in international transactions arise mostly between the various entities of multinational enterprises and assume special importance in view of the substantial volume of such transactions;

Having regard to the considerations in the Report referred to above regarding the methods to be followed for the correct determination of transfer prices for goods, technology, trademarks and services and of interest rates on loans between associated enterprises;

Having regard to the need to achieve consistency in the approaches of tax authorities, on the one hand, and of associated enterprises, on the other hand, in the determination of transfer prices for the purposes of ensuring correct taxation of profits and avoidance of double taxation.

I. RECOMMENDS to the Governments of Member countries:

1. that their tax administrations take into account, when reviewing, and if necessary, adjusting transfer prices between associated enterprises for the purposes of determining taxable profits, the considerations and methods set out in the Report referred to above for arriving at arm's length prices when goods, technology, trademarks and services are provided or supplied or loans granted between associated enterprises;

2. that they give the Report referred to above publicity in their country and have it translated, where appropriate, into their national language(s);

3. that they develop further co-operation between their tax administrations, on a bilateral or multilateral basis, in matters pertaining to transfer pricing.

II. INSTRUCTS the Committee on Fiscal Affairs:

1. to pursue its work on issues pertinent to transfer pricing and to the assessment of taxable profits of associated enterprises in general;

2. to report periodically to the Council on the results of its work in these matters together with any relevant proposals for improved international co-operation.

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Vol. 32, No. 4, 1976. P. 138-142.

Survey of the proposed imputation system for the taxation of distributed corporate profits.

*Revision og Regnskabsvaesen*
MIDDELBOE, B.

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Vol. 46, No. 2, February 1977. P. 72-84.

Survey of the implications of the new provisions concerning the reduction of economic double taxation of distributed corporate profits.

*Revision og Regnskabsvaesen*
WOGENSEN, S.O.

Aendringer i fusionsloven.
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Survey of the recent changes in the taxation provisions regarding corporate mergers.

*Skattepolitisk Oversigt*

Skattegodtgørelse til aktionaerer.
Vol. 33, No. 1, 1977. P. 7-11.

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*European Taxation*

Treaty negotiations.
Vol. 18, No. 7, July 1978. P. 255-256.

The Danish Inland Revenue Department has released information on the status of negotiations regarding the conclusion of double taxation treaties. Details are presented here.

# C. FINLAND

## BOOKS

**VEROSOPIMUKSET SKATTEAVTALEN 1974.**

Redigerade av Hillel Skurnik.
Helsinki, Suomen Lakimiesliitto 1974. 460 pp.

Double taxation treaties 1974, edited by Hillel Skurnik. This work contains the authentic texts of double taxation treaties concluded by Finland with other countries with respect to income tax, death duties and mutual assistance as published in the Finnish Official Gazette up to date and including no. 42/1974. The text of the O.E.C.D. Draft Convention of 1963 in the official texts (English and French) and in the unofficial Swedish and Finnish translations is also appended.

**SKATTEFÖRFATTNINGARNA 1978.**

6th Edition. Edited by Hillel Skurnik.
Helsinki, Finlands Juristförbund, 1978. 460 pp.

Compendium of Finnish tax laws in the Swedish language. Case law has been included and the laws are printed as of No. 314/78 of the Official Gazette of Finland.

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*Bank of Finland*
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Vol. 52, No. 7, July 1978. P. 20-29.

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inkomst och förmögenhet. Given i Nådendal den 11 augusti 1978.
No. 627, 1978. P. 1460-1464.

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## D. NORWAY

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ARNTZEN, Sven, Jr.; SWARTZ, Dena.
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Oslo, Sven Arntzen Jr. and Dena Swartz, 1976. 72 pp.

English translation of the text of the Joint-Stock Companies Law in Norway.

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Oslo, Sem & Stennerson a/s, 1972.
5th Edition. 408 pp.

New revised and updated edition of volume III of a series of books containing the text and annotated comment respecting various special laws concerning depreciation, regional development, the creation of tax-free reserves, special provisions for taxation of companies and shareholders, and capital gains tax, as well as a survey of tax treaties concluded by Norway with Denmark and Sweden.

SAASTAD, O.
**NØKKELEN TIL SELVANGIVELSEN FOR 1976.**

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**THE NORWEGIAN ACCOUNTING ACT 1977.**

Oslo, Sven Arntzen, Dena Arntzen, 1977. 14 pp.

English translation of the Act of 13 May 1977, No. 35 pertaining to the obligation to keep accounts, etc. (The Accounting Act).

**LOVGIVNING VEDRØRENDE DEN NORSKE KONTINENTALSOKKEL/LEGISLATION CONCERNING THE NORWEGIAN CONTINENTAL SHELF.**

5th Edition.
Oslo, Royal Ministry of Industry and Handicraft, 1977. 270 pp.

Unofficial English translation of the Norwegian text of basic law and Royal Decrees relating to the Norwegian Continental Shelf, including taxation.

ARNTZEN, Adreas; BUGGE, Jens; UNDERLAND, Ulf.
**COMPANY, TRADE AND TAX LAW IN NORWAY.**

Oslo, Den Norske Creditbank, 1978. 502 pp.

Guide to provide information concerning Norwegian laws with respect to the establishment of new business, types of company, registration of firms, taxation, concession rules, foreign exchange regulations and other business legislation. The material is updated as of December 31, 1977. It is probably the most detailed guide to Norwegian company, trade and tax regulations published in the English language.

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**NØKKELEN TIL SELVANGIVELSEN FOR 1978.**

Oslo, Norsk Skattebetalerforening, 1978/79. 117 pp.

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Norwegian National Report 32nd IFA Congress Sydney, 1978.
Oslo, The Norwegian Branch of the International Fiscal Association (IFA), 1977. 27 pp.

**INVESTMENT AND TAXATION: NORWAY**

London, Touche Ross International, 1978. 30 pp.

Short study of the major provisions relating to investment incentives, exchange controls, work and residence permits, business entities and taxation.

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*Die Aktiengesellschaft*
STEINIGER, Wolfgang.

Das norwegische Aktienrecht.
Vol. 23, No. 7, July 1978. P. 189-196.

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(Official translation of this Norwegian Act.)

*European Taxation*

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Vol. 9, No. 3, 1969. P. 61-62.

*European Taxation*

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Vol. 10, No. 4, April 1970. P. I/101, 5 pp.

GULNES, N.

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In: Monthly Survey, Oslo, Der Norske Credietbank, Supplement, May 1973. P. 1-4.

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Report from the Finance Committee on the Taxation of Submarine Petroleum Resources, etc. Unofficial translation of Report O. No. 60 (1974-75). Oslo, Det. Kongelige Finans- og Tolldepartement, 1975. 49 pp.

*European Taxation*

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Vol. 9, No. 8, 1969. P. 170-176.

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Oslo, Royal Norwegian Ministry of Finance, February 1970. 30 pp.

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*Finanz-Rundschau*

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**SKATTER OCH KAPITALFLYKT.**

Stockholm, Jurist — och samhällsvertare — förbundets Förlags AB, 1972. 470 pp.
(Rätts — och samhällsvetenskapliga biblioteket, 4.)

Thesis entitled "Taxes and Exodus of Capital" aims to explore the influence of taxation on the international mobility of portfolio investment and its owners to and from Sweden. Summary in English is appended.

**FASTIGHETSTAXERING.**

Stockholm, Ministry of Finance, 1973. 499 pp.

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**RESERVES FOR FUTURE INVESTMENT: A SWEDISH TAX INCENTIVE.**

Amsterdam, International Bureau of Fiscal Documentation, 1974, 114 pp.

Selected Monographs on Taxation, Volume 1 (Joint venture with the Harvard Law School International Tax Program).

BARR, N.A.; S.R. James; A.R. Prest.
**SELF-ASSESSMENT FOR INCOME TAX.**

London, Heinemann Educational Books, 1977. 218 pp. £ 7.50.

Study analyzing the income tax systems in the United Kingdom, the U.S.A., Canada and Sweden followed by arguments for and against self-assessment. The authors conclude in favour of a phased introduction of a system of self-assessment into the United Kingdom.

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**DEKLARATION OCH BESKATTNING.**

Skatterna på inkomst och förmögenhet, arv, gåva m.m. Mervärdeskatten Arbetsgivaravgifterna.
Stockholm, Norstedt & Söners förlag, 1977. 387 pp.

Revised and extended 23rd edition of a textbook explaining the income and capital taxes, death and gift taxes, value added tax and employer's contributions as of November 15, 1977.

BRACEWELL-MILNES, B.; J.C.L. Huiskamp.
**INVESTMENT INCENTIVES.**
**A COMPARATIVE ANALYSIS OF THE SYSTEMS IN THE E.E.C., THE U.S.A. AND SWEDEN.**

Deventer, Kluwer, 1977. 143 pp.

Study of the rational philosophy behind investment incentives granted, and a comparative description of such measures prevailing in Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Sweden, United Kingdom and the United States of America.

GEIJER, E.; E. Rosenqvist; H. Sterner.
**SKATTEHANDBOK. DEL I.**

Stockholm, Norstedts, 1977. 1250 pp.

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A report of the 1972 Government Commission on Taxation.
Stockholm, Liber Förlag, 1978. 278 pp.

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**SKATTE- OCH TAXERINGS FÖRFATTNINGARNA. SÅDANA DE LYDER DEN 1 JANUARI 1979.**

Stockholm, Liber Förlag, 1979. 608 pp.

Annual tax manual containing Swedish text of Swedish tax laws as of January 1, 1979.

**THE SWEDISH BUDGET 1979/80.**

A summary published by the Ministry of Economic Affairs and the Ministry of the Budget.
Stockholm, 1979. 147 pp.

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*European Taxation*
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En Suède les fonds de reserve pour investissements.
2ème Année, 1971-1. P. 15, 6 pp.

Discussion of the business cycle equalization reserve existing in Sweden and some other Scandinavian countries.

*Svensk Skattetidning*
ENGBLOM, R.

Tillfälliga åtgärder på beskattningsområdet för att främja investeringarna inom näringslivet.
Vol. 39, No. 9, 1972. P. 459, 6 pp.

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Volume XXVII, No. 6, June 1973. P. 241-245.

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Vol. 23, No. 8, August 1973. P. 419-425.

Survey of the new provisions concerning tax incentives for research and export promotion.

*Skattenytt*
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Vol. 23, No. 8, August 1973. P. 381-413.

Article on the tax consequences of employer contributions to pension funds and personal funds.

*European Taxation*
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Vol. 14, No. 4, April 1974. P. 131-135.

*Svensk Skattetidning*
MATTSSON, N.

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Vol. 42, No. 7, 1975. P. 373-396.

Article on the concept of residence in the Local Tax Act.

*Wirtschaftsdienst*
STRÖMBERG, D.

Investitionsrücklagen nach schwedischem Muster ?
Vol. 55, No. 12, December 1975. P. 602-608.

The reserve for future investment in Sweden discussed as possible tax instrument in the Federal Republic of Germany.

*Intertax*
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Taxation of international firms — a Swedish view.
No. 1, 1976. P. 15-20.

*Internationale Wirtschafts-Briefe*
HAUSER, W.

Das Steuerrecht Schwedens. Übersicht über die Steuern und öffentlichen Abgaben.
1. Teil, No. 4, February 1976. P. 105-116.
2. Teil, No. 5, March 1976. P. 151-158.

Survey of the income tax system in Sweden in a series of essays on taxes and levies in Sweden.

*Svensk Skattetidning*
FERNSTRÖM, O.

Realisationsvinstbeskattningen vid försäljning av aktier och annan lös egendom.
Vol. 43, No. 8, 1976. P. 567-573.

Survey of the main provisions regarding the taxation of capital gains with respect to shares and other types of movable assets.

*Svensk Skattetydning*
SUNDVIK, Ove R.R.

Fortsatta investeringsstimulanser.
Vol. 44, No. 8, 1977. P. 448-451.

Survey of the various changes, including extensions, in a number of investment incentives as per January 1, 1978.

*European Taxation*
GROSSKOPF, Göran.

Proposed new legislation against tax avoidance in Sweden.
Vol. 18, No. 10, October 1978. P. 357-359.

*Skattenytt*
NORDEN, Jan-Hendrik.

Utländska bolags etablering och beskattning i Sverige.

Vol. 28, No. 10, October 1978. P. 419-437.

Article on the taxation implications of establishing a subsidiary company, a branch or similar business organization in Sweden.

*Internationale Wirtschafts-Briefe*
HÖLZL, M.

Die Verbrauchsteuern in Schweden.
No. 15, August 1976. P. 489-495.

Overview of the various consumer taxes levied in Sweden (excise taxes, value added tax, turnover tax on motor vehicles etc.).

*Intertax*

Value added tax and foreign entrepreneurs.
No. 9, September 1978. P. 334-337.

# OECD STUDY*: The Taxation of Wealth

All OECD countries tax wealth or capital gains in one way or another. Today many of their governments are reviewing how existing provisions fit in with their overall tax policies and their economic and social policy aims. It is in this context that the OECD Fiscal Committee has just published a study entitled "The Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals", covering capital taxes in force in 21 OECD countries — that is, all except Iceland, Greece and Turkey. **

The report, which generally refers to the position in January 1976, though recording changes between January 1976 and June 1978, covers the following taxes:

(i) annual net wealth taxes. This refers to taxes on the value of assets minus debts related to such assets;

(ii) capital transfer taxes. These refer to taxes imposed on transfers of assets during lifetime or at death;

(iii) capital gains taxes, which refer to taxes imposed on gains from the sale of assets. Though not strictly speaking taxes on capital, they are included in the report because the objectives of taxing capital gains are often similar to those of taxing net wealth and capital transfers and so are the administrative problems encountered.

For each of these three taxes, the report concentrates on the taxation of individuals and not of companies.

As well as summarising the policy issues, including the arguments for and against adopting these taxes and particular forms of them, the report gives a comprehensive description of the taxes in force in OECD Member countries, including the practical problems of their administration.

A more detailed summary of the report is contained in the OECD Observer, issue No. 96.

* "The Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals". 195 pages, OECD, Paris, 1979. £10.80, $22.00, F 88. ISBN 92-64-11896-9.

** An attached table shows the forms of capital taxation — net wealth, capital transfer and capital gains — imposed in OECD Member countries.

**FORMS OF CAPITAL TAXATION IN OECD MEMBER COUNTRIES, 1976**

| Country | Net Wealth Tax 1 | Transfer Tax 2 | Capital gains Taxation 3 |
|---|---|---|---|
| Australia | — | E | — |
| Austria | W* | H | B |
| Belgium | — | H | B |
| Canada | — | — | I |
| Denmark | W | H | C |
| Finland | W | H | B |
| France | — | H | I 4 |
| Germany | W* | H | B |
| Ireland | W*5 | H | C |
| Italy | — | E and H | B |
| Japan | — | H | I |
| Luxembourg | W* | H | B |
| Netherlands | W* | H | B |
| New Zealand | — | E | — |
| Norway | W | H | I |
| Portugal | — | H | C |
| Spain | — | H | I |
| Sweden | W | H | I |
| Switzerland 6 | W | H and E | C and I and B |
| United Kingdom | — | E | C |
| United States of America | — | E | I |

W means personal net wealth tax.
E means estate-type transfer tax.
H means inheritance-type transfer tax.
C means separate capital gains tax.
I means comprehensive taxation of capital gains to income tax.
B means the taxation of capital gains of businesses (whether incorporated or not but no comprehensive taxation of the capital gains of individuals.
* Single-rate net wealth tax.
1 Personal net wealth tax only.
2 Excludes net taxes on financial and capital transactions.
3 Excludes the taxation of the capital gains of individuals where such taxation is narrowly based or confined to short term gains.
4 Introduced during 1976, but postponed until 1979 for movable property.
5 Abolished as from 6 April 1978.
6 All taxes at the Cantonal level with considerable variation amongst the Cantons.

# GENERAL PROBLEMS OF INTER-COMPANY TRANSACTIONS ACROSS THE BORDER

## with a discussion of Austrian practice

by Dr. Franz Helbich*

### I. INTRODUCTION

Since World War II the total volume of world trade has expanded tremendously [1] and in 1978 it reached a record high of US$ 1,300,000,000. During the period from 1950 to 1975 this growth amounted to about a 65 percent increase in volume among the industrialized countries of the free world and, during this same 25 year period, trade in the communist countries rose by about 10 percent and in the developing countries it expanded by approximately 25 percent.

It was world trade that inspired the creation and development of multinational companies (hereinafter referred to as MNCs). It was world trade that necessitated the creation of a new form of doing business to facilitate international interaction. This expansion of international trade during recent decades has been primarily due to a steady increase in investment abroad in general and by the MNCs. The MNCs account for about three-quarters of the industrial production in the non-communist world. [2] They have become, as they have matured, the leading advocates of world-wide economic integration.

Many political and socio-political developments also occurred during this same period. Individual states, in answer to their own immediate needs, promulgated systems of taxation on a national basis without regard to the effect they might have on transactions outside their borders. These tax laws often led to an increase in the tax burden suffered by an individual company seeking to engage in business internationally. Thus the growth of international or intercompany contacts has given rise to unforeseen problems in many areas, problems that must be solved if there is to be a continuing pattern of growth.

### II. PROBLEMS OF ASSOCIATED COMPANIES AND AREAS THAT REQUIRE INTERNATIONAL COOPERATION

Because of the high rate of industrialization in a great number of countries of the world many structural, social and economic imbalances and disadvantages have occurred as a result of the expansion of world trade and the accompanying technological progress both of which have been decisively influenced by associated companies. In answer to these problems both the individual nations and the MNCs are attempting to remedy this situation and improve any structural disruption by means of economic policies that are oriented more to the "quality of life" — whatever may be understood by this term — that may result from any changes rather than the push for increased industrialization that may have been of vital importance in the past. In this paper I can only provide a list of problems which cannot claim to be either complete or provide an adequate definition of the problems faced when attempted to correct imbalances caused by industrialization.

Because the MNCs are integrated into the various national economies — just as all other enterprises — they are subject to the laws, regulations and general practices of these countries. Intercompany transactions across borders tend to emphasize the numerous differences between countries, differences that involve both *risks* as well as *opportunities.* These differences include, for example, the labor cost per unit of production, the type and extent of co-determination, the socio-political and political structures in individual countries, the type of democratic method used and an understanding of these methods, the general economic atmosphere of a country, etc. These differences are at the same time both the *motivations* for transactions across the border and, in turn, the *results* of these activities. The central problem in this interaction is the discrepancy between those countries that have formulated a national solution to a particular problem and those that have not yet formulated such a solution. Therefore some type of international agreement is needed to assist the communications between those countries that have not yet formulated a solution to a particular problem and those that have formulated a solution, but one which may not be a viable answer to the situation faced by the trading companies.

The following areas are ones in which international agreement is either non-existent or is being achieved only at a snail's pace:

— *Corporation law:* up to now only a very inadequate structure exists for mergers, takeovers and spin-offs across borders. Specific measures, for example, a European type of corporation, are still in the distant future.

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* This paper was submitted at the working Conference of Management Centre Europe held on April 18, 1979 in Vienna. Dr. Franz Helbich, A-1190 Wien, Iglaseegasse 60, Tel. 32 41 87 — 32 23 73.

1. 6.4 percent per annum between 1950/60, 9.2 percent per year between 1960/70, 22.9 percent between 1970/75, and by 13 percent each in 1976/77.
2. Deutsche Bank AG, Economic Bulletin, October 1969, p. 8.

- *Commercial law:* here there is distinct progress and important steps have been made in the area of legislation on cheques, bills, patents and royalties.
- *Foreign exchange control law* and a framework for the setting and the changing of currency exchange rates are non-existent.
- The *legal standards* for the *control of imports, exports and prices* in which the social and political structures of the various countries find a particularly distinctive expression are non-existent.
- *Anti-trust law, customs* regulations and finally the important field of *tax legislation* — with a view to favorable (lacking) or unfavorable (multiple) burdens — which was the subject of the working conference is moving slowly.

In addition to separate national developments it is to be noted that there is a *development towards harmonization* that can be seen particularly in the regional groupings (for example, the Common Market, COMECON).

I believe that the "quiet harmonization" of small countries, such as Austria, constitutes not the least important of these developments towards world-wide economic integration.

## III. PRINCIPLES, WAYS AND MEANS OF OVERCOMING THE EXISTING DISCREPANCIES

For overcoming these discrepancies in individual countries and bridging the gaps, (partial) *acceptance* of foreign regulations, combined in many instances with the *principle of reciprocity*, might serve as a formula; this holds true, for example, in trade and economic legislation as would the principle of *harmonization* of national regulations with international standards within the scope of the Common Market and COMECON. In addition, we might also apply the principle of judging a transaction or a contract by questioning whether this could have come about among independent third parties; this test is expressed in the *concept of dealing at arm's length.*

In Austria the arm's length concept is applied to domestic relationships, particularly those economic relationships between a corporation and its shareholders; there the concept is used to solve the fiscal problem of hidden distribution of profits and disguised contribution of capital. This constitutes, at the same time, a general and a legal concept that requires the use of many types of legal fiction but it also has a certain validity in the fields of customs tariffs, anti-trust legislation and the determination of prices and currency exchange rates.

In view of the international double taxation that occurs in many instances, the use of *corresponding* (correlative) adjustments is internationally *an extremely desirable goal.* Through the medium of bilateral tax treaties it would seem to be a relatively simple matter to both invoke and enforce; however, the *fact is,* when offered this relief as a mandatory measure, *nations have turned away.* This is clear from looking at the number of countries which made reservations with respect to Article 9(2) of the OECD Model Convention dealing with mandatory adjustments.

The reservations by Article 9(2) of the OECD Model Convention, the questionable efficiency of mutual agreement procedures and the absence of remedies under national laws do not safeguard enterprises against double taxation, and thus put the free flow of capital and economic growth of nations in jeopardy. I believe that there must be alternatives. Among the various methods of binding arbitration, the establishment of an international framework consisting of general guidelines by which the various national tax authorities involved are to judge seems to be a workable solution. I believe that the creation of an international tax court will be highly significant.

## IV. INDICATIONS ON AUSTRIAN PRACTICE, PRESENTED BY MEANS OF THE TAX TREATMENT OF MANAGEMENT FEES

In Austrian domestic law as well as in the double taxation conventions concluded by our country, the arm's length concept is firmly established. An example by which one can view its practical implementation in our country is to look at how the fees paid to foreign parent companies are handled. This situation raises the problem of under what conditions such fees paid are deductible for the domestic enterprise (Art. 4, Para. 4, Income Tax Act).

Within this paper I cannot go in depth into the various elements involved in the calculation of these fees such as license agreements, control costs, cost sharing in purchasing and sales, R & D, management support itself and assistance in personnel matters, industrial design, etc. Rather, I should like to outline the established practice:

1. Payments to foreign headquarters (calculated with or without reasonable profit) are recognized as deductible expenditures for the domestic subsidiary, provided these services are actually rendered to this subsidiary.
2. It is not sufficient to register these costs at the foreign headquarters and to distribute them by a certain key ratio to the subsidiaries; in addition, the books and records of the domestic subsidiary have to show that these services were *actually* rendered to the *domestic* enterprise.
3. Our fiscal authorities require that services rendered by the domestic subsidiary to the foreign headquarters be registered as well and charged against the fees to be paid to headquarters.
4. Generally the proved expenditures of the foreign headquarters are accepted as a basis for estimating the costs accruing to the domestic subsidiary; in addition, the ratios resulting from the comparison of the balance sheet of the domestic subsidiary with the consolidated balance are accepted as a basis for determining the extent of the deductible expenditures accepted here.

These rules are followed in current practice. "Arrangements" (with the tax administration) are valid for three years (the interval for tax audits) and in most cases are changed only upon a detailed presentation of facts and only for the future. Arrangements considered as binding by both sides form the foundation of the practical implementation in this difficult field of reasonable remuneration in transactions between associated enterprises.

## V. MEANS AND TENDENCIES FOR SOLVING THESE PROBLEMS, PARTICULARLY IN THE FIELD OF TAXATION

During the 19th century the various national states succeeded only after an extensive period of development in adjusting their legal systems to the new developments of industrialization associated with the industrial revolution. In many stages new legislation was adopted, for example, in the field of social security, corporate structures and the laws on pollution, e.g. noise, smoke, odors, etc. Thus they regulated and integrated technological and scientific development into their legal systems.

Current developments in technology and in the economy have proceeded far beyond national states, and even regional grouping such as the Common Market, COMECON, LAFTA, etc. However, we are lacking political structures that would form the counterpoise and organizational centers that the national states had during the 19th century. Only gradually are the outlines of such structures becoming discernible within the scope of the U.N. and some regional groupings of states; however, the required factual and legal efficacy is lacking. The solution to the many problems pending and the legal integration of actual developments and disproportions of the various national solutions into a superior, comprehensive and legally enforceable structure is much more difficult than during the 19th century. Limitation on national prerogatives and the acceptance of the necessity of supra national and legally effective organisations is scarce currency everywhere. These are the hard facts that we are facing in our efforts. As an attorney representing matters before the highest Austrian fiscal court, the Supreme Court for Administrative Matters, I believe that progress can be made primarily by institutionalizing existing and new methods and procedures. Theoretical insight and practical experience have demonstrated to me that the establishment of an International Tax Court is necessary. Even though this might seem to be a somewhat utopian goal, all efforts aimed at such a solution — as, for example, this workshop — should be supported. After all, only an intense effort and active consideration will finally result in success. As this workshop is part of this endeavour I should like to wish you a successful meeting in this city of not only tradition but also of forward-looking designs for the future.

# Conference Diary

### SEPTEMBER 1979

*Management Centre Europe:* International Tax Management, Copenhagen (Denmark), September 24-25 (English).

### NOVEMBER 1979

*Tilburgse Fiscalistenvereniging "de Smeetskring":* Municipal Real Property Taxes, Tilburg (Netherlands), November 23 (English).

### FEBRUARY 1980

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

### SEPTEMBER 1980

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

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# General tax problems of transfrontier corporate transactions

by Dr. Jakob Strobl*

## I. INTRODUCTION

*The field I am concerned with in this article is a comparatively new one. When I entered the German Revenue Service some 25 years ago, there were no lectures on this field, no conferences on problems presented by Tax Treaties and no "Handbuch zur Prüfung von Auslandsbeziehungen" (Handbook on the tax audit of foreign transactions) a compilation of practices and rulings in this field by the German tax authorities. At that time, experience in this area was the domain of the big multinational companies in the oil and car manufacturing fields.*

*I have observed both the growing interest and the importance of this field — for middle-sized companies as well — and the growth of IFA in the last two decades.*

*I attempt to highlight certain basic problems in international tax law in the field of intercompany transactions which have preoccupied me for several years. It is my conviction that certain basic problems are too easily ignored by tax officials as well as by tax advisors in the discussion of methods and the ascertainment of reasonable intercompany pricing. The English proverb "One cannot see the wood for the trees" could be applied: In the entanglement of the various methods, such as cost plus method, resale price method, and technical issues, the basic issues are very often overlooked.*

*There will be political overtones in these comments which cannot be avoided because tax law is so closely linked with political opinions and objectives; we are all aware of the growing mistrust of big companies, the multinational or transnational companies as they are called, both in the tax field and elsewhere.*

*In the following pages I will comment on what I consider are the basic issues which should be brought to the attention of those working in this field and which illustrate my position.*

## II. INTERCOMPANY PRICING AS A MEANS OF SHIFTING PROFITS

It is a widespread belief, which is shared not only by tax officials, that intercompany pricing is used widely (!) as a means of shifting profits to countries with lower tax rates or to tax havens.

The attitude of national tax authorities and the EEC authorities is characterized by the fear and suspicion that individuals as well as enterprises take advantage of "letterbox companies" in tax haven countries, so arranging transactions as to benefit from lower tax rates in such countries. From this attitude stems the fact that on December 19, 1977 the Council of the EEC issued its first Directive in the area of direct taxes on the mutual exchange of information between Tax Authorities.[1] Politically the Commission had already indicated its position in the so-called Holding Report of June 18, 1973 (file reference: KOM (73) fin.) and in the Report on Multinational Companies of November 7, 1973 (file reference: KOM (73) 1930). Finally, the Council adopted a resolution which led to and is explained in the Directive referred to above.[2]

The line of thinking and the approach in the field of intercompany pricing can be illustrated by comments on this Directive made by a leading official of the Commission who stated in a lecture given in one of the International Tax Conferences that the Directive represents the first step in the control of international tax evasion, which includes not only "tax fraud" (tax evasion) but also arrangements involving — in the view of tax authorities — "abuse" of international differences in tax, such as the employment of "letterbox companies in tax havens" and so-called *transfer pricing* (my italics).

As I understand these comments, they strongly indicate the existence of the belief stated above that intercompany pricing is widely employed in this grey area of tax evasion and tax avoidance.

In my experience of tax audits German tax agents (Betriebsprüfer) are very mistrustful in the international field. It is very difficult to convince them that there has been *no* tax planning behind a transaction and that no shifting of profits was intended. Furthermore, several statements in the German "Handbook" mentioned above support my views and show this attitude. I could cite various remarks made in articles and in speeches at various conferences which are in line with my observations.

I strongly believe that this fear and attitude of mistrust is *not* justified.

As experience clearly shows, the majority of transactions are conducted between countries with a similar tax burden. Business dealings with companies in tax havens are of secondary importance and in practice play a very lim-

* Strobl, Killius & Vorbrugg, Munich. Marion Koebner, Solicitor, London, assisted the author with the English version. This article is based on a lecture given on April 17, 1979, at the Management Centre Conference in Vienna. The lecture took up the thread of Dr. Helbig's paper (see the preceding article) on "General problems of intercompany transactions across the border".

1. Official Gazette of the EEC No. L 336/15 of December 27, 1977.
2. OJ. EEC No. L 35/1 of February 14, 1975.

ited rôle for the majority of enterprises. In addition, tax considerations are, as a rule, of secondary importance in business deals between affiliated companies. The business consideration always comes first and transactions between affiliated companies are entered into from the commercial angle.

Many tax issues emerge from a retrospective approach very often adopted by tax agents who then suspect tax motives which did not exist and could not be foreseen by the management when making their decision.

Furthermore, it is my firm conviction that although "tax fraud" and abuse by means of tax haven operations exist, the number of cases is greatly exaggerated by tax officials and the public. The legislation in various countries (in the United States the so-called Sub-part "F" Income Legislation; in Germany the Aussensteuergesetz — Statute regulating foreign tax matters) is very limited in its effect and significance, although it may have a prohibitive effect for some taxpayers. The revenue gained from this legislation makes a very small contribution to the budget. In my opinion the existing principles of good business aims will lead in most instances to the same result as does such detailed and complicated legislation in this area.

The majority of businessmen, whether large or small, consummate their business deals in an orderly and correct manner. Thus mistrust is certainly *not* justified. It is a matter of importance to us that tax officials and tax agents should look also on international transactions with an unbiased and non-suspicious eye, which does not exclude close examination and scrutiny if suspicion is warranted. What is decisive and important is the attitude, the approach. This must be open and based upon trust, not suspicion.

In this connection, there can be no doubt that the growth and impact of multinational companies in both developed and underdeveloped countries contribute towards the mistrust and suspicion evident on the international tax scene, bearing in mind that such companies are being held responsible for much of the damage and disadvantages to which modern industrial techniques are bound to lead.


### Summary

**Efforts should be made by all parties concerned, in particular tax officials, to do away with the atmosphere of mistrust and suspicion in examining international transactions between affiliated companies. Tax administrations should realize that by far the majority of business deals are based on business considerations and that tax considerations play a comparatively insignificant rôle in this area, in particular tax haven operations.**

**The tax authorities should have a more liberal aproach and be more well-disposed to business. We need principles and guidelines not only for companies conducting international business but also for the tax authorities, which will include the principles discussed above ("Guidelines for Multinational Enterprises", OECD, 1976).**


## III. LESS INTERFERENCE IN BUSINESS DECISIONS BY TAX AUTHORITIES

In the last few years I have noted a closer scrutiny by the tax authorities in the international field in many countries, a better training of tax agents performing such tax audits, detailed regulations in the intercompany pricing field, etc. For instance, several years ago the United Kingdom was an "underdeveloped country" in the area of intercompany pricing; now there is a bright young group specializing in the review of pricing policies of multinational companies. In the United States and in Germany there is an experienced tax audit staff as well as an office of international operations coordinating the collection of data and tax audits in the international field.

In addition joint tax audits by tax authorities — for instance, between the United States and Canada — are already being conducted and a similar programme may be initiated between European countries and between the United States and the U.K.

I realize and appreciate that such a development is necessary and warranted by the complexity and difficulty of business operations in the international field and the tax authorities must be equipped with personnel trained in this area and able to understand and examine these complicated problems. However, it is noticeable that this training is very much directed towards educating and training international tax agents to have mainly the interest of their fiscal authority at heart and not towards respecting and accepting a business decision of an affiliated enterprise, in particular if in retrospect the business decision is shown to have been wrong.

A basic principle in international tax audits should be that in the proper course of business (i.e. after proper study and preparation in accordance with modern management methods) a business decision should not be challenged or otherwise disregarded by the tax authorities, unless there is the intent to commit a tax fraud or to shift profits to low tax countries.

Permit me to illustrate this problem:

A multinational concern has established a large manufacturing capacity in one of the EEC countries in order to serve its European subsidiaries. It now appears that too big a manufacturing capacity was created in the euphoria of the 1970s based on the market prognosis of the European subsidiaries. At present, the overcapacity leads to higher costs of goods compared with those the European subsidiaries would have to pay for such goods from independent sources. However, in the future the European subsidiaries may enjoy the benefits and advantages of lower costs if the capacity of this factory can be fully used at a later date.

I believe that the arm's length doctrine cannot be interpreted so narrowly as to disregard the fact that a subsidiary is a member of a group and therefore must also share in and be prepared for such disadvantages. The wrong business decision cannot be blamed on the parent company in the U.S. who had the final say, because the manufacturing operation was built to serve the European subsidiaries and they are, from an economic point of view, the owners.

The tax authorities in the European countries where the subsidiaries are based should not be allowed to attack the business decision which, at least for the time being, is wrong, and must respect such a decision even if a temporary disadvantage results for its local taxpayer.

### Summary

**It should be a well established principle of international tax law that a business decision made in the ordinary course of business and in the proper application of management methods cannot be challenged or otherwise attacked by the tax authorities even if later developments prove it wrong. The tax authorities should concentrate on combatting tax evasion and tax avoidance, i.e. cases where affiliated companies arrange their business affairs merely to avoid or evade taxes.**

**It should be kept in mind by the taxpayer that, generally speaking, the burden of proof will be on the tax authorities. The tax authorities should not be allowed to shift this burden on to the taxpayer on the principle that information must be given freely in the international field by affiliated companies.**

## IV. CORRESPONDING ADJUSTMENT

If an adjustment is made in the field of intercompany pricing in one country the other country should make a corresponding adjustment. Double taxation is contrary to the spirit and object of tax treaties and is, in my experience and opinion, usually caused by conflicting interests of the tax authorities.

It will come as a surprise to a layman and even to many tax consultants that it is necessary to make such a plea since the practice of this principle should go without saying, in particular if the tax rates for corporations are rather similar and hardly any incentive exists for shifting profits from countries with similar tax rates.

Practice, however, looks quite different because most governments are not prepared to follow the OECD proposal for an automatic adjustment set out in Article 9 (para. 2) of the Model Tax Treaty 1977. [3] The reason for this is rather simple: governments are not prepared to give up their sovereignty lightly, in particular in the tax field, in spite of political statements to the contrary.

I recommend that the organizations of taxpayers, including industrial organizations and the Chamber of Commerce, should strongly request that such a corresponding adjustment be introduced.

In this connection the problem of the competent authority procedure arises since this procedure should provide a remedy in cases where the two tax authorities take different positions in this area. I cannot, within the scope of this contribution, discuss the various handicaps and problems in this procedure — for example its lengthiness, the difficulties arising for the taxpayer through not being represented in the negotiations between governments, etc. It is to be hoped that the forthcoming IFA Congress in Berlin, in 1981 — which will deal with this subject — will bring a better understanding of the procedure and recommendations for its improvement.

In order to meet the basic objective of a tax treaty it is absolutely essential that governments are forced to resolve the case by mutual agreement and not merely "have to endeavour", as is the wording in most tax treaties.

In this connection the proposed Directive on Arbitration Procedure should be mentioned (published November 25, 1976) which provides for the appointment of a Committee of the two governments in the case of a competent authority procedure with the inclusion of a *neutral* member on such a committee, thereby forcing the governments to come to an agreement. Surprisingly enough this proposal was not accepted by the members of the EEC, whereas the approval of the Directive on the exchange of information mentioned above was readily given, although the business organizations understood this to be a package deal, meaning that on the one hand furtherance of the exchange was to be provided for and on the other hand a benefit to the taxpayer would accrue, in the introduction of an arbitration procedure within the competent authority procedure. I understand that constitutional reasons were put forward against the arbitration procedure, but I believe that this is merely a reflection of the fact that governments are not prepared to cede sovereignty in this matter. I see in this attitude also indications that the approach of the tax authorities in this area is not an objective and unbiased one. It should be mentioned in this connection that the exchange of information is as a rule used to the detriment of the taxpayer; less effort is being made to exchange information where it would be for the *benefit* of the taxpayer, for example, where the taxpayer can show that a royalty rate of — say — 6 percent is being demanded by the U.S. Tax Authorities in auditing the parent company as licensor and the German Tax Authorities merely allow a 4 percent royalty. This procedure should also be used to inform the tax authorities of the position taken by the other tax authority and the taxpayer should be entitled to request such an exchange of information.

### Summary

**The appropriate bodies of taxpayers — industrial organisations, etc. — must strongly request that a mechanism be found to avoid double taxation in the intercompany pricing field, except where tax evasion or tax fraud are concerned. Furthermore, the tax authorities should be forced to come to an agreement in a competent authority procedure which should be made more effective and less time-consuming.**

**The same efforts which are being made to improve the exchange of information procedure should be**

3. Publ. No. ISBN 92-64-11693-1.

**also lent to the improvement of the competent authority procedure. Controversial positions taken by the tax authorities in this procedure should not be fought on the backs of the taxpayers in the two countries concerned. In these instances the *right* parties in most cases are the tax authorities; it is they who are confronted with conflicting opinions in the two countries.**

## V. DIFFERENT ATTITUDES AND CRITERIA ADOPTED BY GOVERNMENTAL AGENCIES

It is a matter of growing concern that intercompany prices are not only reviewed and scrutinized by the tax authorities of the various countries concerned but also by antitrust authorities (of the EEC) and domestic antitrust authorities, for instance, the German "Bundeskartellamt" (Federal Cartel Office). In addition the authorities in some countries also supervise exchange control or domestic price controls. In most instances the valuation rules of imported goods by the customs authorities follow the so-called "Normalpreis" which is similar to the arm's length concept in essence; however, certain additions or deductions are made for various charges and costs.

As far as we know various authorities in one country are not bound by the decisions and approach of other authorities whether domestic or foreign. German Case Law establishes clearly that the German Tax Authorities are not bound by a position taken by the German Customs Authorities in the case of valuation of goods. The scope of this brief contribution does not permit an analysis and comparison of the different criteria and tests applied by the various authorities to judge the pricing structure domestically and internationally. It should be noted, however, that the enterprise can determine only *one* price whether to an unrelated party or to an affiliated entity abroad, whereas the various authorities whether within one country or in various countries are *not* bound by the position of the other authority.

The decision of the Council on intergovernmental consultation procedures on the guidelines for multinational enterprises [4] provides under item (4) on page 19 as follows:

> "*Member countries may request that consultations be held in the Committee on any problem arising from the fact that multinational enterprises are made subject to conflicting requirements. Governments concerned will cooperate in good faith with a view to resolving such problems, either within the Committee or through other mutually acceptable arrangements.*"

It would be my recommendation that the appropriate parties in the countries concerned collect evidence of conflicting views of the various authorities and submit such collected data to this organisation. I have noticed, for instance, that the EEC antitrust authorities are conducting a price comparision of pharmaceutical products within the EEC and requesting the companies in the various countries of the same group to give detailed information on the pricing structure and to explain the price differences in the various countries.

There should be an attempt by the various authorities both internally and abroad, at least to ensure that the examination of prices is based on the same criteria. The businessman should be entitled to expect a uniform approach by the authorities. If one insists on the review of the pricing structure by the various authorities from various angles, the aim should be to render the various authorities bound by each other and not allow them to interpret or examine the same factual situation differently.

In conclusion I would like to state that we not only need a harmonization of direct and indirect taxes in the EEC but also a harmonization "of the approach of the various authorities examining intercompany pricing structure".

This should apply not only within the tax authorities in various countries but also to the various other agencies reviewing price structure. May I strongly recommend a closer study of this problem and the collection of evidence of conflicting views of the authorities.

### Conclusion

**In a world where most governments believe in exercising as much control as possible on business we should attempt to strive for an unbiased and objective approach by the tax authorities in particular in the international field and to restrict their interference in business decisions. Furthermore, we should endeavour to strengthen the position of the taxpayer vis-à-vis the tax authorities if in different countries they take contradictory views of the same factual issue. In my view the tax authorities should be obligated to reach a comprise.**

4. P. 19 of the OECD publication cited above.

# MULTILATERAL CONVENTION

## for the avoidance of double taxation of copyright royalties?

**By J. van Hoorn jr.**

UNESCO and the World Intellectual Property Organization (WIPO) have been working for several years on the problem of double taxation of copyright royalties remitted from one country to another. The work is near to completion as a result of a meeting of a Third Committee of Governmental Experts held in Paris from 19 to 30 June 1978. The following is a brief summary of the proceedings, followed by the text of a Draft Multinational Convention and by a few personal comments.

Official delegations from 49 countries attended the meeting, as well as observers from 13 inter-governmental and international non-governmental organizations. The working languages were Arabic, English, French, Russian and Spanish.

The countries represented were: Algeria, Argentina, Austria, Belgium, Brazil, Cameroon, Canada, Colombia, Congo, Czechoslovakia, Denmark, Egypt, Finland, France, German Democratic Republic, German Federal Republic, Ghana, Guatemala, Hungary, India, Iraq, Iran, Italy, Ivory Coast, Jamaica, Japan, Jordan, Korea, Kuwait, Lesotho, Libya, Malaysia, Mexico, Monaco, Morocco, Netherlands, Norway, Pakistan, Poland, Portugal, Saudi Arabia, Spain, Sweden, Switzerland, Tunisia, United Kingdom, U.S.A., U.S.S.R., Democratic Yemen.

The Chairman was the head of the Hungarian delegation and delegates from Spain, Iraq, Japan, Lesotho and Mexico were elected as vice-chairmen.

Of the 32 less developed countries represented 13 had at least one delegate from their Ministry of Finance while 15 of the 17 developed countries had a tax expert in their delegation. In other words, slightly more than half of the countries sent a tax expert.

Discussions focussed on the question of the nature of an "international instrument" and whether this should be a multilateral convention or an international recommendation. A number of delegations were of the opinion that the double taxation of copyright royalties should be avoided through bilateral general tax agreements. They feared that the large number of existing agreements would require re-negotiation if a multilateral convention would come into being. Other delegations rejected this argument and based themselves on previous discussions. In their opinion, a multilateral convention should contain no more than general principles. For the actual solutions, a model for bilateral agreements should be prepared with a view to implementing the general principles.

During the discussions, observers from organizations representing authors' interests pointed out that double taxation of copyright royalties is prejudicial to the interest of authors whose work is disseminated throughout the world. They felt that only a multilateral convention would do away with this injustice.

A majority (not including most of the developed countries) voted in favour of a multilateral convention. The articles of this convention are to be followed by commentaries elucidating the texts of the convention. These commentaries will be drafted at a later stage.

During the examination of the proposed texts setting forth the general principles, some delegations proposed that in bilateral agreements copyright royalties should be granted "preferential treatment" and that the multilateral convention should include a clause under which the contracting States would undertake to provide for such treatment. This proposal was turned down, partly because of the vagueness of the term, partly because such a recommendation was felt to go beyond the Committee's terms of reference.

After the discussions a drafting committee formulated the following text:

### DRAFT MULTILATERAL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION OF COPYRIGHT ROYALTIES

*The Contracting States,*

Considering *that the double taxation of copyright royalties is prejudicial to the interests of authors and thus constitutes a serious impediment to the dissemination of works, which is one of the basic factors in the development of the culture, science and education of all peoples,*

Believing *that the encouraging results already achieved in the fight against double taxation, especially by means of national measures and of bilateral agreements, whose beneficial effects are generally recognized, can be improved by the conclusion of a multilateral convention specific to copyright royalties.*

Being of the opinion *that these problems must be solved while respecting the legitimate interests of States and particularly the needs specific to those where the widest possible access to work of the human mind is an essential condition to their continuing development in the fields of culture, science and education,*

Seeking *to find effective measures designed to avoid as far as* *possible, or failing this, to limit double taxation of copyright royalties,*

*have agreed on the following provisions:*

## I
## DEFINITIONS

### ARTICLE I
### Copyright Royalties

*1. For the purposes of this Convention and subject to the provisions of paragraphs 2 and 3 of this article, copyright royalties are payments of any kind made on the basis of the domestic copyright laws of the Contracting State in which the royalties arise, as a condideration for the use of, or the right to use, a copyright in a literary, artistic or scientific work, including such payments made in respect of legal or compulsory licences or in respect of the "droit de suite".*

*2. This Convention shall not, however, be taken to cover royalties due in respect of the exploitation of cinematographic works or works produced by a process analogous to cinematography as defined in the domestic copyright laws of the Contracting State in which the royalties arise when the said royalties are due to the producers of such works or their heirs or successors-in-title.*

*3. With the exception of payments made in respect of the "droit de suite" the following shall not be considered as copyright royalties for the purposes of this Convention: payments for the purchase, rental, loan or any other transfers of a right in the material base of a literary, artistic or scientific work, even if the amount of this payment is fixed in the light of the copyright royalties due or if the latter are determined, in whole or in part, by that of the said payment. When a right in the material base of work is transferred as an accessory to the transfer of the entitlement to use a copyright in the work, only the payments in return for this entitlement are copyright royalties for the purposes of this Convention.*

*4. In the case of payments made in respect of the "droit de suite" and in all cases of the transfer of a right in the material base of a work referred to in paragraph 3 and independently of the fact that the transfer in question is or is not free of charge, any payment made in settlement of or as a reimbursement for an insurance premium, transport or warehousing costs, agent's commission or any other remuneration for a service, and any other expenses incurred, directly or indirectly, by the removal of the material base in question, including customs duties and other related taxes and special levies, shall not be a copyright royalty for the purposes of this Convention.*

### ARTICLE II
### Beneficiary of Copyright Royalties

*For the purposes of this Convention, the "beneficiary" of copyright royalties is the beneficial owner thereof to whom all or a part of such royalties is paid, whether he collects them as author, or whether he collects them as heir or successor-in-title of the author, or as representative or agent of the author, his heirs or successors-in-title.*

### ARTICLE III
### State of Residence of the Beneficiary

*1. For the purposes of this Convention, the State of which the beneficiary of the copyright royalties is a resident shall be deemed to be the State of residence of the beneficiary.*

*2. A person shall be deemed to be a resident of a State if he is liable to tax therein by reason of his domicile, residence, place of effective management or any other relevant criterion as agreed to in a bilateral agreement on double taxation of copyright royalties. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital he possesses there.*

### ARTICLE IV
### State of Source of Royalty

**Alternative A**
*For the purposes of this Convention, a State shall be deemed to be the State of source of copyright royalties when such royalties are originally due as a result of the use of a literary, artistic or scientific work in that State.*

**Alternative B**
*For the purposes of this Convention, a State shall be deemed to be the State of source of copyright royalties when such royalties are originally due:*
- *(a) by that State or by a political or administrative subdivision or local authority of that State;*
- *(b) by a resident of that State except where they result from an activity carried on by him in another State through an installation established therein; or*
- *(c) by a non-resident of that State, where they result from an activity carried on by him through an installation established therein.*

## II
## GUIDELINES FOR ACTION AGAINST DOUBLE TAXATION OF COPYRIGHT ROYALTIES

### ARTICLE V

*Any action against double taxation of copyright royalties shall respect the sovereignty of States in fiscal matters.*

### ARTICLE VI

*The measures against double taxation of copyright royalties shall not give rise to any tax discrimination based on nationality, race, sex, language or religion.*

### ARTICLE VII

*Copyright royalties may be taxed either by the State of source or by the State of residence or by both, provided, however, that in the latter case the double taxation thus created be avoided in accordance with the provisions of Article IX.*

### ARTICLE VIII

*The competent authorities of the Contracting States shall exchange information in so far as it is necessary for the implementation of this Convention and is not incompatible with their domestic laws.*

## III
## IMPLEMENTATION OF THE GUIDELINES FOR THE ACTION AGAINST DOUBLE TAXATION OF COPYRIGHT ROYALTIES

### ARTICLE IX
### Alternative A

*Each Contracting State, in accordance with its Constitution and the guidelines set out above, shall make every possible effort to adopt domestic measures to avoid double taxation where possible and, should it subsist, to eliminate it or, failing this, to reduce its effect by means of bilateral agreements. A model bilateral agreement relating to the avoidance of double taxation of copyright royalties and comprising several alternatives is annexed, by way of illustration, to this Convention. The Contracting States, while respecting the provisions of this Convention, may conclude bilateral agreements based on the norms that are most acceptable for them in each particular case.*

### ARTICLE IX
### Alternative B

*Each Contracting State, in accordance with its Constitution and the guidelines set out above, undertakes upon the entry into force of this Convention in respect of that State, to adopt domestic measures to avoid double taxation where possible and, should it subsist, to eliminate it immediately or, failing this, to reduce its effect by means of bilateral agreements. A model bilateral agreement relating to the avoidance of double taxation of copyright royalties and comprising several alternatives is annexed, by way of illustration, to this Convention. The Contracting States, while respecting the provisions of this Convention, may conclude bilateral agreements based on the norms that are most acceptable for them in each particular case.*

## IV
## FINAL CLAUSES

### ARTICLE X
### [Ratification, acceptance, accession]

### ARTICLE XI
### [Reservations]

### ARTICLE XII
### [Entry into force]

### ARTICLE XIII
### [Termination]

### ARTICLE XIV
### [Languages of the Agreement]

### ARTICLE XV
### [Interpretation]

### ARTICLE XVI
### [Settlement of disputes]

## DRAFT PROTOCOL ANNEXED TO THE MULTILATERAL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION OF COPYRIGHT ROYALTIES

*The States party to the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties (hereinafter called "the Convention") that are party to this Protocol have accepted the following provisions:*

1. *The provisions of the Convention on copyright royalties apply also to the taxation of royalties paid to performers, producers of phonograms and broadcasting organizations in respect of rights related to copyright or "neighbouring" rights, in so far as the latter royalties arise in a State party to this Protocol and their beneficiaries are residents of another State party to this Protocol.*
2. *[Entry into force.]*

Finally, the Committee adopted the following resolution:

## RESOLUTION
### adopted by the Committee

*The Third Committee of Governmental Experts on the Double Taxation of Copyright Royalties remitted from one country to another, convened jointly by UNESCO and WIPO and meeting at UNESCO Headquarters in Paris from 19 to 30 June 1978,*

Having considered *the preliminary draft multilateral and bilateral instruments and the commentaries thereon, prepared by the Secretariat of UNESCO and the International Bureau of WIPO, pursuant to the resolution adopted by the Second Committee of Governmental Experts meeting in 1976,*

1. Considers *that the solution of the problems in question may be found in the adoption of a multilateral convention restricted to guidelines and accompanied by a model bilateral agreement, comprising several alternatives, so as to govern the measures taken to give practical effect to the principles contained in the said convention, in the relations between Contracting States;*
2. Accepts *the draft multilateral convention for the avoidance of double taxation of copyright royalties which is annexed to the report of its deliberations;*
3. Invites *the Secretariat of UNESCO and the International Bureau of WIPO to prepare, in the light of the Committee's discussions:*
   *(i) a draft commentary explaining the draft multilateral convention;*
   *(ii) a draft model bilateral agreement;*
   *(iii) a draft commentary explaining this draft model bilateral agreement;*
4. Considers *that it has fully complied with its terms of reference;*
5. Recommends *that an International Conference of States be convened in 1979 by the Directors-General of UNESCO and of WIPO with a view to the adoption of a multilateral convention on this subject, accompanied by a model bilateral agreement;*
6. *Consequently* recommends *that the competent organs of UNESCO and WIPO take the necessary administrative and budgetary measures to enable this conference to be held;*
7. Requests *the Secretariat of UNESCO and the International Bureau of WIPO, as part of the preparations for that conference:*

*(i) to submit the texts referred to in paragraphs 2 and 3 above to governments and to the international non-governmental and intergovernmental organizations concerned for their observations;*

*(ii) to communicate such observations to them as soon as possible after they have been received.*

## SOME PERSONAL COMMENTS

1. The large majority of participating countries belong to the group of developing countries, most of which have concluded no or very few general tax agreements. While it is difficult for someone who is no expert in the field to judge the actual need of measures against double taxation of copyright royalties, one can accept the desirability of removing tax obstacles to a free exchange of literary work throughout the world.

2. The question is whether a special convention is necessary to achieve the desired purpose. Most developed, and several developing, nations have introduced unilateral relief measures for various kinds of foreign-source income and it would seem that these measures serve this purpose quite satisfactorily. Where bilateral treaties exist, the problem is largely if not entirely solved.

3. The text submitted is the result of much work. This was apparently the third meeting which lasted ten working days. In addition, preparatory work must have been done by both UNESCO and WIPO. The result is, frankly, not very impressive. Some of the observers expressed their disappointment because of the fact that the text adopted was no more than a declaration of principle without any commitment on the part of contracting States. One can understand this disappointment although, as stated above, many satisfactory solutions exist in practice. The really disappointing feature of the draft multilateral convention is that it in no way reflects the expertise in international tax matters which has developed over the years in all kinds of international or regional organizations.

4. There are certainly good reasons for the conclusion of multilateral tax treaties which are not as general in scope as the existing bilateral tax agreements and the OECD Model Convention. During the Third ESCAP Seminar on Foreign Investment and Tax Administration, held in Sydney, September 1978, such specific "partial" multilateral conventions were recommended. The reason was that countries may have reservations, for various reasons, on several points while agreeing on certain other clauses. It would be beneficial to all countries involved to conclude a multilateral convention on those points which meet with general approval. The present draft on copyright royalties, however, is not a good example of such a partial convention. While it is true that this text is to be followed by a model for bilateral conventions, the wording of this draft makes one fear that such a model may not be easy to accept from a technical fiscal point of view. The Committee apparently did not do their homework properly. It is not surprising to see that the minority vote was provided by those countries whose delegations included tax experts. Literature is not only an art but also a profession. So is taxation. It is a pity that so much work has been done by so many people of good intentions, but with such a poor result.

5. The object of the exercise deserves the sympathy and full support of all who are in any way interested in, or are responsible for, the world-wide dissemination of culture. This, however, is not the way to do things. Those who took part in all this work, and devoted so much time and effort to it, will not be grateful for these critical remarks; they may even be very angry. Criticism should be positive, however, and these remarks are meant to be positive, in the sense that they serve as a warning to all those who want to achieve a similar purpose. There are many good purposes to achieve, and many cannot be achieved because of existing tax barriers. These should be removed, as quickly as possible, but on the basis of principles which in the international tax area have developed in a largely satisfactory manner.

The purpose of this article and these personal notes is to indicate how things should not be done.

# SINGAPORE'S NEW TAX INCENTIVES

## The economic expansion incentives (relief from income tax) (amendment) act, 1979

**Lee Fook Hong, FCIS, FAIA**

CONTENTS



## I. INTRODUCTION

*The Economic Expansion Incentives (Relief from Income Tax) (Amendment) Bill was published in the Government Gazette Bills Supplement No. 10 of March 12, 1979. It was introduced into Parliament and read the first time on March 5, 1979. After the third and final reading, it was passed by Parliament on March 30, 1979 and assented to by the President on April 7, 1979.*

*The Economic Expansion Incentives (Relief from Income Tax) (Amendment) Act, 1979 came into force on April 20, 1979. It seeks to implement the new tax incentives announced by the Minister for Finance in the 1978 Budget Speech.*

*Four new parts have been introduced by the Amendment Act, each dealing with a separate incentive scheme:*

| | *Part* | *Sections* |
|---|---|---|
| — International Trade Incentives | IV A | 37A to 37L |
| — Investment Allowances | VI A | 46A to 46I |
| — Warehousing and Servicing Incentives | VI B | 46J to 46 S |
| — International Consultancy Services | VI C | 46T to 46AA |

*Below is a summary of the main provisions of the four new incentives introduced by the 1979 Amendment Act. For ease of reference, the existing and new tax incentives available under the Economic Expansion Incentives (Relief from Income Tax) Act, 1967 as amended are summarised in the Appendix.*

## 2. INTERNATIONAL TRADE INCENTIVES

Part IV A (Sections 37A to 37L) provides incentives to approved international trading companies which are granted for:

(a) the incremental exports of qualifying Singapore manufactured goods and Singapore domestic produce; and
(b) the entrepot trade in qualifying commodities.

"International trading company" means a company engaged in the following and approved by the Minister:

(a) International trade in "qualifying manufactured goods" or "Singapore domestic produce", the export sales of which goods or produce separately or in combination exceed $10 million per annum.
(b) Entrepot trade in any qualifying commodities, the export sales of which qualifying commodities exceed $20 million per annum.

"Qualifying manufactured goods" mean Singapore manufactured goods in respect of which one or more certificates of origin or other documents indicating that the goods are manufactured in Singapore have been issued by the Department of Trade.

"Singapore domestic produce" means:

(a) eggs, chickens, orchids, and aquarium fish produced in Singapore; and
(b) other domestic produce approved by the Minister.

"Qualifying commodities" mean any commodities other than:

(a) tin in the form of ore, ingots or slabs;
(b) natural rubber;
(c) crude palm oil, palm kernel oil, and palm kernels;
(d) crude coconut oil, copra and coconuts;
(e) logs including sawn timber;
(f) crude petroleum and petroleum products;
(g) spices (raw and unprocessed);
(h) pepper; and
(i) such other commodities as may be excluded by the Minister by notification in the Gazette.

"Incremental export sales" mean the excess of total value of export sales over basic export value.

"Export sales" mean export sales, F.O.B. excluding samples, gifts, test-market materials, exhibits, and other promotional materials.

Where during the tax relief period an international company carries on any trade or business which is distinct from the trade or business which includes its relevant export sales, the company is required to maintain separate accounts for the distinct trade or business for the same accounting period. The income from that distinct trade or business is computed and assessed according to the provisions of the Income Tax Act.

The total income of an international trade company is ascertained according to the provisions of the Income Tax Act and, in addition, the following conditions apply:

(a) income from any commissions and other non-trade sources is to be excluded and separately assessed;
(b) capital allowances, including allowances brought forward, must be deducted; and
(c) any unutilised losses brought forward must also be deducted.

For ease of reference, below is the formula to be used in calculating the relief.

"Qualifying export income" is ascertained as follows:

$$\frac{\text{Total Value of Relevant Export Sales} - \text{Relevant Base Export Value}}{\text{Total Sales}} \times \text{Total Income}$$

Fifty percent of the qualifying export income is tax exempt while the other 50 percent is subject to tax at 40 percent. The net effect is that the total export income is taxed at the concessionary rate of 20 percent during the tax relief period which is five years from the day of commencement.

"Base export value" is determined as follows:
For the basis period for the first year of assessment within the tax relief period the base export value is:

> 1/3 of the total value of the relevant export sales during the three years immediately preceding the date of its application.

For the basis period for any subsequent year of assessment within the tax relief period the base export value is:

> 1/3 of the total value of the relevant export sales during the three qualifying years immediately preceding that basis period.

The base export values for second and subsequent years are to be based on a moving average.

"Qualifying year" is a year in which the export sales in respect of:

(a) qualifying manufactured goods or Singapore domestic produce exceed \$10 million; or
(b) qualifying commodities exceed \$20 million.

Where the required information for the three-year period is not available the Minister may specify such other relevant base export value as he thinks fit, having regard to the circumstances of the case.

*Exempt dividends*

Any dividends paid out of tax exempt profits under this Part are exempt in the hands of the shareholders. Such dividends are not subject to deduction of tax under Section 44 of the Income Tax Act.

Companies which are exporters of qualifying Singapore manufactured goods or domestic produce, the annual export sales of which exceed \$10 million, or who are entrepot traders in non-traditional commodities, the annual export sales of which exceed \$20 million, may submit their applications to the Department of Trade, Ministry of Trade & Industry, which is responsible for adminstering the International Trade Incentives.

## 3. INVESTMENT ALLOWANCES INCENTIVES

A new Part VI A (Sections 46A to 46I) has been inserted by the 1979 Amendment Act to introduce a new tax incentives scheme for the granting of investment allowances.

This incentive scheme is available as an alternative to existing pioneer status and export incentives for approved manufacturing and related servicing companies. Pioneer status and export incentives provide for specified periods of tax relief during which the approved company is totally or partially exempted from income tax.

To qualify for the investment allowances under this Part, a company must carry out an approved project for:

(a) manufacture or increased manufacture of any product; or
(b) provision of specialised engineering or technical services.

"Approved project" means a project approved by the Minister. Under the investment allowances scheme, a company is granted tax exemption on a specified amount of profits equal to the investment allowances. Such profits exempted from tax are based on a specified percentage not exceeding 50 percent of fixed capital expenditure.

The Minister for Finance is empowered to exercise his discretion to specify the percentage and the amount of fixed capital expenditure on which the percentage shall be applied.

"Fixed capital expenditure" means capital expenditure incurred on an approved project on:

(a) factory building excluding land; and
(b) new productive equipment and/or second-hand productive equipment if approved by the Minister to be used in Singapore.

Fixed capital expenditure must be incurred within a specified period not exceeding five years.

The percentage not exceeding 50 percent , which is to be specified by the Minister, will vary from project to project depending on its merit and the tax relief period will not exceed five years commencing from the investment day which is determined by the Minister.

In addition to an investment allowance, usual depreciation allowances or accelerated depreciation can be claimed by a qualifying company.

During the tax relief period and within two years after the end of the tax relief period, a company which has been granted an investment allowance is prohibited from selling, leasing out or disposing of, without the approval of the Minister, any assets on which an investment allowance has been granted.

There is provision for carry forward of any balance of any investment allowance to subsequent years of assessment until the full amount of the investment allowance granted to the company has been fully set off. Any dividends paid out of exempted income of a company which has been granted an investment allowance are also exempt from tax in the hands of shareholders. Such dividends which are tax exempt are not subject to deduction of tax under Section 44 of the Income Tax Act.

The Economic Development Board is responsible for administering investment allowance incentives; companies which may qualify for incentives under this Part may submit their applications to the E.D.B.

## 4. WAREHOUSING AND SERVICING INCENTIVES

Part VI B (Sections 46J to 46S) introduces incentives for companies engaged in certain types of warehousing and servicing activities. These incentives will only apply to a company in respect of eligible goods or eligible services specified in the certificate issued to the company for the purpose of tax relief.

"Eligible goods or services" in relation to a warehousing company or servicing company mean the eligible goods or services specified in the certificate issued by the Minister.

To qualify, a company must incur not less than $2 million of fixed capital expenditure on:
(a) building (excluding land); and
(b) new productive equipment and/or second-hand productive equipment if approved by the Minister to be used.

Under this scheme, the tax relief period for an approved warehousing company or servicing company is five years. A company which qualifies for warehousing and servicing incentives is granted tax exemption for one half of the profits derived from export earnings or export services. The net effect is that the company is required to pay only 20 percent of tax on the total export income.

Export income is ascertained by reference to incremental export earnings in respect of eligible goods and services to persons overseas.

"Incremental export earnings" are the excess of export earnings over a given base.

"Earnings" may be defined as:
(a) in relation to a warehousing company:
  — the consideration received or receivable from the sales of goods including the provision of services connected or related to such services; or
  — the commissions received or receivable therefrom;
(b) in relation to a servicing company:
  — the consideration received or receivable from the provision of services.

During the tax relief period, a warehousing company must not acquire any sales and the servicing company must not acquire any services from any other persons in connection with its trade or business without the written approval of the Minister. When permission is granted by the Minister, he may vary the base export earnings and impose such conditions as he thinks fit.

Any dividends paid out of tax exempt income of a warehousing company or servicing company are exempt from tax in the hands of shareholders. Such dividends are not subject to withholding tax under Section 44 of the Income Tax Act.

Companies which are eligible for warehousing and servicing incentives may submit their applications to the Economic Development Board for processing and consideration.

## 5. INTERNATIONAL CONSULTANCY SERVICES INCENTIVES

Part VI C (Sections 46T to 46AA) provides an incentive scheme for certain consultancy services in respect of approved overseas projects.

Any company or form which provides consultancy services in respect of overseas projects with an annual consultancy revenue exceeding $1 million may apply to the Economic Development Board for this incentive.

The aim of this incentive is to promote the establishment of consultancy firms or companies or engineering contractors in Singapore which export their services to overseas clients.

An "approved overseas project" means an overseas project of the kind specified in the certificate issued to a consultancy company or firm. "Consultancy revenue" mean the gross revenue (excluding costs in respect of materials used or sub-contracts made) derived by a consultancy company or a consultancy firm from its profession or business.

"Consultancy services" mean any of the following services:
(a) advisory services relating to any technical, construction or engineering matter;
(b) design and engineering;
(c) fabrication of machinery and equipment;
(d) procurement of materials and equipment;
(e) management and supervision of the installation or construction of any project;
(f) data processing, programming and other computer services;
(g) any other services which the Minister may, by notification in the Gazette, declare to be consultancy services for the purposes of this Part.

"Eligible consultancy revenue" means gross revenue derived by a consultancy company or firm from the provision of services in respect of approved overseas projects excluding costs in respect of materials used or sub-contracts made.

The tax relief period is five years. The tax relief to be granted is that one half of the qualifying income is exempt from tax.

The income qualifying for tax relief is ascertained by reference to the incremental consultancy revenue in respect of approved overseas projects and the incentive is granted in respect of the excess of consultancy revenue over the base consultancy revenue.

For incentives under this Part, a consultancy firm is also eligible. But for incentives under International Trade Investment Allowances and Warehousing & Servicing, only a company is eligible to apply.

A consultancy firm, unlike a company, is not a legal entity for tax purposes and the partners are assessed on their respective shares of the consultancy firm's income.

## APPENDIX

### SUMMARY OF ALL TAX INCENTIVES AVAILABLE UNDER THE ECONOMIC EXPANSION INCENTIVES (RELIEF FROM INCOME TAX) ACT, CHAPTER 135 OF THE REVISED EDITION

| Incentives | Requirements | Type of Relief | Relief Period |
|---|---|---|---|
| *Existing incentives* | | | |
| 1. Pioneer industries | Production of a pioneer product and application in writing to the Minister to be approved as a pioneer enterprise | Exemption of tax on pioneer profits | 5 years or such longer period determined by the Minister, but not exceeding 10 years |
| 2. Expanding enterprises | New qualifying capital expenditure on plant and machinery — more than $10 million | Tax exemption on excess of expansion income over pre-relief income | 5 years |
| 3. Export enterprises | i) Not less than 20 percent of the value of the total sales; and Not less than $100,000 in export sales | i) Tax exemption for 90 percent of the export profits in excess of the average annual export value | i) For a non-pioneer enterprise — 5 years from the export year For a pioneer enterprise — if export year falls within the period of its old trade, 3 years from the commencement of its new trade |
| | ii) Fixed capital expenditure of more than $1,000 million; or $150 million with majority paid-up capital held locally and it promotes Singapore's technology | ii) Tax exemption for 90 percent of the export profits in excess of the average annual export value | ii) 15 years in aggregate |
| 4. Foreign loans and credit facilities | Approved foreign loans from non-residents — not less than $200,000 for purchase of productive equipment | Tax exemption for interest on the loans | Duration of the loan |
| 5. Royalties or technical assistance fees | Approved royalties or technical assistance fees or contributions to research and development costs | Reduced rate of 20 percent; ***or*** full exemption if royalties invested locally in approved enterprises | Period of agreement or arrangement |
| *New Incentives (effective 20.4.79)* | | | |
| 6. International trade incentives | Exporter of qualifying Singapore manufactured goods or domestic produce — (annual export sales exceed $10 million); Entrepot trader in non-traditional commodities — (annual export sales exceed $20 million) | 50 percent of the qualifying export income is tax exempt while the other 50 percent is subject to tax at 40 percent | 5 years |
| 7. Investment allowances | Companies proposing to carry out projects for manufacture or increased manufacture of any products ***or*** for the provision of specialised engineering or technical services | Exempt income based on a specified percentage (not exceeding 50 percent) of fixed capital expenditure | 5 years |
| 8. Warehousing and servicing incentives | Warehousing company or technical or engineering service company — provided new fixed capital expenditure exceeds $2 million. Sales or services must not be acquired from any other person in connection with the trade or business of the company | Tax exemption for one half of the profits derived from export earnings and export services | 5 years |
| 9. International consultancy services incentives | Company ***or firm*** providing consultancy services in respect of any overseas project — provided annual overseas consultancy fees exceed $1 million | Tax exemption for one half of the qualifying income | 5 years |

# JAPAN: The 1979 tax reform
## Paving the way for a new tax

by Makoto Miura

## I. INTRODUCTION

The direct aim of the 1979 tax reform was in the first place to increase tax revenue. However, its secondary and more indirect aim was to pave the way for a new tax, i.e. the so-called "general consumption tax".

The need for increased tax revenue becomes clear if one looks at the Japanese debt position. One of the main features of Japanese budget policy during the past years has been an excessive debt financing, i.e. the Government has been obliged to issue a large amount of bonds to cover its budget deficit. Since the oil crisis the ratio of receipts from the issuance of bonds to total revenue has increased as follows:

| | | |
|---|---|---|
| 1974: 11.3 percent | 1976: 29.9 percent | 1978: 32.0 percent |
| 1975: 25.3 percent | 1977: 29.7 percent | 1979: 39.6 percent |

It is quite obvious that this ratio is substantially higher than in other developed countries and in order to remedy this situation the Japanese Government introduced a "Seven Year Economic Plan — 1979-1985" whose main purpose is the increase of tax revenue. The present ratio of tax revenue to national income of 19.6 percent (1979) should, according to this plan, be increased to 26.5 percent in 1985 and the present ratio of social security contributions to national income should go from 9 percent in 1979 to 11 percent in 1985.

The main thrust of the new policy is directed at the increase of indirect taxes. Although the tax burden in Japan is in general lower than in other developed countries, it is in particular the burden of indirect tax on individual consumption expenditure which is lower than in European countries. Compare, for instance, Japan with 7.3 percent of indirect tax (1979) to the United Kingdom: 16.6 percent (1977), Germany: 17.0 percent (1976) and France: 19.9 percent (1977).

Therefore, it is interesting to note that one of the most important features of the Japanese tax reform is an increase of indirect taxation. However, such an increase cannot be significant enough to be able to cover in any substantial manner the budget deficit, so that the Government is now doing its utmost to introduce a new indirect tax, the so-called "general consumption tax", which resembles significantly the value-added tax as it exists in Europe.

The Tax Committee in its report of December 27, 1978 recommended the introduction of a general consumption tax in 1980 and the Government came to almost the same conclusion in its outline of a tax reform published on December 28, 1976. However, the opposition to the introduction of this tax is very strong. Many opposition groups demand that the present tax system with its inequitable and unfair results first be reformed before the introduction of a new tax is contemplated. For this reason the present Japanese tax reform attempts to eliminate or at least to mitigate such existing tax provisions which are considered to inequitable or unfair.

**Contents**




* Director of the Institute of Tax and Management.

On March 30, 1979 the 1979 Tax Reform Bill was passed by the Diet (Parliament) without any significant amendments. However, it was a hard battle and the Government only won by a vote of 125 to 121.

The most important items involved in the tax reform and the increase of revenue expected are shown in the following table:

| *Item* | *Revenue increase in 1,000,000,000 Yen* | |
|---|---|---|
| | 1979 | 1980 |
| Gasoline tax | 232 | 309 |
| Local road tax [1] | 40.8 | 54.3 |
| Aviation fuel tax [2] | 24 | 24 |
| Municipal aviation fuel tax [3] | 4.3 | 4.3 |
| Reduction of medical doctors' expense deduction | 73 | 100 |
| Restriction of the deductibility of entertainment expenses for corporate income tax purposes | 30 | 74 |
| Restriction of elimination of other privileged tax treatment | 89 | 134 |
| Introduction of a special exemption for aged dependents for individual income tax purposes | ·/· 14 | ·/· 14 |
| Total | 479.1 | 685.6 |
| Allocated to: | | |
| – the General Account Budget | 434 | 627 |
| – the Special Account Budget (Local road tax and municipal aviation fuel tax) | 45.1 | 58.6 |
| Total | 479.1 | 685.6 |

In addition to these tax increases the Government introduced a bill for the increase of tobacco prices, i.e. the increase of the tobacco tax.

The opposition parties strongly objected to these tax increases. They insisted that the increase of indirect taxes would reduce the taxpayer's effective income and that it would stimulate inflation. In addition, they argued that the reduction or elimination of certain privileged tax treatment were only half-way measures.

On March 30, 1979 the tax reform bill was passed by a very small margin since the Government Party — the Liberal Democratic Party (LDP) — barely commands a majority of the votes in the Diet. The Government did not, however, include the "Tobacco Bill" in the reform bill and eventually this proposal proved to be abortive. Although it is expected that the Ministry of Finance will have completed a draft bill for the introduction of a general consumption tax by the beginning of 1980, it is obvious that the Government at this moment does not have sufficient political support to introduce such a bill in Parliament.

## II. INCREASE OF INDIRECT TAXES

### A. Gasoline tax

The increase in indirect taxation takes up 62.8 percent of the total tax increase introduced by the tax reform of 1979 of which 56.9 percent comes from the gasoline tax (inclusive of the local road tax). [4] The gasoline tax proper is increased from 36,500 yen to 45,600 yen per kilolitre and the local road tax from 6,600 yen to 8,200 yen per kilolitre, so that total gasoline tax increases from 43,100 yen to 53,000 yen per kilolitre. The Ministry of Finance estimates that the retail price of gasoline will be increased from 97 yen to 108 yen per litre and that the ratio of the tax component in the retail price will go up from 44.4 to 49.9 percent. However, this estimate is obviously too low, because in May 1979 the retail price of gasoline was already around 100 to 115 yen per litre so that after June 1, when the law becomes effective, the price will increase to 120 to 125 yen per litre.

This price increase is perhaps not so dramatic as it seems, if it is appreciated that because of the strong position of the yen the price of gasoline has steadily gone down over the past years so that in the last year it was only approximately 90 yen per litre. It may be expected that in 1979 the 1974 price will be restored as a result of the tax increase and the weakening of the yen.

The revenue from the gasoline tax and the local road tax has been earmarked for the five-year road construction plan which started in 1954. This plan is being executed in a number of programs, seven of which have been completed and present activities are being directed under the eighth program. Examining past records it appears that up to and including the seventh program the ratio of the revenue from these taxes to the total expenditure for the road building plan was approximately 90 percent. If the increase in the gasoline tax and the local road tax had not been effected this ratio would have been reduced to 78 percent which would have caused serious financial problems for the road construction plan.

It should be appreciated that the increase of the gasoline taxes presents a dilemma to the Government. On the one hand it is intended to use the increased revenue to meet the increased cost of road construction but on the other hand in order to save oil it is intended to push down gasoline consumption which — if this plan is successful — may mean that the revenue from these taxes is reduced.

### B. Aviation fuel tax

The aviation fuel tax has been increased from 13,000

1. The local road tax is in fact a national (and not a local) tax which is levied on gasoline shipped from refineries or withdrawn from bonded areas.
2. The aviation fuel tax is imposed on aviation fuel supplied to aircraft in Japan, except fuel for international flights. Eleven-thirteenths of the revenue is credited to the General Account of the State and then remitted to the Airport Construction and Improvement Special Account. The remainder is transferred to municipal governments to be earmarked for expenditure related to airports.
3. See note 2, above.
4. See note 1, above.

to 26,000 yen per kilolitre. Two-thirteenths of the revenue of this tax is remitted to those municipalities which have airports for the carrying out of construction preventing environmental pollution, in particular noise prevention. Twenty percent of the tax revenue (or 2/65) paid to the municipalities is distributed by them to the prefectures.

## III. INCREASE OF DIRECT TAXES

The increase of direct taxation is primarily caused by the reform of the so-called "special tax measures" under which various groups of taxpayers received special tax treatment which has gradually developed into unintended tax privileges for these groups, resulting in unequal taxation between various categories of taxpayers.

### A. Reduction of medical doctors' expense deduction

Since 1954 physicians and dentists could with respect to income received under the national health scheme elect to deduct either the actual expenses connected with the services they rendered under this scheme or take a lump sum deduction of 72 percent of the fees received. The lump sum deduction was introduced some 25 years ago as an incentive for medical doctors and dentists to co-operate with the then newly introduced social medicare program. However, according to an investigation carried out by the Board of Audit, it appears that the 72 percent deduction is far too generous as the average expenses amount to approximately 52 percent of the remuneration received. This privileged treatment of doctors and dentists has been one of the causes for them to be among the highest income groups in Japan in terms of after tax income. It is small wonder that for a long time groups of taxpayers have urged the Government to withdraw this privileged treatment and that the Tax Committee of Japan also recommended in its 1974 report to reduce these privileges. However, every attempt to eliminate or alter them met strong opposition from the Japan Medical Association and its supporters in the Liberal Democratic Party. Finally, at the end of 1978, a compromise was reached which resulted in the following reform which became effective on April 1, 1979.

Physicians and dentists who receive a remuneration from the national health services may still take the 72 percent expense deduction provided that the income received is less than 25,000,000 yen per year.

If they derive more than 25,000,000 yen per year from the national health services, the deduction percentage is degressive as follows:

| *Annual remuneration* | *Deduction percentage* | |
|---|---|---|
| (in 1,000,000 yen) | 1979 | 1980 and later years |
| 25 - 30 | 70.5 % | 70 % |
| 30 - 40 | 64.5 % | 62 % |
| 40 - 50 | 60.75 % | 57 % |
| 50 and more | 57 % | 52 % |

The result of this measure is that members of the medical profession will receive larger tax bills which is illustrated in the following table:

| *Annual remuneration* | *Income tax (yen)* | |
|---|---|---|
| (in 1,000,000 yen) | 1979 | 1980 and later years |
| 30 | 35,500 | 36,000 |
| 40 | 342,500 | 358,000 |
| 50 | 897,000 | 1,208,000 |
| 70 | 2,664,500 | 3,545,000 |
| 100 | 5,505,000 | 7,395,000 |

There are two groups which object to these new provisions: in the first place, the medical profession which complains that they are the only individuals who suffer such a drastic tax increase for which they receive no compensation, and the second group which feels that the medical profession has still retained most of its privileges and wishes the total abolition of the lump sum deduction.

### B. Securities transactions

Capital gains accruing from the transfer of securities by an individual taxpayer are, in principle, exempt from individual income tax. However, there exist some exceptions to this general rule. For instance, if an individual person concludes during a given year more than 50 security transactions, the capital gains will be taxed if more than 200,000 shares were involved in those transactions.

The 1979 tax reform provides that capital gains will also be taxed if an individual in a given year transfers more than 200,000 shares of one and the same company provided that the aggregate face value of these shares exceeds 10,000,000 yen. In such a case the capital gain has to be reported in the taxpayer's tax return and it will be aggregated with his other taxable income.

### C. Entertainment expenses

Entertainment expenses incurred by a business are in principle deductible from taxable income. However, for corporations there is a limitation, i.e. a full deduction is allowed for entertainment expenses in an amount of 4,000,000 yen per year increased by 0.025 percent of paid-in capital and legal capital surplus. Any excess is only deductible for 15 percent, i.e. 85 percent of such expenses is added back to taxable income and is subject to the 40 percent corporate income tax. As of fiscal 1979 the deduction has been drastically reduced, i.e.:

(i) corporations whose capital is less than 10,000,000 yen may take a full deduction with respect to entertainment expenses up to a maximum of 4,000,000 yen per year, provided that they can prove that the expenses are required for the carrying on of their business;
(ii) corporations whose capital is between 10,000,000 and 50,000,000 yen may take an automatic entertainment expense deduction of 3,000,000 yen;
(iii) corporations whose capital exceeds 50,000,000 yen

may take an automatic entertainment expense deduction of 2,000,000 yen.

In any case where these maximum amounts are exceeded, the corporation may only deduct 10 percent of the excess entertainment expenses incurred.

It is noted that the provision which allowed the corporation to deduct — in addition to the fixed amount — 0.025 percent of paid-in-capital has been abolished.

At first sight it may seem strange that the larger the corporation the lower the allowable entertainment expense deduction. It cannot be denied that the bigger the corporation the higher the amounts will be it requires for public relations. To illustrate this point: in 1977 the entertainment expenses of corporations totalled 2,409 billion yen, i.e. 4.33 percent of total operating expenses. An amount of 830 billion yen or 34.5 percent of these entertainment expenses did not qualify for deduction and was consequently subject to corporate income tax. The percentage of non-deductible entertainment expenses was 77.9 percent of total annual entertainment expense for corporations having a capital in excess of 10 billion yen and 15.3 percent for corporations whose capital is less than 1 million yen.

However, the Government explained that it had intended to grant only a maximum deduction of 2,000,000 yen, but that it was decided to increase this amount for smaller corporations as a kind of financial aid, since these corporations are currently going through a particularly difficult economic period.

## D. Reduction or elimination of tax incentives

### 1. *Reserve for bad debts*

The reserve for bad debts is a reserve for expected loss in the collection of receivables. Starting from fiscal 1979 the percentage taken from these receivables which may be deducted from taxable income is reduced for corporations as follows:

| *Type of business* | *Percentage reduction* | | |
|---|---|---|---|
| retail or wholesale | 2 % | to | 1.6 % |
| retail on installment payments | 2.5 % | to | 2 % |
| manufacturing | 1.5 % | to | 1.2 % |
| banking and insurance | 0.5 % | to | 0.5 % (unchanged) |
| others | 1.2 % | to | 1 % |

### 2. *Reserve for price fluctuations*

The amount credited to the reserve for price fluctuations for the decrease in value of inventories and securities may be deducted as an expense. However, the maximum amount deductible is, in principle, their total book value at the end of the accounting period less 98 percent of such book value. This percentage is 95 percent for listed stocks and other commodities designated by the Ministry of Finance, e.g. commodities subject to sharp price fluctuations, such as iron ore and raw cotton and 99.2 percent for securities other than listed stocks.

These percentages will be gradually reduced over the years and they will be eventually abolished, i.e. no deduction will be available with respect to price fluctuations after 5 years with respect to non-designated commodities and after 10 years with respect to designated commodities and stocks. The percentage reduction will be as follows:

| *Fiscal Year* | *Non-designated commodities* | *Designated commodities and stocks* |
|---|---|---|
| 1979 | 98.3 % | 95.4 % |
| 1980 | 98.6 % | 95.8 % |
| 1981 | 98.9 % | 96.2 % |
| 1982 | 99.2 % | 96.6 % |
| 1983 | 99.6 % | 97.0 % |
| 1984 | – | 97.5 % |
| 1985 | – | 98.0 % |
| 1986 | – | 98.5 % |
| 1987 | – | 99.0 % |
| 1988 | – | 99.5 % |

This percentage reduction extends over a remarkably long period of time taking into account the impatience of the Japanese.

### 3. *Overseas market development reserve for small and medium sized enterprises*

Corporations with capital not exceeding one billion yen which derive their income partly or wholly from "overseas transactions" may deduct from their taxable income certain amounts credited to this reserve. The maximum amount deductible is a percentage of the proceeds from qualifying overseas transactions carried on in the preceding accounting period (in certain cases in the second preceding accounting period).

The following percentages apply:
(a) export of merchandise purchased from third parties — 1.7 percent of the proceeds of such export in case of corporations with capital of not more than 100,000,000 yen and 0.85 percent for corporations with capital in excess of 100,000 yen but not exceeding one billion yen;
(b) other export transactions — 2.3 percent of the proceeds of such export in case of corporations with capital of not more than 100,000,000 yen and 1.15 percent for corporations with capital in excess of 100,000 yen but not exceeding one billion yen.

The tax reform reduces, starting with fiscal 1979, the percentage of 0.85 percent to 0.82 percent and the percentage of 1.15 percent to 1.12 percent.

### 4. *Special depreciation allowances*

The special increased initial depreciation of 20 percent of the acquisition cost of certain machinery and equipment used for the promotion of rationalization by the enterprise and which are of direct benefit to perople's lives has been abolished.

In the following cases the percentage of special depreciation was reduced or the list of qualifying assets shortened:
— qualifying plant and equipment for the prevention of pollution;
— qualifying industrial water supply equipment;

- qualifying plant or equipment for the regeneration of dregs;
- qualifying plant or equipment designed to improve on effective utilization of energy;
- qualifying steel vessels;
- certain new equipment acquired by small or medium sized enterprises.

*5. Investment tax credit*

The 1978 tax reform introduced an investment tax credit as a temporary measure to stimulate investment in the private sector. Enterprises which acquired certain qualifying plant and equipment during the period from April 1, 1978 through March 31, 1979 could, in lieu of the special depreciation allowances, credit 10 percent of the acquisition against their individual or corporate income tax assessment up to a maximum of 20 percent of their taxable income. There was a carry-over provision for unused credits which could be taken against the income of the next three years. The investment credit expired on March 31, 1979 and was thus automatically terminated. However, the investment credit has been retained for enterprises in certain structurally depressed branches of industry, for instance, shipbuilding, electric and open-hearth steel production, the production of aluminium, ammonia, urea, phosporic acid, alloy steel, synthetic fiber and textile spinning. The investment credit applies during the period starting from April 1, 1979 through March 31, 1981.

## IV. REDUCTION OF DIRECT TAXES

The 1979 tax reform does not exclusively increase direct taxation; in some cases it offers a tax reduction for certain categories of taxpayers. Apart from the extension of the investment tax credit for structurally depressed branches of industry discussed above, a special exemption was introduced for aged independent persons and certain real property transactions by small landowners will receive a better capital gains tax treatment. This last measure will be discussed in somewhat more detail.

Capital gains derived from the sale or other disposal of land, buildings and rights to use real property during the period from January 1, 1976 through December 31, 1980 are not subject to the normal progressive individual income tax but to a separate capital gains tax. Its rates are as follows:

### A. Short-term capital gains

Short-term capital gains are gains derived from the sale or other disposal of property acquired on or after January 1, 1969. The rate is the higher of:

(a) 40 percent of the gain; or
(b) 110 percent of the difference between:
  (i) the individual income tax computed at normal progressive rates on the sum total of "normal" taxable income and capital gains, and
  (ii) the individual income tax computed on the "normal" taxable income.

The purpose of this provision is to tax capital gains at a higher rate than if they were part of "normal" taxable income.

### B. Long-term capital gains

Long-term capital gains are gains derived from the sale or other disposal of property acquired before January 1, 1969. These gains are taxed in the following manner:

(a) The portion of the capital gains not exceeding 20,000,000 yen is separately taxed at a rate of 20 percent;
(b) The portion of the capital gains in excess of 20,000,000 yen is subject to a tax which equals the difference between:
  (i) the individual income tax computed at progressive rates on "normal" taxable income increased by 3/4 of the amount of long-term capital gain; and
  (ii) the individual income tax computed at progressive rates on "normal" taxable income increased by 3/4 of 20,000,000 yen or 15,000,000 yen.

This provision will generally result in a lower taxation than if the long-term capital gain were added to normally taxed income.

The 1979 tax reform introduced a rate reduction of capital gains tax intending to increase the supply of land suited for house construction. It will, therefore, only be applicable in a limited number of cases. Capital gains from the following transactions will qualify:

1. Transfer by the owner to the central or local government;
2. Transfer by the owner to the Japan Housing Corporation or to the Land Development Corporation;
3. Expropriation;
4. Transfer of land of more than 1,000 square meters to persons or entities who possess a license issued by the governor of the prefecture;
5. Transfer of land for house construction (even if less than 1,000 square meters) if the purchaser intends to construct more than 50 ordinary houses or more than 30 highly fire resistant houses on the land, provided the same condition has been met as under 4, above.

## V. CONCLUSION

It is obvious that the tax increases introduced under the 1979 tax reform are too small to cover the enormous budget deficit. The Government's solution of this problem is the introduction of a general consumption tax and although it has not been able to introduce such a tax at this time it remains high on the Government's priority list. The removal of inequalities in the current tax legislation was the condition of obtaining the co-operation of powerful groups in the Diet, and the

Ministry of Finance asserts that such removal has now been completed. However, the next request of the opposition parties is to reduce Government spending but in this respect the opposition is not in agreement among itself. Some groups demand that the military expenses be reduced as well as the investment in infrastructure from which big business benefits. Other groups wish that social welfare expenditure be cut and again other groups insist that there should be a large scale dismissal of government officials, etc.

Prime Minister Ohira has indicated that the Ministry of Finance will start the preparatory work for the 1980 Budget as soon as possible. Normally the work on the draft budget is started at the end of August but this year work has begun in June. The reason is that the Government wishes to have its proposals for a reduction of Government spending ready and announced as early as possible thus hoping to obtain more support for the introduction of the general consumption tax.

## In next issues

A review of the Ethiopian fiscal system
— by *M. Fissehatsion*

A survey and analysis of the tax systems in the Caribbean Common Market
— by *Roy T. Gobin*

Tax changes in Singapore, the Income Tax (Amendment) Act 1979
— by *Lee Fook Hong*

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— by *M.P. Dominic*

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— by *Jap Kim Siong*

Bangladesh: Annual Budget 1979-80
(Budget Speech by Mirza Nurul Huda, Minister of Finance)

United States: Proposed Internal Revenue Service Regulations
on the creditability of taxes

# NEW CHINESE JOINT VENTURE LAW

*On July 8, 1979 the Chinese Government issued a new joint venture law which spells out the conditions under which foreign investors may carry on business activities in the People's Republic of China. The profits from joint ventures will be subject to an income tax. It is not perfectly clear at this moment whether that income tax will follow the current tax-legislation (see below). An unofficial translation of the text of the new joint venture law was distributed by the official Chinese news agency Xinhua and is reproduced below.*

**Article 1**

With a view to expanding international economic co-operation and technological exchange, the People's Republic of China permits foreign companies, enterprises, other economic entities or individuals (hereinafter referred to as foreign participants) to incorporate themselves, within the territory of the People's Republic of China, into joint ventures with Chinese companies, enterprises or other economic entities (hereinafter referred to as Chinese participants) on the principle of equality and mutual benefit and subject to authorization by the Chinese government.

**Article 2**

The Chinese government protects, by the legislation in force, the resources invested by a foreign participant in a joint venture and the profits due him pursuant to the agreements, contract and articles of association authorized by the Chinese government as well as his other lawful rights and interests.

All the activities of a joint venture shall be governed by the laws, decrees and pertinent rules and regulations of the People's Republic of China.

**Article 3**

A joint venture shall apply to the Foreign Investment Commission of the People's Republic of China for authorization of the agreements and contracts concluded between the parties to the venture and the articles of association of the venture formulated by them, and the commission shall authorize or reject these documents within three months. When authorized, the joint venture shall register with the General Administration for Industry and Commerce of the People's Republic of China and start operations under license.

**Article 4**

A joint venture shall take the form of a limited liability company.

In the registered capital of a joint venture, the proportion of the investment contributed by the foreign participant(s) shall in general not be less than 25 percent.

The profits, risks and losses of a joint venture shall be shared by the parties to the venture in proportion to their contributions to the registered capital.

The transfer of one party's share in the registered capital shall be effected only with the consent of the other parties to the venture.

**Article 5**

Each party to a joint venture may contribute cash, capital goods, industrial property rights, etc. as its investment in the venture.

The technology or equipment contributed by any foreign participant as investment shall be truly advanced and appropriate to China's needs. In cases of losses caused by deception through the intentional provision of outdated equipment or technology, compensation shall be paid for the losses.

The investment contributed by a Chinese participant may include the right to the use of a site provided for the joint venture during the period of its operation. In case such a contribution does not constitute a part of the investment from the Chinese participant, the joint venture shall pay the Chinese government for its use.

The various contributions referred to in the present article shall be specified in the contracts concerning the joint venture or in its articles of association, and the value of each contribution (excluding that of the site) shall be ascertained by the parties to the venture through joint assessment.

**Article 6**

A joint venture shall have a board of directors with a composition stipulated in the contracts and the articles of association after consultation between the parties to the venture, and each director shall be appointed or removed by his own side. The board of directors shall have a chairman appointed by the Chinese participant and one or two vice-chairmen appointed by the foreign participant(s). In handling an important problem, the board of directors shall reach decision through consultation by the participants on the principle of equality and mutual benefit.

The board of directors is empowered to discuss and take action on, pursuant to the provisions of the articles of association of the joint venture, all fundamental issues concerning the venture, namely, expansion projects, production and business programs, the budget, distribution of profits, plans concerning manpower and pay scales, the termination of business, the appointment or hiring of the president, vice-president(s), the chief engineer, the treasurer and the auditors as well as their functions and powers and their remuneration, etc.

The president and vice-president(s) (or the general manager and assistant general manager(s) in a factory) shall be chosen from the various parties to the joint venture.

Procedures covering the employment and discharge of the workers and staff members of a joint venture shall be stipulated according to law in the agreement or contract concluded between the parties to the venture.

**Article 7**

The net profit of a joint venture shall be distributed between the parties to the venture in proportion to their respective shares in the registered capital after the payment of a joint venture income tax on its gross profit pursuant to the tax laws of the People's Republic of China and after the deductions therefrom as stipulated in the articles of association of the venture for the reserve funds, the bonus and welfare funds for the workers and staff members and the expansion funds of the venture.

A joint venture equipped with up-to-date technology by world standards may apply for a reduction of or exemption from income tax for the first two to three profit-making years.

A foreign participant who re-invests any part of his share of the net profit within Chinese territory may apply for the restitution of a part of the income taxes paid.

**Article 8**

A joint venture shall open an account with the Bank of China or a bank approved by the Bank of China.

A joint venture shall conduct its foreign exchange transactions in accordance with the foreign exchange regulations of the People's Republic of China.

A joint venture may, in its business opera-

tions, obtain funds from foreign banks directly.
The insurances appropriate to a joint venture shall be furnished by Chinese insurance companies.

**Article 9**
The production and business programs of a joint venture shall be filed with the authorities concerned and shall be implemented through business contracts.
In its purchase of required raw and semi-processed materials, fuels, auxiliary equipment, etc., a joint venture should give first priority to Chinese sources, but may also acquire them directly from the world market with its own foreign exchange funds.
A joint venture is encouraged to market its products outside China. It may distribute its export products on foreign markets through direct channels or its associated agencies or China's foreign trade establishments. Its products may also be distributed on the Chinese market.
Wherever necessary, a joint venture may set up affiliated agencies outside China.

**Article 10**
The net profit which a foreign participant receives as his share after executing his obligations under the pertinent laws and agreements and contracts, the funds he receives at the time when the joint venture terminates or winds up its operations, and his other funds may be remitted abroad through the Bank of China in accordance with the foreign exchange regulations and in the currency or currencies specified in the contracts concerning the joint venture.
A foreign participant shall receive encouragements for depositing in the Bank of China any part of the foreign exchange which he is entitled to remit abroad.

**Article 11**
The wages, salaries or other legitimate income earned by a foreign worker or staff member of a joint venture, after payment of the personal income tax under the tax laws of the People's Republic of China, may be remitted abroad through the Bank of China in accordance with the foreign exchange regulations.

**Article 12**
The contract period of a joint venture may be agreed upon between the parties to the venture according to its particular line of business and circumstances. The period may be extended upon expiration through agreement between the parties, subject to authorization by the Foreign Investment Commission of the People's Republic of China. Any application for such extension shall be made six months before the expiration of the contract.

**Article 13**
In cases of heavy losses, the failure of any party to a joint venture to execute its obligations under the contracts or the articles of association of the venture, force majeure, etc. prior to the expiration of the contract period of a joint venture, the contract may be terminated before the date of expiration by constultation and agreement between the parties and through authorization by the Foreign Investment Commission of the People's Republic of China and registration with the General Administration for Industry and Commerce. In cases of losses caused by breach of the contract(s) by a party to the venture, the financial responsibility shall be borne by the said party.

**Article 14**
Disputes arising between the parties to a joint venture which the board of directors fails to settle through consultation may be settled through conciliation or arbitration by an arbitral body of China or through an arbitral body agreed upon by the parties.

**Article 15**
The present law comes into force on the date of its promulgation. The power of amendment is vested in the national people's congress.

# Taxes currently found in the People's Republic of China*

In articles 7 and 11 reprinted above, reference is made to the tax laws of the People's Republic of China. There are currently a number of different taxes, the most important being the following:

- Industrial and Commercial Income Tax (plus Surcharge)
- Industrial and Commercial Consolidated (Sales) Tax

both based on legislation enacted in 1950 with subsequent amendments.

The *Industrial and Commercial Income Tax* and the Surcharge thereupon are currently levied on the net profit from all types of enterprises. There are, however, certain exceptions and reliefs. The tax rate varies from 5.75 percent to a maximum of 34.5 percent. The (local) surcharge is based upon the amount of tax that has been calculated and is at present levied at a uniform rate of 60 percent in all provinces of the Prople's Republic of China.

The *Industrial and Commercial Consolidated (Sales) Tax* also applies to all types of enterprises. It can be classified as a sales tax although it also has, in certain respects, features of an excise duty. It is, generally speaking, based upon the gross receipts of an enterprise. The rates reflect the degree of necessity of a particular item to the economy as such, and/or to the average consumer.
Items of basic need are taxed at a low rate (lowest rate 1.5 percent) whereas luxury goods are taxed at rather high rates (up to 69 percent). There are, however, certain exemptions.

In Article 11 of the text of the law printed above, reference is made to a *Personal Income Tax*. No details are yet known of this tax.

* For a detailed discussion see : TAXES AND INVESTMENT IN ASIA AND THE PACIFIC; Chapter on the People's Republic of China. Published by INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, P.O. Box 20237, AMSTERDAM.

# NIGERIA: Tax Considerations for Investment and Business Decisions

by A.C. Ezejelue*

## I. INTRODUCTION

*In making investment and business decisions a number of factors must be taken into consideration, inter alia, the feasibility and viability of the project, financing options, political stability, possibilities of nationalization, exchange control policies, availability of raw materials and labour, market potential, communication network, the legal structure and language. Which part each of these factors plays depends upon whether the decision involves the location of a new enterprise or a capital expenditure programme within an existing enterprise.*

*Although subordinate to the commercial factors, the tax factors are of great importance in many investment decisions. It is doubtful, however, how many of such decisions are influenced by tax considerations. This may be due to the dynamic and changing nature of tax provisions.*

*Nonetheless, the tax implications of many business decisions are so far-reaching that some projects considered otherwise as borderline cases may become worthwhile proposals. Some tax provisions have specific economic goals and others which may have no specific economic objectives have impact on business decisions.*

*In developing countries like Nigeria, there exist quite a number of disincentives to industrial projects, such as inadequate infrastructure, undeveloped market arising from very low per capita income, and a dearth of trained and disciplined manpower. The government has attempted to counterbalance these inhibiting factors through the introduction of numerous tax incentives and shelters. The purpose of this paper is to review the current state of affairs in this direction in Nigeria.*

*This will enable managers and investors to consider the after-tax results of their major business decisions. Inputs into investment decisions — which include considerations such as tax costs, tax incentives, timing of tax payments and tax allowances and reliefs — should be on an after-tax basis.*

CONTENTS



## II. EXISTING COMPANY TAXES

There are two main types of taxes levied upon companies: income tax and capital gains tax.

### (a) Income tax

Income tax is payable for each year of assessment upon the profits of any company (unless specifically exempt) accruing in, derived from, brought into or received in Nigeria. These include profits arising from trade or business and also rent, dividends, interest,[1] discounts, charges, annuities and any amount deemed to be income or profits under the Companies Income Tax Act, 1961 (CITA) as amended.

Section 26 of CITA exempts profits of some specified companies such as ecclesiastical, charitable or educational institutions of a public character, registered friendly societies, co-operative societies and statutory corporations. Interest received by or credited to a company from the Federal Mortgage Bank of Nigeria is also exempt from tax.

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1. With effect from 1978/79 the interest payable on loans granted to aid investment in agriculture will enjoy special exemption from taxation.

*Type of Government:*
Federal military Government

*Head of State:*
General Olusegun Obasanjo

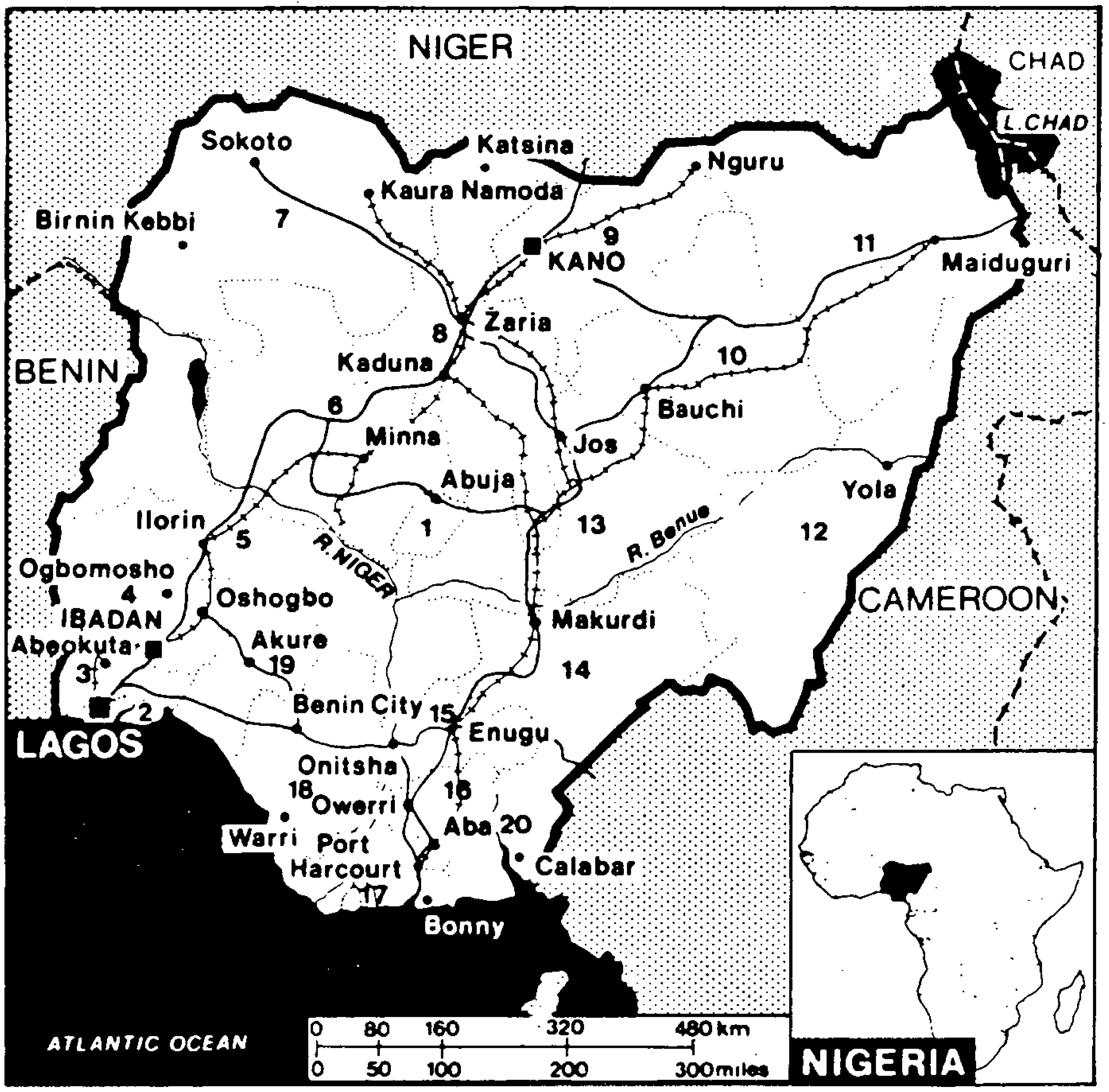
*Capital:*
Lagos

*Land area:*
356,669 square miles (913,073 sq km)

*Monetary unit:*
₦ = Naira (divided into 100 Kobo (K))

*Languages:*
English is used officially and for business in addition to tribal languages, e.g., Ibo, Hausa and Yoruba

*Organizational membership:*
African Development Bank, Opec, United Nations, Member of General Agreement on Tariff and Trade (GATT), Signatory of the Lome Convention, Member of ECOWAS (Economic Community of West African States), Member of the World Bank, Organization of African Unity (OAU), British Commonwealth Member State




# NIGERIA: A SURVEY

*Located on the Gulf of Guinea on the western coast of Africa, the Federal Republic of Nigeria is the richest African nation. Independent since 1960, Nigeria's approximately 100 million people the most densily populated nation in Africa consists of over 400 ethnic groups. However, the Hausa-Fulani in the northern part of the country, the Ibo in the southeast and the Yoruba in the southwest are the largest of these groups. Currently ruled by General Olusegun Obasanjo under a Federal Military Government that has pledged to return the country to civilian rule by October 1, 1979, Nigeria is faced with a myriad of problems. However, its great potential must be weighed against its current condition.*

*In contrast to the boom years that resulted from the discovery of oil and the subsequent price escalation, the country is currently faced with cut backs in its development program and a freeze on its spending policy as a result of both reduced oil revenues and difficulties with the balance of payments due to declining oil earnings and the continuing high level of imports. Nigeria does have a great potential for economic development; it has a large population which could provide both a work force and a con-*

sumer market, a physically large land area, 356,669 square miles (913,073 sq. km.) with good arable land varying in climate from the tropical to the temporate. It contains vast national resources including tin, silver, coal, iron and most importantly oil. Nigeria's wealth is primarily a result of oil production. The discovery of oil in the Niger delta region and in off shore deposits in addition to those near Lake Chad led to Nigeria's great prosperity in the 1970's. Not only are these deposits of high quality but also since Nigeria is geographically closer to Europe and the United States than most other oil producing countries it has an added marketing advantage. These oil deposits are estimated to last for at least another 30 years and should provide both the raw material for petroleum refineries and the capital needed for developmental projects. Thus while recent events may have reduced the amount that oil contributed to the budget, in the 1978-79 budget speech General Obasanjo emphasized that "Petroleum still remains the greatest contributor to the economy. . ." (p. xi) and should continue to do so in the future.

Following the oil price rise in 1972-73 the government's revenues reached an estimated ₦ 53 billion in 1975-76 and all but ₦ 684 million of this was a result of oil earnings. An expansive spending program based upon this new wealth has led to the current monetary difficulties for while the reserves are declining the expenses incurred during the expansive period are now being presented for payment. Lesser amounts of revenue have been accumulated by the government during the last few years for several reasons, oil production has decreased due to the government's desire to protect a natural resource and an international policy of conservation which occurred at approximately the same time as the appearance on the market of new sources of low sulphur crude that are similar to Nigeria's, thus sales diminished and correspondingly the proceeds from these sales were less than previously. While state participation in Nigeria's oil industry began in 1971 when Nigeria became a member of OPEC, the government has restricted its participation to general policy matters and has left the actual running of the industry to the major foreign oil companies and thus does not directly control production and must seek other avenues by which to regulate the economy.

Agriculture once the major ingredient in the Gross Domestic Product now contributes only a fraction of what it previously supplied to the budget. Ground nuts, cocoa, palm oil and cotton among other products were once leading exports, now however even food production has not kept up with the population increase and shifting habitation patterns. Food has had to be added to an expanding list of essential imports despite the fact that given Nigeria's geography it should be capable of being self sufficient in the production of food for its citizens.

The Government in recognition of this problem "has given the highest priority to agriculture. . ." (xiv) but many difficulties will have to be overcome to reverse the population flow as farmers seeking the advantages of urban living and higher wages drift towards the cities. While this is not a uniquely Nigerian problem it is perhaps more acutely felt here because of the fact that while huge tracts of arable land stand unproductive basic food must be imported contributing unnecessarily to the drain on the rapidly diminishing reserves. A major contribution to this unfortunate situation is Nigeria's lack of infrastructure. Roads, gasoline stations, refrigerated trucks, cold storage facilities all necessary to insure that the produce once harvested will reach the market and provide the farmers with adequate returns for their effort are all lacking. In addition people must be encouraged to return to agriculture but this can only be accomplished when rural dwelling is a viable alternative to urban living. Basic facilities must be improved to reverse this urban drift.

Although manufacturing is still in its earliest stages in Nigeria and only accounts for a small percentage of the Gross Domestic Product light industry and some consumer goods are manufactured in Nigeria. Beer, cotton textiles, paints, rubber, soap detergents, soft drinks, some electrical appliances and pharmaceuticals among other items are manufactured locally. To encourage the development of business and industry the government encourages enterprises connected with agriculture or petro-chemicals. At the same time in order to develop trained manpower and increase local ownership a specific policy of Indigenization had been codified under the Nigerian Enterprises Promotion Decrees. Under this system industries are classified under different schedules that allow varying degrees of foreign ownership. Compliance by foreign business had not proved too difficult but because of the current monetary problems repatriation of the proceeds takes a long time due to the limited amount of foreign exchange that is now available in the country.

Various other efforts to control the economy have been initiated by the government. In a strongly worded statement the Commissioner of Finance declared that "Realism must take the place of expensive and unjustifiable tastes for foreign goods of all description." For while there has been "a significant reduction in the demand for crude petroleum which is (Nigeria's) main source of revenue and foreign exchange earning. . . (xvii) imports remained high. Thus under the 1978-79 budget (a revised) import policy became a major goal "in order to conserve. . . foreign exchange and protect local industries" (xxxi).

In addition to measures taken to reduce the government's expenditures and to stabilize the budget, in January of 1978 a $1 billion multicurrency loan agreement was signed in London. This agreement concluded between Nigeria and a consortium of banks from the US, West Germany, The Netherlands, Japan, France, United Kingdom, Switzerland, Belgium, Italy, the Middle East and the Far East will provide funds for financing such projects as petroleum refineries, storage tanks and pipelines, port expansion and other needed infrastructure projects.

Nigeria's prognosis is excellent despite the danger of a heavy dependence on a single source of income, oil, for there is great economic potential in agriculture, manufacturing and consumer businesses. Once the current difficulties have been resolved, Nigeria once again should experience a boom period but now wiser as a result of this experience should maintain a steady path towards economic growth for the nation.

Except in the cases of new businesses, businesses that have been discontinued and businesses that have changed their accounting date where special provisions under Section 30 of CITA apply, income tax for all established and continuing companies is charged on a preceding year basis — i.e. income of the income tax year (April 1st to March 31st next following) preceding the year of assessment.

The current rate of company income tax with effect from the 1978-79 fiscal year is 45 percent. This has changed over the years. For instance, between 1972-73 and 1974-75 a two-tier rate of tax, 40 percent on the first 10,000 naira and 45 percent on any excess over 10,000 naira, applied; in 1975-76 a flat rate of 40 percent applied on the taxable profit; and in 1976-77 and 1977-78 a flat rate of 45 percent applied; and in 1978-79 the rate was 50 percent. If, following the past trend, further substantial rises in tax rates are to be anticipated in the future, it may be advantageous to postpone certain significant periodic and uninventoriable expenses such as major repairs and advertising.

### (b) Capital gains tax

Under the Capital Gains Decree 1967, capital gains tax is payable in certain circumstances by companies disposing of "chargeable assets". Chargeable assets are all assets not specifically exempt, whether or not such assets are within Nigeria. However, Section 4 exempts disposals of non-Nigerian assets by non-resident individuals or companies or disposals of assets of "non-resident" trusts.

Assets which are specifically made chargeable are the following:

(i) options, debts and incorporeal property generally;
(ii) non-Nigerian currency; and
(iii) self-created property.

Gains arising from the following, among others, are exempt:

(i) disposal of business assets (such as land, buildings, plant, machinery, ships, aircraft, goodwill) if the proceeds are reinvested bona fide in other assets used for the purposes of the trade;
(ii) disposal of property by way of gift, whatever the value;
(iii) disposal of motor-cars unless they are of a type not commonly used as a private vehicle and are unsuitable to be so used. With effect from the 1972-73 assessment year, stocks and shares were included in "chargeable assets". From 1975-76 the Decree was amended to make this tax applicable throughout the federation as well as to non-residents, whether individuals or companies. In order to halt the incidence of non-payment of capital gains tax it is obligatory for the Federal Commissioner of Stamp Duties to demand tax clearance certificates when checking documents on the sale by any company of assets before such documents are accepted for stamping and registration.

The rate of capital gains tax has remained 20 percent on the total amount of chargeable gains accruing in a year of assessment after deductions allowed under the Decree. Since the rate of company income tax is higher than the rate of capital gains tax, it is usually desirable — where possible — to have profit treated as capital gains instead of treating it as ordinary income. But it would appear that this is not usually possible in Nigeria.

Some assets which are not "chargeable" under this decree may, on disposal, attract either a balancing charge or a balancing allowance, depending on whether they are sold for more or less than their written down value.

### (c) Super tax

Super tax, a child of circumstance, was a wartime measure imposed on profits in excess of 10,000 naira or 15 percent of share capital, whichever was greater. It was, however, scrapped with effect from 1972-73; companies may therefore grow to any size without fear that their profits will attract super tax.

## III. ADJUSTED PROFIT

Accounting and taxable incomes are usually not identical, as a result of tax provisions designed to encourage particular types of transactions. These provisions vary from time to time and are based on fiscal, economic, social, and political considerations. Consequently, if tax procedures are used to measure income for external reporting this can lead to imprudent and commercially unsound financial accounting.

### (a) Deductions allowed and deductions not allowed

To ascertain a company's profits on which tax assessment will be levied all the expenses which are incurred wholly, exclusively, necessarily and reasonably for the purpose of the business are deducted. Specifically the following expenses, among others, are admissible (Sec. 27 of CITA):

(i) interest on loans employed as capital in acquiring the profits;
(ii) rent and premiums;
(iii) repairs of premises, plant, machinery or fixtures employed in acquiring the profits, or renewal or alteration of any implement, utensil or article so employed;
(iv) bad debts and specific provisions for bad debts;
(v) contributions to a pension, provident or other retirement benefits fund, society or scheme approved by the Joint Tax Board;
(vi) donations made to certain organisations,[2] provided the donations are made out of profits

2. Such organizations, which include the Nigerian Red Cross, Boys Brigade, Boy Scouts, Girl Guides, Government-owned or teaching hospitals, are specifically mentioned in the Companies Income Tax (Amendment) Decree 1971 (Decree No. 10) of 1971.

and do not exceed 10 percent of the total profit for the relevant year of assessment.

The Act (Section 28) as amended also disallows certain expenses or deductions which include: depreciation of fixed assets, capital repaid or withdrawn, any expenditure of a capital nature, appropriations from profits, reserves out of profits (excluding bad debts and their specific provisions), dividends declared by a company and any sum recoverable under an insurance or contract of indemnity.

**Head office expenses no longer deductible**

With effect from 1973-74, head office expenses for foreign companies were no longer allowed as deductible expenses but were to be borne in the country in which such office is situated. This is because such expenses are not regarded as "wholly, exclusively, necessarily, and reasonably" incurred for the purposes of producing the income. While it may be possible that some big companies have incurred expenditure for services rendered by overseas parent companies, the figures have usually been inflated. The other expenses of foreign companies for management, technical and other services were either totally disallowed or accepted on the basis of a minimal percentage of the turnover or takings. However, from 1974-75, fixed management, technical and royalty fees were to be payable in the first five years of the establishment of a new company, and thereafter a percentage of gross profit (or, in exceptional cases, net sales or turnover) not exceeding 5 percent in appropriate and deserving cases.

Also with effect from 1973-74, where a company pays any amount of interest, management fee or royalty to any other company, the paying company should deduct and pay tax on such fees at the appropriate rate in the year in which such payment is reflected in the income statement of the paying company as being due to the beneficiary. As from 1979-80, management fees and technical assistance fees became taxed gross at the standard company tax rate of 45 percent.

With effect from 1977-78 limits have been formally imposed on allowable rental expenses incurred by companies on staff accommodation as follows:

(i) *Lagos:* A maximum of 14,000 naira per annum for a flat and a maximum of 28,000 naira per annum for a building;

(ii) *Other places:* A maximum of 5,000 naira per annum for a flat and a maximum of 20,000 naira per annum for a building.

### (b) Automatic exemption of the first 6,000 naira profit

With effect from 1975-76, small companies relief was abolished, and, in its place, the first 6,000 naira taxable profit of all companies, irrespective of size, is exempt from tax. Thus, a company making a taxable profit of 8,000 naira would pay tax on only 2,000 naira. This exemption which provided a comfortable tax shelter for many companies, particularly the small companies, has been withdrawn from 1979-80.

## IV. DIVIDEND AND DIVIDEND POLICY

### (a) Introduction of provisional tax on interim dividends

Due to the delay in the payment of tax by a number of companies, either because the accounts were not ready or the auditing was not completed or because the tax assessed was in dispute, the 1978-79 Budget provided for a provisional tax. With effect from the 1978-79 financial year, companies declaring interim dividends will immediately pay, within 30 days, provisional tax on the interim dividend with the understanding that any excess payment will be refundable at the end of the assessment year.

The budget further provided that provisional accounts must be prepared by companies not later than three months after the end of the accounting year and advance tax payments made to the Revenue on the basis of the unaudited accounts by a process of self-assessment within 30 days. Where applicable, revised assessments will be made later, when final and audited accounts are submitted to the Revenue.

This may involve companies in maintaining a running account on a monthly basis for the purposes of advance company tax. This involves also paying closer attention to the timing of dividend payments. If interim dividends are declared, tax payment falls due and may affect the working capital position adversely.

### (b) Payment of dividends

Prior to 1972-73 companies paid dividends net to the shareholders. But with effect from 1972-73 dividends were expected to be paid gross to the shareholders. Thus, company profits were taxed without regard to dividends payable to the shareholders by the Inland Revenue while the states taxed the actual gross dividends and receivable by persons resident within their areas. In the case of non-resident shareholders, dividends are paid gross but the paying company is obliged to deduct tax and pay it to the Revenue. Non-resident shareholders who have paid their tax will be allowed to remit their share of any interim dividend on production of the necessary tax clearance.

With effect from 1975-76 there was a reversion to pre-1972-73 arrangements whereby dividends are regarded as being paid net to shareholders. Shareholders who suffer tax by deduction at source on their dividends have a one-year time limit to claim a refund.

With effect from 1976-77, 30 percent gross dividend restriction was imposed, increased to 40 percent from the 1978-79 fiscal year. Some companies circumvent this restriction on the rate of dividends declared by increasing their paid-up share capital through issue of bonus shares and through asset revaluation.

To avert this, with effect from 1977-78, any increase arising from asset revaluation should be placed in a special "Asset Revaluation Account" and must not be used for issuing scrip bonus shares. Also, the computation of the 40 percent dividend restriction should exclude scrip issues or bonus shares issued from October 1, 1976. This means that where scrips were issued after

September 30, 1976, each equity share will earn proportionately less than 40 percent gross.

**Example 1:**

| | naira |
|---|---|
| Issued and fully paid capital as at September 30, 1976 | 500,000 |
| Scrip issues in January 1978 | 250,000 |
| Total new capital | 750,000 |
| Approved dividend: 40% of 500,000 | 200,000 |

Thus, the rate of dividend paid on the total shareholding is:

$\frac{200,000}{750,000} \times 100 =$ 27 percent gross (approx.)

The above situation does not apply where share capital has been increased by injecting new capital into the business, i.e. through offers for subscription.

The basis for the computation of dividend distribution has been changed from equity shares to after-tax profit from 1979-80 fiscal year. Tax on the profits should be paid before dividends are paid out and the maximum dividend declarable or payable is 50 percent of the company's after-tax profit. Although company tax has been reduced to 45 percent, dividends payable to shareholders will attract a withholding tax of 12.5 percent, which should be paid over to the tax authorities of the states in which the shareholders are respectively resident.

The net effect of the present practice may be to increase government revenue, improve the net cash flow for the company, and to reduce the rate of dividend payable to the shareholders.

**Example 2**

| | naira |
|---|---|
| Total profit before tax | 400,000 |
| Deduct tax at 45 percent | 180,000 |
| After-tax profit | 220,000 |
| Maximum dividend payable (50 percent of 220,000) | 110,000 |
| Deduct tax withheld for the states at 12.5 percent | 13,750 |
| Available for distribution to shareholders | 96,250 |

If we assume the facts in Example 1 (see above) a comparison of rate of dividend payable to the shareholders on both equity share and after-tax profit bases follows:

| | Equity share basis | After-tax profit basis |
|---|---|---|
| On total profit | $\frac{200,000}{400,000} \times 100 = 50\%$ | $\frac{96,250}{400,000} \times 100 = 24\%$ |
| On total shareholding | $\frac{200,000}{750,000} \times 100 = 27\%$ | $\frac{96,250}{750,000} \times 100 = 13\%$ |

The shortfall to the shareholders through the 12.5 percent withholding accrues to the State Revenue and the 5 percent tax shortfall to the Inland Revenue through reduction of tax rate to 45 percent accrues to the company. Also, the new guideline stipulates the maximum dividend payable while leaving the minimum open.

## V. FINANCING OPTIONS

When additional financing becomes necessary, it can be raised through the sale of shares or long-term loans. The owners can provide any of these options. Such financing can provide an extra tax shelter if the owners supply the funds through long-term loans instead of purchasing additional shares. In the long run it makes no difference to the owners whether their additional funds attract interest or dividends. However, from the point of view of the company, the tax liability will be reduced if the owners supply the funds through loans. This is because interest on borrowed money is an allowable expense for tax purposes, but dividends are appropriations of profit and so do not carry any tax advantage. The option of financing through loan will have the effect of increasing the earnings per share on equity shares.

## VI. CAPITAL ALLOWANCES

### (a) Existing allowances

Capital allowances on qualifying capital expenditures are available to companies. Capital allowances are made against the tax assessment, and *not* as an expense in computing the profit used for that assessment (credit against tax). The following rates of capital allowance are effective from 1970-71:

| | Initial Allowance % | Capital Allowance % |
|---|---|---|
| Industrial buildings | 15 | 10 |
| Other buildings (non-industrial) | 5 | 10 (rates effective 1975-76) |
| Plant (including transport and moving equipment) | 20 | 12½ |
| Mining | 20 | 12½ |
| Plantation | 25 | 15 |

A reconstruction "investment allowance" of 25 percent of the qualifying expenditure which is given in addition to the initial allowance was introduced as a result of the civil war. It is, however, withheld in certain cases.

Effective from 1976-77 an enhanced capital allowance on housing estates has been introduced as follows: 20 percent initial allowance plus 10 percent annual allowance for the first year and 10 percent annually thereafter. This is to assist and encourage companies and organizations that are prepared to put up housing estates under some given conditions. With the Land Use Decree 1978 coming into effect, the acquisition of land for such estates will be easy.

In order to encourage investment in agriculture, with effect from 1978-79, all capital expenditures on plant and equipment incurred in agricultural production will, in addition to the existing capital allowances, enjoy an investment allowance of 10 percent. Also those who lease out agricultural equipment will be entitled to capital allowances from 1978-79.

### (b) Project evaluation via capital allowances

Recently in project evaluation in Nigeria, there has arisen the need to evaluate capital allowances as additions to the overall value of the project's outputs or as deductions from its investment input values. One such evaluation employs an extension of the usual present value model.[3]

In the model, where many asset items are involved, the average rates are substituted for initial and annual allowances applicable to the various individual asset components of the project's capital assets. These average rates are calculated as follows:

| | | naira |
|---|---|---|
| Assume that total cost of various individual asset components is | = | 1,000,000 |
| Total initial allowances (IA) on the assets | = | 178,000 |
| Total annual allowances (AA) on the assets for the first year | = | 101,000 |

Thus average IA = $\frac{178{,}000}{N}$ = X naira and

average AA = $\frac{101{,}000}{N}$ = Y naira

where N = number of asset items that make up the 1,000,000 naira.

Thus IA = X for a project may be defined as:

$$X = \frac{\sum_{i=1}^{n} IAi}{N}$$

while AA = Y is defined as:

$$Y = \frac{\sum_{i=1}^{n} AAi}{N}$$

where IAi = initial allowance on qualifying assets 1,2,3, ..., n emplyed on the project.

AAi = annual allowance on qualifying assets 1,2,3, . . ., n employed on the project.

N = number of qualifying assets.

In order to build the present value model for evaluating an asset via capital allowances, the following symbols are used:

c = the cost of the asset

n = its estimated economic life in years

t = the tax rate

i = the investment allowance proportion (assume that investment allowance is applicable in this project).

x = the initial allowance

y = the annual allowance

p = profit of the year.

Tax incentive is defined as the difference between the tax on profit, had there been no capital allowances, and the tax on profit, taking the allowances into consideration.

Thus, in year one, the tax incentive will amount to

$S_1 = tp_1 - t\,[p_1 - (c\,(i) + K)] = t\,(ci + K)$

where $K = X + Y_1$ as already defined.

As the practice is to subsequently allow only the AA at reducing balance, after the first year, the written down value (WDV) of the investment (for tax purposes) at the end of year one will be equal to: $c\,(1-i) - K = c - ci - K = Z$

WDV at end of Year 2 = $[c\,(1-i) - K] - Y_2 = Z - Y_2$

WDV at end of Year 3 = $\{[c\,(1-i) - K] - Y_2\} - Y_3 =$

$= (Z - Y_2) - Y_3$

WDV at end of Year n = $Z - Y_2 - Y_3 - \ldots - Y_n = 0$

This assumes that the AA = $Y_j$ (where j = 1,2, . . ., n) for the n years will be sufficient to write down the total cost of the assets to zero at the end of their useful life, and that there will be no balancing allowance or charge arising at their disposal. Since the tax incentive at the end of year one = $S_1 = t\,(ci + K)$ and since only decreasing AAs will be granted for the subsequent useful lives of the asset, the tax incentive at the end of Year 2

$= S_2 = ty_2$.

Similarly, tax incentive for year 3 becomes

$S_3 = ty_3$.

And tax incentive for n years

$= S_n = ty_n$.

Thus the total tax incentives for n years

$= t\,[ci + X + Y_1 + Y_2 + \ldots + Y_n]$.

Since the tax incentives are not equal for all the years, the present value of the total tax incentives may be expressed as follows:

$$V = t\,\left[\frac{(ci + X + Y_1)}{1 + r} + \frac{Y_2}{(1+r)^2} + \frac{\ldots + Y_n}{(1+r)^n}\right]$$

In the above, V discounts all the cash inflows, by way of tax savings resulting from the investment, to the present, assuming that the desired rate of interest r is known.

If $V \geq c$ then the investment could be adjudged desirable from the point of view of capital allowances because the tax savings from the investment will be able to repay the loan raised to acquire the asset plus the interest over the n number of years.

## VII. TREATMENT OF LOSSES

Under section 31 of CITA as amended a company can claim and obtain relief in respect of losses sustained in any year of assessment. Like profits, losses are determined on a preceding year basis. However, under this section a loss could be set off against the profit of the actual accounting year if specifically claimed within a time limit. Thus, although the loss for tax year 1979-79 will normally be the loss incurred by a company during

3. Derived from a model used by SKOUP & Co. Ltd., Enugu, associated Nigerian business consultants.

the year ending December 31, 1977 (assuming that the accounting year of the company ends on this date), such a claim could make the loss that of tax year 1977-78. This makes it possible to get a refund of tax already paid.

This section provides for the following deductions to be made from ascertained total income of a company in respect of losses:

(a) any loss incurred in the relevant year of assessment, provided such a loss is claimed in writing within twelve months after the end of the year of assessment; and

(b) any loss incurred during the preceding years of assessment which are carried forward, subject to a maximum of the assessable profit from that same source of activity in which the loss was incurred.

But under Decree No. 47 of 1972, loss relief became available for set-off against future profits only, and cannot as under Section 31 of CITA be set off against the profits of the accounting year. Under both the CITA and Decree No. 47, such unabsorbed losses may be carried forward indefinitely until they are completely extinguished from subsequent profits from that course. But with effect from 1976-77, the period for the carry forward of any unabsorbed loss was restricted to four years, after which period any unabsorbed losses will lapse. This means that if a company continues to make little or no profit from that particular source of activity, it stands a good chance of not absorbing some of its losses.

However, in order to boost agricultural production, with effect from 1978-79, where losses are suffered by a company engaged in agriculture, such losses can be carried forward indefinitely until they can be wiped off against future profits.

Where a loss arises from the letting of any property other than land or buildings, and the letting is not a trade or business, it is not available for the carry-forward provisions.

## VIII. NEW TRADE OR BUSINESS

The preceding year basis of assessment applies only to established and continuing businesses. In the case of new companies, the following special rules apply in respect of their assessable profits for the first three years of operation:

*First year* — Actual profits from the date of commencement to the following March 31;

*Second year* — The profits of the first 12 months from the date of commencement;

*Third year* — Preceding year basis. (If preceding year conditions are not fulfilled, the Revenue may, generally, again take 12 months' profits from the date of commencement.)

The company may, however, make a claim to be assessed for the second and third years on the actual profits of those years, i.e. April 1 to the following March 31 in each case. The claim must be for the two years and not for one or the other only of those years. Such a claim, which must be made by a written notice, may be made at any time within two years, after the end of the second year of assessment, to the Revenue, and may be revoked (e.g. if subsequently it turns out to be disadvantageous to the company) within twelve months after the end of the third year of assessment.

As is normally the case, the company's adjusted income statement for the first year will form the basis of assessment for the first three years of assessment. If, therefore, the profit of the first year is neither maintained nor improved upon in the second and third years, it may spell hardship for the company. It is to ride through this probable hardship that the relief, by way of the company's option on how to be assessed for the second and third years, was introduced.

Since the company's accounts for the first year are likely to form the basis of assessment for the first three years, it may be advantageous to the company to try and expense as many items as possible in the first year so as to reduce the taxable profit to the barest minimum.

### Capital allowances in relation to new businesses

In view of the special rules for assessing a new company for its first three years of operation, in some cases initial allowances or balancing allowances (or charges) could be made more than once for the same asset in cases where assessment is based on profits computed on a basis other than the preceding year basis. In order to prevent such double reliefs the Third Schedule to the CITA provides, inter alia, that where two basis periods overlap, the period common to both of them is deemed to fall in the first basis period only.

As a corollary, where a new company exercises the option to have its second and third years assessed on actual profits of those years, any qualifying capital expenditure incurred up to the end of the third fiscal year attracts its first capital allowances in the fiscal year in which it is incurred. The implication of this is that the exercise of this option accelerates the claiming of relief in respect of the assets.

**Example:**

Chidinma commenced business on January 1, 1974 and makes up its account to December 31 of each year. The following assets qualifying for initial allowance were bought:

| | |
|---|---|
| January 1, 1974 | naira 3,000 |
| May 1, 1974 | 4,000 |
| September 1, 1975 | 2,000 |
| February 27, 1976 | 1,500 |

The initial allowances will fall to be claimed as follows:

| Date bought | Cost naira | Where no option is exercised | Where option is exercised |
|---|---|---|---|
| Jan. 1, 1974 | 3,000 | 1973-74 | 1973-74 |
| May 1, 1974 | 4,000 | 1974-75 | 1974-75 |
| Sept. 1, 1975 | 2,000 | 1976-77 | 1975-76 |
| Feb. 27, 1976 | 1,500 | 1977-78 | 1975-76 |

The above illustrates the fact that the exercise of option expedites the claiming of initial allowances in the year the asset is bought. This is important for an investor who places a high degree of premium on liquidity either because of the great danger of obsolescence or where the investment is extremely risky due to political instability, impending war and chances of nationalization, or where the company is besieged with a weak cash-and-credit position. In this situation the interest of the company may be the immediacy of the payback of the capital invested rather than long run profitability.

## IX. CESSATION OF TRADE OR BUSINESS

The following rules of assessment apply where a company permanently discontinues business:

(i) In the final or ultimate year, assessment is based on actual profits of that year, from April 1 to the date of cessation;

(ii) In the penultimate year, assessment is based on the income as computed on the preceding year basis, or the actual amount of income of that year, whichever is greater.

The question and date of cessation is one of fact depending on the circumstances of the individual case. There is no cessation if a company transfers from one territory to another, provided it is still in the same line of business. Where a company sells or transfers all its business assets to another company it amounts to cessation. Where, however, a company sells or transfers its business to Nigerians or to a Nigerian company for the purposes of better management, the Inland Revenue may, if it is satisfied that one company has control over the other or that both are controlled by some other person or are members of a recognized group of companies, direct that cessation and commencement provisions shall not apply.

The choice of the date of cessation may be very important from the income tax point of view. In general, if the profits are falling, it is advisable to cease at once; if they are rising, it may be advantageous to carry on until *after March 31.*

Recent results of Nkechi & Co. were as follows:

| | |
|---|---|
| Year ending December 31, 1973: | 1,860 naira |
| Year ending December 31, 1974: | 2,100 naira |
| Year ending December 31, 1975: | 2,520 naira |

Nkechi formed Nkechi Limited to take over the business. It was estimated that if the business was not taken over until March 31, 1976, the profit for the interval would be 660 naira, and if the take-over was delayed until April 20, 1976, the profit for the interval would increase to 781 naira.

The avoidance of an increase on the full year's assessment (i.e. 1974-75) means less assessment in the case of cessation on April 20, 1976. The advantage, therefore, lies in the fact that while in each case 1975-76 is on actual profits, carrying on into 1976-77 (i.e. by continuing to April 20, 1976) avoids the increase in 1974-75. From the foregoing illustration some amount of income tax is saved if Nkechi & Co. discontinues on April 20, 1976. Each case depends upon the facts, and in every such situation the alternative assessments should be computed before a rational decision can be reached.

From the capital allowances point of view, the application of the special cessation provisions could operate to the disadvantage of a company because of the intervals that may exist between succeeding years of assessment. However, this is taken care of by the provisions of paragraph 1 (b) (iii) and (iv) of the Third Schedule to CITA. The import of this paragraph is that where there is an interval between the basis periods for succeeding years of assessment, then, unless the second of these years of assessment is the year of cessation (in which case the interval is deemed to be part of the first basis period), the interval is deemed to be part of the second basis period.

| | Assessed as discontinued on March 31, 1976 | | Assessed as discontinued on April 20, 1976 | |
|---|---|---|---|---|
| | Original | Final | Original | Final |
| | naira | naira | naira | naira |
| ULTIMATE YEAR | | | | |
| 1975-76: PYB: (Preceding Year Basis) | 2,100 | – | – | – |
| ACTUAL: $\frac{9}{12}$ of 2520 + 660 | – | 2,550 | – | – |
| 1976-77: PYB | – | – | 2,520 | – |
| ACTUAL: $\frac{\frac{2}{3}}{3\frac{2}{3}}$ of 781 | – | – | – | 142 |
| PENULTIMATE YEAR | | | | |
| 1974-75: PYB: | 1,860 | – | – | – |
| ACTUAL: $\frac{9}{12}$ of 2100 | | | | |
| + $\frac{3}{12}$ of 2520 | – | 2,205 | – | – |
| 1975-76: PYB: | – | – | 2,100 | – |
| ACTUAL: $\frac{9}{12}$ of 2520 | | | | |
| + $3\frac{2}{3}$ of 781 | – | – | – | 2,529 |
| Add year before penultimate year | – | – | – | 1,860 |
| | | 4,755 | | 4,531 |

## X. PIONEER COMPANIES

In order to stimulate commercial and industrial activities in Nigeria some companies are granted pioneer status under the Industrial Development (Income tax relief) (Decree No. 22) of 1971 as amended to date. Investors wishing further information on the procedure for obtaining pioneer status or on types of industries already so declared should contact the Federal Ministry of Industries. Pioneer companies enjoy certain tax privileges such as a tax holiday which may extend over the first five years of operation. Relief for losses incurred during the "holiday" period could be claimable from profits made after the holiday period. Also, capital allowances due during the holiday period are deferred until the period is over.

With effect from 1977-78, agro-allied projects whose raw materials were produced locally qualify for pioneer certificates and so enjoy a tax shelter for five years.

## XI. DOUBLE TAXATION ARRANGEMENTS

Under the CITA there were double taxation relief arrangements between Nigeria and the U.K., the U.S.A., Denmark, Sweden, New Zealand, Norway, Sierra Leone, Gambia and Ghana. These arrangements were terminated [4] by Nigeria with effect from April 25, 1978, with a view to re-negotiating new arrangements later with the countries involved.

The first discussion[5] on a re-negotiated agreement since the termination notices were served was started on January 15, 1979, between Nigeria and the United Kingdom.

## XII. BUILDING AND CONSTRUCTION INDUSTRY

With effect from 1977-78, the Turnover Tax Decree of 1969 was amended to the effect that companies in the construction and building industry will pay either a turnover tax of 2½ percent (which will not be subject to deduction for capital allowances) or the normal company income tax, whichever is the higher. The 2½ percent tax is on the total turnover including sums subcontracted. Therefore, the Revenue has the option to collect all the 2½ percent on the total contract price from the main contractor. Where the 2½ percent rule is operative, no claim for the exemption of the first 6,000 naira profit from tax will be entertained.

## XIII. SPECIAL PROVISIONS FOR CERTAIN TYPES OF COMPANIES

There are certain companies the nature of whose businesses transcend national frontiers. These call for a special formula for ascertaining that part of their world income attributable to the business carried on in Nigeria. The companies in this category include shipping and air transport companies, cable and wireless undertakings and certain insurance companies. Special provisions as contained in Sections 19 through 21 of CITA apply to them.

Companies engaged in the business of oil winning are not taxed under the CITA due to the special and complicated nature of the oil industry generally. A separate tax law known as the Petroleum Profits Tax Act 1959 guides the taxation in this industry. This principal Act has been amended by Decrees No. 65 of 1966, No. 1 of 1967, No. 9 of 1969, No. 22 of 1970, and No. 15 of 1973. They provide, among other things, for capital allowances, rate of tax, treatment of losses, offsetable taxes,[6] deductions allowed and deductions not allowed.

## XIV. ACCOUNTING METHODS

The accounting methods used could have some tax effects. For instance, use of the LIFO method of inventory valuation during periods of rising prices could have the effect of postponing tax payment by inflating the cost of goods sold and thereby reducing income chargeable to tax at the time being. But use of the FIFO method during inflationary periods has the opposite effect. Therefore, the LIFO method will be more desirable, if expansion is desired in periods of increasing prices, because it postpones payment of income tax and makes more cash available. Also the use of either an accrual or cash basis of accounting and the basis for recognizing revenue in the accounts may have the effect of shifting income from one year to another — thus either deferring or accelerating tax payment. This idea of postponement is important if a company is in bad shape in terms of working capital.

However, from the Revenue point of view, use of the FIFO method is preferable and is usually insisted upon. In some cases the LIFO method is acceptable, provided it is consistently applied. Also the Revenue insists on the use of the accrual basis of accounting, except in the case of professionals where the cash basis may be allowed as a concession. In a decision,[7] the Onitsha High Court held that ". . . tax is properly assessed on the amount accruing due in any particular year . . . and not on the amount actually received".

## XV. PERSONAL INCOME TAX

As in the case of companies, individuals are assessed

4. Legal Notices Nos. 35-43, *Federal Republic of Nigeria Official Gazette*, Lagos, 27:65, July 15, 1978.
5. *Business Times*, Lagos, 16:4, Tuesday, January 16, 1979, p. 1.
6. In arriving at the *tax payable* for any accounting period, any royalties due in respect of oil liable to local refinery and custom duty or other like charges, which liability was incurred during the accounting period to the Federal Government, levied in respect of plant, equipment, storage tanks, pipelines, etc., essential for use in the company's petroleum operations may be deducted from the *assessable tax*.
7. Dr. Igwegbe v CIR O/Tax 1A/1960 as quoted by C. Njokanma, *Income Tax Law and Practice in Eastern Nigeria* (Aba: Cynako Ltd., 1975), p. 253.

for Nigerian tax upon income accruing in, derived from, brought into, or received in Nigeria in respect of gains, profits, salaries, wages, fees, allowances, other gains or profits from an employment including gratuities, compensations, bonuses, premiums, benefits or other perquisites allowed, given or granted by any person to an employee, rent from property, dividends, interest or discounts, pension, charge or annuity, etc.

Nigeria can be a high tax country for those in receipt of higher incomes — i.e. over 30,000 naira. The rates of tax are graduated in nine stages, ranging from 10 percent to 70 percent, subject to a guaranteed minimum tax of 1 percent of an individual's total income where there is no chargeable income after granting reliefs or where tax payable as computed in accordance with the tax rates schedule is lesser than the 1 percent minimum.

However, an individual enjoys various allowances and reliefs which have the effect of reducing the chargeable income. The allowances [8] include: personal, wife's, dependents', children's and life assurance.

## XVI. CONCLUSION

This paper deals with some of the tax variables which can influence investment and business decisions in Nigeria. In view of the fact that, today, 50 percent of the income of a company subject to Nigerian tax must generally be paid out in income taxes, alert investors and managers should constantly pay attention to every possible tax savings. Ample and full consideration has usually been given to the commercial aspects of the proposal but there is a distinct tendency to treat the financing and tax aspects as fixed parameters rather than as variables which can be adjusted.[9] The days are gone when tax factors could be disregarded as adjustable inputs into investment and business decisions.

Tax considerations imply not only the knowledge of the tax laws but also its application to existing alternatives for every transaction so as to be able to choose the alternative that attracts the greatest tax advantage or the least tax liability.

As in many countries, tax evasion is illegal and unethical while tax avoidance is a legitimate activity. Tax planning which involves careful and adequate consideration of tax factors as they bear on business decisions is the surest way of legally preventing a tax liability from coming into existence.

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8. For analysis of these allowances, see A.C. Ezejelue, "Evolution of Direct Taxation in Nigeria", *The Tax Executive,* 31:1, October 1978, pp. 34-48.
Also note that in order to compensate for the "motor basic allowance", with effect from April 1, 1979, which reduced the take-home pay of senior officers, personal allowances for all employees have been increased from a minimum of 600 naira to a fixed sum of 1,200 naira.

9. Malcolm J. Finney, "Problems of Corporate Direct Investment in the UK", *The Tax Executive,* 31:1, October 1978, pp. 8-26.

# Tax incentives for foreign investors in Argentina

by Máximo Bomchil Jr.*

## I. THE NEW APPROACH TO FOREIGN INVESTMENTS

*Since 1976, Argentina has followed a policy of promotion of foreign investments. In August of that year a new law regulating foreign investments in Argentina was enacted. This new legislation repealed the existing law, which had proved too restrictive to be compatible with new foreign investments as well as with the growth of foreign capital already existing in the country.*

*This old law was part of a trend that can be clearly detected in Argentina beginning in late 1970. At that time a number of government regulations began to reflect a certain hostility towards foreign companies operating in the country. This trend escalated slowly at the beginning and then very rapidly after the inauguration of a new administration in May 1973.*

*It can safely be said that this trend has now passed its hour of triumph and has begun its decline. The present government has clearly stated that foreign capital shall participate in the achievement of Argentina's national goals in the area of economic development.*

*In this context the government has enacted a series of new laws regulating such matters as transfer of technology, financial institutions, customs tariffs and industrial promotion with the clear objective of opening Argentina's economy to the outside world and reestablishing the traditional Argentine legal principle of equality between foreign and local investors. In fact, some exceptions to this principle will continue to exist but it is important that the new legislation has rescued the principle as the general applicable rule.*

*In July 1977, a new law on industrial promotion was enacted (Law No. 21,608 published in the Official Gazette of July 27, 1977), derogating the regime in force until that date which had been inefficient in promoting local industry, mainly due to the bureaucratic procedure which had to be followed to obtain industrial promotion benefits, and allowing foreign investors to benefit from them. This article will analyze the tax incentives contemplated by the law and to what extent and under which conditions foreign investors have access to them. For this purpose we will describe briefly the aims and structure of the Argentinian industrial promotion system and tax incentives as well as the administrative procedures which have to be followed to benefit from them.*

## II. STRUCTURE OF THE SYSTEM

The aims of the new Argentinian industrial promotion regime are to encourage the regional development of industry, imporve the efficiency of existing industry, help the installation of new activities in frontier areas, press on with the development of industries necessary for security and national defence and facilitate the transfer of industries from highly concentrated areas to underdeveloped zones. The law not only promotes the installation of new industries but also the modernization, specialization, integration, merger, restructuration, expansion and transfer of existing companies.

The industrial promotion system is formed by the new law (No. 21,608), its general implementing regulations (Decree No. 2541/77 published in the Official Gazette of September 2, 1977) and complementary decrees dealing with sectorial, regional and special schemes. In principle it can be said that it constitutes a closed system in the sense that the authorities may grant industrial promotion benefits only as long as the investment projects fall under the scope of a regional, sectorial or special scheme; therefore the importance of these complementary decrees. In practice, however, benefits have been granted in specific cases to projects which were not covered by the said schemes. This, for example, was the case with a recent major foreign investment in the chemical industry, where, although the industrial project was not covered by any sectorial, regional or special scheme, the investor was granted special import duty protection for products similar to those which were to be manufactured locally.

Sectorial decrees regulate the promotion of particular branches of industries. They determine which benefits may be granted and for how long, requirements to comply with, limitations and exclusions, antipollution measures, evaluation criteria, etc. The most important sectorial schemes in force at present are for petrochemicals, mining, paper, steel, shipyards, forestry and fishing. Most of these schemes were enacted under the now abrogated old law on industrial promotion but the new law has kept them in force until new regulations are issued on the subject. A new petrochemical sectorial scheme was put into force in April 1979 and the government is at present studying new regulations for the mining sectors.

The regional schemes aim to promote the different geographical areas of the country specially taking into account for the location of industries their distance from consumption centers and suppliers and other socioeconomic factors, such as density of population and stage of development, so as to achieve a balanced industrial growth of the country. The general guidelines for regional schemes are laid down by Decree No. 922/73. Specific decrees for several Argentine provinces

* Partner in the Law Office of M. & M. Bomchil.

have been issued, e.g. Decree No. 2140/74 for the provinces of Jujuy, Salta, Tucumán and Santiago del Estero, located in the North of the country, Decree No. 893/74 for the provinces of Catamarca, La Rioja and San Luis, in the West of Argentina and Decree No. 575/74 for the provinces of Formosa, Chaco, Corrientes and some regions of Santa Fe in the North-East of the country. These regional schemes determine the industries which are considered priority industries for the provinces concerned and are therefore eligible to receive industrial promotion benefits. Industries not considered priority industries may also be granted benefits if they comply with certain other requirements, mostly related to the number of persons to be employed, raw material used, exports, etc.

Finally, special schemes are available for development areas or industrial concentrations which the government defines as such.

## III. REQUIREMENTS AND CONDITIONS

The general requirements and conditions with which projects must comply in order to be eligible for industrial promotion benefits are contained in the industrial promotion law and its implementing regulations. As mentioned above, specific requirements for sectorial, regional and special schemes are established by the respective decrees.

The investment project must have as an objective an *industrial activity*. According to the implementing regulations, industrial activities are those which cause the physical or chemical transformation, in form or in essence, of raw materials into new products, by means of an industrial process, that is to say by the application of uniform manufacturing technology or the employment of machinery or equipment. The implementing regulation contain a long list of activities which are considered industrial, which list may be modified by the authority in charge of the application of the law as it deems convenient.

In the evaluation of the projects the objectives of the law as above described will be taken into consideration. Industries which manufacture basic or strategic products, contribute to import substitution or supply exports are given priority as well as those which are dedicated to transforming regional raw materials or are situated in areas with a high rate of unemployment or a very low gross regional product or use advanced technology or manufacture products of accepted international quality levels.

Projects must show proof of viability, profitability and reasonable cost of production. The beneficiaries must possess suficient technological and management skill.

The favoured industries are expected to have done the building and possess installations that preserve proper living conditions and avoid environment pollution.

The authority in charge of the application of the law must take care when granting promotional facilities that there is no undue effect upon efficient industry already installed in the country or in the process of installation.

Projects must contemplate a genuine contribution of own capital of at least 20 percent calculated on the total value of fixed assets. The authorities may reduce this percentage to 10 percent in exceptional cases for projects of national priority interests. The graduation of benefits may also be adjusted to a greater or lesser degree according to the amount of own capital contribution. Projects must have an adequate financial structure and a correct relationship between net assets and liabilities with third parties.

Foreign investors have to establish a domicile in the country in order to apply for the benefits.

## IV. TAX INCENTIVES

The law offers as tax incentives the *exemption from, and the reduction, suspension and deferral of taxes and writing-off of fixed assets for a determined period in a total or partial form.* These tax incentives may be given for a period of time of up to 10 years, counting generally from the day the project is begun.

In the case in which benefits consist of taxation deferral, the updating of these is established for the purpose of payment, according to the variation of local wholesale prices as determined by the administration.

The main taxes to which the incentives are applicable are the following:

a) *Income tax.* Companies incorporated in Argentina (stock corporations and partnerships are subject to a flat rate of 33 percent on their net taxable income, i.e. gross income less expenses incurred in producing the income. Dividends or profits distributed by these companies to shareholders or partners resident in Argentina are free of any other tax, but when payment is effected to shareholders or partners abroad, they will be subject to a further withholding tax of 17.5 percent. This additional withholding takes the total aggregate income tax for shareholders or partners abroad to 44.72 percent (33 percent corporate tax + 17.5 percent withholding on dividends). However, the withholding tax on dividends is not applicable when dividends are paid in the form of stock dividends, that is, when profits are capitalized, or when they are reinvested in other ways in the company, for example as reserves. Branches and other sorts of permanent establishment of foreign companies located in Argentina are subject to a flat rate of 45 percent on their net taxable income.

   The tax incentive is generally granted by means of allowing the beneficiary to deduct from his net taxable income the investments effected in the project, either in a total or partial form for a determined period of time.

b) *Value added tax.* The value added tax is levied in Argentina on sales and leasing transactions on movable goods, construction, manufacturing and processing works, the rendering of certain services specifically determined by the law, and importation of goods. The rate is 16 percent. The amount of tax due is determined by applying the said rate to the net taxable sale price and deducting therefrom the amount of tax paid on prior purchases of supplies and materials.

c) *Net worth tax.* This tax is levied on the net worth of companies and permanent establishments of foreign companies located in Argentina. The rate is 1.5 percent annually on the net worth calculated as provided in the law (assets located in Argentina less liabilities).

d) *Stamp tax.* Stamp taxes are levied in Argentina by each province and by the Federal Government in the city of Buenos Aires. They are applicable on contracts, mortgages, deeds and practically all other agreements evidenced by documents. Although the rates vary in each province, the applicable rate is generally 1 percent. The Federal Government may, under the provisions of the industrial promotion law, issue exemptions only from the Federal stamp tax, because the provincial stamp duties are not within its jurisdiction. However, most of the provinces have enacted local industrial promotion laws which also provide for the exemption of the provincial stamp taxes.

e) *Tax on additional profits.* The foreign investment law enacted in August 1976 introduced a "special tax on additional profits". According to the law all foreign investors, whether they have a registered investment or not, may freely remit their profits and repatriate the capital. There is no limit placed on the amount of profits which may be remitted nor of capital which may be repatriated. The Executive Power may limit the right of *non-registered investors* to remit profits and repatriate capital if difficulties in the payment of the external indebtedness of the country occur and only while such difficulties subsist. The *registered investor* instead maintains his right to remit profits and repatriate capital in spite of such limitations and may continue to request from the Central Bank foreign currency to do so. The price that the registered foreign investor must pay for the guarantee of availability of foreign exchange is the special tax on additional profits. When profits of registered investors exceed annually, after taxes, 12 percent of the registered capital, the excess will be subject to the special tax according to the following rates:

| *Profits paid* | *Rate* |
|---|---|
| From 12% to 15%, the excess over 12% | 15% |
| From 15% to 20%, the excess over 15% | 20% |
| More than 20%, the excess over 20% | 25% |

It is important to mention that this special tax is applicable to *profits paid to the investor* whether in the country or abroad, but not if the profits are reinvested in Argentina, in the same company which generated them or in another company with the authorization of the government.

The foreign investment law authorizes the Executive Power to exempt the foreign investor from this tax or to raise the margin at which profits may be remitted free of the tax above 12 percent. Therefore, it is highly possible that the authorities will resort to this provision in case they wish to exempt the foreign investor from the tax, instead of applying the industrial promotion law.

## V. THE "TRANSFER OF INCOME" PRINCIPLE

Both Argentina's income tax law and industrial promotion law provide for a limitation when the benficiary of tax incentives is a foreign investor, which in some cases renders the benefits useless. The said laws provide that when the owner of the investment project is a foreign investor, *the tax benefits will produce no effect to the extent that they result in an income transfer to a foreign state.* This means, in other words, that the incentives will have no effect in Argentina if the state of origin of the investor taxes profits originated by the tax incentives. Through this provision the law purports to avoid a foreign state increasing its revenues as a consequence of tax incentives granted by the Argentinian government.

This principle of "income transfer" was introduced in our tax law in 1973 in applying a policy of discrimination against foreign investors. As indicated above, this policy has now been completely modified. The new laws on foreign investments, transfer of technology, industrial promotion, etc. show very clearly that the traditional Argentine policy of equality between local and foreign investors has be re-established. Although difficult to justify in this context, the principle of "income transfer" has been kept in our tax legislation and even been strengthened by its inclusion in section 4 of the Industrial Promotion law.

Curiously enough, the authorities have been unable to enforce the principle up to now, due to the difficulties in determining in each particular case the measure of the income transfer to the foreign state. In January 1977, the law was modified with the purpose of facilitating the proof of the income transfer. The amendment provided that the extent of the transfer would be determined in accordance with the documentation that the taxpayer was obliged to file, consisting in certificates issued by the appropriate authorities or other qualified persons of the investor's country of origin. The total transfer of income to the foreign state would be presumed, should the taxpayer neglect to present the said certificates, and consequently the tax incentives would become ineffective. It does not require a very deep analysis to come to the conclusion that the new provisions clarify what the proof can consist of, but remove none of the difficulties of determining the measure of the income transfer to the foreign state in each opportunity in which profit remittances are made.

We know of no case in which the principle has been applied although the provision has been in force for more than 5 years. Probably the authorities will end by recognizing the practical impossibility of enforcing the provision and will finally abrogate it. Until such time, two points are worth bearing in mind.

First, it is reasonable to argue that a transfer of income derived from a tax incentive can occur exclusively when the incentive is granted with respect to the withholding tax or the special tax levied on dividends paid to shareholders abroad; these are taxes borne by the shareholders, whose profits can be taxed by their country of origin. On the other hand, no income transfer happens when the incentives concern taxes borne by the company itself (for example the corporate income tax, value added tax, tax on net worth, etc.), because no foreign state benefits directly from such incentives as no other state other than Argentina taxes the company located in the country. This being so, the effect of the income transfer principle is minimized. Second, the application of the principle may be wholly avoided by investing in Argentina through a subsidiary or a branch of the foreign investor domiciled in a tax haven country. In this case no foreign state would benefit, at least directly, from Argentinian tax incentives.

## VI. Procedure

The authority charged with the application of the law is the Secretariat of Industrial Development, a section of the Ministry of Economy.

The procedure for requesting industrial promotion benefits has two steps regulated in detail by a resolution of the Secretariat (No. 773/77). The first step the investor must consult the Secretariat on the possibilities of obtaining industrial promotion benefits for a particular project and request authorization to file a definitive proposal of investment. The project is evaluated and the authorities must decide within 60 days whether the filing of the definitive project can be authorized and under which conditions. The second step is initiated by the filing of the definitive project, for which purpose the investor has 120 days from the date of obtaining the above approval. The authorities must within 120 days come to a final decision as to the concession of the benefits. A special duty must be paid upon filing the definitive project to meet the costs of the study and analysis. This duty is calculated according to a decreasing percentage on the amount of the project the details of whose application are regulated by resolution of the Secretariat No. 998/77. Consultations in the first step are free of duties.

The decision as to the granting of the industrial benefits is taken by the Executive Power by means of a decree when the beneficiary is a foreign investor or a local company of foreign capital (companies domiciled in Argentina in which foreign investors own more than 49 percent of its capital or have enough votes to prevail in the meetings of shareholders). For this purpose the Secretariat submits the project to the Executive Power recommending the granting or refusal of the incentives requested.

When a foreign investment is involved in the project the most convenient procedure is to apply directly for an approval for effecting the foreign investment at the Undersecretariat of Foreign Investments, requesting simultaneously the granting of promotional measures. The Undersecretariat will contact the Secretariat of Industrial Development and both applications (foreign investments and industrial promotion benefits) will be decided together.

## VII. PROHIBITIONS AND EXCLUSIONS

It was mentioned above that one of the aims of the industrial promotion regime is to encourage the regional development of industry and facilitate the transfer of industries from highly concentrated areas, such as the Federal District and other big cities, to underdeveloped zones.

Pursuing this aim the industrial promotion law prohibits the establishment of new industries in the Federal District and provides further that the installation, expansion or improvement of industries already established in the areas within a radius of 60 kilometers from the Federal District and the cities of Córdoba and Rosario, in the center of the country, will be excluded from the benefits of the law.

## VIII. INVESTMENTS IN SOUTH ARGENTINA

As a last point it should be mentioned that Law No. 19,640 of May 1972 introduced a general exemption from all national taxes for industries established in certain regions of South Argentina (Tierra del Fuego, Antártica e Islas del Atlántico Sur). Foreign investors may benefit from such exemption including all the main taxes mentioned above as well as several other national taxes of lesser importance.

## IX. CONCLUSIONS

The new law on industrial promotion constitutes a remarkable improvement in the establishment of an efficient and flexible system for the promotion of the installation and modernization of industry in Argentina. Its application during the past 3 years is the best proof of it. It should become an incentive for foreign investments in Argentina as well.

# U.S. Oil Companies and the Foreign Tax Credit

Revenue Ruling 79-93 provides that the Libyan surtax paid or accrued under Article 14 (1)(a) of the Libyan Petroleum Law No. 25 of 1955 for taxable years beginning prior to July 1, 1978 can under certain circumstances be credited against U.S. 1979 income tax. See also *32 Bulletin for international fiscal documentation* 110 (March 1978).

## ISSUE

Are amounts paid or accrued to Libya as surtax under Article 14(1)(a) of the Libyan Petroleum Law No. 25 of 1955. as amended through January 1, 1975 ("Petroleum Law") for taxable years beginning prior to July 1, 1978, that are properly deemed to be paid or accrued in taxable years beginning after July 1, 1978, pursuant to sections 907 and 904 of the Internal Revenue Code of 1954, treated as income, war profits, or excess profits taxes within the meaning of section 901(b) of the Code in the years to which they are carried?

## FACTS

The taxpayer, a United States corporation that uses and has used the calendar year as its taxable year at all relevant times, is in the business of exploring for, developing, and producing crude oil and natural gas in the country of Libya.

Pursuant to the Article 14(1)(a) of the Petroleum Law and Clause 8(1)(a) of the Second Schedule to that law, the taxpayer paid amounts to Libya as surtax for taxable year 1978 and prior taxable years, which exceeded the amounts allowable as foreign tax credits under sections 907 and 904 of the Code. The amounts paid in 1978 to Libya also exceeded the amounts allowable in 1977 and 1976 by reason of the limitations under sections 907 and 904. To the extent provided in sections 907 and 904, certain of the amounts paid in 1978 which could not be utilized in 1977 and 1976 can be carried to taxable year 1979.

## LAW AND ANALYSIS

Subject to the limitations contained in sections 901 through 908, section 901(a) of the Code permits domestic corporations to claim a credit for income taxes paid or accrued to foreign countries.

Section 907(a) limits the amount of oil and gas extraction taxes which are allowable in applying section 901 by a formula based on a taxpayer's foreign oil and gas extraction income. Section 970(f) provides that certain amounts of the oil and gas extraction taxes paid by a taxpayer which exceed the limits set forth in section 907 (a) shall be deemed to be oil and gas extraction taxes paid or accrued in the two preceding or five succeeding taxable years as provided in section 907(f).

Section 907(b) of the Code provides that the provisions of section 904 shall be applied separately with respect to a taxpayer's foreign oil related income. Section 904(c) provides for a carryback of two years and a carryover of five years of the amount of income taxes paid to a foreign country for any taxable year that exceeds the limitation provided by section 904(a).

Rev. Rul. 78-63, 1978-1 C.B. 228, holds that the surtax imposed on oil companies by Article 14(1)(a) of the Petroleum Law is not a creditable income tax for purposes of section 901 of the Code. However, pursuant to the authority contained in section 7805(b), Rev. Rul. 78-63 provides that it will be applied prospectively only to amounts paid or accrued to Libya for taxable years beginning on or after July 1, 1978. Rev. Rul. 78-63 revoked Rev. Rul. 68-552, 1968-2 C.B. 306, which held that the surtax was a creditable income tax for purposes of section 901. Thus, amounts paid or accrued to Libya as surtax for taxable years beginning prior to July 1, 1978, will be treated as creditable income taxes for purposes of section 901 by reason of section 7805(b).

Because amounts of Libyan surtax for taxable years beginning prior to July 1, 1978, are treated as income taxes within the meaning of section 901(b) of the Code, these amounts will also be treated as creditable income taxes for purposes of computing the amounts which may be deemed paid in a preceding or succeeding year pursuant to section 907(f) and section 904.

Amounts paid or accrued to Libya as surtax under Article 14(1)(a) of the Libyan Petroleum Law No. 25 of 1955, as amended through January 1, 1975 for taxable years beginning prior to July 1, 1978, that are properly deemed paid or accrued in taxable years beginning after July 1, 1978, pursuant to sections 907 and 904 of the Code, will be treated as income taxes within the meaning of section 901(b) of the Code in the years to which they are carried.

# Taxation of Non-Resident Alien Real Estate Transactions in the United States

THE SECRETARY OF THE TREASURY
WASHINGTON

*May 4, 1979*

*Dear Mr. Chairman:*

*Section 553 of Public Law No. 95-500, the "Revenue Act of 1978," required the Treasury Department to conduct a study and analysis of the appropriate tax treatment of income from, or gain on the sale of, interest in United States property held by nonresident aliens and foreign corporations. The Secretary is required to transmit a report of the results of this study, together with the recommendations of the Department, within six months of the date of enactment of the Act.*

*Pursuant to these provisions, I hereby submit a report entitled "Taxation of Foreign Investment in U.S. Real Estate."*

*Under present law, capital gains realized by nonresident aliens and foreign corporations are not subject to U.S. tax unless they are "effectively connected" with a U.S. trade or business. The Treasury Report finds that, while most real property holdings of foreign persons is used in a U.S. trade or business, foreign persons rarely incur capital gains tax on the disposition of their U.S. property holdings. The Report identifies various ways in which the capital gains on real estate, which would ordinarily be taxable, can be converted into capital gain on some other asset, which would not. The principal means by which this is accomplished is through a real property holding company, and converting gain realized on disposition on the "effectively connected" property into gain realized on disposition of the shares, which is not deemed "effectively connected."*

*The Treasury does not believe that taxing capital gain on the sale of corporate shares is desirable or practical. But to prevent unintended tax avoidance, the Treasury recommends modifying certain specific statutory provisions under which foreign taxpayers convert taxable gain on real estate into nontaxable gain. The Report describes certain steps which may be taken in this regard. The Treasury plans to work with the Congress and with other agencies of the Government in developing formal legislative proposals in this area.*

*I am sending an identical letter to Senator Russell B. Long, Chairman of the Committee on Finance.*

*Yours very truly,*

*W. Michael Blumenthal*

*The Honorable*
*Al Ullman, Chairman*
*Committee on Ways and Means*
*House of Representatives*
*Washington, D.C. 20515*

## CHAPTER 1 – INTRODUCTION AND SUMMARY [1]

This Report was prepared pursuant to section 553 of the Revenue Act of 1978, which stated:

SEC. 553 STUDY OF TAXATION OF NONRESIDENT ALIEN REAL ESTATE TRANSACTIONS IN THE UNITED STATES

(a) STUDY. – The Secretary of the Treasury shall make a full and complete study and analysis of the appropriate tax treatment to be given to income derived from, or gain realized on, the sale of interests in United States property held by nonresident aliens or foreign corporations.

(b) REPORT. – The Secretary of the Treasury shall submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a final report of its study, together with its recommendations, no later than 6 months from the date of enactment of this Act.

Chapter 2 summarizes available statistics on the nature and extent of foreign investment in U.S. real estate.[2] Chapter 3 describes taxation of foreign investment income under present U.S. statutory law; Chapter 4 explains how U.S. statutory law is modified by existing tax treaties. Chapter 5 describes and analyzes proposals to change the statutory treatment of foreign taxpayers' capital gains on the sale of U.S. real estate.

The statistics presented in Chapter 2 suggest that foreign investors

1. This Report seeks to describe and analyze present U.S. law for taxing income from, and capital gain on the sale of, U.S. real estate. The Report does not purport, however, to take a position or resolve any ambiguities in the interpretation of existing statutes, regulations, revenue procedures, and so forth. The Report cannot and should not be relied upon by taxpayers or the Internal Revenue Service in resolving pending or future determinations of taxpayers' liability for U.S. tax.

2. The term, "real estate", as used here means land and its improvements, and buildings and their structural components. "Foreign investors" are individuals who are neither U.S. citizens nor resident in the United States, corporations chartered under foreign laws, foreign governments, and foreign trusts and estates. "Foreign Investment in U.S. real estate" includes not only direct ownership by a foreigner of U.S. real estate, but also ownership of an interest in a U.S. corporation, partnership, trust or estate whose assets consist primarily of U.S. real estate. A foreign investor may buy U.S. real estate for his own use in a non-real-estate business (e.g., manufacturer's plant), for lease to some other user, or merely for a non-income-producing investment. This Report, however, is concerned only with real estate which is leased or held for investment.

own a small percentage of U.S. real estate generally or of farmland in particular. Both Commerce and Agriculture Department statistics indicate that foreigners own less than one half of one percent of U.S. agricultural land; previously unpublished statistics based on 1974 tax returns indicate that total receipts of foreign and foreign-controlled corporations whose primary U.S. operations were real estate represented approximately 3 percent of the total receipts of all real estate corporations in the United States. Comparable statistics for individuals and partnerships are unavailable. Although press clippings and other sources indicate that such investment has been growing rapidly over the last five years, hard statistical evidence documenting this trend is simply unavailable.

Tax return data also indicate that real estate investors, domestic and foreign, often report losses on their U.S. tax returns. Real estate ventures are frequently undertaken by partnerships, rather than by corporations, because losses offset other income earned by partners. Although most foreign corporations and shareholders of foreign-controlled U.S. corporations investing in U.S. real estate come from Canada, the United Kingdom and other industrialized countries, a substantial minority listed addresses in the Bahamas, the Netherlands Antilles and other western hemisphere countries.

The specific rules under which foreign investors are taxed by the United States on income and capital gain from U.S. real estate are complex, but their essential features can be described simply. Individuals who are neither citizens nor residents of the United States and foreign corporations have, for U.S. tax purposes, three types of income:

— Income, *including capital gains*, which is effectively connected with a U.S. trade or business. This income can be *offset by allowable deductions* and is *taxed at progressive rates* under the same general rules as those applicable to U.S. citizens, residents or corporations.

— Interests, dividends, rents and certain other U.S.-source income not effectively connected with a U.S. trade or business, against which *no deductions* are allowed and which is *taxed at a flat rate of 30 percent* (less for certain items for residents of countries with which the United States has a tax treaty in force). U.S.-source capital gain not effectively connected with a U.S. trade or business is included in this category only in the exceptional case of a nonresident alien who is present in the United States for 183 days or more in the year in which such gain is realized.

— All other income, which is *exempt* from U.S. tax.

Foreign investors ordinarily prefer to have rental income from U.S. real estate considered effectively connected with a U.S. trade or business so as to qualify for deductions. Under statutory law, a foreign taxpayer who does not have such a trade or business may simply elect to have U.S. real property income taxed as if it were.

When real estate is sold, a foreign investor can avoid U.S. tax on his capital gain only if such gain is *not* effectively connected with a U.S. trade or business. Although statutory law does not intend that capital gain on assets used in a trade or business escape taxation, Chapter 3 identifies five ways (there may well be others) of achieving that result under present rules. Four of those ways depend only on a careful use of existing statutes, the fifth requires a treaty provision, but would be ineffective without the *statutory* exemption for capital gains on real estate not used in a trade or business.

Chapter 4 describes in greater detail the ways in which tax treaties modify U.S. statutory law. Although a substantial portion of foreign investment in U.S. real estate comes from or through foreign countries with which the United States has a tax treaty, the analysis of available statistics and relevant law suggests that *statutory rules, not treaty modifications of those rules, allow foreign investors to avoid U.S. taxes on real estate income and capital gains.*

Chapter 5 describes and analyzes proposals to treat all capital gain derived directly or indirectly from U.S. real estate as effectively connected with a U.S. trade or business and, thus, subject to U.S. tax. Analysis of a hypothetical investment in U.S. farmland suggests that under present law a foreign investor bears a lighter U.S. tax burden than a domestic investor does, but would bear a heavier burden if his capital gain were subject to tax. Taxing capital gain on the sale of U.S. real property would be fully consistent with international practice; indeed, the United States is somewhat unusual in not presently taxing such gain.

Taxing part or all of the capital gain on the sale of *shares* in a corporation owning U.S. real estate would, however, be a departure from international norms. A tax on the capital gain on the sale of shares is, moreover, difficult to enforce. A careful analysis of the specific steps a foreign investor must go through to avoid U.S. capital gains tax suggests that present abuses might be curtailed by modifying the rules relating to "like kind exchanges" of property, corporate liquidations and reorganizations, and so forth, rather than assessing a tax on the sale of corporate shares.

Taxing capital gain on the sale of U.S. agricultural land alone would raise U.S. Treasury revenues by an estimated $22 million in 1979; taxing capital gain on all U.S. real estate sold by foreign taxpayers would raise Treasury revenues by $142 million. The balance of payments impact of the proposal cannot be estimated with any precision, but would probably be relatively small.

## CHAPTER 2 – STATISTICAL BACKGROUND

### I. Introduction

This chapter summarizes available evidence on foreign investment in U.S. real estate generally and agricultural land in particular. Although all statistics could be improved, those pertaining to foreign investment in U.S. real estate should be approached with more than the usual caution. Under generally accepted accounting practices, assets are usually valued at historical cost; this practice may substantially understate fair market value or replacement cost of assets like U.S. real estate whose prices have been inflating rapidly. Moreover, statistical coverage of large investors tends to be better than that of small investors; the typical real estate investment is small by comparison to that in other industries. Finally, the most recent comprehensive Commerce Department and Internal Revenue Service statistics pertain to 1974, Newspaper accounts suggest that foreign investment in U.S. real estate has been growing rapidly in the last five years, but comprehensive statistics are simply unavailable.

### II. Commerce Department and Other Non-Tax Statistics

The most recent benchmark census by the Department of Commerce of total foreign direct investment in the United States was based on 1974 data; results from that survey are summarized in Table 2-1. The Commerce Department statistics exclude U.S. affiliates [3] whose total assets and total annual revenues were both less than $100,000; assets are stated at book value (usually based on original cost) and net of depreciation (buildings

3. According to Commerce Department definitions, a U.S. affiliate of a foreign investor is a U.S. branch of a foreign corporation or a U.S. corporation at least 10 percent of whose equity is owned by foreign investors.

## TABLE 2-1

### ASSETS, LIABILITIES & NET WORTH OF U.S. AFFILIATES[1] OF FOREIGN COMPANIES
(Millions of Dollars)

| | All Industries | Real Estate |
|---|---|---|
| Year End 1974 | | |
| Total Assets[2] | 174,272 | 4,245 |
| Property, Plant and Equipment (Net) | 29,366 | 2,601 |
| Property (Net) | 4,733 | 521 |
| Total Liabilities | 134,165 | 3,387 |
| Long Term | 20,865 | 2,273 |
| Net Worth | 40,107 | 858 |

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: U.S. Department of Commerce, Foreign Direct Investment in the United States, Volume 2: Benchmark Survey, 1974, (April 1976).

1. Includes U.S. Companies of which at least 10 percent of the equity was owned by foreigners.
2. All assets stated at book value net of depreciation. Accumulated depreciation was equal to $4,523 million in total of which $327 million was in real estate.

## TABLE 2-2

### 1978 FOREIGN INVESTMENT IN THE U.S. REAL ESTATE INDUSTRY IDENTIFIED FROM PRESS CLIPPINGS BY THE OFFICE OF FOREIGN INVESTMENT IN THE UNITED STATES

| Country of Parent* | Number of Transactions | Number with Money Given | Total Purchases (in millions) | Percent of Total |
|---|---|---|---|---|
| Canada | 55 | 38 | $ 564.5 | 51.3 |
| Netherlands | 12 | 9 | 131.6 | 12.0 |
| Netherlands Antilles | 12 | 9 | 28.3 | 2.6 |
| United Kingdom | 9 | 7 | 81.4 | 7.4 |
| West Germany | 15 | 10 | 79.7 | 7.2 |
| Total | 158 | 112 | 1,101.0 | |

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*The source of 10 transactions was not identified.

Comments:
1. There were 13 transactions with value in excess of $25 million accounting for 62.0 percent of the total investment identified. They were mainly by Canadian developers.
2. Only 20 transactions are definitely identified as involving a farm or ranch. There is therefore not much overlap with the purchases identified by the Department of Agriculture.

and equipment are depreciated for reporting purposes in financial statements and tax returns, but land is not).

Table 2-1 indicates that total assets of U.S. affiliates of foreign investors had book value of $174 billion in 1974. Property, plant and equipment (net of depreciation) had book value totaling $29 billion; property alone (i.e. land and improvements) was valued at $4.7 billion. Property, plant and equipment includes not only real estate leased to other users, but also such assets used by a U.S. affiliate in a business other than real estate. Foreign affiliates whose primary industry was real estate reported assets worth $4.2 billion, of which $2.6 billion represented property, plant and equipment, and $621 million property alone. Property, plant and equipment of real estate affiliates increased by 20 percent between 1973 and 1974. The Commerce Department also estimated that foreign-owned affiliates owned 1.1 million acres of U.S. agricultural land at the end of 1974.

The Commerce Department's Bureau of Economic Analysis updates certain benchmark statistics with annual sample surveys; the most recent survey indicates that net foreign investment (i.e., assets less liabilities) in the U.S. real estate industry decreased by $20 million between 1976 and 1977.[4] This finding, which is hard to reconcile with press accounts, may reflect book losses reported by existing investments and inadequate coverage of new investment. A different picture of new investment is provided by the Commerce Department's Office of Foreign Investment in the United States (OFIUS), which prepares annual tabulations of foreign purchases of U.S. property as reported in the press — see Table 2-2. OFIUS clippings identified 158 foreign purchases of U.S. real estate in 1978; the 112 purchases for which a price was reported amounted to $1.1 billion. Several of the larger purchases reflected in Table 2-2 were by Canadian developers. Purchases through the Netherlands Antilles (and, to a lesser extent, the Netherlands and the United Kingdom) may have been by corporations owned by residents of third countries.

The available statistics describing foreign investment in U.S. agricultural land are more current than those for U.S. real estate generally. According to a recent report by the General Accounting Office, foreigners owned an estimated three tenths of one percent of the land in the countries surveyed; if those countries are typical of the United States as a whole, foreigners owned 3 million acres (as compared to the Commerce Department estimate of 1 million acres as of 1974) of the estimated one billion total acres of U.S. agricultural land in 1978.[5] In 1977 and the first half of 1978, foreigners were purchasing U.S. agricultural land at a rate of 560,000 acres per year, which constituted about 2 percent of the acreage sold in that period. Assuming that foreigners purchased agricultural land worth $1,000 per acre (as opposed to the U.S. national average of $591 per acre,[6]

4. William K. Chung and Gregory C. Fouch, "Foreign Direct Investment in the United States, 1977," *Survey of Current Business*, U.S. Department of Commerce, Washington, D.C., August 1978, Tables 13 and 14.
5. U.S. General Accounting Office, Foreign Ownership of U.S. Farmland, *Much Concern, Little Data*, June 12, 1978. This material can also be found in the Report to the General Accounting Office, in *Foreign Investment in United States Agricultural Land*, published by the U.S. Senate Committee on Agriculture, Nutrition and Forestry, (January 1979).
6. Available statistics do not indicate the average price per acre of land purchased or owned by foreign investors. Evidence does suggest, however, that foreign investment tends to be concentrated in agricultural land of higher average value. Because the price of prime U.S. farmland may substantially exceed $1,000 per acre, this Report has assumed that foreign-owned farmland was worth $1,000 per acre on average. Experts at the Department of Agriculture agree that this estimate is reasonable.

# TABLE 2-3

## SELECTED BALANCE SHEET AND INCOME STATEMENT ITEMS BY TYPE OF RETURN AND SELECTED INDUSTRY

(Money Amounts are in Millions of Dollars)

| Type of Return and Selected Industry | Number of Returns | Total Assets | Depreciable Assets (Net) | Land | Mortgages Notes and Bonds Payable | Total Receipts | Total Deductions | Taxes Paid | Interest Paid | Depreciation | Net Income | Deficit |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| CORPORATIONS [1] | | | | | | | | | | | | |
| Lessors of buildings | 166,985 | $62,833 | $34,145 | $11,792 | $5,185 | $14,394 | $5,737 | $2,022 | $2,898 | $2,010 | $1,710 | $927 |
| Lessors of mining, oil, and similar property | 784 | 549 | 171 | 54 | 48 | 227 | 140 | 15 | 14 | 12 | 88 | 2 |
| Lessors of railroad and other property | 6,183 | 1,754 | 466 | 739 | 106 | 219 | 179 | 24 | 43 | 26 | 63 | 23 |
| Real estate investment trusts | 325 | 14,705 | 2,919 | 961 | 4,978 | 1,429 | 1,869 | 65 | 899 | 81 | 74 | 514 |
| Corporations | 174,277 | 79,841 | 37,701 | 13,546 | 10,317 | 16,269 | 15,782 | 2,126 | 3,854 | 2,129 | 1,935 | 1,466 |
| PARTNERSHIPS WITH BALANCE SHEETS [2] | | | | | | | | | | | | |
| Lessors of buildings | 215,923 | 117,877 | 84,177 | 19,131 | 98,803 | 20,121 | 23,754 | 2,847 | 7,744 | 5,135 | 1,768 | 5,401 |
| Other Lessors | 21,772 | 4,808 | 546 | 3,421 | 2,445 | 363 | 413 | 50 | 155 | 49 | 131 | 181 |
| Partnerships with Balance Sheets | 237,695 | 122,685 | 84,713 | 22,552 | 101,248 | 20,484 | 24,167 | 2,897 | 7,899 | 5,184 | 1,899 | 5,582 |
| Corporations and partnerships with balance sheets | 411,972 | 202,526 | 122,414 | 36,098 | 111,565 | 36,753 | 39,949 | 5,023 | 11,753 | 7,313 | 3,834 | 7,048 |
| ALL PARTNERSHIPS [2] | | | | | | | | | | | | |
| Lessors of buildings | 260,635 | n/a | n/a | n/a | n/a | 20,858 | 24,478 | 2,956 | 7,904 | 5,308 | 1,909 | 5,530 |
| Other Lessors | 32,349 | n/a | n/a | n/a | n/a | 527 | 494 | 65 | 160 | 59 | 222 | 189 |
| Partnerships | 292,984 | n/a | n/a | n/a | n/a | 21,485 | 24,972 | 3,021 | 8,064 | 5,367 | 2,131 | 5,719 |
| Corporations and Partnerships | 467,261 | n/a | n/a | n/a | n/a | 37,754 | 40,754 | 5,147 | 11,918 | 7,496 | 4,066 | 7,185 |
| SOLE PROPRIETORS [2] | | | | | | | | | | | | |
| Lessors of buildings | 29,684 | n/a | n/a | n/a | n/a | 906 | 955 | 103 | 248 | 185 | 97 | 146 |
| Other Lessors | 34,817 | n/a | n/a | n/a | n/a | 83 | 117 | 18 | 24 | 28 | 22 | 56 |
| Farm landlords | 360,610 | n/a | n/a | n/a | n/a | 2,879 | 1,466 | 236 | 83 | 182 | 1,526 | 113 |
| Sole proprietors | 425,111 | n/a | n/a | n/a | n/a | 3,868 | 2,538 | 357 | 355 | 315 | 1,645 | 315 |
| Corporations, partnerships and sole proprietors | 892,372 | n/a | n/a | n/a | n/a | 41,622 | 43,292 | 5,504 | 12,273 | 7,891 | 6,711 | 7,500 |
| INDIVIDUALS REPORTING INCOME OR LOSS FROM REAL ESTATE [3] | 1,176,287 | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | 975 | 1,095 |
| All returns | 2,067,659 | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | 6,686 | 8,595 |

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n/a Not available

1. Source: Internal Revenue Service, Corporation Source Book of Statistics of Income, 1975.
2. Source: Internal Revenue Service, Statistics of Income — 1975, Business Income Tax Returns.
3. Source: Internal Revenue Service, Statistics of Income — 1975, Individual Income Tax Returns.

## TABLE 2-4

### SELECTED INCOME STATEMENT AND BALANCE SHEET ITEMS OF DOMESTIC CORPORATIONS ENGAGED IN REAL ESTATE AND OWNED 50 PERCENT OR MORE BY A FOREIGN ENTITY BY COUNTRY OF ADDRESS OF FOREIGN OWNER, 1974

(Money Amounts in Millions of Dollars)

| Country | Number of Returns | Total Assets | Depreciable Assets (Net) | Total Receipts | Total Deductions | Net Income | Deficit |
|---|---|---|---|---|---|---|---|
| All geographic areas | 760 | $2,110 | $1,198 | $311 | $363 | $7 | $60 |
| Canada | 294 | 470 | 255 | 64 | 77 | 1 | 14 |
| Latin America | 78 | 90 | 30 | 11 | 15 | * | 5 |
| Panama, excluding Canal Zone | 13 | 44 | 21 | 4 | 7 | * | 4 |
| Peru | 55 | 13 | 1 | 2 | 2 | — | * |
| All other Latin America | 10 | 33 | 8 | 5 | 6 | * | 1 |
| Other western hemisphere | 85 | 236 | 154 | 29 | 36 | 1 | 8 |
| Bahamas | 34 | 102 | 70 | 8 | 12 | — | 5 |
| All other western hemisphere (includes Netherlands Antilles) | 51 | 133 | 84 | 21 | 24 | 1 | 3 |
| Europe | 53 | 287 | 115 | 40 | 44 | 3 | 8 |
| Luxembourg | 16 | 24 | 16 | 2 | 3 | — | 1 |
| Switzerland | 3 | 3 | 3 | 1 | 1 | — | * |
| United Kingdom | 25 | 155 | 108 | 26 | 29 | 1 | 4 |
| West Germany | 4 | 69 | 32 | 8 | 6 | 3 | * |
| All other Europe | 5 | 36 | * | 3 | 6 | — | 1 |
| Africa | 3 | 15 | 2 | 3 | 3 | * | — |
| Liberia | 3 | 15 | 2 | 3 | 3 | * | — |
| Asia | 93 | 141 | 49 | 19 | 25 | 1 | 7 |
| OPEC countries | 9 | 23 | 18 | 2 | 5 | — | 2 |
| Japan | 71 | 82 | 12 | 15 | 18 | 1 | 4 |
| All other Asia | 13 | 36 | 19 | 2 | 2 | * | * |
| Australia | 24 | 11 | 5 | 22 | 21 | * | — |
| Country not stated | 129 | 844 | 613 | 121 | 135 | * | 14 |

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Office of Tax Analysis

Source: Unpublished Internal Revenue Service tabulations.

* Less than $500,000

the *value* of foreign purchases was approximately $560 million, or 4 percent of the total value of agricultural land sold in 1977. Finally, the average size of foreign purchase, 1,141 acres, was almost four times as large as the overall U.S. average of 308 acres. That difference, combined with the assumption that foreigners purchase somewhat more expensive land than domestic purchasers, implies that the average purchase by a foreign buyer was worth about $1.1 million, six-to-seven times as large as the average domestic purchase. This difference may be attributable, at least in part, to the fact that foreigners are typically making large, first-time purchases, whereas many domestic buyers are presumably making marginal additions to existing holdings.

### III. Tax Return Statistics

Tables 2-3, 2-4 and 2-5 present tax return statistics on real estate operations by domestic and foreign investors in 1974 or 1975. Table 2-3 is based on all corporations (foreign or domestic), partnerships and sole proprietors (including farm landlords) whose primary industry is U.S. real estate, and all other individuals reporting income or losses from real estate.[7] Because many of the rules for taxing the real estate income of domestic persons also apply to foreign persons, data from domestic tax

7. A farm landlord is an individual filling Form 4835 reporting gross farm rental income and expenses, but not "materially participating" in the operation or management of a farm. Such landlords typically provide land to a farmer in exchange for a share of farm production. A sole proprietor is an individual who included with his Form 1040 either Schedule C (Profit or Loss from Business or Profession) or Schedule F (Farm Income and Expenses). Other individuals are those who included with their Form 1040 Schedule E (Supplemental Income Schedule) and reported rental income.

returns provide important information. Table 2-3 documents an important aspect of real estate investment; losses are more often reported on tax returns than net income. For corporations, partnerships, farm landlords, sole proprietors and individuals, total deficits amounted to $8.6 billion, and total net income was $6.7 billion. Unlike other industries, where the corporate form predominates, real estate investment is most commonly undertaken by partnerships; total receipts of real estate partnerships amounted to $20.5 billion, as contrasted to the $14.4 billion of such receipts by real estate corporations. Real estate investors often prefer partnerships because under U.S. tax laws losses flow through to the partners and may shelter the partners' other income from taxation.[8]

Table 2-4 is based on the 1974 tax returns of U.S. real estate corporations 50 percent or more of whose equity was owned *by foreign persons;* Table 2-5 presents comparable statistics for *foreign* real estate corporations with income effectively connected with a U.S. trade or business. Taken together, these tables provide further insight into the nature and extent of foreign ownership of U.S. real estate:

— The $373 million in total receipts of these two types of corporations taken together equals approximately 3 percent of the total receipts of all U.S. real estate corporations and 1 percent of such receipts by U.S. real estate corporations and partnerships. This $373 million does not include rental income of foreign individuals, trusts or estates owning U.S. real estate in their own names or holding an interest in a U.S. real estate partnership.[9]

— Foreign owners of U.S. real estate corporations most often listed addresses in Canada, Western Europe (especially the United Kingdom), and other western hemisphere countries (especially the Bahamas and, to a lesser extent, the Netherlands Antilles). Foreign corporations investing directly in U.S. real estate are, by contrast, predominantly from other western hemisphere countries.

— Foreign investment in U.S. real estate through U.S. corporations is much larger than direct ownership by foreign corporations ($311 million vs. $62 million in business receipts). Both types of corporations are typically reporting tax losses, rather than positive income.

## TABLE 2-5

### FOREIGN CORPORATIONS ENGAGED IN U.S. TRADE OR BUSINESS WHOSE PRINCIPAL INDUSTRY WAS REAL ESTATE, BY COUNTRY OF INCORPORATION, 1974

(Money Amounts in Millions of Dollars)

| Country | Number of Returns | Total Receipts | Total Deductions | Net Income | Deficit |
|---|---|---|---|---|---|
| All geographic areas | 347 | $62 | $78 | $3 | $20 |
| Canada | 74 | 13 | 15 | * | 3 |
| Latin America | 65 | 6 | 6 | * | 1 |
| Panama, excluding Canal Zone | 60 | 5 | 6 | * | 1 |
| All other Latin America | 5 | * | * | * | * |
| Other western hemisphere (includes Netherlands Antilles) | 138 | 36 | 48 | 2 | 14 |
| Europe | 39 | 5 | 4 | 1 | * |
| Liechtenstein | 10 | 1 | 1 | * | * |
| United Kingdom | 6 | 4 | 3 | 1 | * |
| West Germany | 16 | * | * | * | * |
| All other Europe | 17 | * | * | * | * |
| Africa and Asia | 13 | 1 | 2 | * | 1 |
| Australia | 7 | 1 | 1 | * | * |

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* Less than $500,000

## CHAPTER 3 — U.S. STATUTORY LAW

### I. Taxation of U.S. Individuals and Corporations

*A. Ordinary Income and Loss*

To appreciate how the United States taxes foreigners, it is necessary to understand how the United States taxes its own citizens, residents, corporations and other entities. U.S. citizens, whether living in the United States or in a foreign country, foreign individuals who are resident in the United States, U.S. corporations, U.S. trusts and U.S. estates are all taxed on their worldwide income. Deductions are allowed for most ordinary and necessary costs of earning income and for other specifically enumerated expenses. Losses from one activity can be offset against income from other activities. Individuals may either itemize deductions, or claim a standard deduction (zero bracket amount),[10] and may exempt $1,000 for themselves, each qualifying dependent, and on account of blindness or age over 65 years. Income derived outside the United States is included in U.S. taxable income, but a dollar-for-dollar credit is provided for income taxes paid to foreign governments.[11]

The allowance of deductions and the consolidation of income and losses are particularly important to real estate investors. Rental income from real estate can be reduced by operating expenses (utilities, maintenance, etc.), insurance, property taxes, mortgage interest and, in the case of buildings, depreciation. Because most readers are familiar with the first four items, only the fifth, depreciation, needs to be described in any detail.

8. Losses flow through to the shareholders of Subchapter S corporations, but the restrictions on such corporations (e.g., 15 or fewer shareholders, none of whom may be a foreign individual or taxpayer, the need to make a unanimous election, the restriction to a single class of stock) may make this form unattractive to real estate investors.
9. A nonresident alien with income effectively connected with a U.S. trade or business (e.g., real estate) is required to file a U.S. tax return, Form 1040NR. However, the Internal Revenue Service does not presently compile statistics based on Form 1040NR. All Forms 1040NR are excluded from the I.R.S. tabulations based on Form 1040 filed by U.S. citizens and resident aliens.
10. As of 1979, the zero bracket amount is $3,400 for married individuals filing jointly, $1,700 for married individuals filing separately, and $2,300 for inmarried individuals.
11. The amount of the foreign tax credit cannot, however, exceed the U.S. tax attributable to income derived outside the United States.

Because buildings and equipment may depreciate in value on account of wear and tear, obsolescence, etc. necessary to the production of income, a deduction is allowed for depreciation. Under U.S. tax accounting rules, the depreciation deduction is not, however, based on the actual gain or loss in the *market* value of the property (so called economic depreciation). Rather, the depreciation allowance is calculated so that the aggregate of amounts set aside, plus the salvage value at the end of the estimated useful life of the depreciable property, will equal the cost or other basis of the property. Under this approach, calculation of the depreciation allowance depends on the depreciation *base* and the estimated *useful life* of the investment. Under the statute, taxpayers choose a particular *method* for amortizing the base over the sstimated useful life.

No depreciation can be taken with respect to land. For buildings, the depreciation base generally equals the original cost of acquiring the property less the cost attributable to the land.

## TABLE 3-1

### ACCELERATED DEPRECIATION METHODS* EXPRESSLY PERMITTED FOR REAL ESTATE PROPERTY UNDER U.S. TAX LAW

| Type of Property | Method of Depreciation |
|---|---|
| Land | No Depreciation Permitted |
| New Rental Housing | 200 percent declining balance, sum of the years digits, or other accelerated method |
| Used Rental Housing (with remaining useful life of 20 or more years) | 125 percent declining balance |
| New Commercial Property | 150 percent declining balance |
| Used Commercial Property | Straight-line only |

* These different methods are best illustrated with a numerical example. Suppose a building cost $1 million, had an estimated useful life of 50 years. Under the straight-line methods, the investor could claim a depreciation deduction of $20,000 (one fiftieth of $1 million) in each of the fifty years (assuming the building had no salvage value). Under the 200 percent declining balance method, he could claim a deduction of $40,000 in the first year (two fiftieths of $1 million), $38,400 in the second year (two fiftieths of $960,000, the original base less the first year's depreciation), etc. The 150 percent or 125 percent declining balance is the same as the 200 percent declining balance method, except the fraction is 150 percent or 125 percent, respectively, of the straight-line fraction. Under the sum-of-the-years-digits method, one first totals the digits from 1 to 50 and obtains the sum, 1275. In the first year, the depreciation deduction equals 50/1275, or 3.92 percent, of the depreciation base; in the second year, the depreciation deduction equals 49/1275, or 3.84 percent, of the depreciation base, etc. In the early years of an investment, the sum-of-the-years-digits method produces a result closely approximating the 200-percent-declining balance method.

Taxpayers are permitted to make certain switches in the method of depreciation. For new rental housing, for example, the most rapid depreciation would be achieved by using the 200 percent declining balance method for the first three years and then switching to the sum-of-the-years-digits method. Taxpayers may, subject to certain conditions, change from any declining balance method of depreciation to any other method without express IRS permission. Once a taxpayer has changed to a straight-line method, however, IRS consent is required to change to any other method.

The owner estimates the useful life of the building according to the type of construction, the age of the building when acquired, and other "facts and circumstances". Under the straight-line method, depreciation deductions are taken in equal annual installments over the useful life of the investment. U.S. law, however, specifically allows accelerated methods of depreciation as follows:

Under the accelerated methods, higher depreciation in the early years of an investment is offset by lower depreciation in the later years. Accelerated depreciation allows an investor to postpone the recognition of income and, thus, defer his tax payments. This makes investment in real estate more attractive than it would otherwise be under a straight-line method.

As shown in Table 2-3, real estate deductions typically exceed rental income and result in losses for tax purposes. Losses shown on real estate investment can offset income from other activities in computing a taxpayer's total taxable income, "sheltering" such other income from taxation. This tax-shelter feature makes real estate investment particularly attractive to individuals whose high income would otherwise place them in a high tax-rate bracket.

*B. Capital Gain*

Over the last two decades, U.S. real estate has appreciated rapidly in value. Indeed, the expected capital gain, not the operating income, has become the primary non-tax inducement to real estate investment. Because real estate is ordinarily held for more than one year, this section will describe only the tax treatment of long-time capital gain. When real estate is sold, a U.S. taxpayer treats any gain up to the amount of prior "excess depreciation" as ordinary income[12] and the balance, if any, as capital gain.[13] Under the new provisions of the Revenue Act of 1978, an individual may deduct an amount equal to 60 percent of capital gain on the sale of this property and pay tax on the remaining 40 percent. With a maximum tax rate of 70 percent on ordinary income, the maximum effective rate on capital gain of individuals is 28 percent (40 percent of 70 percent).

An individual with substantial long-term gain may be affected by the alternative minimum tax. Alternative minimum taxable income as defined by the Revenue Act of 1978, equals taxable income plus the long-term capital gains deduction plus certain adjusted itemized deductions. Alternative minimum taxable income is taxed at progressive rates; the highest rate, 25 percent, applies to alternative minimum taxable income in excess of $100,000. The individual's income tax liability equals the higher of the tax computed under the ordinary rules and the tax computed under the alternative minimum tax rules.

An unmarried individual with no ordinary income or itemized

12. The recapture rule for real estate is more generous than for other depreciable assets. If other assets are sold, the seller must treat any gain up to the amount of *all* prior depreciation, not just the excess over the straight-line amount, as ordinary income and the balance, if any, as capital gain.

13. For example, suppose an investor purchased a property for $1 million and had claimed total depreciation deductions of $500,000. Had the investor used straight-line rather than accelerated depreciation, his total depreciation deductions would have been $400,000. If the property is sold for $2 million, his net gain realized for tax purposes would be $1,500,000. He must, however, treat $100,000, the excess of accelerated over straight-line depreciation, as ordinary income. The remaining $1,400,000 is capital gain. If the property was held for more than one year, he may deduct an amount equal to 60 percent of the capital gain, or $40,000. Thus, his net taxable income is $660,000 ($1,000,000 plus 40 percent of $1,400,000).

deductions, and who claims no tax credits, but who has long-term capital gain of at least $108,000, but less than $214,000, would pay by the alternative minimum tax. As a consequence, the marginal rate of taxation of his capital gain within this bracket would be *raised* to 25 percent. Because the only credit allowed against the alternative minimum tax is a foreign tax credit (the computation of which is specially controlled by the alternative minimum tax rules), the alternative minimum tax provisions impinge most heavily on individuals with substantial deductions for long-term capital gains (or adjusted itemized deductions) *and* tax credits, such as the investment tax credit, not allowerd against the alternative minimum tax.

Individuals do not recognize capital gain on the sale of a principal residence provided a new principal residence is acquired within 18 months. And, an individual who is at least 55 years old may elect once in his lifetime to exclude $100,000 on the sale of a principal residence.

Long-term capital gains of corporations are taxed without any special deduction either as ordinary income or at a flat rate of 28 percent, whichever produces a lower amount of tax.

Corporations and individuals may lessen the impact of the capital gains tax if the purchaser spreads payment over two or more years. If the seller requires payment of less than 30 percent in the year of sale, he may defer recognition of his capital gain in accordance with the schedule of payments. For example, if a buyer makes a down payment of 25 percent of the purchase price and agrees to pay off the balance in three annual installments of 25 percent (plus appropriate interest), the seller can recognize 25 percent of total net gain with each payment.

### *C. Taxation of Partnerships*

A partnership is *not* a taxable entity under U.S. law; rather, each partner in determining his own tax includes his distributive share of the partnership's taxable gross income and of certain other specified items of gain, loss, income, deduction or credit. U.S. law provides that a partner's distribution of any item of income, loss, deduction or credit is to be determined by the partnership agreement, unless the agreement contains no provision determining a partner's distributive share, or unless the applicable provision lacks "substantial economic effect."

Appendix C describes a hypothetical example of a partnership between a domestic and a foreign taxpayer. By allocating the tax losses to the domestic investor, who is not limited in his ability to offset such losses against other U.S. income, and allocating only capital gain to the foreign investor, who may be exempt from U.S. tax on such gain under present U.S. law, *both* investors may obtain higher after-tax returns than could either one investing separately.

## II. Taxation of Nonresident Aliens and Foreign Corporations

### *A. Introduction*

A nonresident alien or foreign corporation has three types of income for U.S. tax purposes:

1. Income, including capital gain, effectively connected with a U.S. trade or business. This type of income can be offset by allowable deductions and is taxed generally according to the same rules and rates as those applicable to the income of U.S. citizens or corporations.

2. Certain other income having a U.S. source, which is taxed at a flat rate of 30 percent (or at a lower rate if a tax treaty applies), and against which *no deductions are allowed.* This category includes:

    a. interest, dividends, rents and certain other items of income or gain which are of U.S. source, but which are not effectively connected with the active conduct of a U.S. trade or business.

    b. an individual's capital gain on U.S. property, but only in the exceptional case of the nonresident alien who is present in the United States for more than 183 days in the year in which the gain is realized.

3. All other income, which is exempt from U.S. taxation, whether of U.S. source or not.

This section describes how the residence of an alien individual is determined for U.S. tax purposes, how the income or capital gains of nonresident aliens, foreign corporations, foreign trusts and foreign estates is allocated among the three types enumerated above, and how each type of income is taxed.

### *B. When is a Foreigner a Resident of the United States for Income Tax Purposes?*

Because a foreign individual's U.S. tax liability may be substantially affected by whether he is or is not considered a U.S. resident for U.S. tax purposes, the criteria for determining residence are important. The Internal Revenue Code itself provides no explicit standards. Regulation 1.871-2(b), however, does provide standards:

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

An alien who has been in the United States for less than a year is presumed under I.R.S. regulations not to be a resident for tax purposes. The burden of proof fails on the individual or the Internal Revenue Service, as the case may be, to rebut the presumption of nonresidence. This may be done by examining the following factors:

> *Visa* — Some visas under which foreigners enter the United States allow the individuals to take up residence, but others do not. The type of visa does not govern for tax purposes, but legal residents under U.S. immigration laws would usually be residents for tax purposes.
>
> *Length of Stay* — The longer a foreigner remains in the United States, the more likely it becomes that he or she will be deemed a resident for tax purposes. Foreigners staying in the U.S. for more than one year are presumed by the I.R.S. to be residents for tax purposes.
>
> *Other Factors* — Owning a home or condominium, signing a long-term apartment or office lease, maintaining bank and charge accounts, registering a car or getting a driver's license, and joining a church or club in the United States are evidence of U.S. residence.

# TABLE 3-2

## WITHHOLDING TAX RATES ON INCOME OTHER THAN COMPENSATION FOR PERSONAL SERVICES UNDER CHAPTER 3, INTERNAL REVENUE CODE, AND INCOME TAX TREATIES

| Income code number | | | 2 | 3 | 5 | | | 6 | 7 | 9 | 10 | 11 | 12 | 13 | 14 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Country of residence of payee | | | | | Interest on tax-free convenant bonds — Bonds issued before Jan. 1, 1934 | | | Dividend paid by a | | | | Copyright royalties | | | |
| Name | Code | Interest paid by U.S. obligors general | Interest on real prop mortgage | Interest paid to a controlling foreign corporation | If obligor assumes over 2% of tax | If obligor assumes 2% or loss of tax | Maturity date extended on or after 1/1/34 and obligor assumes over 27,5% of tax | U.S. corporation general | U.S. subsidiary to foreign parent corporation | Capital gains | Industrial royalties | Motion pictures and television | Other | Real prop. income and natural resources royalties | Pensions and annuities |
| Antigua | AC | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Australia | AS | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [c.h.]15 | 30 | 30 | 30 | [h]0 | 30 | 0 |
| Austria | AU | [gh]0 | 30 | 0 | [h]0 | [h]0 | [h]0 | [h]15 | [b.h.]5 | 30 | [h]9 | [h]10 | [h]0 | 30 | [d]0 |
| Barbados | BB | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Belgium | BE | [g]15 | [g]15 | [g]15 | 2 | [g]15 | [g]15 | [g]15 | [g]15 | [e.g.m.]0 | [g]0 | 30 | [g]0 | 30 | [d.f.]0 |
| Belize (British Honduras) | BH | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| British Virgin Islands | VI | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Burundi | BY | [h]15 | [h]15 | [h]15 | 2 | [h]15 | [h]15 | [h]15 | [h]15 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Canada | CA | [h]15 | [h]15 | [h]15 | 2 | [h]15 | [h]15 | [c.h.]15 | [c.h.]15 | [h]0 | [h]15 | [h]15 | [h]0 | [h]15 | 0 |
| Denmark | DA | 0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]15 | [b]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Dominica | DO | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Falkland Islands | FA | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Finland | FI | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b.g.]5 | [e.g.m.]0 | [g]0 | [g]0 | [g]0 | 30 | [d.f.]0 |
| France | FR | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]15 | [b.g.]5 | [e.g.m.]0 | [g]5 | [g]0 | [g]0 | 30 | [d.f.]0 |
| Gambia | GA | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Germany, Fed. Rep. of | GE | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [g]15 | [e.g.m.]0 | [g]0 | [g]0 | [g]0 | 30 | [d]0 |
| Greece | GL | [h]0 | [h]0 | 30 | [h]0 | [h]0 | [h]0 | 30 | 30 | 30 | [h]0 | 30 | [h]0 | 30 | [d]0 |
| Grenada | GR | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Iceland | IC | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b.g.]5 | [e.g.m.]0 | [g]0 | 30 | [g]0 | 30 | [d.f.]0 |
| Ireland | EI | [c.h.]0 | [c.h.]0 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Italy | IT | 30 | 30 | 30 | 2 | 30 | 27 1/5 | [h]15 | [b.h.]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Jamaica | JM | 30 | 30 | 30 | 2 | 30 | 27 1/5 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Japan | JA | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]15 | [b.g.]10 | [e.g.m.]0 | [g]10 | [g]10 | [g]10 | 30 | [d]0 |
| Luxembourg[1] | LU | [h]0 | 30 | [h]0 | [h]0 | [h]0 | [h]0 | [h]15 | [b.h.]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Malawi | MI | [c.h.]0 | [c.h.]0 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |

| | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Montserrat | MH | 30 | 30 | 30 | 2 | 30 | 27 1/5 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Netherlands | NL | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b.g.]5 | [e.g.m.]0 | [g]0 | [g]0 | [g]0 | 30 | [d]0 |
| Netherlands Antilles[n] | NA | [h]0 | 30 | 30 | [h]0 | [h]0 | [h]0 | [h]15 | [b.h.]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| New Zealand | NZ | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [h]15 | [b.g.]5 | 30 | 30 | [h]0 | 30 | 30 | 30 |
| Nigeria (before 1979) | NI | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Norway | NO | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b.g.]10 | [e.g.m.]0 | [g]0 | 30 | [g]0 | 30 | [d.f.]0 |
| Pakistan | PK | 30 | 30 | 30 | 2 | 30 | 27 1/2 | 30 | [b.h.]15 | 30 | [h]0 | 30 | [h]0 | 30 | [d.f.]0 |
| Poland | PL | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [b.g.]10 | [e.g.m.]0 | [g]10 | [g]10 | [g]10 | 30 | 30 |
| Romania | RO | [g]10 | [g]10 | [g]10 | 2 | [g]10 | [g]10 | [g]10 | [g]10 | [e.g.]0 | [g]15 | [g]10 | [g]10 | 30 | [d.f.]0 |
| Rwanda | RW | [h]15 | [h]15 | [h]15 | 2 | [h]15 | [h]15 | [h]15 | [h]15 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| St. Christopher-Nevis-Anguila | SC | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| St. Lucia | ST | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| St. Vincent | VC | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Seychelles | SE | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Sierra Leone | SL | 30 | 30 | 30 | 2 | 30 | 27 1/2 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| South Africa | SF | 30 | 30 | 30 | 2 | 30 | 27 1/2 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 |
| Sweden | SW | [h]0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]0 | [h]15 | [b.h.]5 | [h]0 | 0 | 0 | 0 | 30 | [d]0 |
| Switzerland | SZ | [h]5 | [h]5 | [h]5 | 2 | [h]5 | [h]5 | [h]15 | [b.h.]5 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Trinidad & Tobago | TD | 30 | 30 | 30 | 2 | 30 | 27 1/2 | 30 | 30 | 30 | [g]15 | 30 | [g]0 | 30 | [d.f.]0 |
| Union of Soviet Socialist Republics | UR | [o]0 | 30 | 30 | 2 | 30 | 27 1/2 | 30 | 30 | [p]0 | 0 | 0 | 0 | 30 | 30 |
| United Kingdom[k] | UK | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]0 | [g]15 | [g]15 | [e.g.]0 | [g]0 | [g]0 | [g]0 | [c.h.]15 | [d]0 |
| Zaire | CG | [h]15 | [h]15 | [h]15 | [g]0 | [h]15 | [h]15 | [h]15 | [h]15 | 30 | [h]0 | [h]0 | [h]0 | 30 | [d]0 |
| Zambia | ZA | [c.h.]0 | [c.h.]0 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [b.c.h.]5 | 30 | [c.h.]0 | [c.h.]0 | [c.h.]0 | [c.h.]15 | [d]0 |
| Other countries | | 30 | 30 | 30 | 2 | 30 | 27 1/2 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 |

[a] No U.S. tax is imposed upon a dividend paid by a U.S. corporation which has less than 20 percent of its gross income from U.S. sources for the 3-year period preceding the declaration of such dividend. (See section 861 (a) (2) (A) of the Internal Revenue Code)

[b] The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation having the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g., a certain percentage of its total income most consist of income other than dividends and interest)

[c] The exemption or reduction in rate applies only if the recipient is subject to tax on such income in the country of residence. Otherwise a 30 percent rate applies. In the case of Canada, this requirement applies to intercorporate dividends only.

[d] Exemption does not apply to U.S. Government (Federal State, or local) pensions and annuities; 30 percent rate applies to such pensions and annuities.

[e] The treaty exemption applicable to U.S. source capital gains includes capital gains under section 871 (a) (2) if received by a nonresident alien present in the U.S. for a period not exceeding 183 days. (182 days for Belgium)

[f] Includes alimony.

[g] Under the treaty the exemption or reduction in rate does not apply if the recipient has a permanent establishment in the United States and the property giving rise to the income is effectively connected with such permanent establishment. Notwithstanding the treaty, if the income is not effectively connected with the conduct of a trade or business in the United States by the recipient, such recipient will be deemed not to have a permanent establishment in the United States under section 894(b), I.R.C.

[h] Under the treaty the exemption or reduction in rate does not apply if the recipient is engaged in the conduct of a trade or business in the United States through a permanent establishment located in the United States. However, if the income is not effectively connected with the conduct of a trade or business in the United States by the recipient, such recipient will be deemed not to have a permanent establishment in the United States for the purpose of applying the reduced treaty rate to the item of income concerned. Section 894(b), I.R.C.

[i] Bangladesh has not indicated that it wishes to assume the responsibilities or exercise the rights of the United States—Pakistan income tax treaty.

[j] Exemption is not available when paid from a fund, under an employees' pension or annuity plan, contributions to which are deductible under the tax laws of the United States in determining taxable income of the employer.

[k] Yemen has not indicated that it wishes to assume the responsibilities or exercise the rights of the United-States-United Kingdom income tax treaty.

[l] Exemption from or reduction in rate of tax not applicable in the case of income of holding companies entitled to special tax benefits under the laws of Luxembourg.

[m] Exemption does not apply to gains from the sale of real property; 30 percent rate applies to such sales.

[n] The exemption or reduced rates applicable to U.S. source dividends, interest, industrial, and literary royalties do not apply when these items are paid to a Netherlands Antilles investment or holding company entitled to special tax benefits under Netherlands Antilles law and owned by persons or corporations not resident in the Netherlands.

[o] The exemption applies only to interest on credits, loans, and other indebtedness connected with the financing of trade between the U.S. and the U.S.S.R. It does not include interest derived from the conduct of a general banking business.

[p] The exemption only applies to gains from the sale or other disposition of property acquired by gift or inheritance.

Aliens wishing to avoid having a U.S. residence for tax purposes generally enter the U.S. on temporary visas, limit the length of any one stay in the United States, and so forth, while those wishing to establish residence do the opposite.

The dividing line between taxation as a U.S. person and taxation as a foreign person is much simpler and more automatic in the case of a corporation than in that of an individual. The United States regards the place of incorporation as determinative; an entity incorporated in the United States is domestic, while all other are foreign. This rule, which has the obvious virtue of simplicity, may also be subject to manipulation: investors who wish to be taxed under the rules applicable to foreign corporations incorporate outside the United States; those who prefer the rules applicable to domestic corporations incorporate in one of the fifty States or the District of Columbia. Countries other than the United States often look to the place of "effective management," rather than (or in addition to) the place of incorporation, in determining the tax status of corporations. Like the U.S. residence rules for individuals, the place of effective management rules for corporations depend on the facts and circumstances of individual cases and differ from one country to another.

*C. When is a Nonresident Alien or a Foreign Corporation Engaged in a Trade or Business Within the United States?*

Although the concept of having a U.S. trade or business is critical to U.S. taxation of a foreign investor's income, the Internal Revenue Code provides little explicit guidance for making this determination. The performance of personal services within the United States is, with one limited exception, a U.S. trade or business; trading in securities or commodities through an independent agent by a foreigner for his own account is not. In the case of real estate, whether a foreign investor has a U.S. trade or business is usually determined by the following factors:

— *Size of the Investment:* The more substantial the investment, the more likely the person will be considered to be engaged in a U.S. trade or business.

— *Terms of a Lease:* A lessor with a long-term net lease to a single tenant under which the lessee assumes responsibility for paying maintenance and operating costs, insurance, property taxes or mortgage interest has been considered not engaged in a U.S. trade or business. The shorter the lease, the greater the share of the costs incurred by the owner, rather than the tenant, and the more numerous the tenants, the more likely it becomes that the lessor will be deemed to be engaged in a U.S. trade or business.

— *Nature of the Property:* Leasing unimproved land, including agricultural land, has been considered not to be a U.S. trade or business.

— *Personal Use:* If a house or condominium is used by the owner and rented out only occasionally, the investor is considered not to have a U.S. trade or business.

If a partnership as an entity is considered to be engaged in a U.S. trade or business, so too will be all partners. The Internal Revenue Code also provides that a foreign beneficiary of trust or estate will be considered engaged in a U.S. trade or business if the trust or estate is engaged in a U.S. trade or business.

*D. What Income is Effectively Connected with a U.S. Trade or Business?*

If a nonresident alien or foreign corporation is considered to be engaged in a U.S. trade or business, the income which will be considered effectively connected with the U.S. trade or business consists of three types:

— Interest, dividends, rents and other such U'S.-source income, plus capital gains or losses, if the income is derived from assets used in (or held for use in) the conduct of a U.S. trade or business, or if the trade or business activities were a material factor in the realization of such income.

— All other U.S. source income (e.g., income derived from goods sold in the United States).

— Certain foreign source income attributable to the U.S. trade or business.

To take an obvious example, suppose a foreign corporation or non-resident alien owned U.S. real estate and was considered by the nature of its investment to be engaged in a U.S. trade or business. Rental income from that real estate would be considered effectively connected with the U.S. trade or business, as would U.S.-source interest income on cash balances maintained to pay property taxes and meet other expenses of the U.S. trade or business. However, if the corporation also earned U.S.-source interest on long-term bonds which were not held for use in the conduct of its U.S. trade or business, this latter income might not be effectively connected with the U.S. trade or business.

*E. Election to have Real Property Income Taxed on Net Basis*

Even if a foreigner is not otherwise engaged in a U.S. trade or business and would consequently not be entitled to any deductions, he may elect to have his real property income taxed net of deductions. Real property income includes income from, or capital gain on the sale of, real estate, rents or royalties from mines, wells or other natural resource deposits, and capital gain from the sale of timber, coal and iron ore. The difference between a tax of 30 percent on gross rental income and a tax on that same income less all allowable deductions can be substantial.

The disadvantage of making the net election allowed by statute is that capital gain on the sale of the real estate will generally also be considered effectively connected with the elected U.S. trade or business and thereby lose what might otherwise be tax-exempt status. Under section 871(d), an election, once made, cannot be revoked without permission of the Internal Revenue Service. Foreigners typically resolve this dilemma by making an election and finding some other way to avoid the capital gains tax.

*F. Treatment of Foreign Taxpayers versus Domestic Taxpayers*

Income effectively connected with a U.S. trade or business of a foreign taxpayer is generally taxed by the United States according to the same rules and rates and rates as those applicable to comparable U.S. taxpayers. There are, however, certain exceptions to this general rule:

— A foreigner's losses effectively connected with a U.S. trade or business cannot be used to offset U.S.-source interest, dividends, and other income not effectively connected with a U.S. trade or business.

— A nonresident alien can claim only one personal exemption. Additional exemptions cannot be claimed for dependents or on account of the individual's age or blindness.

A nonresident alien must itemize deductions — that is, he cannot claim the standard deduction, or zero-bracket amount. Apart from the charitable contributions, deductions are generally limited to those allocable to income effectively connected with the U.S. trade or business.

— A nonresident alien cannot file a joint return with his spouse[14]. Not only will he be subject to the harsher limitations and schedules applicable to married individuals filing separate returns, but he cannot limit his tax on personal services income (wages and salary, etc.) to the otherwise applicable maximum rate of 50 percent.

— A nonresident alien may not elect, nor join with others in electing, to have a U.S. corporation in which he is a shareholder taxed according to the rules of Subchapter S. The Subchapter S rules allow a U.S. corporation with 15 or fewer shareholders to elect not to pay tax provided its shareholders include a proportionate share of the corporation's income or loss in their own taxable income.

### *G. Taxation of Interest, Dividends, Rent and Other Income Not Effectively Connected with a U.S. Trade or Business*

The preceding discussion describes the taxation of income which is effectively connected with a U.S. trade or business or, in the case of real property income, which the foreign investor elects to be taxed as if it were. The United States also taxes U.S.-source "interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed and determinable, annual or periodical gains, profits and income" which are earned by foreigners, but which are not effectively connected with a U.S. trade or business. No deductions are allowed against such income and, in the absence of a tax treaty, the rate of tax is 30 percent. As Table 3-2 indicates, however, the rate is reduced, often substantially, for residents of foreign countries with which the United States has a tax treaty.

The withholding rate on rent from real estate investment is often not reduced by treaty and, where it is reduced, is lowered only to 15 percent. Moreover, mortgage interest, property taxes, operating expenses, and depreciation cannot be deducted from rental income in determining the amount of the tax.[15] The disallowance of all deductions serves as a powerful incentive for foreigners to elect to be taxed as if they were engaged in trade or business, if they otherwise would not be.

### *H. Taxation of Capital Gains of Foreign Investors*

Foreign investors may under certain circumstances be taxable in the United States on capital gains derived from sales of U.S. real estate. Capital gains which are effectively connected with a U.S. trade or business are taxable under the same rules and at the same rates as are applicable to U.S. taxpayers. Capital gains which are considered not to be effectively connected are tax exempt, except for a foreign individual who, though not a resident of the United States, is present in the United States for more than 183 days in the year in which the gain is realized.

The historical evolution of U.S. taxation of capital gain on the sale of U.S. property may help explain why the tax applies only to gain effectively connected with a U.S. trade or business or gain of a nonresident alien present in the United States for more than 183 days. The Revenue Act of 1921 specifically included capital gain on the sale of real property located in the United States in the income of a nonresident alien subject to U.S. tax; the Revenue Act of 1934 added capital gains from the sale of personal property, which includes stocks, bonds and other financial assets.[16] Under these statutes, nonresident alien and foreign corporations were taxable in the U.S. on a net basis. The Revenue Act of 1936 introduced the method of taxing foreign persons not engaged in U.S. business on a flat rate basis. Section 211 of that Act limited the U.S. tax on a nonresident alien or foreign corporation who was not engaged in a U.S. trade or business and who did not maintain an office or place of business in the United States to 10 percent of his U.S. source dividends, interest, rents, wages, salaries, annuities, and periodical gains, profits and income. It did not subject capital gains to the flat rate tax. The House Report offered the following explanation for this change:

> In section 211, it is proposed that the tax on a nonresident alien not engaged in a trade or business in the United States and not having an office or place of business therein, shall be at the rate of 10 percent on his gross income from interest, dividends, rents, wages, and salaries and other fixed and determinable income. This tax (in the usual case) is collected at the source by withholding as provided for in section 143. Such a nonresident will not be subject to the tax on capital gains, including gains from hedging transactions, as at present, it having been found impossible to effectually collect this latter tax. It is believed that this exemption from tax will result in additional revenue from the transfer taxes and from the income tax in the case of persons carrying on the brokerage business.[17]

In subsequent years, Congress eliminated the provision that a foreign taxpayer which had a U.S. office of fixed place of business, but which was not "engaged" in U.S. business, would be taxable on a net basis. The flat rate of taxation on interest, dividends, and other income of taxpayers not engaged in a U.S. trade or business was gradually increased, and the special rule for capital gains of nonresident aliens present in the United States for 90 and then 183 days were added. Also, in 1966 the distinction between effectively connected income and not effectively connected income of taxpayers who were engaged in a U.S. trade or business was introduced. But the exemption for capital gains of foreign corporations and nonresident aliens not engaged in a U.S. trade or business has remained since 1936.

To avoid capital gains taxation under present law, the foreign investor must find a way of severing any connection between the gain and the (actual or deemed) U.S. trade or business which qualified him for taking deductions against his operating income. At present, at least five such ways are available:

1. A foreigner who *is* engaged in trade or business (and thus has made no *election* to be so taxed) may make an installment sale and postpone receiving payment until after the end of the year in which the property was sold. Under the installment sale rules, the gain is recognized in proportion to the amount of the installment payment (see above). Although an *election* to be taxed as if engaged in trade or business cannot be revoked, the *actual determination* in the absence of an election is made anew each year. So although a foreign investor may have been engaged in trade or business, he would no longer be in trade or business when most or all the gain is reported.

2. Suppose the foreign resident owned the real estate through

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14. If a nonresident alien is married to a U.S. citizen or resident, the nonresident alien may elect to join his or her spouse in filing a joint return. If this election is made, the nonresident alien individual is treated as a resident for U.S. tax purposes, and thus the married couple is taxable on their combined worldwide income.

15. If such expenses are paid by a tenant under the terms of a net lease, such expenses are added to the net lease payment made to the foreign owner in computing the base to which the withholding tax is applied.

16. Since 1921, U.S. citizens and residents have been required to include capital gain on the sale of real property, corporate shares and other capital assets.

17. U.S. Congress. House. Committee on Ways and Means. Revenue Bill of 1936. 74th Cong. 2nd Sess. H. Rept. 2475 (1936).

a holding company, the company sold the real estate and was liquidated within a year, and its assets (e.g., the proceeds from the sale of the real estate) were distributed to shareholders. Under section 337 of the Internal Revenue Code, a corporation, if it pursues the liquidation according to certain proscribed steps, will not recognize such a gain for tax purposes. While the shareholders must recognize the capital gain, that capital gain is considered to be realized in exchange for their stock. Because stock ownership does not *per se* constitute a trade or business, the capital gain is tax exempt. The holding company, not its shareholder(s), is engaged in a U.S. trade or business. In short, capital gain on the sale of U.S. real estate, which would have been taxable, is converted into capital gain on the sale of corporate shares, which may well be exempt.

3. The same result would be obtained if the foreign shareholders sold their *shares* in the holding company. Capital gain on the sale of shares is generally tax exempt. The buyer could liquidate the holding company and recognize no capital gain; the only gain the liquidated company would recognize would be the amount of its prior "excess depreciation" and any similar items subject to recapture.

4. If the foreign investor exchanges his U.S. property for foreign property "of a like kind," his taxable gain is limited to the cash or other "boot" received as part of the overall exchange. Thus, a foreign investor could exchange his U.S. real estate (and cash and other "boot," if necessary) for foreign real estate and, as long as he receives no "boot," pay no capital gains tax. The foreign real estate he purchases may have been recently acquired for this specific purpose by his trading partner. If he then turns around and sells the foreign real estate, that gain will not be effectively connected with a *U.S.* trade or business and, thus, will be exempt from U.S. tax.

5. As discussed in Chapter 4, many of our tax treaties permit a foreigner who is *not* engaged in a U.S. trade or business, but who elects to have his real estate income taxed as if it were, to revoke that election in the year in which the real estate is sold. (Under our statutory law, the net election cannot be revoked without the special permission of the I.R.S.) A foreigner who is not a resident of a country with which the United States has a tax treaty providing for such an annual election can establish a holding company in a country, such as the Netherlands Antilles or the British Virgin Islands, with which we have a trax treaty permitting an annual election.

No doubt there are other avenues for avoiding U.S. taxation of capital gains. Although these methods require careful tax planning, the substantial value of foreign investments in U.S. real estate would usually justify the added legal and accounting costs of such planning.[18]

### III. Investments by Foreign Governments

Section 892 of the Internal Revenue Code provides that:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

The Internal Revenue Service and Treasury Department have recently proposed regulations interpreting the section 892 exemption as applying only to non-commercial income. Income from "commercial activities" would, however, be taxable. According to the proposed regulations, "commercial activities" would include:

> — activities that would and generally constitute a "trade or business within the United States"
>
> — obtaining or holding "net leases" on property.

Thus, under the proposed regulations income earned by foreign governments from U.S. real estate would be taxable in the same way as if it were earned by a foreign corporation.

### IV. Federal Estate and Gift Taxation

The United States taxes the estates and gifts of aliens resident in the United States in the same manner as it taxes those of U.S. citizens. However, the definition of residence for estate and gift taxes differs from that for income tax purposes. For estate and gift tax purposes, an alien's residence is his *domicile*, his permanent home to which he *ultimately* intends to return. Thus, an alien who was present in the United States with no definite plans as to the *length* of his stay, but with the ultimate intention of some day returning to a foreign domicile, would be resident for income tax purposes, but not for estate tax purposes. Likewise, an alien not present in the United States and with no definite plans as to the length of his stay outside the United States, but with a definite intention to return some day to a domicile in the United States, would be a resident for estate tax purposes, but not for income tax purposes. To avoid needless confusion in this Report, an alien who is resident in the United States for estate and gift tax purposes will be referred to as a *domiciled* alien.

The *estates* of U.S. citizens and domiciled aliens are subject to U.S. estate tax upon the value of all property "real and personal, tangible or intangible" owned by the individual at the time of his death. Such individuals qualify for a credit against the tax of $47,000, which effectively exempts approximately $175,000 of property from estate tax.

Similarly, the *gifts* of U.S. citizens and domiciled aliens are subject to U.S. gift tax upon the value of all gifts made by (not to) the individual. The estate and gift taxes imposed upon such persons are "integrated" under the Tax Reform Act of 1976; that is to say, the amounts of gift and estate tax are computed at the same rate, and prior gifts made by an individual are included for the purpose of determining the bracket of, or rate of tax imposed upon, any subsequent gift or upon the individual's estate. The $47,000 "unified" credit may be claimed against any gift until the amount an individual may claim has been exhausted; once an individual has claimed part of this credit against a gift tax due, the amount he may claim against the tax on a subsequent gift or upon his estate is reduced by a corresponding amount.

Aliens not domiciled in the United States are subject to estate taxes only upon property situated within the United States. The existing statute does not define what property is situated within the United States, except with respect to certain limited classes of property. The Estate and Gift Tax Regulations provide that real property located within the United States is deemed to be situated within the United States for the purpose of the estate tax imposed upon nonresident aliens. The Internal Revenue Code itself provides that stock issued by a foreign corporation is

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18. Knowledgeable practitioners suggest that the use of a Netherlands Antilles or other foreign holding company, a common tax avoidance device, is worth the legal and accounting costs only for investments of $250,000 or more. As noted in Chapter 2, the size of the average foreign purchase of U.S. farmland is $1 million.

deemed to be property situated without the United States for these purposes. The Estate and Gift Tax Regulations provide that shares of stock issued by a domestic corporation are treated as property within the United States.

The rate of tax imposed upon the taxable estates of nondomiciled decedents is substantially lower than that imposed upon domiciled or citizen decedents. The initial rate is 6%, and the highest 30%, compared to a range of 18% to 70% applicable to the estates of domiciled and citizen decedents. Aliens not domiciled in the United States are entitled, however, to a lower amount as a credit against estate tax; they may claim a credit of only $3,600, which is the equivalent of exempting $60,000 of property from tax.

Aliens not domiciled in the United States are subject to U.S. gift taxes only on *tangible* property situated within the United States. Real estate is considered tangible property. Gifts of tangible property situated in the United States by nondomiciled aliens are taxed according to the same rules and rates as are gifts of all property by U.S. citizens and domiciled aliens; prior gifts of tangible U.S. property are reflected in the computation of U.S. estate tax on U.S. Property of a deceased alien not domiciled in the United States.

In summary, aliens not domiciled in the United States can avoid federal estate taxes by holding U.S. real estate through a foreign corporation and federal gift taxes through a foreign or a domestic corporation.[19] For this reason, estate and gift taxes do not appear significantly to impede foreign investment in U.S. real estate, but they do affect the legal form in which that investment occurs.

## Chapter 4 — Tax Treaties

Chapter 3 describes the manner in which foreign persons investing in United States real estate minimize the taxation of income derived from their United States real estate investment. The methods of achieving tax minimization described in Chapter 3 are the products of provisions of U.S. statutory law; they are not primarily the product of double taxation conventions (treaties) in force between the U.S. and other countries.

Double taxation conventions do, however, play a role in the manner in which the income derived by foreign persons from U.S. real estate investments is taxed. In particular, U.S. conventions with certain "tax haven" jurisdictions appear to be exploited by some foreign persons resident outside these jurisdictions, who can gain certain advantages by "structuring" their U.S. real estate investments "through" the tax haven jurisdiction. Although the tax savings achieved by these devices are, in the case of real estate, small in comparison to the tax savings which result from the operation of U.S. statutory law, the opportunities for achieving them may nonetheless affect the design of foreign investments in the United States.

The operation and impact of the conventions may be very difficult for non-experts to understand when studying arrangements whereby foreign persons invest in U.S. real estate. Limited improvements in the manner in which income from foreign investment in U.S. real estate is taxed might be made by modifications of existing U.S. double taxation arrangements, even though a major change in the general pattern of taxing this income cannot be achieved through the treaty process. For these two reasons, this chapter is devoted to analyzing the use of tax conventions by foreign persons investing in U.S. real estate.

### I. Tax Conventions Generally

The United States is a party to 26 conventions in force for the elimination of double taxation and the prevention of fiscal evasion with respect to taxes on income or on income and capital. These conventions are applicable to 38 independent nations, and eight territories of other nations. These conventions are always bilateral.

The general purpose of income tax conventions is to avoid double taxation of income where persons resident in (or corporations organized in) one country derive income in a second country. The principal means by which this is achieved is through reciprocal concessions of taxing jurisdiction by the two states signatory to the convention. These concessions regulate which state — the state of residence or the source state — has the primary right to tax with respect to particular classes of income. For instance, a double taxation convention may provide that the state where real property is located has the primary right to tax the income derived from the property, or that royalty income from one state shall be exempt from tax in that state. The former example is an instance where the primary right to tax is allocated to the source state, the latter where the right to tax is allocated to the state of residence. As these examples indicate, the reciprocal concessions embodied in a double taxation convention are ordinarily defined according to types of income.

Double taxation conventions therefore avoid double taxation only by means of provisions under which the signatory states relinquish taxing rights. Conventions do not in themselves purport to impose taxes in the contracting states. The provisions of double taxation conventions are self-executing under U.S. law; that is, they operate to limit provisions of domestic law inconsistent with the convention without implementing legislation expressly overriding domestic law, international treaties or conventions which purported to impose any tax not otherwise imposed under domestic law would not be selfexecuting under U.S. constitutional law; that is, the tax involved could not be imposed without implementing legislation adopted by both houses of Congress according to constitutionally prescribed procedures for the adoption of revenue laws. For these reasons, deficiencies in U.S. statutory law which permit any class of income to escape taxation cannot be corrected by treaty. Thus, if it is perceived that the present pattern of taxation contains unwarranted gaps in the taxation of income derived from foreign investment in U.S. real estate, those gaps must be filled by statute. They cannot be filled by bilateral treaties.

In accordance with the method of double taxation conventions generally, U.S. conventions involve two sets of concessions by the U.S. With respect to some categories of income, the U.S. agrees to accord the primary right to tax the source state. U.S. conventions achieve this by requiring the United States to allow a credit for taxes paid to the other country in an amount not to exceed the U.S. tax which would otherwise be imposed upon the income in question. Second, the United States agrees to reduce or eliminate its tax upon persons resident in (or corporations organized in) the treaty partner on their income from investment or business in the United States. It is these latter provisions which are relevant to the taxation of foreign investment in U.S. real estate.

The object of convention provisions reducing or prohibiting U.S. taxation of described categories of U.S. income is to reduce U.S. tax on income in circumstances where the income is subject to taxation by the state of the recipient's residence (or citizenship). Two provisions of the United States model income tax con-

19. The United States presently has in force estate or estate and gift tax conventions with 13 countries. One such convention (Netherlands) and two conventions signed, but not yet in force (the United Kingdom and France), provide that shares in a U.S. corporation can be excluded from the taxable U.S. estate of an alien domiciled in the treaty country.

## TABLE 4-1

### SELECTED PROVISIONS OF U.S. INCOME TAX TREATIES AFFECTING FOREIGN OWNERSHIP OF U.S. REAL PROPERTY

| Country | Date of signature of treaty or most recent protocol (P) | Annual net basis election | Waiver of U.S. second dividend tax | Waiver of U.S. second interest tax | Treatment of capital gains in U.S. | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Exceptions to source country exemption | | | |
| | | | | | General source exemption | real property | P.E. or fixed base property | 183 day presence in source state | other |
| Antigua[1] | 1958 | x | x | x | | | | | |
| Australia | 1953 | x | x[2] | | | | | | |
| Austria | 1956 | x | x | x | | | | | |
| Barbados[1] | 1958 | x | x | x | | | | | |
| Belgium | 1970 | | x | x[10] | x | x | x | x | |
| Belize[1] | 1958 | x | x | x | | | | | |
| British Virgin Islands[1] | 1958 | x | x | x | | | | | |
| Burundi[3] | 1959 | x | | | | | | | |
| Canada | 1966 (P) | x | x | x | x | | x | | |
| Denmark | 1948 | x | | | | | | | |
| Dominica[1] | 1958 | x | x | x | | | | | |
| Egypt[4] | 1975 | | | x[10] | x | x | x | x | |
| Falkland Islands[1] | 1958 | x | x | x | | | | | |
| Finland | 1970 | | | | x | x | x | x | |
| France[5] | 1978 (P) | x | | x[10] | x | x | x | x | x[5] |
| Gambia[1] | 1958 | x | x | x | | | | | |
| Germany | 1965 (P) | x | x | x | x | x | x | x | |
| Greece | 1950 | x | x | x | | | | | |
| Grenada[1] | 1958 | x | x | x | | | | | |
| Hungary[4] | 1979 | | | x | x | x | x | | |
| Iceland | 1975 | | x | x[10] | x | x | x | x | |
| Ireland | 1949 | x | x | x | | | | | |
| Israel[4] | 1975 | | x | x[10] | x | x | x | x | x[7] |
| Italy | 1955 | x | x | x | | | | | |
| Jamaica[1] | 1958 | x | x | x | | | | | |
| Japan | 1971 | | x | x[10] | x | x | x | x | |
| Korea[4] | 1976 | | x | x[10] | x | x | x | x | |
| Luxembourg | 1964 | x | x | x | | | | | |
| Malawi[1] | 1958 | x | x | x | | | | | |
| Montserrat[1] | 1958 | x | x | x | | | | | |
| Morocco[4] | 1977 | | x | x[10] | x | x | x | x | x[6] |
| Netherlands | 1965 (P) | x | x | x | x | x | x | x[8] | |
| Netherlands Antilles[9] | 1963 (P) | x | x | x | | | | | |
| New Zealand | 1948 | x | x | | | | | | |
| Norway | 1971 | | x | x[10] | x | x | x | x | |
| Pakistan | 1957 | | x | | | | | | |
| Philippines[4] | 1976 | | | x[10] | x | x | x | | |
| Poland | 1974 | | | x[10] | x | x | x | x | |
| Romania | 1973 | | | x[10] | x | x | x | x | |
| Rwanda[3] | 1959 | x | | | | | | | |
| St. Christopher, Nevis & Anguilla[1] | 1958 | x | x | x | | | | | |

vention illustrate this point.[20] Paragraph 6 of Article 4, governing the determination of residence under income tax conventions, provides that if the treaty partner taxes its residents only when income is remitted (rather than when it is earned), the relief from U.S. taxes mandated under the conventions is required only to the extent that the income involved is actually remitted. In a similar vein, Article 16 (investment and Holding Companies) of the model treaty provides that any reductions mandated by the conventions in withholding taxes on dividends, interest, and royalties will not apply to holding companies owned by third country residents if the tax imposed on such income by the treaty partner generates substantially less than would be imposed on other business profits in that country.

Most U.S. double taxation conventions in force do not contain these or parallel provisions, primarily because they were negotiated before the positions embodied in the U.S. model had been fully developed. The model was issued in 1977. Most U.S. treaties were signed and ratified before that; the largest number were signed and ratified in the late 1940's and early 1950's.

Various provisions of double taxation conventions may be of concern to foreign investors in U.S. real estate. Table 3-2 above described the withholding rates applicable under the various treaties to interest, dividends, rents and royalties. Real estate investors may make the election under the statute to be taxed on a net basis on their rental income, however, and this tends to limit the application of withholding rates with respect to rental income.

Table 4-1 below summarizes provisions of U.S. conventions in force or signed with respect to matters which are of particular relevance to real estate investors. The Table shows the following:

– Most tax conventions signed before 1970 allow residents of the other contracting state to elect on an annual basis to have real property income offset by deductions when the foreign resident has no "permanent establishment"[21] in the United States. These provisions give these residents rights substantially broader than those enjoyed by residents of other countries, who to receive "net basis" treatment must make an election revocable only with I.R.S. consent. Most conventions signed since 1970 do not provide for an annual election.

– Most conventions waive the U.S. withholding taxes on interest and dividends paid by foreign corporations earning a majority of their income from a United States business. (As explained more fully below, this waiver of the "second withholding" taxes is of greatest significance to a company holding U.S. assets, incorporated in the treaty country, but owned by third country residents). However, most conventions signed since 1970 do not waive the second withholding tax on interest payments which the foreign investor has deducted in calculating his U.S. taxable income. Under present treaty policy, the United States will agree to waive its second withholding taxes on dividends and interest

20. The U.S. model income tax treaty reflects the preferred position of the United States in tax treaty negotiations. If a foreign country does not have a copy of the model treaty, the U.S. Treasury provides an advance copy to facilitate treaty negotiations. Thus, the model treaty is, in essence, the starting offer of the U.S. Treasury in tax treaty negotiations.

21. A "permanent establishment" is a treaty concept and is defined in general to mean a fixed place of business through which the business of an enterprise of wholly or partly carried on. In general, having a "permanent establishment" implies as high or higher level of economic involvement as the statutory concept of having a trade or business. In the particular case of real estate, the two notions are largely synonymous.



| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| St. Lucia[1] | 1958 | x | x | x | | | | | |
| St. Vincent[1] | 1958 | x | x | x | | | | | |
| Seychelles[1] | 1958 | x | x | x | | | | | |
| Sierra Leone[1] | 1958 | x | x | x | | | | | |
| Sweden | 1963 (P) | | | | x | x | x | | |
| Switzerland | 1951 | x | x[2] | x[2] | | | | | |
| Trinidad & Tobago | 1970 | x | | x[10] | | | | | |
| Union of South Africa | 1950 (P) | x | | | | | | | |
| U.S.S.R. | 1973 | | | | | | | | |
| U.K. – present treaty | 1966 (P) | x | x | x | x | | x | x | |
| U.K. – proposed treaty[4] | 1979 (P) | | x | x[10] | | | | | |
| Zaire[3] | 1959 | x | | | | | | | |
| Zambia[1] | 1958 | x | x | x | | | | | |

Office of the Secretary of the Treasury
Office of Tax Analysis

1. 1958 extension of U.K. treaty as in effect at that time.
2. Payments are xempt from U.S. tax only if paid to residents of the other country.
3. 1959 extension of Belgian treaty as in effect at that time.
4. Signed but not yet in force.
5. The 1978 protocol is signed but not yet in force.
6. Country of situs of real property may tax gain on sale of shares or similar interests in real property cooperative or corporation whose assets consist principally of that property.
7. A U.S. resident is taxable by Israel on gain from the alienation of shares in a real estate holding company. A protocol which is not yet signed will make this provision reciprocal.
8. Source right to tax applies only if asset is held less than 6 months.
9. 1955 extension of Netherlands treaty as then in effect, as amended by a 1965 protocol.
10. Though the U.S. does not preserve the precise form and scope of the second interest tax, it does retain the right to tax interest paid by a resident of the other State if the payor has a P.E. in the U.S. in connection with which the indebtedness was incurred, and which bears the interest.

only if the treaty partner imposes comparable withholding taxes.

— In many cases, the United States has agreed generally to exempt residents of the treaty partner from taxation on capital gain from the sale of U.S. property. In all but two cases, however, the exemption does not apply to real estate (i.e., the treaty does not preclude taxation of capital gain on the sale of U.S. real estate). The two exceptions to this rule, Canada and the United Kingdom, tax their residents' capital gain from the sale of U.S. real estate at rates comparable to those applicable to U.S. citizens or corporations.[22]

### II. Conduit Countries

*A. Netherlands Antilles*

Although most recent conventions contain provisions designed to limit benefits under the convention to individuals and corporations taxable in the treaty country, some of the older conventions do not contain adequate protection against this result. These conventions may be used by third-country residents using a holding company incorporated in the treaty country (or territory). In addition to the legal tax advantages derived from the careful use of a holding company, the third country resident may wish to conceal his investment from tax, foreign exchange, or other authorities in his home country or in the United States. Third-country residents may be able to achieve this objective by "structuring" investments "through" some of the countries with which the U.S. has double taxation conventions in force.

The most important of the "conduit" countries is the Netherlands Antilles. The United States signed a double taxation convention with the Netherlands in 1948. In 1955, the U.S. and the Netherlands executed a protocol to this convention making the provisions of the convention applicable to the Netherlands Antilles. In 1963, the U.S. and the Netherlands executed a protocol to the convention which modified the application to the Antilles of the dividend, interest, and royalty withholding articles. In 1966, the U.S. and the Netherlands executed a protocol to the convention which modified the application of the provisions of the convention. The 1963 protocol does not apply to the Netherlands, and the 1966 protocol does not apply to the Netherlands Antilles.

The Netherlands Antilles has no estate, gift or inheritance tax, no tax on capital gains, and no withholding taxes on dividends, interest or other payments to nonresidents. In calculating income subject to the Netherlands Antilles corporation tax, a holding company can deduct operation expenses, property taxes, mortgage interest and depreciation. The Antilles does not permit deductions for accelerated depreciation as generous as those permitted by U.S. law, however, so that a company may in certain circumstances be unable to show a tax loss for Antilles profits tax purposes even when it shows such a loss for U.S. income tax purposes. But even where this occurs, the income shown in the Antilles will usually be taxed only at 2-3 percent rates in the Antilles. Under Antilles law active business income earned by an Antilles corporation outside the Antilles, and rental investment income earned by certain holding companies outside the Antilles are taxed at one-tenth the otherwise applicable tax rates. A final advantage of an Antilles holding company is that the Netherlands Antilles allow corporations to issue bearer shares, which assures the confidentiality of ownership.

The U.S.-Netherlands Antilles treaty modifies U.S. or Netherlands Antilles law in three ways of significance to real estate investors:

1. First, and most critically, dividends and interest paid by a Netherlands Antilles company are exempt from the *U.S.* "second withholding" taxes. The United States applies a withholding tax not only to dividends and interest paid by a U.S. corporation (unless more than 80 percent of the corporation's gross income is foreign source), but also to a portion of dividends and interest paid by a foreign corporation if 50 percent or more of the foreign corporation's gross income (e.g., rent) is effectively connected with a U.S. trade or business.[23] The purpose of this "second withholding" tax is to limit the disparity in U.S. tax treatment of a U.S. and a foreign corporation with a trade or business in the United States.

As a consequence of a treaty waiver of the "second withholding" taxes, interest on a mortgage financing a U.S. real estate investment can be paid tax free by a holding company. Suppose, for example. that a foreigner had $1 million which he wished to invest in U.S. real estate. Rather than investing directly, he may establish a Netherlands Antilles holding company to which he advances $250,000 as equity. The holding company may then buy the U.S. real estate, advancing the $250,000 equity contribution as a down payment and arranging for a $750,000 mortgage held directly or through a financial intermediary by the company's own shareholder. Assuming the Netherlands Antilles company is not too thinly capitalized, the mortgage interest payments will be deductible in computing the holding company's taxable income in the United States. Even though the interest is payable to a foreign mortgage holder, the Netherlands Antilles convention exempts that interest from the U.S. "second withholding" tax. As noted above, the Netherlands Antilles itself imposes no withholding tax. That portion of the foreigner's total return on his $1 million U.S. real estate investment which the mortgage interest represents thereby escapes U.S. income tax.

2. Under the Netherlands Antilles convention, the election to be taxed on net, rather than gross, income from real estate which is not attributable to a trade or business conducted through a "permanent establishment" can be made (and thus revoked) annually. A Netherlands Antilles company which does not have a permanent establishment can therefore deduct substantial expenses (e.g., operating costs, property taxes, insurance premiums, mortgage interest and, where applicable, depreciation) while the property produces rental income, and then, by not making the election in the year the property is sold, pay no tax on the capital gain. (Under U.S. statutes, this election cannot be revoked without the special permission of the Internal Revenue Service.)

3. The convention also provides that income from real estate and interest on real estate mortgages are taxable only in the country where the real estate is located (the United States in this instance). The Netherlands Antilles interprets this article to exempt the U.S. real estate income of a Netherlands Antilles company from Netherlands Antilles income tax (which, in any event, would have been minimal because of the allowance of deductions and the preferential rates of taxation for foreign business income and holding companies' foreign rental income).[24]

22. The new U.K.-U.S. treaty which has been signed, but is not yet in force, contains no exemption from source-country tax on capital gains.

23. The fraction of a dividend or interest payment by a foreign corporation to which the U.S. withholding tax applies is the ratio of gross income effectively connected with a U.S. trade or business to worldwide gross income of the corporation.

24. This interpretation of the convention is not inevitable. In the reciprocal case — of a U.S. corporation deriving income from Antilles real estate — the U.S. does not interpret the convention as precluding the right of the U.S. to tax the income, by virtue of a provision of the convention reserving each state's right to tax its own nationals as though the convention had not come into effect.

*B. British Virgin Islands*

The income tax convention between the U.S. and the British Virgin Islands is an extension of a 1945 convention between the U.S. and the United Kingdom. A 1959 protocol extended the 1945 convention and its subsequent protocols to 20 jurisdictions which at the time were United Kingdom dependencies. In 1966, the U.S. and U.K. executed a protocol to the 1945 convention. This protocol does *not* apply to the British Virgin Islands or the other territories to which the 1945 convention was extended. In 1975, the U.S. and U.K. signed a convention which when it takes effect would replace the 1945 convention. Three protocols to the new 1975 convention have been signed, but neither the convention nor the protocols have been ratified. The new convention would not apply to the territories to which the 1945 convention was extended.

A foreign investor can reach the same favorable results by establishing a holding company in the British Virgin Islands as it can via the Netherlands Antilles. Like the Netherlands Antilles treaty, the British Virgin Islands treaty exempts a holding company from the U.S. "second withholding" tax on dividends and interest and allows the company to elect on an annual basis to be taxed in the U.S. as if it were engaged in a U.S. trade or business. The British Virgin Islands does impose a corporate income tax of 15 percent; deduction for operating expenses, interest, property taxes, and depreciation are allowed; and a taxpayer may claim a credit for income tax paid to a foreign government. More importantly, *income is taxed only if it is remitted to the British Virgin Islands.* This means that if income is never deposited in or otherwise paid over to the British Virgin Islands, it is not taxable in the British Virgin Islands. The "remittance" basis of the BVI tax law plays the same role in the use of the BVI for these purposes as is played by statutory favored treatment in the Netherlands Antilles. Like the Netherlands Antilles, the British Virgin Islands has no estate, gift, inheritance, capital gains tax, nor withholding taxes on dividends and interest paid to non-residents. Although bearer shares are not allowed, a foreign investor may conceal his ownership by having a nominee register as the shareholder in the BVI.

## CHAPTER 5 – ANALYSIS AND CONCLUSIONS

### I. Summary of Relevant Tax Provisions

Income effectively connected with a U.S. trade or business earned by a nonresident alien or a foreign corporation is taxed under generally the same rules as those applicable to a U.S. citizen or corporation, respectively. Much foreign investment in U.S. real estate constitutes a U.S. trade or business; that which does not may, at the election of the foreign investor, be taxed as if it were. Allowable deductions often equal or exceed rental income; losses, rather than positive income, are reported for tax purposes.

If a foreign taxpayer engaged in a U.S. trade or business by reason of a real estate investment sold such U.S. real estate, the gain would ordinarily be effectively connected with the trade or business and taxable in the United States. Present law, however, offers a careful foreign investor several ways of reclassifying the gain as not effectively connected with a U.S. trade or business, and as a consequence, ordinarily exempt from U.S. tax. The ways of avoiding U.S. capital gains tax identified in this Report were:

1. An installment sale.

2. An exchange for foreign property of a like kind.

3. Sale of the property by a holding company, coupled with a complete liquidation of the company within one year.

4. Sale of the shares of a holding company (the new owner can liquidate the company with minor tax consequences and gain a stepped-up basis in the property).

5. Under a tax treaty, revoking an election to be taxed on a net, rather than a gross, basis.

Although any one of these methods of avoiding capital gains may not work or not work well in some cases, the methods are numerous and varied enough that one or more would usually be available. Although the role of tax treaties, especially the U.S.-Netherlands Antilles treaty, has been highlighted in public discussion, the opportunities for avoiding capital gains tax derive largely from U.S. statutes, rather than U.S. treaties.

### II. Legislative Proposals

A proposal by Senator Wallop to tax the capital gain on the sale of agricultural land was included in the Senate version of the Revenue Act of 1978. Apart from tax equity between domestic and foreign taxpayers, the primary concern expressed in the Senate debate was that exemption from capital gain taxation encouraged foreign investors to bid up the price of U.S. farmland. Because neither the House of Representatives nor the Treasury had had an opportunity to consider the proposal carefully, the House-Senate conference committee decided to delete the proposal, but to ask the Treasury to prepare this Report.

In January 1979, Senator Wallop introduced S. 208, a bill substantially similar to the bill the Senate passed in 1978. Essentially the same bill, H.R. 3106, was introduced in the House of Representatives by Congressman Grassley; both bills have broad, bipartisan support. Under each bill, capital gain on the sale of:

— land used in farming, suitable for use in farming, or in a rural area; and

— shares in a corporation or an interest in a partnership, trust or estate, to the extent gain was in excess of $3,000 and attributable to the unrealized appreciation in such land (or similar gain which a corporation had realized, but elected not to recognize, under section 337)

would be considered effectively connected with a U.S. trade or business and, therefore, subject to U.S. capital gains tax. The purchaser of affected agricultural land, corporate shares or partnership interests would be required to withhold tax equal to 30 percent of a foreign investor's taxable gain. (The taxpayer could file for refund of an overpayment.) H.R. 3106 would override tax treaties five years after its date of enactment, S. 208 would not.

If capital gains on the sale of land were always considered effectively connected with a U.S. trade or business, a foreign owner could not avoid tax by making an installment sale and deferring recognition of the gain or by failing to make an annual election to be taxed net of deductions. Thus, two of the tax avoidance methods noted above would not work. If capital gains on the sale of corporate shares (to the extent such gains were attributable to unrealized gain on agricultural land) were also considered effectively connected, two other methods described above for avoiding capital gains tax would presumably not work either: the gain upon liquidation of a holding company, or the sale of such a company's shares. Although S. 208 would not affect exchanges for foreign property of like kind, such exchanges could be easily covered by an appropriate amendment.

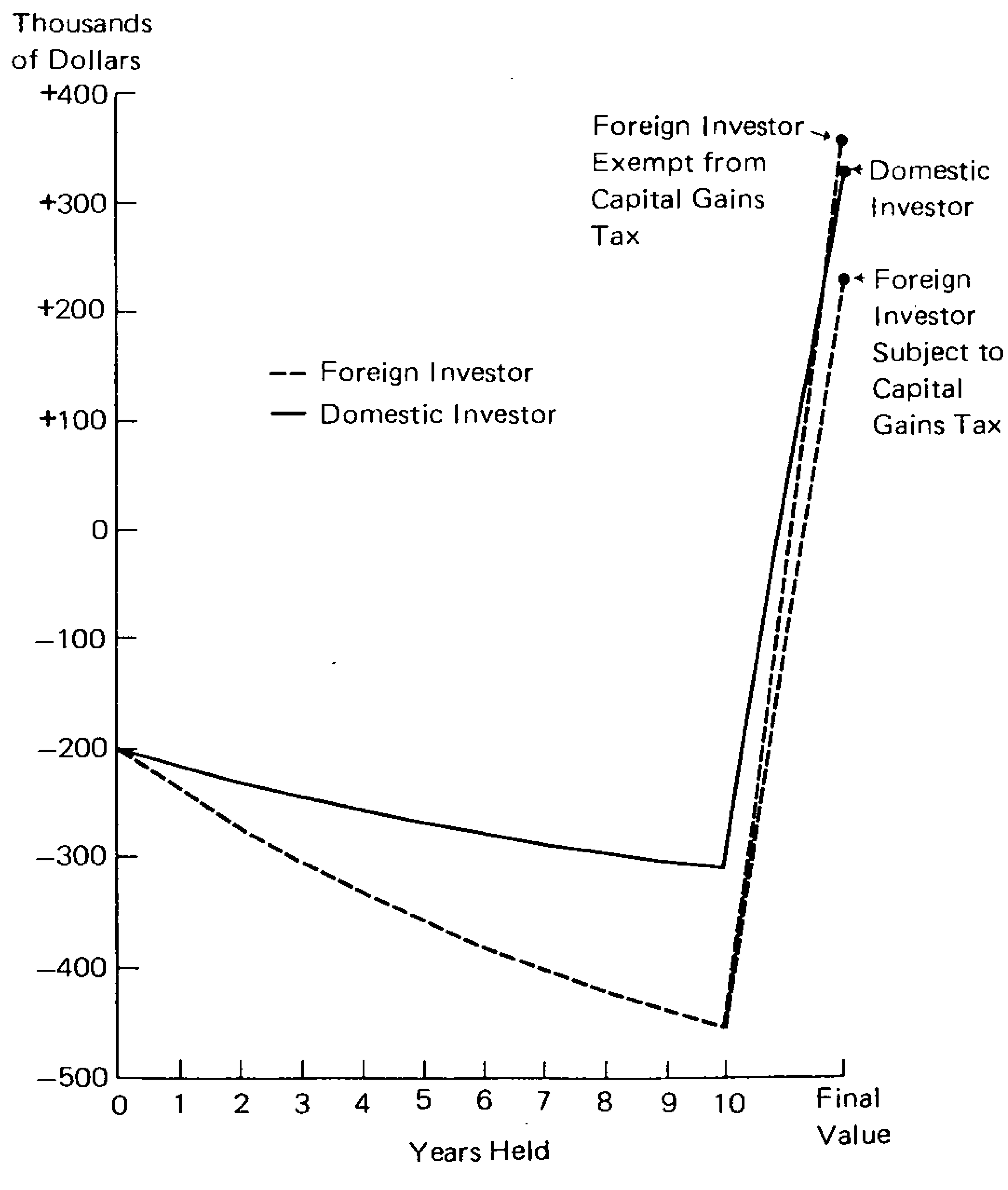
### III. Impact of Capital Gains Taxation on a Hypothetical Investment

The burden of the U.S. capital gains tax depends on how rapidly property appreciates in value, how long the property is held, and other features of specific cases. No hypothetical example can convey the diversity of circumstances to be found in actual cases. Carefully constructed examples can, however, put proposals for changes into a clearer economic perspective. The particular example summarized in this section and described more fully in Appendix C proceeds on the hypothesis that an investor purchases unimproved agricultural land for $1 million, $800,000 of which is obtained from a conventional, 40-year mortgage carrying interest of 10 per annum. For ten years, the investor receives $50,000 in annual rent and pays out $10,000 each year in property taxes and other actual expenses. With mortgage payments of approximately $82,000 per year, the investment has a pretax cash outflow deficit of $42,000 per year. After ten years, the investor sells the property for $2.9 million (this amount is derived from the average rate of appreciation for all U.S. farmland from 1968 to 1978).

The cash-flow profile of such an investment for a domestic and a foreign investor are depicted in Figure I. Each investor would have to put up $200,000 initially and $42,000 in each subsequent year. Figure I depicts the accumulated amounts invested; funds which are spent or received after a period of years are measured by their present (or discounted) value to adjust for the time value of money.[25] Present value allows meaningful comparisons between payments and receipts occurring in different years.

Because this hypothetical investment requires additional cash inputs in every year, the accumulated cash flow depicted in Figure I declines steadily over the ten-year life of the investment. Note that the accumulated present value of cash payout by the domestic investor is *less* than that by the foreign investor. This difference reflects an assumption that a domestic investor can use the tax losses generated by this investment to shelter other income from U.S. taxation,[26] but that the foreign investor has no other U.S. income which can be similarly sheltered. That is to say, real estate investment is assumed here to provide a tax shelter for a domestic investor, but to have no such shelter value for a foreign investor. Needless to say, there may be cases in which a foreign investor can take advantage of such shelter value.

**FIGURE 5-1: PRESENT VALUE OF ACCUMULATED CASH FLOW FROM A HYPOTHETICAL INVESTMENT IN U.S. FARMLAND TO A FOREIGN VS. DOMESTIC INVESTOR**




When the real estate is sold and the mortgage principal paid off, each investor is left with net proceeds of $2.1 million, a substantial return on his cash outlays over the prior ten years. Our hypothetical example assumes that the foreign investor can avoid paying U.S. capital gains tax. The domestic investor must, however, pay ordinary income tax on 40 percent of his capital gain (which, in turn, equals his $2.9 million in gross proceeds less his basis in the property, $1 million). The tax, which amounts to $343,000, exceeds the tax savings from his prior real estate losses, even when both amounts are converted to their present values. Thus, the real estate investment generates a higher return to the foreign investor than to the domestic investor.

The foreign investor in this example does somewhat better than the domestic investor because, under the assumptions which underlie the example, the *de facto* exemption from capital gains tax is worth more than the ability to shelter income other than real estate income from taxation. The net advantage of the foreign investor would be larger if he could use the real estate losses to shelter other income from taxation *and* avoid paying capital gains taxation. In fact, a foreign investor may have the best of both worlds in at least three different ways:

— The losses may offset other effectively connected income.

— If the real estate is held by a foreign-controlled U.S. corporation, the real estate losses can offset other U.S. income whether or not such income would be considered effectively connected if earned by a foreign corporation. Table 2-4 indicated that U.S. companies, not foreign companies, were in 1974 the primary corporate form for foreign investment in U.S. real estate.

— A partnership agreement between a domestic and foreign investor might be structured to allocate all the losses to the former and only capital gain to the latter. In an example given in Appendix C, the hypothetical investment undertaken by a domestic-foreign partnership obtains a higher rate of return than that obtained by either partner investing separately. A partnership agreement may allow a foreign investor to derive indirectly some benefit from real estate losses allocated to a domestic partner.

Thus, the assumption that the foreign investor derives no benefit from real estate losses is probably too strong, and the net tax advantage of a foreign investor compared to a domestic investor is larger than that calculated above and depicted in Figure I.

This conclusion — that a foreign investor bears a lighter tax burden than a domestic investor — would be reversed if the foreigner were taxable on his capital gain. In the hypothetical example described in Appendix C and depicted in Figure I, a foreign investor who can make only limited use of his real estate losses, but is taxable on his capital gain, is worse off than a domestic investor who can make better use of the real estate losses.

The results reached in the hypothetical case are, we repeat,

25. For example, the present value of the $10,000 in property taxes and other expenses payable at the end of the first year is $9,091 (assuming a 10 percent discount rate). That is to say, if the investor put $9,091 in a bond maturing in one year and paying interest of 10 percent, he could pay the $10,000 tax with the proceeds when the $9,091 bond matured.

26. Because real estate investment often attracts wealthy investors, the domestic investor is assumed to be in a 60 percent marginal tax bracket.

sensitive to the underlying assumptions about the rate of capital appreciation, the extent to which the initial investment is financed with borrowed money, the tax bracket of the investor, the rate of discount and so forth. The main point is that the differential treatment of capital gains is one of several differences in the way the United States taxes foreign versus domestic taxpayers. Some differences (e.g., treatment of capital gains, taxation limited to effectively connected and specified other U.S. income) favor foreign taxpayers, others (e.g., treatment of losses, number of exemptions) favor domestic taxpayers. Whether foreign taxpayers are better or worse off than domestic taxpayers when all the differences are considered together depends on the circumstances of a particular investment and investor.

## IV. Policy issues in Taxing Capital Gains from the Sale of Real Estate

### *A. Tax Policy Considerations*

In considering U.S. taxations of foreigners on their U.S. source capital gains, a critical issue is tax equity — a foreign investor with more than a minimal presence in the United States should not bear a lighter tax burden than a comparable domestic investor. United States real estate arguably represents, in and of itself, a presence that is more than minimal. This conclusion has, in fact, wide international acceptance. Section I of Article 13 (Capital Gains) of the O.E.C.D. model income tax treaty provides:

> Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in the other State.

Appendix B to this Report summarizes other countries' rules for taxing capital gain on the sale of domestic real property by foreign owners. As shown there, virtually all countries tax such gain using the same rules as those applicable to domestic owners. The U.S. exemption for gain on real property not effectively connected with a U.S. trade or business is unusual by international standards.

Countries' tax practices differ widely, however, in taxing capital gain on the sale of shares in a corporation holding real property. As noted above, several of the methods for avoiding U.S. capital gains tax on the sale of real estate involve the use of holding companies. As Appendix B indicates, some countries attempt to tax such gains; other do not.

The U.S. exemption of a foreign taxpayer's capital gains on the sale of corporate shares has at least three justifications:

— *Compliance.* A tax on capital gains on the sale of corporate shares and other securities is difficult to collect because transfers of ownership are usually not recorded (as opposed to transfers of real estate, which are) and can and frequently do take place outside the United States. Such a tax could only be effectively enforced through measures that would seriously burden the overall market in such securities. These measures are not desirable, nor would it be desirable to enact a tax that cannot be effectively enforced.

— *Gross vs. Net Taxation.* Dividends, Interest and other income on financial assets are taxed without the benefit of deductions unless such income is effectively connected with a U.S. trade or business (in which case deductions are allowed, but capital gains are subject to tax). Exemption from capital gains taxation may be seen as an offset, roughly, for the prior denial of deductions from such income.

— *Balance of Payments.* The exemption from capital gains tax makes domestic securities easier to sell on international markets.

Taxing capital gains on the sale of corporate shares would not be justified by general international practice and would, in fact, run contrary to U.S. tax treaties. Such a tax would not affect the sale of shares by residents of countries with a current treaty exemption (see Table 4-1).

Then, it makes considerable sense to draw a line between capital gains on the sale of assets used in a U.S. trade or business and capital gains on the sale of shares. The next issue, however, is whether the rules for distinguishing effectively connected and non-effectively connected gains should be so easily manipulable. The abuse highlighted in this Report is the *conversion* of capital gains on real estate which had been used in a U.S. trade or business (by election, if not in fact) into capital gains on the sale of shares.

This, in turn, suggests that an appropriate and effective remedy may focus on one or more steps in the various processes by which gains which should be taxable are converted into tax-exempt gains. For example, in the case of a "like kind" exchange, it may be easier to impose a tax when U.S. property is exchanged for foreign property than when the foreign property is subsequently sold. Similarly, it may be difficult to impose a tax on the sale of corporate shares of a holding company, but it appears possible to deny the new owner an all but tax-free liquidation and step-up in basis.

In contemplating changes in statutory law, our treaty obligations to other countries must be taken into account. As noted in Table 4-1, approximately half of the treaties currently in force would preclude a U.S. tax on capital gains from the sale of shares by residents of the treaty country. These treaty obligations could be overridden, but doing so would tend to make it far more difficult to obtain satisfactory treaties in the future. On the other hand, there should be considerably less international objection to a prospective override of the treaties, coupled with a sufficient time lag so that reciprocal international agreements on limited taxation of shares can be negociated.

### *B. Economic Impact of Taxing Foreign Investors' U.S. Capital Gains*

The rate at which foreign-owned assets typically appreciate in

**TABLE 5-1**

**REVENUE ESTIMATES FOR THE TAXATION OF FOREIGN CAPITAL GAINS**

| Investment | 1979 Revenue (million $) | Assets Sold (millions) | Tax as a Percent of Sales Value |
|---|---|---|---|
| Agricultural Land | 22 | $ 150 | 14.7 |
| Commercial Real Estate | 120 | 1,000 | 12.0 |
| Stocks and Direct Investment | 134 | 1,100 | 12.2 |
| Total | 276 | 2,250 | 12.3 |

Office of the Secretary of the Treasury
Office of Tax Analysis
April 10, 1979

Assumptions made in revenue estimate:

1. Five percent of farmland and 10 percent of commercial real estimate turn over each year;
2. Foreigners are taxed at the rate of 24 percent, reflecting a 60 percent marginal tax rate and a 60 percent exclusion of long term capital gains from taxation;
3. The ratio of gain to basis is 1.5 for farm property and 1 for commercial property.

value or the length of time they are held can only be surmised. Table 5-1 presents exceedingly rough estimates of the potential gain in U.S. Treasury revenues from taxing foreigners' capital gains on U.S. agricultural land, all other real estate, and all U.S. property (including stocks, bonds and other financial assets). The first column indicates that the U.S. Treasury might have gained up to $276 million from subjecting all U.S. property to be sold by foreigners in 1979 to the capital gains tax. This additional tax would represent approximately 12 percent of the estimated value of U.S. property sold by foreigners in 1979. Taxing capital gain on agricultural land only would yield an estimated $22 million, on all real estate $142 million.

Like all revenue estimates, those in Table 5-1 take no account of behavioral adjustments lessening the impact of the tax. Foreign investors might, for example, hold their investments for longer periods of time. The extent to which their aggregate investment in the United States would be reduced if capital gains were subject to U.S. tax is virtually impossible to predict. Aggregate purchases by foreigners of U.S. real property in 1979 will probably be less than $5 billion, and a substantial fraction of that will be financed with mortgages from U.S. lenders. Statistical analysis of the U.S. balance of payments behavior suggests, moreover, that long-term foreign investment in the United States depends more on the growth of the U.S. economy than on changes in the current rate of return on U.S. investment.[27] This statistical result accords well with the common observation that foreigners invest in U.S. real estate as a hedge against economic and political uncertainty overseas and not because of a small differential between the rate of return on U.S. real estate and that on foreign property.

## APPENDIX A

### Glossary

*Foreign Investment:* Foreign Investment is the gross value of assets in the U.S. owned directly and indirectly by foreign individuals and corporations. These are ordinarily stated at historical cost net of depreciation. This definition of foreign investment differs from the balance of payment definition. The balance of payment definition is based on net equity inflow, retained earnings of U.S. subsidiaries of foreign shareholders, and total earnings of U.S. branches of foreign corporations. As a consequence, the balance of payments measure does not reflect property whose acquisition was financed with borrowed funds or non-income cash flow (e.g., depreciation allowances).

*Real Estate Investment:* Real estate investment is land and buildings leased to other users or held purely for investment. It does not include land and buildings used by an investor in some other, non-real-estate, trade or business.

*Agricultural Land:* Agricultural land is land used for farming, including agriculture, forestry, and timber production. It also includes idle land if its last use was for agricultural production within the past 5 years.

*Foreign Individual:* An individual who is neither a U.S. citizen nor a U.S. resident.

*Residence:* An alien actually present in the U.S. who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. If he lives in the U.S. and had no definite intention as to his stay, he is a resident. An alien whose stay in the U.S. is limited to a definite period of time by the immigration laws is not a resident except in exceptional circumstances.

*Domicile:* A domicile is acquired by living in a locality with the intent to make it a fixed and permanent home. To change domicile two conditions must be satisfied: (1) residence must be changed (2) there must be an intention to remain at the new residence permanently.

*Corporation:* A corporation is defined to be any association which is taxed as a corporation under the Internal Revenue Code. The essential features of a corporation are associates (shareholders), an objective of carrying on business and dividing the gain therefrom, continuity of life, centralization of management, limited liability, and free transferability of interests.

*Foreign Corporation:* A foreign corporation is a corporation which is not organized under the federal laws of the United States or the laws of the fifty states or the District of Columbia.

*Trust:* A trust is an arrangement created either by a will or an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries. Generally speaking, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

*Estate:* The property and debts of a decedent.

*Partnership:* A partnership is a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954.

*Permanent Establishment:* Permanent establishment is a concept used in U.S. tax treaties to determine the way in which business income is taxed. While the precise definition varies from treaty to treaty, generally a permanent establishment means a fixed place of business through which the business or an enterprise is wholly or partly carried on.

*Trade or Business Within the U.S.:* Whether or not a nonresident alien is engaged in a trade or business is a basic distinction used in the U.S. statutory law to determine tax treatment and is a lower threshold of activity than the maintenance of a "permanent establishment" concept used in tax treaties. A U.S. trade or business includes any business operation in the U.S. involving the sale of services, products, merchandise, in the ordinary course of business. It also, with minor exceptions, includes the performance of personal services.

*Effectively Connected Income:* Income effectively connected with a trade or business in the U.S. includes income from personal services performed in the U.S., income derived from the active conduct of a trade or business in the U.S., and income derived from the assets used in, or held for use in, the conduct of a trade or business in the U.S.

*Capital Gains:* Capital gains are gains from the sale or exchange of a capital asset or an asset whose tax treatment is the same as a capital asset. Assets which do not receive capital gains treatment include stock in trade or other property included in inventory or held for sale to customers.

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27. See Richard Berner, Peter Clark, Howard Howe, Sung Kwak and Guy Stevens, "Modeling the International Influences on the U.S. Economy," International Finance Discussion Paper 93, Board of Governors, U.S. Federal Reserve Bank, Washington, D.C. 1978. This analysis found that rates of return variables had no statistically significant impact on the rate of foreign investment in the United States. This particular finding was not specifically reported in the summary discussion cited here, but was obtained by the Treasury Department from the authors of the Federal Reserve Board study.

*Basis:* Basis, which is used in determining the amount of capital gains, generally means the cost of the asset plus improvements less applicable depreciation, amortization, and depletion. If stock is sold, basis is also reduced by the amount of nontaxable distributions prior to the sale.

*Depreciation:* Depreciation, for tax purposes, is a deduction allowed for the exhaustion, wear and tear, and obsolescense of property used in the trade or business or property held for the production of income. The allowance does not apply to land, inventory, stock in trade, and personal assets. The allowance permitted for tax purposes does not depend on the actual decline in the market value of the asset over time.

*Excess Depreciation:* Excess or "additional depreciation" is the excess of the accumulated deduction for depreciation over the amount that would have been taken under the straight line method. The straight line method allows a fixed annual deduction over the estimated useful life of the asset.

## APPENDIX B

### Taxation of Real Property Gains of Nonresidents: Some International Comparisons

#### I. General Observations

The United States taxes nonresidents on gains derived from ("effectively connected" with) a U.S. business activity. But otherwise, a nonresident is exempt from U.S. tax on gain from the dispositions of assets in the United States unless physically present in the United States for more than 183 days in the year the gain is realized.

Such a broad exemption of capital gains of nonresidents is unusual. The United Kingdom apparently taxes the capital gains of nonresidents only if derived from business assets in the United Kingdom. But nearly all other industrial countries, and virtually all of the developing countries for which the information is readily available, tax nonresidents on capital gains from the disposition of real property in the country as well as on gains derived from business activity there. A smaller number also tax gains derived by nonresidents on the sale of a "substantial" holding of shares in domestic corporation (with "substantial" typically defined as 25 percent or more of the outstanding shares). And a few tax any sale of shares or other rights when the underlying assets are real property.

Thus, in terms of its intended reach, U.S. law is generous in the treatment of capital gains of nonresidents. However, at the practical level, nonresidents may be able to escape tax on gains realized from the disposition of real property in other countries, despite the broader scope of their laws. This can result if exemption is granted for gains on assets held longer than a specified number of years, or because of difficulties of enforcing the tax.

In the simplest case, where an individual owner of a piece of land sells it and transfers the title accordingly, some countries exempt the gain from tax if the property was held for a specified number of years. Capital gains of domestic residents are usually taxed at lower rates than ordinary income and may be completely exempt if property is held for a sufficient length of time. The same tax benefits are generally available to nonresidents if they satisfy conditions of realizing long-term gains.

The tax on the gain from the sale of real property can often be avoided by transferring the ownership of the property to a corporation and selling the shares of the corporation rather than the real property directly. If the corporation is foreign with respect to the country where the real property is located, gain on the sale of its shares is almost invariably beyond the scope of a country's tax law. If it is a domestic corporation and a substantial holding is sold, several countries assert jurisdiction to tax. However, enforcement may be difficult, especially if both the buyer and seller are nonresidents and the sale takes place in another country. If there is favorable tax treatment of gains on the liquidation of a corporation, this may offer another route for disposing of real property with little or no tax.

In short, the United States, along with the United Kingdom, is exceptional in not taxing nonresidents on gain from the disposition of real property other than business property; but there are enough loopholes in most foreign laws that, despite their frequently broader scope in attempting to tax nonresidents, effective taxation of gain on the disposition of real property by nonresidents is probably rarely realized.

*Examples of Capital Gains Taxes Applicable to Nonresidents on Sales of Real Property*

The following examples are very simplified and do not attempt to describe the complex variations in different countries' taxation of capital gains. Moreover, they look only to income taxes and do not consider, for example, taxes on capital. The rates indicated are individual income tax rates. References to sales are meant to include other dispositions which give rise to tax liability, e.g. exchanges or deemed sales.

*A. No taxation of gain on real property*

The United Kingdom taxes nonresidents on capital gains only if derived from the sale of assets of a U.K. business. The Netherlands does not tax gains on real property under the income tax but applies a transfer tax on the sale.

*B. Taxation of gain on real property but not shares*

Denmark, Italy, Japan, Luxembourg, New Zealand, Norway and Sweden are among the countries which tax nonresidents on gains from real property but not gains from the sale of corporate shares. Thus, the tax does not apply if, instead of holding the real property, the nonresident sets up a corporation to own the property and sells the shares of the corporation. However, Italy taxes corporations on the appreciation in value of land and buildings not directly used in commercial operations; the tax applies on the disposition of such property or every 10 years if no transfer takes place.

*C. Taxation of gains on real property and "substantial holdings" of corporate shares*

Several other countries, including Austria, Belgium, Canada, France, and the Netherlands, do not single out real estate holding companies but tax gains on the sale of shares in domestic corporations if the shares sold amount to 25 percent or more (33 percent in the Netherlands) of the outstanding shares of the corporation. In Canada, the tax applies to any sale if the corporation is privately held, as opposed to a publicly owned corporation. Canada also has complex rules to prevent avoidance of the tax through the use of trusts, etc.

Again, however, gain on the sale of real property directly may be exempt from tax if the property was held for a specified number of years. Gain on the sale of a substantial holding is rarely exempt after a holding period, but long-term gains in general may be taxed at lower rates than apply to ordinary income.

In Austria, gain on the sale of real property is exempt if the seller owned the real property for more than 5 years. Otherwise, ordinary income tax rates apply (about 20-60 percent).

Belgium taxes gain on the sale of undeveloped land at 33.5 percent on residential land held less than 10 years and on other undeveloped land held less than 5 years, at 16 percent on residential land held from 10-16 years and other land held for 5-8 years, and exempts the gain on residential land held longer than 16 years and on other land longer than 8 years. (The ordinary rates applicable to individuals' income range from about 40-60 percent.)

In Canada the holding period is not relevant, but capital gains are taxed at one-half the ordinary rates (6-43 percent Federal).

In France, the taxable portion of gain on the sale of real property varies with the period of ownership; after 10 years, one half of the gain is excused and after 20 years the gain is exempt. Taxable gains are adjusted for inflation and taxed at a flat rate of 33-1/3 percent, or 15 percent on securities held more than 10 years. (For residents tax is calculated as 5 times the tax due at ordinary income tax rates (5-60 percent) on one-fifth of the gain; i.e., the tax in effect averages the gain over a 5-year period.)

The Netherlands does not have a special regime for capital gains. Gains on the sale of business assets or on substantial holdings of corporate shares are taxed under the income tax, but in the case of gain on the sale of a substantial shareholding, a flat 20 percent tax applies if it results in a lower tax than the ordinary rates (of about 20-70 percent for individuals). Sales of real property are subject to a transfer tax of 5 percent of the market value of the property.

*D. Taxation of gains on real property and of shares representing real property*

Finland, Germany, Ireland, Israel and Mexico are examples of countries which, in addition to taxing gains from the direct sale of real property, also tax gains on the sale of shares in a corporation whose assets consist primarily of real property.

Finland taxes nonresidents on gains from the sale of shares in a Finnish corporation if 50 percent of the corporate assets consist of real property. However, gains on the direct disposition of real property held more than 10 years are exempt. Gains which are not exempt are taxed at full income tax rates (individual rates range from about 10-51%).

Germany also taxes nonresidents on gains on real property or rights relating to real property in Germany. However, gains on assets held longer than two years are considered long-term gains are not taxed. Short-term gains are taxed at full income tax rates (22-56% for individuals).

Under Ireland's capital gains tax, introduced in 1975, nonresidents are taxable on gains from real property in Ireland and from shares deriving their value from Irish real property, without regard to the period of ownership. A flat rate of 30 percent applies (cf. income tax rates of about 26-77%).

Israel taxes nonresidents on real property in Israel, on assets representing a direct or indirect right to such property, and on the sale of more than 25 percent of the shares of an Israeli corporation. On property held longer than two years, the gain is adjusted for price increases or devaluation of the Israeli currency. The inflationary gain is taxed at 10 percent, the real gain at ordinary tax rates (about 25-60%) but not more than 50 percent.

Mexico taxes gains on the sale of real property or of shares of real estate holding companies. The taxable portion of the gain declines with the period of ownership to 50 percent on property held 10 years or more. Gains on the sale of real property are taxed 80 percent at lower rates and 20 percent at ordinary rates. Gains on shares are taxed at ordinary rates (13-50 percent) and the buyer must withhold 20 percent of the purchase price. In the case of direct sales of real property, there is no withholding, but the buyer is jointly liable for the tax.

*E. Taxation of gains on real property and all corporate shares*

Some countries, including Argentina and Brazil, tax nonresidents on gains realized on the sale of shares of domestic corporations as well as on the disposition of real property itself. Ordinary income tax rates apply. There is generally an inflation adjustment. In Argentina, the gain on real property is adjusted for inflation only if the property is held more than two years.

Exchange controls can be used to help enforce such a tax. For example, in both Argentina and Brazil, a penalty tax is levied on "excess remittances" when dividends paid by local corporations to nonresident shareholders exceed a specified percentage of the registered capital of the corporation. When a sale of shares takes place between nonresidents on a foreign exchange, it is in the interest of the nonresident purchaser to report the purchase price so that the registered capital will be increased for purposes of the excess remittance tax.

Spain taxes gains on the sale of real property and movable property, including corporate stocks and bonds. Real property held less than 3 years and movable property held less than 1 year are taxed as ordinary income. Property held longer than those periods is taxed at a flat rate of 15 percent, except that gains on stocks and bonds held more than 5 years are exempt. Certain real estate holding companies are exempt from income tax altogether. These provisions seem to apply to nonresidents as well as residents.

## APPENDIX C

### Technical Analysis

This Appendix analyzes in greater detail the hypothetical investment in U.S. agricultural land set forth in Chapter 5. The land is purchased for $1 million and financed by a $200,000 down payment and an $800,000 recourse mortgage. Table A-1 shows the value of various items over the ten years the land is owned. Rental income shown in Column (1) is $50,000 per year in each of the ten years. The mortgage has a forty year repayment period and a 10 percent interest rate, so $81,808 must be repaid each year. Columns (2) through (5) show the total annual mortgage payment, the mortgage interest, the repayment of principal, and the principal amount outstanding at the end of each year, respectively. Column (6) indicates property taxes, administration costs and other deductible expenses paid by the investor. Column (7) shows the taxable income, (in this case, a loss) which equals rental income less mortgage interest and other deductible expenses; because land cannot be depreciated for tax purposes, the taxable income is not reduced by a depreciation deduction, as it would have been for commercial real estate. If a domestic investor has other income, he can reduce his total U.S. tax liability by offsetting his real estate loss against that income. The domestic tax saving shown in Column (8) equals 60 percent of the tax loss shown in Column (7). This 60 percent rate would be appropriate for a married couple filing a joint return with taxable income of $109,400, or an unmarried individual with taxable income of $55,300. Because investments generating tax losses are more valuable to high-income than to low-income taxpayers, a 60 percent tax bracket may be typical for real estate investors.

Column (9) shows the net cash flow to the foreign investor; it equals the $200,000 outflow when the land is purchased and the difference between rental income and the sum of the mortgage payment and operating expenses in each subsequent year. Column (10) shows the present value of the cash flow in Column (9); that value is calculated by dividing the actual cash flow by $(1+i)^n$, where $i$ is the discount rate and assumed to be 10 percent here,[28] and $n$ is the number of years elapsed

28. The appropriate discount rate to use in these calculations is the taxpayer's after-tax rate of return on alternative investments.

## TABLE A-1

### NUMERICAL VALUES OF HYPOTHETICAL INVESTMENT IN AGRICULTURAL LAND

| Year | Rent (1) | Mortgage Payment (2) | Mortgage Interest (3) | Repayment of Mortgage Principal (4) | Mortgage Principal Outstanding (5) | Other Expenses (6) | Taxable Income (7) | Domestic Tax (8) | Cash Flow to Foreign Investor (9) | Discounted Present Value of Previous Column (10) | Accumul. Value of Previous Column (11) | Cash Flow to Domestic Investor (12) | Discounted Present Value of Previous Column (13) | Accumulated Value of Previous Column (14) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Purchase | | | | | | | | | −200,000 | −200,000 | −200,000 | −200,000 | −200,000 | −200,000 |
| 1 | 50,000 | 81,808 | 80,000 | 1,808 | 798,192 | 10,000 | −40,000 | −24,000 | −41,808 | −38,007 | −238,007 | −17,808 | −16,189 | −216,189 |
| 2 | 50,000 | 81,808 | 79,819 | 1,989 | 796,203 | 10,000 | −39,819 | −23,891 | −41,808 | −34,552 | −272,559 | −17,917 | −14,807 | −230,996 |
| 3 | 50,000 | 81,808 | 79,620 | 2,188 | 794,015 | 10,000 | −39,620 | −23,772 | −41,808 | −31,411 | −303,970 | −18,063 | −13,571 | −244,567 |
| 4 | 50,000 | 81,808 | 79,402 | 2,406 | 791,609 | 10,000 | −39,402 | −23,641 | −41,808 | −28,555 | −332,525 | −18,167 | −12,408 | −256,975 |
| 5 | 50,000 | 81,808 | 79,161 | 2,647 | 788,962 | 10,000 | −39,161 | −23,497 | −41,808 | −25,959 | −358,484 | −18,311 | −11,370 | −268,345 |
| 6 | 50,000 | 81,808 | 78,896 | 2,912 | 786,050 | 10,000 | −38,896 | −23,337 | −41,808 | −23,600 | −382,084 | −18,471 | −10,426 | −278,771 |
| 7 | 50,000 | 81,808 | 78,605 | 3,203 | 782,847 | 10,000 | −38,605 | −23,163 | −41,808 | −21,454 | −402,538 | −18,645 | −9,568 | −288,339 |
| 8 | 50,000 | 81,808 | 78,284 | 3,523 | 779,324 | 10,000 | −38,284 | −22,970 | −41,808 | −19,504 | −423,042 | −18,838 | −8,788 | −297,127 |
| 9 | 50,000 | 81,808 | 77,932 | 3,876 | 775,448 | 10,000 | −37,932 | −22,759 | −41,808 | −17,331 | −440,373 | −19,049 | −8,079 | −305,206 |
| 10 | 50,000 | 81,808 | 77,544 | 4,263 | 771,185 | 10,000 | −37,544 | −22,526 | −41,808 | −16,119 | −456,492 | −19,282 | −7,434 | −312,640 |
| Final Sale | | | | | | | 751,402 | 450,841 | 2,107,320 | 812,463 | 355,971 | 1,656,478 | 638,644 | 326,004 |
| | | | | | | | | | (1,818,373) | (701,062) | (244,570) | | | |

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Office of Tax Analysis

between the initial purchase and the cash flow to be discounted. Column (11) gives the accumulated value of all prior amounts shown in Column (10). Columns (12), (13), and (14) show the current cash flow, discounted present value and accumulated discounted present value, respectively, for a domestic investor; the cash flow to the domestic investor equals the cash flow to the foreign investor shown in Column (9) plus the tax saving shown in Column (8).

The bottom row in Table A-1 indicates what happens when the property is sold for $2,878,505 at the end of the tenth year. The foreign investor pays off the outstanding mortgage principal, $771,185 and keeps the remainder, $2,107,320. The domestic investor must pay not only the mortgage balance, but also a capital gains tax. With an original basis of $1,000,000, his net gain is $1,878,505. Assuming he can deduct 60 percent of this amount and pay tax at the rate of 60 percent on the remaining 40 percent (i.e., the effective rate is 24 percent of the net gain), his tax on the capital gain would be $450,841. Thus, the domestic investor's net proceeds are $1,656,478, which equals $2,878,320 minus $771,185 and minus $450,841.

If the foreign investor had to treat his capital gain as if it were effectively connected with a U.S. trade or business, he would have the same net gain as the domestic investor, $1,878,505, 40 percent of which, $751,402, would be taxable. This income could, however, be reduced by the accumulated value of the last seven years' losses, $269,824, leaving $481,578 subject to tax. If the tax rate is 60 percent, the amount of the tax is $288,946. The net proceeds from the sale of the property by a foreign investor subject to capital gains taxation is, thus, $1,818,373. The present value of those net proceeds is $701,062, which would bring the accumulated present value down to $244,570. These last three items are shown in brackets under the bottom row of Table A-1.

This example can also be used to illustrate how a partnership between a domestic and a foreign investor can be structured to yield a higher return to the two taken together than is obtained by either one separately. Suppose that the partnership is structured as follows. The domestic and the foreign investor each put up half of the initial down payment, $100,000. The domestic partner assumes full responsibility for making up any cash deficits from operations. Upon the sale of the land, the proceeds are distributed as follows:

1. The outstanding mortgage principal is paid off. If the proceeds are insufficient for these purposes, the domestic investor makes up the shortfall.

2. The domestic investor recovers the after tax amount of accumulated advances (apart from the initial down payment) plus interest calculated at a rate of 10 percent per annum. If the proceeds net of the repayment of mortgage principal are less than the full amount of the accumulated advances plus interest, the domestic investor is entitled to recover *no* additional amounts from the foreign investor.

3. Any proceeds remaining after repayment of mortgage principal and the domestic investor's recovery of accumulated advances plus interest are shared equally by the domestic and foreign partners.

In the hypothetical example given, the domestic investor would advance each year the $41,808 shortfall in the cash flow. After ten years, the accumulated value of those payments plus interest at the rate of 10 percent is $666,312. When the property was sold for $2,878,505, the proceeds net of the repayment of mortgage principal are $2,107,320. When the partnership is liduidated, the domestic investor receives $666,312 plus half of the remaining $1,441,008 ($720,504), which totals $1,386,816 and the foreign investor receives $720,504.

What might be the tax consequences of this arrangement? If the partnership's tax allocations have substantial economic effect (section 704),[29] the partnership could allocate the full operating loss to the domestic partner; if the foreign partner's capital gain is tax exempt, and 40 percent of the domestic partner's capital gain, $1,258,001, is taxable at a rate of 60 percent, the latter's capital gain tax would be $301,920.[30]

The present value of the investment to the foreign-domestic partnership can now be determined. Prior to the final sale, the accumulated present value is minus $312,460, the same as it was when the investment was undertaken by the domestic investor alone. To this amount would be added $812,463, the present value of the net proceeds of the sale (see the next to last row of Column (10) of Table A-1), less $116,403, the present value of the domestic partner's capital gains tax. The final present value would, thus, be $383,600. This, in turn, is greater than the final present value of the same investment undertaken by either the domestic partner or the foreign partner separately.

Figure 5-1 in the text depicts the accumulated present value of the cash flow to a foreign and a domestic investor as shown in Columns (11) and (14), respectively.

29. The Internal Revenue Service and the Treasury Department are developing regulations to describe when an allocation has substantial economic effect.

30. If the interest payment to the domestic partner is a guaranteed payment under section 707, that portion of the amount received by the domestic partner would be ordinary income rather than capital gain. One half of the partnership's interest deduction would also be allocated to the domestic partner, so the results under this alternative are not substantially different from those in the table.

# I.F.A. in Belgian Parliament

On May 17, 1979, Mr. Tijl Declercq, Member of Belgian Parliament — after having stated that officials of the Belgian Finance Ministry regularly participate in congresses of the International Fiscal Association — asked the Belgian Minister of Finance: (i) how many officials per service branch are involved, (ii) whether they represent the tax administration or only act as private persons and (iii) what function they have at such a congress of "tax consultants".

The Minister replied that two high officials of the direct taxation service had participated in the I.F.A. congresses of 1975 through 1977. He pointed out that also other countries use to send tax officials to these congresses. He further stated that it is:

> *"essential for the tax service that a number of experienced officials follow closely the various trends in the development of international tax law, in particular when the activities involved are on a high scientific level as is the case with the congresses of I.F.A.."*

Source: *Publication of the Belgian House of Representatives "Vragen en antwoorden/Questions et réponses" (publishing questions submitted by Belgian members of parliament to the Government and the ministerial replies) No. 16 of June 26, 1979 at 797.*

# CUMULATIVE INDEX 1979 ~ Nos.1-7

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# Contents

## of the October 1979 issue

## In next issues

A review of the Ethiopian fiscal system
— by *M. Fissehatsion*

Tax changes in Singapore, the Income Tax (Amendment) Act 1979
— by *Lee Fook Hong*

Taxation and savings: some new empirical evidence in the Indian economy, 1960-76
— by *N.R. Vasudeva Murthy*

Taxation in Macao
— by *M.P. Dominic*

Indonesia: Tax Incentive Package to support the third five year development plan (1979-1984)
— by *Jap Kim Siong*

Nigerian Income Tax: Construction companies
— by *George E. Tickner*

The Evolution of Mexico's Public Expenditure Structure
— by *Arthur J. Mann*

United States: Proposed Internal Revenue Service Regulations on the creditability of taxes

# A Survey and Analysis of the Tax Systems in the Caribbean Common Market

by Roy T. Gobin*

Contents



## I. INTRODUCTION

*This study traces the development of the tax structures and compares the major taxes which prevail in the four major countries of the Caribbean Common Market (CARICOM) - Trinidad, Jamaica, Guyana and Barbados. Such a comparison is necessary to provide a framework for evaluating the extent to which taxes need to be harmonized within the commom market if taxation is to be used as an effective instrument in promoting the economic objectives of the union.*

## II. TAX STRUCTURE DEVELOPMENT

A general hypothesis made in the literature [1] of tax structure development is that indirect taxes, mainly in the form of customs duties and excises, are the most important revenue sources in the early periods of development, i.e. at low per capita incomes. However, as the economy becomes more industrialized the importance of these taxes is gradually eroded, as it becomes administratively more feasible to implement income and sales taxation. The development of the tax structure in CARICOM, with the possible exception of Trinidad, has followed the path predicted by theory. The evolution of the major taxes prevailing within the Common Market is shown in Table 1 below.

As can be seen from the table, indirect taxes in terms of revenue importance (as a percentage of total revenue) dominated in the early period (1955-1966), but have gradually declined in the recent period. There are three peculiarities, however, within this overall pattern worthy of note. Firstly, the available evidence indicates that income taxation emerged as a principal revenue source before the development of a broad industrial base, and earlier than is typical in other "less developed countries" (LDCs). [2] This phenomenon is largely explained by the early presence (late 1940s) of foreign-owned firms in the enclave mineral and agricultural sectors in the Caribbean. When agriculture is dominated by small land holdings as is the case in most LDCs, it is difficult to implement an effective system of income taxation. In the Caribbean, however, the sugar plantation organization provided an accessible tax base on which corporation taxation could be applied. In addition it became a convenient medium through which a system of personal income taxation could be organized, since plantations were the major source of labor absorption. Additional corporate tax bases resulted from the growth of petroleum refining in Trinidad and the emergence of bauxite in the 1950s as major sectors in Jamaica and Guyana.

Secondly, while there has been a relative decline in the importance of customs duties over time, it has not been a reflection of any fundamental diversification of economic activities in these economies as is usually implied by theories of tax structure development, but rather reflects the results of fiscal incentive policies designed to encourage import substitution. Over time, an increasing proportion of capital and intermediate imports has been allowed entry on a non-dutiable basis. In addition, the formation of a Free Trade Area has meant a loss of duty on intra-regional imports. [3]

Thirdly, as compared to other LDCs [4] relatively little use was made of internal commodity taxation, which remained unimportant in the tax structure until the late 1960s. The lack of greater interest in the use of any form of sales taxation can largely be explained by the fact that governments in the region, when in need of increased revenues, found it politically more appealing to increase corporate income taxation and/or administratively convenient to increase the marginal rates of personal income taxation, and impose heavier duties on imported manufactured products.

* Assistant Professor, Loyola University, Chicago. This paper is based on a chapter of my Ph.D. thesis submitted to the University of Illinois, Champaign-Urbana, 1978. I am indebted to Professor John F. Due, my supervisor, for providing helpful comments on the chapter.

1. See H. Hinrichs, *A General Theory of Tax Structure Change during Development* (Cambridge, Massachusetts: Harvard Law School, 1966).
2. Evidence based on: R. Chelliah, "Trends in Developing Countries", *IMF Staff Papers* 18, July 1971, pp. 254-327.
3. The elasticity of imports with respect to its base has been less than one in all countries. This result is shown in R. Gobin, *An Analysis of Indirect Taxation in the Caribbean Common Market: Its Impact on the Performance and Role in Tax Policy, ch. 5 (Ph.D. dissertation, University of Illinois, Champaign-Urbana, 1978).*
4. Evidence based on R. Chelliah, *op. cit.*

**TABLE 1**

**Relative importance of major tax revenues**
**(each tax source as a percentage of total tax revenue)**

| | Jamaica | | | | Trinidad | | | | Guyana | | | | Barbados | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Source of taxation | 1955-57 | 1964-66 | 1969-71 | 1972-74 | 1956-58 | 1964-66 | 1969-71 | 1972-74 | 1955-57 | 1964-66 | 1969-71 | 1972-74 | 1955-57 | 1964-66 | 1969-71 | 1972-74 |
| 1. Taxes on income [a] and profit | 31 | 38 | 44 | 47 | 62 | 56 | 55 | 72 | 40 | 37 | 39 | 35 | 42 | 38 | 44 | 47 |
| 2. Taxes on property | – | 1 | 1 | 2 | 1 | 2 | 2 | 1 | – | 2 | 2 | 2 | – | 3 | 6 | 4 |
| Total direct taxes = 1 & 2 | 31 | 39 | 45 | 49 | 63 | 58 | 57 | 73 | 37 | 39 | 41 | 37 | 42 | 41 | 50 | 51 |
| 3. Import duties | 44 | 30 | 23 | 17 | 23 | 25 | 20 | 11 | 41 | 43 | 33 | 18 | 39 | 35 | 28 | 26 |
| 4. Export taxes and other | – | – | – | – | – | – | – | – | 2 | 2 | 2 | 21 | – | – | – | – |
| 5. Total taxes on international trade = 3 & 4 | 44 | 30 | 23 | 17 | 23 | 25 | 20 | 11 | 43 | 45 | 35 | 39 | 39 | 35 | 28 | 26 |
| 6. Excise duties | 22 | 25 | 23 | 17 | 7 | 8 | 9 | 5 | 12 | 14 | 12 | 8 | 9 | 9 | 6 | 4 |
| 7. Sales taxation | – | – | 1 | 7 | – | 3 | 6 | 6 | – | – | 7 | 12 | – | 3 | 6 | 8 |
| 8. Motor vehicle-licences and special excises | 2 | 3 | 3 | 2 | 2 | 4 | 5 | 3 | – | 1 | 1 | 2 | – | – | 5 | 7 |
| 9. Other licences, duties, entertainment taxes | 1 | 3 | 5 | 8 | 5 | 2 | 3 | 2 | 5 | 1 | 4 | 2 | 10 | 12 | 5 | 4 |
| 10. Total taxes on domestic production and transactions = 6 & 7 & 8 & 9 | 25 | 31 | 32 | 34 | 14 | 17 | 23 | 16 | 18 | 16 | 24 | 24 | 19 | 24 | 22 | 23 |
| Total indirect taxes = 5 & 10 | 69 | 61 | 55 | 51 | 37 | 42 | 43 | 27 | 60 | 61 | 59 | 63 | 58 | 59 | 50 | 49 |
| Total tax revenue | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

a Includes royalties in the case of Trinidad.

## III. THE PRESENT SYSTEM OF TAXATION IN CARICOM

### 1. Direct taxation

Direct taxes, as shown, have emerged as a principal revenue in the tax structures of the CARICOM economies since the early 1950s. The principal form of direct taxation is income taxation, levied on individuals and corporations. Wealth taxes account for a negligible proportion of total revenue.

#### 1.a. Personal income taxation

Income tax on individuals is imposed on a global basis, i.e. all income regardless of the source or origin is subject to taxation. Personal exemptions and credits for dependents are allowed under the income tax laws. In terms of local currencies, allowances and deductions are very similar in the territories. Table 2 shows various allowances granted under the system of personal income taxation. In addition personal deductions are allowed for life insurance and health premiums, medical expenses and registered retirement plan contributions. Payment to benevolent organizations in some instances may be deductible.

*Tax rate structure*

The income of resident individuals in the four countries is taxable at graduated rates on chargeable income. The marginal and effective rates of taxation are shown in Table 3 below.

With the exception of Trinidad, progression in the rate structure operates quickly. While the beginning rates of about 5 percent on taxable income are not atypical (apart from Jamaica, where initial rates are excessively high - 20 percent), income bands are narrow and marginal tax rates jump steeply, reaching around 50 percent on taxable income between $9,000 - $10,000. When compared in terms of U.S. dollars, the 50 percent taxable bracket is reached at US$7,501, US$4,000, US$7,500 in Jamaica, Guyana and Barbados, respectively. In Trinidad, the 50 percent taxable bracket is not reached until TT$29,000 or about US$13,000. The rates of progression are most steep in Guyana and Jamaica, imposing a burden on the middle level income groups which is heavier than is typical, especially for developing countries.

**TABLE 2**

**Personal exemptions allowed under income taxation**

| Category | Jamaica (J$) | Trinidad [a] (TT$) | Guyana (G$) | Barbados (Bds$) |
|---|---|---|---|---|
| Taxpayer | 1,500 | 1,800 | 1,000 | 800 |
| Wife [b] | 350 | 1,000 | 1,400 | 1,140 |
| Taxpayer and Wife | 1,850 | 2,200 | 2,400 | 1,940 |
| Each child being educated | 300 | 400 | 400 | 360 |
| Dependent relative [c] | 100 | 300 | 300 | 240 |
| Total [d] | 2,550 | 3,300 | 3,500 | 2,900 |

a The 1978 budget provided for more liberal allowances, which have now been enacted.
b Including wife's earned income.
c With limits between 2-4.
d For a family of 4 with 1 dependent relative.

SOURCE: Income tax laws of individual countries as of 1977. The exchange rate in terms of U.S. dollars were as follows in 1976:
Jamaica: J$1.10 = US$1.00
Trinidad: T$2.40 = US$1.00
Guyana: G$2.55 = US$1.00
Barbados: Bds$2.00 = US$1.00

While high rates of progression are desirable from the point of view of generating revenues and promoting an equitable distribution of income, heavy burdens on the middle income groups may adversely affect developmental initiatives. In the development process, higher levels of capital are needed to secure the growth of output. The rate of capital expansion and efficient utilization depends on the absorptive capabilities of the economy, the most important ingredient of which may be the existence of a skilled labor force. Heavy rates of taxation on middle income ranges can have an adverse effect on the supply of skilled labor. High marginal rates of taxation may not only aggravate the "brain drain" to the more advanced economies but may also act as a deterrent to attracting the relevant skills to the region. Further, the substitution effect associated with high marginal rates of taxation encourages a reduction in the supply of effort, since the gain from increased effort is reduced and may outweigh the income effect (which induces increased work effort as individuals attempt to maintain a desired income level). For those groups which cannot vary their work effort, high marginal tax rates can impair job morale, thereby adversely affecting productivity. Other undesirable consequences of high marginal rates of taxation are the withdrawal of working wives from the labor force, the deterrent effect on the expansion and development of small businesses, and an increased inducement to evade and avoid taxes (especially on the part of traders and professional men).

## 1.b. Corporate taxation

Initially, corporate taxation in the Caribbean was modelled along the fully integrated approach to company taxation - reflecting the British influence on tax legislation in the Caribbean. Under this approach, corporate taxation was integrated with personal income taxation on dividends. Integration was accomplished the shareholder level, with shareholders granted a tax credit on income received from dividends. However, since the early 1970s, in an effort to stem the flow of repatriated profits by foreign-owned companies and to encourage corporations to retain a greater proportion of profits in order to finance capital expansion, the integrated system was replaced by a partial imputation system. Under the present system, there is a basic tax rate on corporate income (profits tax), with full or partial credit granted at the personal income tax level for tax paid on dividends. This is supplemented by a corporation tax, with no credit given to shareholders for tax due on dividends. In addition, a separate withholding tax is levied on dividends remitted to non-CARICOM residents by resident corporations. Guyana also levies discriminatory rates of taxation against non-resident corporations. The rates of corporate taxation are shown in Table 4 below.

The partial imputation system of company taxation is perhaps the more appropriate form of corporate taxation for the Caribbean. [5] The fully integrated approach is of greater relevance when equity considerations are paramount, i.e. where the major concern is centered on the issue of double taxation of dividend income. In the Caribbean, where most of the shareholders of the larger corporations are non-residents, the equity issue is of lesser significance. Of greater import to the region is the likely impact of corporate taxation on investment decisions.

In this respect, the partial imputation system is likely to be more advantageous than an integrated structure yielding equivalent revenue. Investment decisions are perhaps more influenced by the rate of taxation paid by the corporation than by the combined tax burden on the corporation and its shareholders, i.e. corporations are more concerned with the rate of return net of corporation taxes. The lower corporate tax rates are, the higher will be the rates of return, the lower will be the cost per dollar of risk-taking and the earlier will be the recovery of capital invested. In addition, a separate tax on distributed dividends (i.e. the profits tax) can encourage a higher level of retained profits, facilitating the financing of capital expansion. The present system of corporate taxation in the Caribbean appears to offer more stimulus to investment than the previous integrated system of taxation. Withholding taxes on distributed profits to non-residents are designed to encourage a greater retention of profits within the economy. However, the tax can have a negative impact on foreign capital inflows, especially in the non-mineral enclave sectors since foreign capital in these sectors is likely to move, *ceteris paribus*, to areas in the developing world which offer the greatest incentives.

If competing concessions given to industry within CARICOM are to be avoided, a strong case can be made

5. For a general discussion of the use of corporation taxes in LDCs, see G. Lent, "Corporation Income Tax Structures in Developing Countries", *IMF Staff Papers*, November 1977, pp. 722-755.

**TABLE 3**
**Tax rates on personal income**

| Taxable income ($) (in terms of local currency of each country) | Jamaica | | Trinidad [a] | | Guyana | | Barbados | |
|---|---|---|---|---|---|---|---|---|
| | Marginal rate | Effective rate [b] | Marginal rate | Effective rate [b] | Marginal rate [c] | Effective rate [b] | Marginal rate | Effective rate [b] |
| Up to 1,000 | 20 | 20 | 5 | 5 | 5 | 5 | 5 | 5 |
| 1001-2000 | 25 | 22 | 8 | 6.5 | 12 | 8.5 | 10 | 7.5 |
| 2001-3000 | 30 | 25.7 | 13 | 8.7 | 20 | 12.3 | 15 | 10.0 |
| 3001-4000 | 33 | 27.3 | 20 | 11.5 | 25 | 15.5 | 20 | 12.3 |
| 4001-5000 | 35 | 27.5 | 20 | 13.2 | 30 | 18.4 | 25 | 14.8 |
| 5001-6000 | 38.7 | 29.4 | 25 | 15.2 | 35 | 21.2 | 30 | 17.3 |
| 6001-7000 | 42.4 | 31.2 | 25 | 16.0 | 40 | 23.9 | 35 | 19.8 |
| 7001-8000 | 46.3 | 33.1 | 30 | 19.5 | 40 | 25.8 | 35 | 21.7 |
| 8001-9000 | 50.0 | 35.0 | 30 | 20.6 | 45 | 28.0 | 40 | 23.8 |
| 9001-11,000 | 55.6 | 38.7 | 35 | 22.6 | 50 | 32.9 | 47.5 | 27.2 |
| 11001-15000 | 59.0 | 44.0 | 40 | 27.6 | 60 | 40.1 | 48.8 | 32.9 |
| Up to 20,000 | 60.0 | 48.0 | 45 | 32.2 | 70 | 47.6 | 62.0 | 40.2 |
| Up to 30,000 | 60.0 | 52.0 | 50 | 38.1 | 70 | 55.1 | 73.0 | 51.1 |

a In the recent budget (1978) income tax brackets are to be widened in the range between TT$4,000 - TT$20,000.
b Computed as the total tax liability/upper limit of taxable income.
c In the case of Guyana, a 5 percentage point development tax is applied to all incomes and must therefore be added to each figure to obtain the effective marginal rate.
SOURCE: Income Tax Schedules of Individual Countries.

for the equalization of corporate tax rates and withholding tax rates on distributed dividends for companies operating in the *non-mineral sectors* of the region. At present, Guyana — with the highest rates of corporate and withholding taxes — would be the least likely to receive investment flows. Marginal differences in the profits tax rates are less likely to have an impact on investment decisions. If, on the other hand, a regional complementarity of industrial structure is to develop and if a system of industrial programming is planned, a differential corporate rate structure may aid in directing investment flows to the desired productive sectors in the region.

**TABLE 4**
**Corporate tax rates**

| Country | Profits tax rates [a] | Corporate tax rates | Basic rates |
|---|---|---|---|
| Jamaica | 30 | 15 | 45 |
| | 30 | 20 | 50 [b] |
| Trinidad | 30 | 15 | 45 |
| | | | 50 [c] |
| Barbados | 25 | 15 | 40 |
| Guyana | 20 | 25 | 45 |
| | 20 | 35 | 55 [d] |

a Refers to tax which is credited to shareholders on dividends received.
b Tax rates on closed companies.
c Tax rates on petroleum companies.
d Tax rates on commercial (traders) undertakings.
SOURCE: Corporate tax laws in individual countries.

### 1.c. Wealth taxation

Wealth taxation, as shown, constitutes only a small proportion of total revenue in the Caribbean. The principal form of taxation is estate and succession duty — a levy imposed on the value of estates at the time of death of the owner. Guyana has also implemented a capital gains tax and is one of the few LDCs to levy a tax on net wealth (in excess of G$50,000). Jamaica, in April 1974, restructured its property tax into a single unified schedule of taxes based on the site value system. The tax is progressive, ranging from 1 percent for values between J$2,000-J$4,000 to 4½ percent for values exceeding J$50,000. This reform has resulted in a substantial increase in revenue from this source — from about J$4 million in previous years to around J$23 million, or 9 percent of direct tax revenue for 1975-76.

## 2. Indirect taxes

The three most important sources of indirect tax revenue, as shown in Table 1, are customs duties, excises and consumption taxes. Export levies, if considered as an indirect tax, are currently growing in importance in the tax structures of these economies. Of the three, customs duties have historically been the major source of indirect taxes. Since the move from the Caribbean Free Trade Area to the Caribbean Common Market in August 1973, the customs duty structure of the individual territories has been affected by the agreement to move to a common external tariff (CET), the implementation of which is now almost complete. The tariff rates of the CET approximated the average rates of the individual tariffs existing in the four countries prior to the formation of CARICOM. In the tariff rate structure adjustment that followed, Guyana and Barbados were most affected since prior to CARICOM the highest rates of tariffs prevailed in Guyana and the lowest in Barbados. The averaging process led to a downward revision in Guyana and an upward movement of rates in Barbados; the rate structures in Trinidad and Jamaica were not as affected as the other two countries by the introduction of CET.

As in most other countries, tariffs are levied in the main at *ad valorem* rates although some specific rates are employed, mostly on food, beverages and tobacco. The CET has a two-column tariff schedule, based on the Brussels Tariff Nomenclature (BTN) classification, consisting of a General Tariff and a Commonwealth Preferential Tariff. The preferential rates, levied on imports from the Commonwealth, mainly the United Kingdom, have historically been a concession granted in return for a guaranteed market in Britain and later in the EEC for sugar produced in the Caribbean.

The basic principle in structuring the CET [6] has been to levy low rates (around 6-8 percent) on capital goods and raw material imports needed for industries within the region, while higher rates are imposed on final and completely manufactured products. Duties on motor cars and electric appliances, etc. range from 30-45 percent, while duties on other luxury items such as perfume, jewelry, cotton and silk fabrics, range from 30-50 percent (general) and 20-40 percent (preferential). As compared to tariff rates in other LDCs, rates under the CET are relatively low.

Although capital goods and raw materials used in industry are nominally subject to low rates of import duties, in effect most industrial inputs are tax exempt under various "pioneer" industrial incentive laws. Further, under the CET agreement, [7] and Exemptions List, which identified the industries to which member countries could continue to grant non-dutiable status to inputs, was established. The list is exhaustive and covers almost all existing industrial activity in the Caribbean. All member countries have moved to take advantage of the list in order to ensure that their domestic producers are not placed at a competitive disadvantage in the common market.

The major sources on which customs duties are collected are on food, beverages and tobacco, manufactured goods and transport equipment, mainly motor cars. Manufactured goods account for about one third, food, beverages and tobacco for one fifth, and transport for approximately a quarter of total duties collected.

### 2.a. Excise duties

Excise duties, levied only on domestic production, were a major indirect revenue source until the late 1960s (see Table 1). With the exception of Jamaica, the excise systems in CARICOM are limited in scope. Excises, levied at specific rates are confined to a small group of products with a substantial part of excise revenues collected from alcohol products — rum, beer, etc. — in Trinidad, Guyana and Barbados. Excises on the production of petroleum products are the second highest excise revenue-yielding source in Trinidad, while in Barbados a road tax on motor spirits and diesel fuel — essentially a road user charge — is the most productive source of excise revenues.

In Jamaica coverage under the system of excise duties is relatively more extensive than that in the other CARICOM countries. Duties are payable at specific rates, mainly on beer, spirits and cigarettes, and at *ad valorem* rates on the domestic output of a large number of products, with a provision for exemption for sales between producers. There is a wide range of differentiated rates, which like the rate structure of the consumption tax in Guyana appear to have no underlying economic rationale — there are as many as seventeen different *ad valorem* rates in addition to a diverse range of specific duties. Despite expanded coverage, as is common in most LDCs, excises on a few items — beer and stout, cigarettes and tobacco, rum and motor spirits — account for the greater proportion of excise revenue collections — about 79 percent in the fiscal year 1976-77.

### 2.b. Sales taxation

The present system of consumption taxes in Jamaica, Guyana and Barbados and the Purchase Tax in Trinidad bear close resemblance to a manufacturers sales tax. Coverage under these taxes has recently been extended to most locally manufactured goods and imports of finished products, accounting for the increased importance of sales taxation as a revenue source. The destination principle of taxation is applied both to intra-union trade and trade with the rest of the world, i.e. exports are tax-exempt while imports, irrespective of source, are in general subject to the same rates of taxation as locally produced goods.

The tax is payable on a wide range of consumer goods, including alcoholic products. With the exception of a few specific rates, levied mainly on alcoholic products, the rate structure of the sales tax is characterized by *ad valorem* rates. Only in Jamaica do relatively uniform *ad valorem* rates prevail, 5 percent on all taxable consumer items; the major exceptions are refrigerators (10 percent) and stereo equipment (15 percent). At the other extreme, in Guyana the rate structure is highly differentiated, with as many as 27 different *ad valorem* rates prevailing. Rates range from 2 percent on paints to 76 percent on motor spirits and lubricating oils. In addi-

6. See *The Caribbean Community: A Guide*, pp. 31-32 (The Caribbean Community Secretariat, Georgetown). For a detailed description of the rate structure of the CET, see *The Common External Tariff of the Common Market* (Caribbean Community Secretariat, Georgetown, 1973).
7. *Op. cit.*

tion, specific duties are levied on liquor, tobacco, cement, carbonated beverages and petroleum products. The wide variety of rates reflects an attempt to design the rate structure in a manner which would, by commodity class, recoup revenue that was lost as a result of the lowering of customs tariff rate structure which was necessary when Guyana's tariff structure was brought into conformity with the common external tariff. Most consumer goods are subject to tax rates between 10 percent and 25 percent.

Unlike the case of Guyana, where the rate structure does not reflect any apparent tax criteria, the rate structure of the Purchase Tax in Trinidad is designed not only to generate revenue but also to give some consideration to the equity criteria, as relatively higher rates of taxation are imposed on goods regarded as luxury items. Clothing and furniture were subject to low rates of taxation — 3 percent and 10 percent respectively — but since the beginning of 1977 the purchase tax has been removed from these items. Imported food and fruit are subject to a rate of 5 percent, while locally processed goods are exempt. On the other hand, refrigerators are subject to rates of 10-30 percent depending on cubic capacity, and other household durables, such as televisions, radios, electrical appliances etc., to rates of 20-30 percent; duties on alcholic beverages range from 10 to 25 percent. The rate structure is characterized also by a two-part column which distinguishes between domestic and common market products (Part 1) and non-CARICOM imports (Part 2). Rates in the Part 2 schedule are for some products (mainly processed food and fruit) made discriminatory in order to offer additional protection to local industry.

The number of products covered under the tax in Barbados is not as extensive as in the other countries, partly reflecting a narrower manufacturing base. Prior to 1976, only thirty-six items were subject to the tax, but since the abolition of the retail sales tax in 1976 coverage has been expanded to about 85 items. In addition to specific rates on liquor, tobacco and cement, *ad valorem* rates are applied to products ranging from 15 percent on stoves, cookers and washing machines to 25-30 percent on water heaters and air-conditioning equipment. Generally, a rate of 15-20 percent is applied to most household appliances. Prior to the rate revision in 1976, rates were extremely low — about 5-10 percent on most items. The upward structuring of rates appears to be, as in the case of Trinidad, in accord with the principle of levying heavier taxes on luxury consumption.

*Exemptions*

Unprocessed primary products — agricultural produce, fishing, etc. — are exempt from any form of indirect taxation in the region. Services are also outside the scope of sales taxation. A few services are taxed through the imposition of special levies. In Barbados and Jamaica, the services taxes are those usually associated with the tourist industry. In Barbados an 8 percent tax is levied in restaurant sales and in the cost of hotel rooms and food (Hotel and Restaurant Sales Tax); Jamaica imposes a tax of 5 percent (tax de Sejour) on hotel accommodations. Guyana levies a travel tax on the sale of airline tickets and financial services are indirectly reached by requiring commercial banks to purchase special operating licenses. Professionals — doctors, dentists, lawyers — need similar licenses. Tax treatment of most services remains limited in the region.

Throughout the region all industrial machinery and raw materials are exempt from any form of sales taxation. Administratively the suspension method is used in the granting of exemptions. Exports are also not subjected to sales taxation, thus avoiding any tax-induced reductions in competitiveness in foreign markets.

### 2.c. Selective taxes in retail sales

Barbados was the only CARICOM country ever to experiment with a general retail sales tax — from 1974 to 1976. Despite a high revenue yield during its existence, the tax was abolished largely because of political reasons.[8] Distinct from a general sales tax are taxes imposed on retail sales of selected goods. In Jamaica, under the Retail Sales Act of 1974, a 10 percent tax is imposed on the retail sale value of air conditioning units, television sets, stereo equipment, refrigerators (of a capacity exceeding nine cubic feet) and stoves of a value greater than J$100. Motor cars with an engine capacity of under 1199 cc are subject to a tax of 52 percent, while larger cars pay a rate of 57 percent. At present (1976-77) this source yields a revenue of J$11.2 million, with 70 percent of the collections being derived from the tax on motor cars. The taxed items fall into the category of "luxury" consumer durables for which the income elasticity of demand is likely to be greater than one, thus adding progressivity to the overall tax system. In addition, to the extent that there is a tax-induced reduction in the consumption of these goods, scarce foreign exchange is likely to be saved since these goods are either imported and/or have a high import content. By applying the tax to all sales rather than solely to imports, the tax discourages import substitution in undesirable productive activities over the long run.

Trinidad and Guyana impose a selective tax, in addition to import duties, on motor cars (called a Purchase Tax in Guyana and a Motor Vehicle Tax in Trinidad), with the rates varying with the size of the vehicle. In Guyana, the rates range from 24½ percent of the showroom value to a 51½ percent, and in Trinidad from 15 percent to 50 percent.

### 2.d. Export duties

Historically, export duties have not been an important tax in the tax structures of the Caribbean. Profits from the export sectors were reached by corporation taxes. However the higher export prices of sugar which prevailed in 1974 induced the governments of Guyana, Jamaica and Barbados to introduce an export levy on sugar; Jamaica has, in addition, imposed a levy on bauxite exports — 8 percent on the average realized price obtained on aluminium ingots during the calendar year. The intent behind the imposition of these levies was to siphon off a part of the windfall gains from higher world prices for the central governments. The sugar levy is imposed on a sliding scale in Barbados and Guyana, with rates becoming progressively higher as the price received for sugar increases. The rate structure is

8. The tax became an election issue; the criticism raised against its use was that it was likely to be regressive in nature.

much higher in Guyana than in Barbados. A comparison of the rate structure of the sugar levy between Guyana and Barbados is presented in Table 5.

**TABLE 5**

**Sugar levy - Rate structure**

| Barbados | | Guyana | |
|---|---|---|---|
| Price per ton (Bds$) [a] | Export levy (% of gross receipts) | Price per ton (G$) | Export levy |
| 720 - 960 | 10 | 365 - 521 | 55% over $365 |
| 961 - 1680 | 30 | 522 - 625 | 70% on excess over G$521 |
| over 1681 | 50 | over 625 | 85% on excess over G$625 |

a Bds$1 = $G1.25
SOURCE: Ministry of Finance, Barbados and Guyana.

In Jamaica, a flat rate prevails — a charge of J$100 per long ton of sugar exported is made. In Guyana, the levy accounted for 53 percent of total revenue in 1975, but with declining sugar prices in 1976 the proportion fell to 23 percent. In light of the nationalization of the sugar industry in Guyana, the continued existence of high progressive rates has less rationale since the levy now serves merely as a reallocative mechanism by which funds are diverted from the nationalized industry to government current revenues. Immediately following nationalization the need for expansionary funds in the industry is likely to be crucial, due to difficulties of borrowing funds on external capital markets. Unlike sugar there is no special levy imposed on the nationalized bauxite industry in Guyana; in Jamaica where ownership is essentially private, as indicated, a bauxite levy is used. The levies in Barbados and Jamaica do not constitute a part of current revenue — instead revenue from these sources is treated as earmarked funds. The sugar levy in Barbados is allocated to special sugar funds from which expenditures relating to improvements in workers' welfare (e.g. housing, etc.) are made while the bauxite levy in Jamaica is allocated to a capital development fund from which investment projects are to be financed.

In response to higher oil prices, Trinidad restructured its taxation of petroleum companies under the Petroleum Tax Act of 1974, rather than impose a special levy. In essence the new act reduced tax concessions to oil companies; replaced imputed market prices by tax reference prices as the basis for determining income tax liabilities on the production of crude petroleum; increased royalties on new concessions; and increased the profit tax from 45 percent to 47½ percent.

## IV. TAX ADMINISTRATION

The basic tax administrative structure in the Caribbean is typical of the British Commonwealth countries. The Customs and Excise departments in all the countries are responsible for the collection of customs duties, export levies, excise duties, the manufacturers' sales tax and entertainment and betting taxes. In Jamaica, the Excise Department is also responsible for the collection of the Retail Sales tax and Taxe de Séjour. All the other major taxes are administered by the Inland Revenue Department. To all intents and purposes, indirect tax administration is separated from that of direct tax administration and little use is made of established accounting procedures in the administration of the major domestic indirect taxes. Instead enforcement and auditing are secured primarily through physical controls, i.e. a system of inspection and controls.

## V. OBSERVATIONS ON THE SYSTEM OF TAXATION IN CARICOM

An examination and comparison of the major taxes prevailing in CARICOM suggest that from a common market perspective there is a need for greater coordination (harmonization) of corporate income taxation and sales taxation. The movement from the fully integrated approach to the partial imputation system of company taxation is a desirable one in terms of encouraging a higher level of capital accumulation in the region. However, in the absence of a planned system of industrial programming, corporate tax rates need to be equalized, in order to avoid competition among member countries for capital and to induce capital to flow into its most productive uses. The differential approach should only be used in establishing corporate tax rates within the region if a regional production plan comes into existence. Marginal differences in the rates of profit taxation can be maintained without adversely distorting capital flows within the region.

With the destination principle of taxation being retained for regional trade, the present system of commodity taxation appears to be inappropriate for the region. [9] The imposition of consumption taxes (manufacturers sales tax) and the use of the suspension method in freeing inputs from taxation do not ensure a common tax treatment of either output or inputs within the common market. Further the highly differentiated rate structures of the consumption tax in Guyana and the excise system in Jamaica reflect no apparent economic criteria and are likely to produce allocative distortions (excess burden). Indirect tax harmonization may be best achieved by replacing the present system of commodity taxation with a uniform rate, general sales tax extended through to the retail level. A value-added tax which excludes small vendors can be employed. The administration of the tax will be facilitated with the use of a uniform rate structure which will also increase the flexibility in employing the sales tax as a demand management instrument. From the point of view of equity, the special retail levies which are now imposed on goods regarded as luxuries can be maintained along with the present system of exemptions. Greater reliance on sales taxation may also permit a reduction in the personal income tax burdens. Individual income tax bands can be widened and the marginal tax rates lowered in the middle-income ranges — a measure which may reduce tax-induced distortions in factor supplies. Tax reform in these directions can aid in the achievement of national and regional economic goals.

9. For a detailed analysis of the system of sales taxation in CARICOM, see R. Gobin, *op. cit.*, chs. 5-7.

N. M. Qureshi:*

# Trends in Pakistan's Agreements for the Avoidance of Double Taxation of Income

## 1. INTRODUCTION

*Any investment or business profits which transcend the frontier of a particular country give rise to at least two potential tax claims, that of the investor's country of domicile and that of the country in which the investment is made or the business transaction takes place. Since cumulative taxation by the two countries is likely to be prohibitive and act as a deterrent to foreign investment, the tax systems of all capital exporting countries provide unilateral measures to mitigate the effects of double taxation. Such unilateral measures have, however, generally been considered insufficient in providing adequate relief and the consensus has been that a satisfactory accommodation of the conflicting tax claims is possible only through bilateral treaty arrangements between the two countries.*

*The role of bilateral tax treaties is, thus, twofold. In the first place, the effects of double taxation are mitigated through reconciliation of the differences in the concepts of various types of income and their geographical source by either assigning exclusive tax jurisdiction over certain income to one of the treaty countries or dividing revenue among the two countries. Secondly, once the tax treatment of a particular business transaction and its tax liability is specified in the respective countries, it becomes easier for the multinational corporations to make business decisions and, thus, facilitate the inflow of foreign investment from the developed to the less-developed countries.*

*Pakistan has long since appreciated the importance of tax incentives as a measure to attract foreign investment from capital exporting countries. Apart from extending unilateral tax incentives in the form of tax holidays, reliefs and investment credits, Pakistan has entered into a number of tax treaties with both developed and less-developed countries. Whereas most of the agreements concluded up to 1970 were with the developed countries (the U.S.A., the U.K., Ireland, France, West Germany, Denmark, Sweden, Switzerland, Austria, and Japan), agreements were also concluded with comparatively less developed countries of the region such as India and Sri Lanka. In the mid-seventies Pakistan also concluded agreements with Canada, Libya, Malta and Poland. Simultaneously, negotiations were also started with some thirty countries, mostly in the Middle and Far East. Limited purpose agreements in respect of air transportation and shipping have been negotiated with Italy, Greece, and Saudi Arabia, and exemption in respect of such income has been achieved through exchange of diplomatic notes with Iran. Comprehensive agreements with Romania, Bangladesh, Belgium, Thailand, Philippines and Malaysia are at various stages of finalisation. Thus, in all, sixteen comprehensive conventions and one limited purposes agreement are operative, and another ten agreements are expected to come into force in the near future.*

**Contents**



* Chairman of the Central Board of Revenue and ex-officio Secretary to the Government of Pakistan.

## II. SPECIAL FEATURES OF AGREEMENTS CONCLUDED UP TO 1970

Pakistan's bilateral tax treaties concluded up to 1970 are based on the standard draft prepared by its Central Board of Revenue. This draft is essentially based on the London and Mexico Draft Conventions. These conventions generally have separate articles relating to personal scope and taxes covered; definitions including those of resident, industrial and commercial profits and permanent establishment; taxation of business profits; shipping and air profits; dividends; interest; royalties; personal remuneration; elimination of double taxation, mutual agreement procedure; exchange of information, etc. Most of these conventions do not have separate provisions for managerial fees, capital gains, etc. Remunerations for dependent and independent personal services including those of artists and athletes have at times been given identical tax treatment.

The most important aspect of all these conventions is that the source country is entitled to a very limited right of taxation, and the investors from the capital exporting countries generally escape taxation in the source country. Pakistan has, thus, agreed to rather disadvantageous terms in these conventions in the interest of much needed foreign capital and technical know-how. The history of tax treaties in Pakistan shows that factors such as monetary, fiscal, social and other policies have duly influenced the negotiations between Pakistan and the developed countries. The concept of reciprocity underlying the treaties between developed and developing countries was not strictly followed especially when the two states were at vastly different stages of economic and industrial development. The loss of revenue which might be insignificant to the developed countries has constituted a heavy sacrifice on the part of Pakistan which already had scarce foreign exchange resources. However, Pakistan has endeavoured to attract foreign investment not only by extending unilateral tax incentives in the form of tax holidays and tax exemptions but also by entering into tax treaties where the benefits have accrued more to the country of residence of the investors than the source country.

The special features of these conventions, as given in the subsequent paragraphs, shall indicate the extent of tax benefits Pakistan has sacrificed in favour of developed countries. In making a brief comparison, reference is made only to a limited number of articles. This will also serve as a comparison while highlighting the changing trends in Pakistan's recent agreements with countries falling in various categories, i.e. developed, less developed and developing.

### (i) Permanent establishment

The definition of a permanent establishment in all these conventions forms part of the article relating to general definitions. Whereas all the conventions specify a branch, management, office, factory or fixed place of business as an example of permanent establishment, those with Japan, West Germany and Austria also treat a warehouse as a permanent establishment. The conventions with France, West Germany and Switzerland treat setting up of a plant as a permanent establishment if the activities exceed a period of 6 months in the case of the first two countries and 12 months in the case of Switzerland. Dependent agents have been treated as a permanent establishment in all the conventions if such persons have the authority to conclude contracts for or on behalf of their principals and have a stock of goods from which they regularly make deliveries. Independent agents carrying out business transactions for a foreign enterprise in the ordinary course of their business, however, do not constitute a permanent establishment.

Some of these conventions also specify certain categories of establishments which are not to be treated as permanent establishments. Whereas the convention with West Germany excludes from the scope of the definition establishments set up by agencies for collection and transmission of information or for scientific research in connection with finally setting up of a business, the convention with France also covers establishments engaged in advertising or activities auxiliary or preparatory in nature.

### (ii) Business profits

Except for the conventions with the U.S.A., Japan and Sri Lanka, which follow the "force of attraction" principle for taxation of business profits, other conventions follow the "attribution principle". The most important aspect of these conventions is that instead of referring to the "income and profits" from business, these refer to "industrial and commercial profits", which has otherwise been defined in the conventions. There is, however, always an ambiguity as to the interpretation of this expression and it has led to rather lengthy debates.

The conventions with Japan and Sweden entitle the host country to charge tax on profits arising on purchases made in that country. The Japanese treaty further establishes the host country's right to tax income arising on the sale abroad of goods wholly or partially manufactured in that state. The conventions with West Germany and Switzerland contain specific provisions about management fees. Whereas the former provides that such remunerations are taxable in Pakistan if either the services are performed in Pakistan or payments are made by a Pakistani subsidiary to a parent company having a permanent establishment in Pakistan, the latter makes such payments taxable in Pakistan if both the conditions are fulfilled.

### (iii) Air and shipping transport

Generally, the principle of taxation of air or shipping profits from international traffic in the country of residence or place of effective management has been followed in Pakistan's conventions signed up to 1970. The variations are, however, there. As to the taxation of air profits, except for the Sri Lanka treaty which provides for 50 percent sharing of revenue, all other conventions give the exclusive right of taxation of such income to the country of residence or place of effective management. The conventions with the U.K., the U.S.A., Japan and Ireland, however, make such taxation subject to these aircraft also being registered in the country of residence of the enterprise.

As respects shipping profits, except for the conventions with the U.K., Ireland, West Germany, Switzerland and France, such profits are taxable in both the contracting states in the cases of other treaty countries. Whereas the conventions with the U.K., Ireland and West Germany extend the source country's exemption only if the ships are registered in the country of residence of the enterprise, the conventions with France and Switzerland entitle the source country to charge tax on such income.

### (iv) Dividends

By and large all the conventions give the primary right to taxation of dividends to the recipient's country of residence. The source country can also charge tax at normal rates if the recipient is the beneficial owner of such dividends. In the case of inter-corporate dividends, the source country's taxation right is limited to a lower rate provided the recipient company holds the prescribed stock capital of the dividend distributing company. The minimum holding and the tax rates applicable in such cases vary between 25-50 percent and 10-15 percent respectively. The conventions with Sweden and Switzerland also make a further distinction in tax treatment on the basis of a dividend distributing company engaged in an industrial undertaking. Some of the conventions, such as those with Switzerland, France, the U.K., etc., provide for separate reduced rates of tax in the case of Pakistan and the treaty partner. The conventions with Japan, Sri Lanka and Austria provide for tax exemption of dividends received by the governments of the contracting states and the financial institutes and local authorities thereof.

Except for the conventions with West Germany, Switzerland, Denmark, Sri Lanka and Austria which do not entitle the source country to charge tax at normal rates under any circumstances, other conventions provide that the source country shall have such right if the dividends are attributable to a permanent establishment maintained by the recipient in that state.

### (v) Interest

Taxation of interest essentially follows the same principle as dividends. The primary right to tax interest vests with the country of residence of the recipient, but the source country is also entitled to charge tax at a reduced rate if the interest is attributable to a permanent establishment maintained by the recipient in the source country. An exception to the general principle is contained in Pakistan's conventions with Sweden, Austria and Ireland.

Whereas the first two conventions give the exclusive right to tax interest to the source country, the convention with Ireland provides that the home country shall exempt tax on interest if (i) the interest is paid or guaranteed by the source country government, or (ii) if it arises in respect of approved loans or (iii) if the source country levies tax on such income.

The conventions with the U.S.A., Denmark and Sri Lanka do not contain express provisions as to the source of interest income. Accordingly, the treaty countries can charge tax under their domestic laws.

The extent to which the source country can charge tax, as provided in Pakistan's conventions with Japan, West Germany, Switzerland and France, varies between 10 and 30 percent.

### (vi) Royalties

Pakistan's earlier conventions primarily give the exclusive right of taxation of royalties to the recipient's country of residence. The treatment of industrial royalties, royalties paid for cinema and TV films, and for the extraction of natural resources or the operation of mines, however, varies in different conventions.

As to copyright and industrial royalties, the conventions with Sweden, the U.S.A., Japan and Denmark provide for exemption in the source country in the absence of a permanent establishment of the licensor. The conventions with West Germany, Ireland and France entitle the source country to charge tax only if such royalties are attributable to the permanent establishment maintained by the recipient in the source country. The conventions with the U.K. and Switzerland provide for exemption in the source country except where (i) the recipient has a permanent establishment in the source country and (ii) the country of residence does not charge any tax on such royalties. In the case of the convention with Sri Lanka, whereas royalties for scientific and artistic work are exempt in the source country, except where there is a permanent establishment, industrial royalties are taxable in both states in a 50 percent ratio. The Austrian convention gives the exclusive tax right to the source country provided such tax does not exceed 20-25 percent of the gross amount of royalties. The conventions with Switzerland, France, the U.K. and Sweden also contain provisions in respect of the taxation of the capital sum derived from an outright sale of patents, secret processes, etc. Whereas the first two countries give total exemption to such income in the source country, the latter two entitle the source country to charge tax if the recipient maintains a permanent establishment therein.

As to copyright royalties paid for TV and cinema films, the conventions with Japan, West Germany, Switzerland, Denmark, France and Ireland treat these royalties in a manner similar to industrial royalties. However, whereas the U.K. treaty treats them like business profits, conventions with Sweden, the U.S.A., Sri Lanka and Austria do not contain express provisions on the subject and such royalties are thus taxable in both countries under their domestic tax laws. As to the royalties paid for the operation of mines, these provisions are not of much significance for Pakistan. While the conventions with the U.K., Sweden, the U.S.A. and Denmark do not contain specific provisions on the subject, other treaties treat this source of income as income from immovable property.

### (vii) Capital gains

Provisions regarding taxation of capital gains have been made only in two conventions, i.e. the conventions with Switzerland and Austria. Whereas the former entitles both states to charge tax on capital gains from real estate and is silent in respect of gains from alienation of movable assets, the latter entitles the country of situs to charge tax in respect of both types of gains. Further, in the case of disposal of shares the right to tax lies with the country wherein the company is incorporated.

### (viii) Remuneration for personal services

Except for the agreement with France, all other agreements give equal treatment to remuneration for dependent and independent personal services. The former provides for taxation of remuneration from independent personal services in the country where such services are performed. Income of public entertainers and directors' remunerations can be taxed in both states. As to remuneration for dependent personal services, the principles embodied in all the conventions are almost the same as in the OECD Model Draft Convention and give a very restrictive tax right to the country where the services are performed. The Sri Lanka convention entitles both states to charge tax on such income.

As to the tax treatment of temporary residents, except for the conventions with the U.S.A., Japan and France, the host country shall exempt such income if the recipient's stay in that country is less than 183 days in a year, the services are performed for or on behalf of a non-resident and remuneration is paid or borne by the non-resident employer. The convention with the U.S.A. only differs in respect of the third condition, i.e. it varies to the extent that the remuneration should be subjected to tax by the country of residence. Japan's convention, however, also entitles the host country to charge tax if the remuneration exceeds the prescribed amount. Regarding taxation of income of public entertainers, except for the U.S. and German treaties where it is treated in a similar manner to other remuneration, all other conventions give the exclusive tax right to the country where the services are performed. Remuneration of persons working on board a ship or aircraft is generally taxable in the country of residence of the ship or air enterprise.

Remuneration for governmental services paid to persons who are nationals and residents of a state is taxable in that state. Similarly, Government pensions are generally exempt in the source country except where paid to a national of the other state.

### (ix) Other income

The general rule relating to income not specifically dealt with or sources not expressly mentioned in the convention is that it may be taxed in both the states. None of Pakistan's conventions concluded up to 1970 contains a provision of this nature and as such implicitly recognises the host country's right to charge tax under its domestic tax laws.

### (x) Elimination of double taxation

Pakistan has followed both the exemption and credit methods for eliminating double taxation of income charged to tax in both the states. Whereas Pakistan has opted to give credit for tax paid abroad (as provided in the Fourth Schedule to the Income Tax Act, 1922), the other treaty countries have followed the exemption or credit method, whichever suits under their domestic tax laws. The conventions with the U.K., Japan, West Germany, France, Sri Lanka and Ireland also allow a tax sparing credit. In the U.K., West German and French conventions, Pakistan is not obliged to extend a tax sparing credit for the foreign tax paid by its residents. The convention with the U.S.A. provides for a limited tax sparing credit only in respect of the exemption granted to new industrial undertakings under Section 15B of the Pakistan Income Tax Act.

### (xi) Exchange of information

All the conventions generally provide for exchange of information for the dual purpose of carrying out the convention and the prevention of fiscal fraud and evasion. The Swiss convention, however, restricts the information exchanges only to those required for the purposes of carrying out the provisions of the convention. The information exchanges are not automatic except in the cases of the U.S.A. and the U.K.

## III. NEW TAX TREATIES

Since 1970, Pakistan has concluded conventions with Poland, Malta, Libya and Canada. Reciprocal exemption in respect of income from the operation of aircraft in international traffic between Pakistan and Iran has also been secured. Agreements with Romania and Belgium have been signed. Limited purpose agreements have also been signed with Italy, Greece and Saudi Arabia. A number of agreements — with Bangladesh, Thailand, Philippines, Malaysia, the Netherlands and Lebanon — are in the pipeline and are expected to be finalised soon.

There has been a major shift in the pattern of conventions negotiated during the seventies. These are essentially based on the OECD Model Draft Convention. It has, however, been observed that the OECD Model Draft still extends the primary right to tax income arising on international transactions to the country of residence of the investor; following this draft in its entirety in treaties between developed and less developed countries would be sacrificing the major portion of the latter's revenue, especially in the area of dividends, interest, royalties and income from personal and professional services, etc. Pakistan has evaluated the implications of the OECD provisions in the context of its business with other countries and has felt special difficulties to adhere to the OECD provisions because of the absence of a substantial reciprocal flow of investment with these countries. The developed countries have generally claimed that the insistence of the less developed countries, including Pakistan, on the source principle and the allocation of income concept — which is not in keeping with internationally recognised standards of tax treaties — in addition to occasionally imposing corporate tax at a higher rate, is not based on sound grounds. This is, however, not true. In Pakistan's views these standards, as applied to treaties amongst developed countries, work to the detriment of less developed countries because of the sacrifice in revenue involved with no reciprocal benefit because of the substantially unequal mutual flow of investment.

The position in respect of countries at the same level of economic development has been felt to be quite different. Even if the OECD standards are followed, the provisions are expected to be of equal mutual advantage. However, in order to strengthen the tax claim of the host country, Pakistan has consistently advocated that these countries provide for the source country's right to tax in their bilateral conventions, thus further establishing this principle vis-à-vis developed countries. Pakistan's recent conventions, therefore, amply highlight the source principle of taxation. Whereever possible the "attribution" principle has been replaced by the "force of attraction" principle.

As to the taxation of income of air and shipping enterprises from international traffic, Pakistan has tried to adhere to reciprocal exemption of such income with a view to the administrative convenience of both the tax administrations and the air and shipping enterprises as well as the fact that following the net income approach for computation of such profits the source countries receive hardly any revenue because of the overall losses declared by the air and shipping enterprises. In the area of taxation of dividends, interest and royalties, Pakistan has endeavoured to give an extended tax right to the source country. Similarly, the provisions regarding taxation of capital gains have been made more comprehensive covering gains from the disposal of corporate shares. The conditions prescribed for taxation of income from personal services have been comparatively relaxed in order to enable the source country to charge tax on income of temporary residents. An attempt has also been made to entitle the source country to charge tax on governmental salaries and pensions paid to nationals of the host country.

Pakistan has insisted on making a provision for the tax sparing credit in all its treaties. In our view it is of vital importance to have such a provision or similar mechanism in order to ensure that the benefit of the tax incentives offered by Pakistan in order to promote foreign investment in its priority areas of economy is really made available to the foreign investor and is not passed on to the exchequer of the other treaty partner. Pakistan has been able to have this provision incorporated in all its conventions negotiated recently.

## IV. SPECIAL FEATURES

After highlighting the general principles underlying the recently concluded conventions, it is imperative to refer to the individual provisions of Pakistan's recently concluded conventions in some detail. While doing so, it is understood that all the provisions of the conventions concluded up to 1970 establishing the source principle have also been followed in the recently concluded conventions and need not be repeated. The following paragraphs, thus, cover only those aspects of these treaties which further establish the right to tax of the source country:

### (i) Permanent establishment

Some of the recently negotiated conventions treat a permanent sales exhibition, sales outlet, building site or construction or assembly or installation project or supervisory activities in connection therewith, or the furnishing of services including consultancy services, if such activities exceed the prescribed period, as a permanent establishment. This period generally varies between 3 and 12 months. Dependent agents engaged in the manufacture or processing of goods for the parent enterprise as well as independent agents exclusively working for a foreign enterprise or a group of centrally controlled enterprises have also been treated as a permanent establishment in some of the conventions.

The conventions with Malta, Libya, Poland, Canada, etc. exclude the use of facilities solely for the purposes of storage or display of goods or maintenance of a stock of goods for the purposes of storage, display or delivery from the scope of permanent establishment. Except for Poland, these other conventions also exclude the maintenance of a stock of goods solely for the purpose of processing of goods for the enterprises from the ambit of permanent establishment. One of the conventions does not treat the sale of goods in the frame of an occasional temporary fair or exhibition, in the process of closing of such fair or exhibition, as a permanent establishment.

Lately, a dependent agent engaged in any manufacture or processing of goods or merchandise belonging to the parent enterprises, as well as the activities of insurance enterprises (except with regard to re-insurance), has also been treated as a permanent establishment — thus extending the scope of permanent establishment even to those activities which were until recently not considered to give rise to taxable profits in the host country.

### (ii) Business profits

Some of the recent conventions, including the one with Canada, follow the "force of attraction" principle in a limited manner, i.e. both income of the permanent establishment as well as that arising to the head office through the sale of goods or activities of the same or similar character as affected by the permanent establishment shall be taxable in the host country. Recent conventions also provide that expenses incurred for the purposes of a permanent establishment, including executive and administrative expenses so incurred in the host country or abroad, shall be limited only to the reimbursement of actual expenses without allowing any mark-up to the parent enterprise.

### (iii) Shipping and air transport

The recently concluded conventions with Canda, Libya, Malta and Poland provide for reciprocal exemption of profits arising from the operation of aircraft and ships in international traffic. The same principle applies to profits from the participation in a pool, a joint business or in an international operating agency. Some of the conventions also treat management and training fees, rentals from leasing of ships and aircraft, etc. as profits from operation of air and ships in international traffic. The same principle has been followed under the limited purpose conventions, except that with Greece wherein it has been provided that the shipping profit will be taxable in the country in which the ship is registered or documented.

Some of the recent conventions also provide for retroactive application of the provision regarding shipping and air profits.

Lately some of the countries in the Far East have been insisting on sharing revenue arising out of income from international air transportation and shipping. Although Pakistan has accepted this approach in one of its conventions, it still believes that the source concept would not help international air transportation and shipping traffic primarily for the reason that it unnecessarily inconveniences such enterprises without the proportionate revenue collection.

### (iv) Associated enterprises

Whereas the earlier conventions only provide for primary adjustment of the profits between the related enterprises at arm's length standard, some of the most recent conventions also cater for secondary adjustment of such profits, so as to avoid economic double taxation of profits arising through intercompany adjustment of goods, services and intangibles.

### (v) Dividends

The general principle that the country of residence of the investor shall have the primary right to charge tax on dividends and the host country will be entitled only to a limited taxation on dividends arising to a beneficial owner of such dividends has also been maintained in recent conventions. However, it has been agreed to in most of the conventions that whereas both the countries will be entitled to charge tax on dividends, limited taxation in the host country will be restricted only to the intercorporate dividends where the prescribed conditions in respect of stock holding are fulfilled. The prescribed minimum holding and the tax rate vary between 20-25 percent and 10-20 percent respectively. Reduced tax rates shall apply if the dividend distributing company is engaged in an industrial undertaking.

### (vi) Interest

Generally all the conventions provide that interest arising in a contracting state and paid to a resident of the other state may be taxed in the latter state. The host country is entitled to a reduced rate of taxation varying between 10 and 25 percent. The host country is entitled to comprehensive taxation if the interest is attributable to a permanent establishment or fixed base maintained by the recipient therein. All the conventions extend exemption in the host country to interest arising to the Government of the other state, its Central Banks, financial institutions and local authorities.

One of the recently negotiated conventions provides for tax exemption in the host country in respect of interest on government bonds, debentures or other similar obligation as well as a reduced rate of tax on a company's issue of bonds,. debentures, etc. in the host country.

### (vii) Royalties

All the conventions give the primary right of taxation of royalties to the country of residence of the recipient, and entitle the host country to charge tax at reduced rates varying between 10 and 25 percent. Whereas the conventions with Libya, Malta, and Poland do not make any distinction as to the type of royalties, copyright royalties have been exempted in the convention with Canada. Some of the conventions provide for a separate tax rate in the case of payments made for technical know-how and for information concerning industrial, commercial or scientific experience. The convention with Libya treats royalties paid in consideration for cinema and TV films as business profits. It also exclusively entitles the host country to charge tax on industrial and commercial know-how fees.

The host country is also entitled to normal taxation if the royalties are attributable to a permanent establishment maintained therein. Some of the treaties envisage the "force of attraction principle" in this area.

### (viii) Capital gains

Whereas all the conventions provide for taxation of gains from the alienation of movable and immovable property in the country of situs, some of the conventions also entitle the source country to charge tax on gains arising on the disposal of corporate stocks including shares of real estate companies, firms and trusts. Gains from the disposal of ships and aircraft continue to be taxable in the country of residence of the owner-enterprise.

### (ix) Remuneration for personal services

All the recently negotiated conventions contain separate provisions relating to remuneration for independent and dependent personal services, government services government pensions, directors' fees and remunerations for artists and athletes.

As to the taxation of remuneration for independent personal services, whereas the conventions with Poland, Malta and Libya are identical to the corresponding provisions of the OECD Model Conventions, those with Canada and various other countries contain elaborate provisions giving a much extended right of taxation on such income to the host country. Pakistan has also been able to persuade some countries to agree to entitle the source country to charge tax if such remunerations are attributable either to a permanent establishment or a fixed base maintained by the recipient therein or if the recipient's stay exceeds the prescribed period.

As to dependent personal services, whereas the provisions of the conventions with Poland, Malta, Libya, and Canada are OECD based, some of the most recently negotiated conventions further establish the host country's right to tax such income. Some of the conventions with countries in the Far East provide that the host country shall charge tax if the recipient's stay in the host country exceeds the prescribed period of 183 days in a fiscal year and either the remuneration is paid by or on behalf of the non-resident employer or the remuneration is not borne by a permanent establishment maintained by the employer in the host country.

As to governmental services and pensions, except for the conventions with Poland and Libya wherein the right to tax exclusively vests with the country paying such remunerations, all other conventions are OECD based. Thus, nationals of a state receiving salaries and pensions from the Government of the other country are taxable in the host country.

As to directors's fees, while the conventions with Poland, Malta, Libya, Canada and some of the recently negotiated agreements are OECD based, other conventions also incorporate the recommendations of the 7th meeting of the Ad Hoc Group of Experts on tax treaties, i.e. income of company officials in top level managerial positions is treated in the same manner as directors' fees.

As to the income of artists and athletes, the source concept has been broadened in all the conventions. Some of the conventions further elaborate the term "athlete" as recommended by the Ad Hoc Group during the 7th meeting.

### (x) Elimination of double taxation

All the conventions negotiated since 1970 provide for a foreign tax credit as well as the tax sparing credit.

### (xi) Exchange of information

Whereas the conventions with Poland, Malta and Libya have provisions similar to those of the OECD Model Draft Convention of 1964, most of the recently negotiated conventions are on the pattern of the 1974 Draft Convention. Thus, the exchange of information has been made automatic and the information so exchanged can also be disclosed to the courts and other judicial authorities connected with the administration of tax laws.

### (xii) Territorial extension

A special aspect of Pakistan's conventions, except those with the socialist countries, is the provision regarding territorial extension of the convention to those areas for whose foreign relations Pakistan is responsible. This provision has been incorporated to safeguard our interests in the disputed States of Azad Jummu and Kashmir.

The above analysis amply reflects the major shift in our policy towards negotiating tax agreements with other countries since 1970. The concept of source taxation has primarily dominated the concept of taxation in the country of residence. Wherever feasible the "attribution" principle has been replaced by the "force of attraction" principle. The scope of the definition of permanent establishment has been considerably enlarged. The underlying conditions entitling the source country to charge tax on individuals, interest, royalties, capital gains and remunerations for personal services have been relaxed. The tax sparing credit has always been provided in the conventions. Information exchanges have been made automatic and more meaningful.

In Pakistan's view the source concept shall enable the less developed countries to retain much of the needed scarce revenue for their development programmes and at the same time also encourage foreign investment because of a well-defined set of conditions governing taxation of business profits arising on transactions transcending national borders.

# The French Imputation System: The "Avoir Fiscal"*

BY PIERRE KERLAN**

## I. INTRODUCTION

Many people regard the imputation system and the accompanying tax credit (which is known in France as the "avoir fiscal") as having been conceived by the French. However, we must in fact pay tribute to our British colleagues who invented this system a long time ago. And, even though you would look in vain for the old British system in Europe, you should realize that outside Europe it is still in force in many former British colonies.

## II. MAIN FEATURES OF THE SYSTEM

### (i) Simplicity of the French system

At first sight the French system looks very simple since the tax credit to which the shareholder is entitled is equal to one half of the amount of the cash dividend he receives. The advantage of the French system over the British is that under the French system you do not have to use a rather complicated fraction like 35/65 which may change from year to year as is the case in the United Kingdom. We have adopted once and for all a 50 percent credit which I think will remain in force for a long time.

### (ii) Gross up of tax credit

Of course, the French tax credit has to be treated as income by the recipient of the dividend, i.e. he must report the credit and add it to his taxable cash dividend (gross up). The income tax is then computed on the taxpayer's income including the aggregate amount of the dividend and the credit. Therefore, the main characteristic of the French tax credit system is that the benefit of the relief is only available if the dividend is *reported*. Taxpayers who do not report the dividend are not entitled to the credit.

This may perhaps sound strange to you, but you should bear in mind that in many European countries — including France — shareholders may prefer to keep the shares in their homes instead of depositing them with a bank. This is possible since many shares are bearer instruments so that in order to cash the dividend the shareholders only have to detach the coupons and offer these to a bank or to the corporation distributing the dividend. The reason for such behavior is that these shareholders have no confidence in banks or, for that matter, in the fisc.

### (iii) Refund of tax credit

If the shareholder is an individual person who is subject to French income tax and if the income tax is lower than the tax credit to which the shareholder is entitled, the excess amount is refunded to him. However, there is an important difference between individual and corporate shareholders since no such refund is available to the latter.

Another significant feature of the French imputation system is that the benefit of the tax credit system is only available to residents of France, i.e. individual persons who have their tax domicile in France or French corporations. There is one problem in this respect, i.e. the treatment of a French branch of a foreign corporation receiving French dividends. Currently no tax credit is given in such a case. In my opinion this raises the question of discrimination.

### (iv) Dividend must be declared

Another aspect of the French imputation system is that the tax credit is only attached to a declared dividend, i.e. to corporate distributions which have been approved by the general assembly of shareholders. Other payments which are made by a corporation, and which under provisions of the French tax law are treated as profit distributions, do not qualify for the tax credit. Examples are certain fees paid to corporate directors (attendance fees and percentage fees) as well as disguised profit distributions.

### (v) Dividend must be paid from normally taxed profit

Another feature of the French imputation system is that (partial) relief from double taxation of corporate distributions is only available if such distributions have been made from income which was subject to the normal rate of French corporate income tax (50 percent). An additional condition is that the dividend must be paid from income derived in one of the five years preceding the year of dividend distribution. Dividends distributed from income which has been retained for a longer period of time no longer qualify for the tax credit.

For instance, if we assume that a French corporation receives a dividend from a foreign subsidiary this dividend is almost entirely exempt from French corporate income tax. If it redistributes such dividend to its French shareholder there is in fact no reason to grant this shareholder a tax credit for French corporate income tax which was not levied on the income from which the dividend was distributed.

This raises the problem how to check whether the conditions under which a tax credit applies are fulfilled or not.

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* Extract of paper submitted to the meeting of the U.S. Branch of the International Fiscal Association on January 12, 1978. The other papers were published in the July issue of the BULLETIN.

** Ministry of Economic Affairs and Finance, Paris.

When we introduced our imputation system we could choose between two possible systems.

In the first place we could have granted the shareholder the tax credit only with respect to that part of his dividend which qualified for such credit. However, under such a system it would be necessary to ascertain whether the dividend was fully distributed from income subject to the normal rate of French corporate income tax. If not, the tax credit would have to be proportionately reduced. In other words, tax credits would vary depending on which corporation made the dividend distribution and they would also vary from year to year for the same corporation. It was decided no to use this system since it would be too complex and would not be well understood by the taxpayers.

Therefore, another system was adopted under which the shareholder would always receive a tax credit of one half of the cash dividend received. That meant, however, that some device had to be introduced at the corporate level to compensate the French fisc for the tax credit given in those cases where it did not intend to do so. For this purpose we introduced a kind of "advance payment" or "equalization tax", which we called the "précompte". This "précompte" is imposed on those dividend distributions which would not have entitled the recipient to the tax credit.

This can be illustrated with the following simplified example. Assume a French parent corporation — a 10 percent participation is generally sufficient to qualify as a parent — which receives a dividend from its French subsidiary. Such dividend distribution is generally exempt from corporate income tax in the hands of the parent with the exception of an amount of 5 percent of the dividend which has to be added to taxable income and which reflects non-deductible expenses connected with administering the participation. We will, however, disregard this 5 percent add back in order not to complicate the example. If the subsidiary distributes 100, the parent must for tax purposes be deemed to have received 150, i.e. 100 plus 50 tax credit attached to this dividend. If this dividend is distributed, the parent is subject to the "précompte", of one third of 150, i.e. 50. The parent corporation is, however, entitled to the tax credit of 50 which may be credited against the "précompte", thus wiping the latter completely out. The shareholder would then receive a dividend of 100 and would be entitled to a tax credit of 50, thus receiving in fact a value of 150 (which he must declare for income tax purposes).

The situation will be different if a French parent receives a dividend of 100 from its foreign subsidiary. It will in that case also be exempt from corporate income tax with respect to such dividends, but since these dividends are not deemed to carry a tax credit the parent receives only 100 for income tax purposes. If it redistributes this dividend the "précompte" (one third of 100) will be due so that eventually 66.6 will be available for distribution to the shareholder. The latter will be entitled to the tax credit of 50 percent of the dividend of 66.6, or 33.3, which means that he receives a value of 100, i.e. exactly the amount of dividend received by the parent. In other words the shareholder must for income tax purposes gross his dividend up by the amount of the tax credit, but this tax credit will compensate the amount of the "précompte" paid by the distributing company.

Of course, the French imputation system is a little more complicated but the above illustrates its main features.

## III. REASONS FOR THE INTRODUCTION OF THE IMPUTATION SYSTEM

At this point I would like to explain why the French Government introduced the imputation system in 1965.

Before 1965 we had the so-called "classical system" under which there existed double taxation of corporate profits. In the first place corporations were subject to 50 percent corporate income tax. Secondly, distributed income was subject to a schedular income tax which had to be withheld at the source. And finally, individual shareholders were subject to individual income tax on those dividends. Since the schedular withholding tax could not be credited against the individual income tax it was in fact an additional tax burden on dividend income, thus constituting a discrimination against such income in comparison to income derived from activities, like business, employment, etc.

In the sixties we were involved in the creation of a European Common Market which made international competition a more important factor to French industry. In addition, French industry was also suffering a lack of capital as a result of its tax system. The reason was that under the French classical system there was no incentive for corporations to distribute profits because of the extra burden suffered on dividends. Thus investment in shares was not very attractive for the majority of investors which made it in turn difficult for corporations to raise new capital, especially equity capital.

### (i) The Common Market

As I previously said, the Common Market was becoming more and more important to the French economy. At that time the French business community was looking particularly at its main competitor, i.e. the German Federal Republic, and it claimed that German enterprises benefited from a privileged regime in comparison with French enterprises. In this respect they pointed at the German split-rate system which significantly reduced the rate of German corporate income tax on distributed corporate profits. French business was very much in favor of the introduction of a similar tax system in France, and the then French Minister of Economic Affairs and Finance agreed to study the possibilities of the adoption of the German system.

### (ii) The drawbacks of the German split-rate system

After French tax experts had studied the German system they found a number of disadvantages inherent in the German system so that eventually it was proposed to adopt instead an imputation system in France which would normally have the same effect for *residents* of France as the German split-rate system. Some of the disadvantages are the following:

1. Under the German system relief is available with respect to *any* distributed profit, whether the recipient of the income declares this income or not. In adopting the German system we might, therefore, be encouraging tax evasion. On the other hand, the imputation system is superior to the split-rate system in this respect because to obtain the imputation relief, i.e. the tax credit, it is necessary to report the income. I think that this is the main justification of the imputation system.
2. I believe also that some businessmen and also certain politicians found that the introduction of the German split-rate system would present difficult technical problems at the corporate level.
3. Under the German system corporations are induced to distribute as much profit as possible to obtain the full benefit of the reduced rate. But in loss years there will be no incentive at all to distribute a dividend. This would conflict with the French philosophy under which corporate managers attempt to distribute annually approximately an equal amount of dividend in order to balance good and bad years.

## IV. SOME PROBLEMS CONNECTED WITH THE FRENCH IMPUTATION SYSTEM

### (i) Intercorporate dividends

The first problem is connected with intercorporate dividends. If a French corporation has a French subsidiary it is the latter which pays the French corporate income tax. In order to benefit from the tax credit the income must be distributed to the parent corporation. The parent does not — in principle — pay any corporate income tax with respect to the dividend received because of the affiliation privilege. However, if the parent redistributes the dividend to its shareholders the "précompte" becomes due (because the parent did not pay French corporate income tax at the normal rate, see supra). In this stage the French parent can utilize the tax credit which is attached to the dividend, since it may use the tax credit to offset the "précompte" imposed on the redistributed dividend. However, when the imputation system was introduced in 1965 parent corporations were required to make the distribution in the year in which they received the dividend from their subsidiaries. For instance, if a French subsidiary in 1966 made a distribution of profit derived in 1965 (which was subject to 1965 corporate income tax) the parent had to redistribute the dividend in 1966, otherwise the benefit of the tax credit would be lost. This limitation conflicted with the prevailing philosophy which prescribes that dividend distributions should be as evenly spread over the years as possible. It took the Legislature until 1975 to remedy this situation. In that year a provision was adopted which permits French parent corporations to utilize the tax credit for a period of five years.

The second problem was connected with dividends received by French parent corporations from foreign subsidiaries. You may perhaps know that we do not grant a foreign tax credit. Instead foreign dividends — if received by a French parent from its foreign subsidiary — are in principle exempt from French corporate income tax as if they had been received from a domestic subsidiary. At the redistribution of the dividend received, the "précompte" is due (as described above) but in this case there is no tax credit to offset the "précompte". This does not present a problem if the parent corporation redistributes the divident to a *resident* shareholder, since the latter will benefit from the tax credit which compensates the "précompte" paid by the parent corporation with respect to the dividend distribution. The situation will be completely different if the parent corporation redistributes the dividend to a *non-resident* shareholder. This shareholder is not entitled to the tax credit, so for him the "précompte" would in fact constitute an additional tax burden.

For this reason — and also because the "précompte" is very complex — there is much criticism of this feature of the French imputation system. However, the actual impact of the "précompte" is to a significant extent reduced by certain priority rules and also by the extension to five years of the period in which the tax credit can be utilized, as discussed above.

Another factor which reduces the impact of the "précompte" is that under tax treaties French corporations are permitted to credit foreign withholding tax (if any) against the "précompte". In other words, if a French parent corporation receives a dividend from its U.S. subsidiary, 15 or 5 percent U.S. withholding tax will be due (depending on the circumstances) but at the redistribution of the U.S. dividend the U.S. withholding tax may be credited against the "précompte" due. If one realizes that France has concluded approximately 60 tax treaties the significance of the reduction of the "précompte" through the existence of tax treaties may be appreciated.

### (ii) Psychological effects

Quite a different problem existed with respect to the attitude of the general public vis-à-vis the introduction of the imputation system. Many shareholders at first did not understand the new system and one of the main criticisms at that time was that they were obliged to add something to their income — i.e. the tax credit — which they in fact did not receive in cash. Currently, however, the system is working very smoothly, thanks to the assistance of the French banks. These banks send their clients at the end of the year a statement indicating the amount of dividend they have received and the amount of tax credit to which they are entitled. The taxpayer then sends this statement together with his tax return to the tax office.

There is also a political aspect in that it is sometimes stated that the rich benefit from the imputation system. There has been the case of one of our former Prime Ministers who was reported not to pay any income tax at all because the amount of tax credit to which he was entitled offset his income tax liability. This caused a considerable uproar in the press and although the tax administration tried to explain that in fact the Minister had made an advance payment of tax through the tax credit it did not altogether remove the adverse opinion of some persons regarding the imputation system. In fact, when the German Government intended to introduce an imputation system in its country it sent a delegation to Paris to inform itself about this negative aspect.

Another aspect of the problem was the reaction of the boards of directors of French corporations with respect to their proposals for dividend distribution. Some studies were made a number of years after the introduction of the French imputation system and it appears that in fact the corporations were retaining a relatively higher proportion of profits. One can, of course, hardly expect that a relief provision for distributed profit from which solely the shareholders benefit would constitute an incentive for the corporations to increase their dividend distributions. However, it was shown that corporations were roughly paying the same amount of dividend over several years, although during those years the amount of profit on the average increased. In fact, where dividend distributions were increased they did not increase in the same ratio as the increase of profits. This could apparently be justified in the following manner. If a corporation has 100 available for distribution, the shareholders would under the previous system also receive 100. If the corporation would under the imputation system distribute 80, the shareholders would be entitled to a tax credit of 40 and would thus receive 120, so that they would receive some benefit, although not the full benefit, of the imputation system.

#### (iii) Non-residents

At this moment, however, the main problem internationally is the treatment of non-resident shareholders. The normal rule is that a non-resident shareholder of a French corporation does not receive any tax credit under the national income tax provisions. I also explained that when French corporations receiving a dividend redistribute such dividend the "précompte" will be due, which reduces the available distributable profit by one-third. The law does not contain a provision under which the "précompte" can be refunded to such shareholders.

## V. TAX TREATIES

After more than ten years of the French imputation system it can be concluded that the French Government has made the system more flexible and it has also attempted to remedy the international defects of the system. At the end of the sixties and in the beginning of the seventies a large number of Protocols to existing tax treaties were negotiated under which the benefit of the French tax credit was extended to shareholders resident in those treaty countries. However, the benefit is limited to so-called *portfolio shareholders*, i.e. individuals and corporations which own less than 10 percent of the capital of French corporations.

*This policy has now more or less firmly been established and it is not the intention of the French Government to follow the British example, i.e. to grant also to non-resident corporations holding more important participations in a domestic corporation a (limited) tax credit as is currently demanded by the U.S. Government.*

With respect to the tax credit granted to non-resident shareholders we utilize two different systems, i.e. the system followed with respect to German shareholders and the system which is applied to shareholders resident in other countries.

**Beneficiaries of the French "avoir fiscal"**

| | |
|---|---|
| Germany | Protocol 9 June 1979 |
| Switzerland | Protocol 3 December 1969 |
| Luxembourg | Supplementary protocol of 8 September 1970 |
| Finland | Convention of 10 September 1970 |
| United States | Supplementary protocol of 12 October 1970 |
| Austria | Supplementary protocol of 30 October 1970 |
| United Kingdom | Supplementary protocol of 10 February 1971 |
| Belgium | Supplementary protocol of 15 February 1971 |
| Sweden | Supplementary protocol of 9 March 1971 |
| Brazil | Treaty, 10 September 1971 |
| Netherlands | Treaty, 16 March 1973 |
| Spain | Treaty, 27 June 1973 |
| Singapore | Treaty, 9 September 1974 |
| Malaysia | Treaty, 24 April 1975 |
| Former French colonies: | — Gabon, Upper Volta, Mali, Niger, Senegal, Togo, Comoro Islands. |

German shareholders of French corporations report the dividends they receive plus the attached tax credit in their German income tax returns. The German income tax is computed on their income including the aggregate amount of the French dividend and the tax credit. Then the shareholders are entitled to take the (French) tax credit against their (German) income tax liability. At first sight it seems that the German Government is paying the French tax credit but actually it sends its bill to the French Government for the loss of revenue thus suffered. The French Government thereupon refunds the tax credit minus 15 percent withholding tax. This is a rather complicated affair since the refund has to be made to the individual German Länder (States).

With respect to the other treaty countries we follow a different system. The shareholders submit a certificate stating the amount of dividend received and stating also that they are resident in the treaty country concerned. The French Government then directly refunds to them or their bank the amount of tax credit to which they are entitled after deduction of the appropriate amount of withholding tax, i.e. the cash payment of the tax credit is treated as if it were a dividend distribution.

A Ministerial decision provides that the "précompte" will be refunded to all bona fide residents of tax treaty countries — whether portfolio shareholders or shareholders possessing a major interest — provided that they can show a statement from their tax administration confirming that they are resident in the country concerned.

Other Ministerial decisions have granted the benefit of the "avoir fiscal" to foreign investment and pension funds established in Germany, Luxembourg, the Netherlands, the United Kingdom and, under the provisions of the French-United States tax treaty, also to such entities established in the United States.

However, the payment of the "avoir fiscal" is subject to a number of formalities and some of the shareholders of French companies do not claim the benefit of the "avoir fiscal" to which they are entitled under tax treaty provisions or under administrative decisions since they regard the administrative requirements as too complicated to be worth the financial gain. Such criticism is however, mainly expressed by banks.

However, the French Government insists on limiting the payment of the "avoir fiscal" to bona fide residents who declare their French dividends to their national tax authorities.

# Conference Diary

## NOVEMBER 1979

*Management Centre Europe:* International Finance Conference (including tax implications), Geneva (Switzerland), November 7-9 (English, French, German).

*The American Tax Institute in Europe:* The North American Tax Planning Conference, Zürich (Switzerland), November 7-9 (English, French).

*Seminar Services International:* International Contracts Conference (including study of possible tax liabilities of the seller in the country of the buyer), Amsterdam (Netherlands), November 21-23 (English, French, German).

*Tilburgse Fiscalistenvereniging "de Smeetskring":* Municipal Real Property Taxes, Tilburg (Netherlands), November 23 (English).

*Management Centre Europe:* International Tax Management (including handling of disputes between tax administrations), Brussels (Belgium), November 26-27 (English).

## DECEMBER 1979

*Management Centre Europe:* International Cash Management (including international tax aspects in cash management), London (United Kingdom), December 12-14 (English).

## FEBRUARY 1980

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

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

The American Tax Institute in Europe, 2 rue Lyautey, 75016 Paris (France).

Business Perspectives, 11 Alexander Place, London, SW 7 2 SG (U.K.).

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

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

Seminar Services International, 93 Chancery Lane, London WC 2A 1DT (U.K.).

Tilburgse Fiscalistenvereniging: Secretariat, Hogeschoollaan 225, Tilburg (Netherlands).

IFA INTERNATIONAL FISCAL ASSOCIATION NEWS

# Some Features of the Danish Economic System

**Address by Governor Erik Hoffmeyer**
**at the International Fiscal Association Congress**
**in Copenhagen, Monday, September 3, 1979**

GOVERNOR
ERIK HOFFMEYER

*HOFFMEYER, Professor Erik, D.Sc. (Econ); Danish economist and banker. Born 1924.*

*Career: With the Danmarks Nationalbank 1951-59; studied in U.S.A. on Rockefeller Fellowship 1954-55; lecturer on economics, Univ. of Copenhagen 1956, Prof. at the Univ. 1959-64; D.Sc. (Econ) 1958; Economic Counsellor, Danmarks Nationalbank 1959-62; Governor Bikuben Savings Bank 1962-64, Chairman of Board 1964. Governor and Chairman of the Board of Governors of the Danmarks Nationalbank 1965-; Governor for Denmark to the International Monetary Fund 1965-.*

*Pres., Assn. of Political Economy 1951-53; member, Bd. of Management, Nationaløkonomisk Forening (Economic Socy.) 1960-66, of the presidency of the Economic Council 1962-65, and of the Academy of Technical Sciences 1963. Economic Council 1965, Danish Science Advisory Council 1965-72, C.L. David Collection, Member 1967-77, Chairman 1977-; The Housing Mortgage Fund 1969-72; member Board of Directors of the European Investment Bank 1973-77, Chairman of the Committee of Governors of the EEC-Countries 1975-76.*

*Publications: Dollar Shortage and the Structure of U.S. Foreign Trade (thesis 1958); Stabile priser og fuld beskæftigelse (1960); Strukturændringer på penge- og kapitalmarkedet (1960); Velfærdsteori og velfærdsstat (1962); Industriel vækst (1963); Monetary History of Denmark (1968); contributions to Nationaløkonomisk Tidsskrift and international economic journals.*

I once attended a seminar at the Johns Hopkins University chaired by the famous economist Simon Kuznets, who later became a Nobel laureate. The topic to be discussed was under-developed countries and his initial question to the students was how they would start their investigation upon arrival in an under-developed country. His students came up with many proposals for various statistical analyses, but he eventually cut short the discussion with the remark: The first question to be settled is: Who has the power?

I am not suggesting that Denmark is an under-developed country — although in some respects it certainly is — but rather am underlining that you cannot understand our system unless you have answered this question. I have often argued that in our type of society the political power rests with the wage earners. They represent between 80 and 90 percent of the active population and the political parties are dominated by their interests.

It may be worth noting that as regards production and distribution of goods and services this majority has shown a preference for a free enterprise market mechanism. We have become integrated in the OECD economic circle and have benefited enormously by the strong increase in international trade over the last decades.

Within this framework a highly efficient industry and agriculture have developed in our country. Industrial enterprises are typically of medium size, industrial exports account for 72 percent of exports whereas agriculture provides about 28 percent.

# 33rd International Congress of IFA

# Copenhagen

Particularly during the last quarter of the century real income has increased very rapidly and the standard of living in this country is among the highest in the world. Another important feature is that our society over the last 50 years has been transformed into a so-called Welfare Society with the main emphasis on the fulfilment of the interests of the wage earners, which include of course both workers and salaried persons.

The principal features of this society are free access to education for the purpose of securing equal opportunity and a very ambitious level of economic support in case of sickness, old age and unemployment. In all these respects our system belongs to the most advanced in the world, which is generally appreciated by the Danes. There are, however, certain drawbacks which pose problems of a political nature that are extremely difficult to solve.

One is that the incentive to save becomes rather weak in a system where public support is available in case of need. Another — which is far more severe — is that such a system has proved to be extremely expensive to run. A few figures may show the order of magnitude.

| | Percent | Billions of Dkr. | $ equivalent |
|---|---|---|---|
| GDP 1978 | 100 | 301 | 54.5 |
| Public sector | 55 | 167 | 30.2 |
| including | | | |
| education | 8 | 23 | 4.2 |
| health | 6 | 19 | 3.4 |
| old age, etc. | 7 | 22 | 4.0 |
| unemployment | 3 | 10 | 1.8 |
| other social welfare | 9 | 25 | 4.6 |
| subtotal | 33 | 99 | 18.0 |

In spite of the fact that the facilities offered by the public sector are used and appreciated by the receivers and also by potential receivers there has developed a violently growing reaction against covering the costs which can of course only be done by paying taxes. The appetite on the receiving side is higher than the willingness to pay. An elaborate pattern of reactions has developed with the aim of escaping payment of the full amount of taxes.

It is an extremely complicated system which in turn demands scientific analysis and proposals for counter attacks. I do not have the time to burden you with a detailed analysis of this area, but it may be useful to point out the major issues.

Wage earners have the political power. They have created the Welfare State. The instability features are so strong that an improvement of discipline is necessary, particularly regarding the fact that costs have to be covered.

I have tried in this brief survey to point at the salient features of our economy with particular emphasis on the fiscal aspects of the Welfare State. I wish you success in your work and hope that you will receive some impression of a society that is agreeable although it remains to be seen whether a number of conflicting priorities can be resolved. Until this is achieved the system will unavoidably display serious traits of instability.

First is the well-known search for loopholes in tax legislation. It is always easy to arouse fierce public discussion about the use of such rules, particularly regarding the taxation of enterprises, but most of them are really not so serious. They can to a large extent only be used to transfer taxable income from one period to another. This is of course particularly true of depreciation allowances. It may create envy, which is important from a political point of view, but not from a long run fiscal aspect.

The second point I am going to mention is far more serious, i.e. the development of a parallel economy outside the system where taxes are not paid at all. It is not a new thing. Whenever a tax has been imposed, endeavours have been made to avoid paying it. Smuggling is a case in point. But in our type of society this has become more important.

Nowadays these endeavours have spread from smuggling to the provision of all kinds of services where VAT and income tax are being avoided. The same effect is being achieved through an increase in barter economics. It is difficult to assess the magnitude of this parallel or underground economy, but there is no doubt that it is a large item of total transactions and that it is growing. One of the more important negative consequences of this development is that it changes the ethics in the sense that it is considered quite appropriate to engage in such transactions. It becomes good sport to cheat the

State, almost as schoolboys cheat their teachers.

The third point I wish to mention is the tax-wage mechanism. An obvious way to avoid the burden of increased taxation is to try to make others pay. This can be achieved indirectly by demanding higher salaries or wages when indirect or direct taxes have been increased, or in any case where a wage earner feels that taxes are simply too high.

Needless to say, this has even more dangerous consequences than the previous point. It leads clearly to inflationary pressure which can work through the system, whether the rate of unemployment is high or low. I am not contending that this is the sole explanation of the present highly unsatisfactory state of simultaneous high rates of unemployment and inflation. But it is one of the mechanisms which makes it almost impossible to achieve economic stability in the sense of full employment, price stability and external balance. It must therefore give cause for great concern.

I now come to my fourth and final point, which is that wage earners may exert pressure directly on the political parties not to increase taxation in spite of the fact that expenditures rise too fast. The obvious consequence of a too large public deficit is a further inflationary push and a deficit on external accounts. This is, by the way, one of the unpleasant features of our economic performance, that we have had far too large deficits on foreign account. My argument has been that the Danish society has been transformed into one of the most advanced Welfare Societies with many positive aspects, but it has stumbled on the lack of willingness of the ordinary taxpayer to cover the costs.

In former times people revolted against the ruling class when it imposed too severe taxes to cover the extravagances of the ruling class. It might have been military ambitions of a king or emperor or the level of consumption of the upper class or ambitious building projects of the king or the church. But it was a revolt of the ordinary population against a small group, which was considered to demand too much.

The present day problem is far more complicated. It is in essence a revolt against one's own group. All major changes in the direction of the Welfare State have been passed through our Parliament by a wide majority. The revolt against the high level of taxation must therefore be interpreted politically as a sign of regret at the level of welfare which has been created or as ignorance of the reasonably true costs of such a system.

However that may be, it seems quite clear to me that the unwillingness to pay the costs of our Welfare System makes our system unstable. It is impossible for an economist to prescribe a cure for this, because it is basically a question of political logic.

## Mr. Davies Re-elected as President of IFA

*At the Copenhagen Congress the General Assembly of IFA unanimously re-elected Mr. Alun G. Davies as President for another two year term. IFA may look forward to another two years during which it will benefit from Mr. Davies' inspiring leadership.*

## Dr. Huiskamp Appointed as an Assistant Secretary General

*During the Copenhagen Congress Dr. J.C.L. Huiskamp, associate professor of tax law at the Erasmus University in Rotterdam and director of the Rotterdam Institute of Fiscal Studies, was appointed as an Assistant Secretary General. Inasmuch as the scientific work of the IFA has substantially increased it has become more and more pressing to be informed on the work of other international organizations in the tax field in order to integrate IFA's work better with the major activities of these agencies and to improve a closer relationship with their programs.*

# Some Highlights from the Secretary General's 1978 -'79 Report

This Report covers the period between the Sydney and the Copenhagen Congresses. The Secretary General, Prof. Dr. Jan H. Christiaanse, while commemorating the fact that IFA has existed 40 years, compared the first Congress held in 1939 with the 33rd Congress held in Copenhagen in 1979. In 1939 all participants were required, at a minimum to be literate in English, French and German inasmuch as no translations or summaries in other languages were provided. The 33rd Congress general reports were presented in four languages: English, French, German and Spanish and the national reports were supplemented by summaries in the other official languages used by IFA.

The most important highlights are:

*The Sydney Congress, September 1978.* The President of this Congress, Mr. G.L. Herring, Chairman of the Australian Branch, may look back upon a highly successful conference in which 580 persons participated, with an additional 311 companions accompanying them. IFA is grateful to the General Reporters: Prof. J. van Hoorn Jr. and Mr. P.V. Mayes who respectively, implemented the following topics: "Differences in Tax Treatment between Local and Foreign Investors and the effect of International Tax Treaties" and "Taxation of the Extractive Industries". The discussions, capably led by Dr. P. Gmuer and Mr. W. Ritter, resulted in valuable resolutions which were published in the 1978 Yearbook and in the December 1978 issue of the BULLETIN. Distinguished Asian tax experts who had previously attended a conference organised by the Economic and Social Council for Asia and the Pacific (ESCAP) in Sydney were invited as guests. Their presence made the Wednesday afternoon seminar organized by Prof. J. van Hoorn Jr. on "Fiscal Policy and Tax Structures in the Pacific" especially meaningful.

Mr. D. Coutinho, who had expressed his wish to retire as IFA's General Treasurer, was succeeded by Mr. P. den Boer.

Mr. Greason Bryan received an "honorable mention" for this study on "Developed Nations Tax Law and Investment in Low-Developed Countries".

*Mitchell B. Carrol Prize.* IFA lost Prof. Jean Baugniet, Belgium who died suddenly in February, 1979. He had for many years been a member of the Jury charged with the awarding of the Mitchell B. Carroll prize. He was succeeded by Prof. Klaus Vogel (Germany).

*Permanent Scientific Committee.* During the February, 1977 meeting it was decided to amend the procedure for Congress discussions. Also, new directives for general and national reporters were drafted. The preparation time for IFA's scientific work was extended since the National Branches must now nominate their national reporters two years in advance. Accordingly, the national reporters for the Paris (1980) and Berlin (1981) Congresses must be nominated.

*Paris Congress (1980).*

Subject I. The Dialogue between the Tax Administration and the Taxpayer up for the filing of the Tax Return.

General Reporter: Mr. Guy Delorme (France).

Subject II. Rules for Determining Income and Expenses as Domestic or Foreign.

General Reporter: Mr. Robert J. Patrick (U.S.A.).

*Berlin Congress (1981).*

Subject I. Mutual Agreement - Procedure and Practice.

General Reporter: Dr. Karl Koch (Germany).

Subject II. Unilateral Measures to Prevent Double Taxation.

General Reporter: Dr. D. Juch (Netherlands).

*Excutive Committee.* Dr. K.V. Antal (Netherlands) returned in the Executive Committee after a two year absence.

*Membership fee* it was proposed to increase the membership fees; for the 1979-80 year the fees are as follows:

| | |
|---|---|
| individual members of National IFA Branches | US$ 36 (was US$ 33) |
| direct individual members of IFA | US$ 38 (was US$ 35) |
| all corporate members | US$ 85 (was US$ 77) |

The increase will be used to supplement working capital and, if necessary, to expand the Secretariat. [1]

*National Branches.* IFA will accept a National Branch if it has at least twenty members. IFA started with twenty-seven National Branches at the beginning of the Report year. The preparations for the admission of National Branches in Colombia and Hong Kong have progressed to such an extent that it was expected that they would be admitted during the Copenhagen Congress. [2] In that view the efforts of Mr. Guillermo Rico (Colombia), Mrs. Nellie Fong (Hong Kong) and Mr. R.E. Moore (Hong Kong) were particularly recognized.

Indonesia and Singapore are also in the process of creating National Branches, thanks to the efforts of Prof. Soemitro (Indonesia) and Mr. B.K. Ray (Malaysia).

The Swiss Branch commemorated its 30 year's existence in June 1979. [3]

*Members.* In March, 1979 IFA has 5,427 members (in 1978: 5,238).

1. The Copenhagen Congress accepted the increased membership fees.
2. Indeed these Branches were admitted during the Copenhagen Congress.
3. See for the text of the speech held by Dr. Gmuer at the occasion of the 30th birthday of the Swiss Branch, infra.

# 30th Anniversary of the Swiss Branch

**LUNCHEON SPEECH BY DR. PAUL GMUER AT THE CELEBRATION OF THE 30th ANNIVERSARY OF THE SWISS ASSOCIATION OF FISCAL LAW (SWISS BRANCH OF THE INTERNATIONAL FISCAL ASSOCIATION) ON JUNE 15, 1979, IN THE MEISEN GUILD HOUSE IN ZURICH**

Dear Colleagues

When on June 18, 1949 our Association was founded in Zurich by a small group of tax lawyers, the first organization of Swiss adepts of fiscal law saw the light of day. The initiative to this step did not even come from Switzerland, but from IFA, the International Fiscal Association, which was established in 1938 in The Hague. It is represented here today by its Secretary General, Professor *Dr. Jan Christiaanse*, Rotterdam. The present President of IFA, *Mr. Alun G. Davies*, was unfortunately unable to come, but is sending us his best wishes for this great day. His written address reads as follows:

> *"You were kind enough to invite me to be present at the celebration of the 30th anniversary of the Swiss Association of Fiscal Law. Much to my regret, I am unable to come.*
>
> *I have many friends of old standing in the Swiss Association, and it would have been a very delightful gesture to share with them the achievement of 30 years history in the study of fiscal law. The Swiss Association is one of the most reputable, reliable, and conscientious in the whole of IFA. If only other branches were able to touch the hem of your garment, they would be inspired to a remarkable and lively effort in the study of fiscal science. My best wishes go to you all as you sit down to celebrate such a long apprenticeship in fiscal study."*

There is also present from the IFA family *Professor J. van Hoorn* from Amsterdam, Director of the International Bureau of Fiscal Documentation which was created by IFA in the form of a foundation and in the meantime has developed into an important center of fiscal research which publishes its results.

We welcome Mr. Christiaanse and Mr. van Hoorn as our godfathers, so to speak.

As you know, at a later stage our Association adopted the name Swiss Association of Fiscal Law. For, from a gathering of the Swiss members of IFA, we have become *the* organization which in our country unites all those persons who in one position or another, in the administration, in science, in business or in an advisory capacity, engage in matters of taxation. The link with IFA has nevertheless been maintained. Membership of our Association is identical with membership of IFA.

Apart from the constituent assembly there are three events which have proved to be landmarks in the history of our Association: the three International Fiscal Congresses of 1951 in Zurich; 1960 in Basel; 1973 in Lausanne.

Anyone who, like the speaker, assisted in the organization of all these meetings (and, incidentally, also prepared the text of our Articles which is still in effect today) is justified in saying that our Association has in a way become part of his own life. This is why I am taking the liberty of addressing you here today.

In looking around, I notice that there are other veterans present who may have quite similar feelings; I am thinking in particular of my fellow-members of the first Executive Committee: Professor Dr. Willy Rigoleth of St. Gallen; Dr. Max Oetterli of Basel. I also recognize among you Dr. H.U. Frey of Zurich, who represented his bank, Credit Suisse, at the constituent assembly, and who for many years has rendered manifold services to our Association, for example as Chief of Finance of the International Fiscal Congress of 1951.

In the course of the 1950s quite a few persons joined our ranks and ever since have been carrying the torch as rapporteurs, as members of the Executive Committee and by lending active assistance to the organizing committees of our three fiscal congresses. It is not possible for me to name them all. Thanks to the close cooperation in our Association I am linked to many of them by the bonds of sincere friendship. Other persons, too, have equally found our Association has been instrumental in forming friendships.

Many of our prominent members of the Executive Committee have departed this life; may I bring the most important names to your recollection:

*Professor Ernst Blumenstein*, who with his "Schweizerisches Steuerrecht" of 1926/29 and his "System des Steuerrechts" of 1944 contributed an essential share to the scientific fundamentals of our field of law and who was the first President of our Association. He died on July 21, 1951.

*Dr. Josef Henggeler*, his successor in the Presidency, is still vividly remembered even today by all those who knew him as one of the leading tax lawyers of our country. He also presided over the 1951 Fiscal Congress in Zurich. He died on August 26, 1952.

*Professor Max Imboden*, the unforgettable holder of the Chair on Administrative Law and Rector of Basel University, was President of our Association from 1953 until 1962. He died in March 1969, much too early.

I mention further the following deceased members of the Executive Committee whose names will live on in the annals of our Association:

| | |
|---|---|
| Dr. E. Wyss | Director of the Swiss Federal Tax Administration; |
| Dr. Studer | Chief of the Tax Administration of the Canton of Basel-City; |
| Professor Henri Zwahlen | Lausanne; |
| Dr. N. Gaudenz | Chief of the Tax Administration of the Canton of Graubünden; |
| Eugen Isler | Manager of the Schweizerische Treuhandgesellschaft, who was the Secretary of our Association from 1962 until his death on February 7, 1974 |

We are keeping all these personalities in honorable remembrance.

You all know the *current President*, Professor Dr. Kurt Amonn, who has exercised this function since 1974. You will remember Dr. Rodo von Salis, a former tax lawyer, who has become an industrialist and who directed the destiny of our Association from 1962 to 1966.

The predominating mood among the members and the Executive Committee has not at all times been euphoric. It is true that the 1951 International Fiscal Congress in Zurich brought about an initial inflow of new members, but by 1953 their number had reached only 66. In the minutes of the Executive Committee of November 26, 1955 the following can be read:

> *"Besides, it must be pointed out that the efforts made by our Association have so far not met with the response which they deserve. In our neighbouring countries a far greater number of fiscal experts from the administration, from business and from science are members of IFA. We, too, should therefore endeavour to enlarge the circle of our members, which however depends in the first place on what we can offer them. This leads us to the organization of the program. We should conceive our plans in this respect on a long term basis."*

Beginning in 1956 the number of our meetings increased to two per year, and for several years now there have even been three or four. It appears that our former appeal to provide greater attractiveness has not passed unheard, since in the course of the ensuing years the membership total has shown a steady rise and by the end of 1978 came up to 269 individuals and legal entities.

This attractiveness is equally reflected in our finances. The net worth of our Association, which at the end of 1952 amounted to 1,587.50 Sfrs., reached, as you just heard, by the end of 1978 the sum of 60,477.85 Sfrs., to which must be added the fund in the same amount for the Promotion of Research in the field of Swiss Tax Law.

As you will all recall, there is no finance or tax bill on the Federal level, nor are there any bilateral or multilateral treaties between our country and other states, nor is there any activity on the part of Switzerland in international organizations, and finally there is no new development in the field of taxation which has not been given our thorough attention.

Taxation has in the meantime not only developed into an important branch of the law as such, after it had been engaged in a long struggle to attain the recognition it deserves; it has become, also in our country, an ardently contested political issue, tax law itself perhaps to a lesser degree than tax practices and above all the burden of taxes to the citizen and to the economy. Ideology and demagogy have thus made their entry into our field of science. Day after day we find this fact confirmed in the daily press and on the television screen.

Hence it is all the more important that a forum exist, permitting an objective and unemotional discussion of the problems pertaining to tax law and fiscal practice on both a national and an international level.

Nevertheless we are not supposed to be mere technocrats in our field, "useful idiots" in the sense of Lenin. Our discussions must proceed within a framework of values where law, freedom and self-responsibility of each individual take a high rank and where, applied to the economy, free competition prevails over bureaucratic command.

# Bangladesh: BUDGET 1979/80

Extract of the Budget Speech of the Minister of Finance, Mr. Mizza Nurul Huda, pronounced on June 2, 1979.

## FISCAL MEASURES

### A. Tax revenues

Mr. Speaker, Sir,

I will now present before the House the tax measures of the next year's Budget proposed in the light of the Government's fiscal policy and the need for mobilisation of resources.

45. It gives me the great pleasure to inform the House that like previous years, in the current year also, we have not only been able to keep up the growth rate of tax revenues but also made a substantial augmentation of the same. The total collection of revenue in the current year is expected to exceed that of the last year by Tk. 173 crores. [1] This has been possible due to the whole-hearted support of the people and in spite of a large number of duty and tax concessions allowed throughout the year with a view to bringing down the pressure on prices and creating jobs for the unemployed. Our prime objective in the formulation of revenue policies is to mobilise more and more internal resources and thereby reduce our dependence on external assistance. Although we have been devoting all our efforts to broaden the tax base and increase revenue earnings, we have not lost sight of the social justice and equity aspects of the problem.

46. Government has been making constant efforts to augment revenue through improvement in the tax administration despite serious shortage of trained and experienced manpower at all levels, lack of equipment, accommodation and logistics. We have also been making continuous efforts to improve the effectiveness of the tax administration by recruiting officers and staff and by training them up through a crash programme. Obviously, in a complex field like tax administration it takes a long time for a newly recruited official to be effective, well conversant and efficient. In spite of this we have continued our efforts to improve the position in this regard and we are determined to further strengthen our efforts in this sphere. This will improve the supervisory effectiveness directly as well as indirectly through checks and balances. I am confident that through these efforts coupled with our policy of rewards and punishment commensurate with performance will greatly assist in curbing tax evasion.

47. The Government will like to associate the public representatives in appropriate forums, with a view to preventing tax evasion and augmenting revenues.

48. The Taxation Enquiry Commission has since submitted its final report. The recommendations of the Commission are under the active consideration of the Government. A number of their recommendations aimed at rationalisation and improvement of taxation laws and procedures have been included in this year's budget proposals.

49. The Goverment feels that a bigger portion of revenue earnings should come from the direct taxes. For this reason the Goverment lays much stress on increasing realisations from these taxes. With this end in view, the Taxes departments have been reorganised. The Directorate of Tax Intelligence and Investigation has been revitalised and as an extension of the same policy an Intelligence and Investigation Cell has been created in each zonal Commissioner's office. A separate Central Zone has also been created for intensive examination of big and complicated cases. This is expected to yield substantial amount of additional revenue. Apart from this a scheme of summary disposal of smaller cases has been undertaken this year. Under this scheme over two hundred thousand cases have so far been finalised. This time thus saved by disposing of cases involving small revenue has and will be used in more thorough and better examination of bigger cases. This will help in curbing tax evasion and improving tax realisation. Besides these, the survey of new cases has been intensified and eleven thousand new cases have been brought under the tax net till May this year.

50. In the field of indirect taxes my proposals aim at rationalisation of customs duty and removal of the anomalies in the rates and procedures of collection of customs duty, excise duty and sales-tax. We are determined to encourage domestic production and to discourage the consumption of luxury goods. Our continued endeavour to improve administrative efficiency and collection procedures will not only be maintained but also be reinforced in the coming year. I hope, through these efforts, we will be able to collect additional revenues without imposing any substantial new taxes.

### B. Customs duty

51. In respect of customs duty the Government's policy is to increase revenue needed for building up a self-reliant economy by increasing the customs duties on commodities consumed by relatively affluent sections of the society. Simultaneously, in order to further extend the year-round policy of reducing duties on essential commodities needed by the common man which has been pursued during the last three years, I am proposing the following measures:

(a) customs duty on low-priced one-band built-up and kit-form radio for assembly is proposed to be reduced from 50 percent and 25 percent to 25 percent and 10 percent respectively.

(b) as a complement to the already effected duty reduction on bus, cycle, rickshaw, etc., and with a view to easing the transport problem, the duty on built-up and CKD motor cycles up to 75 c.c. is proposed to be reduced from 25 percent and 15 percent (no sales-tax) to 10 percent and 5 percent respectively;

(c) spectacles, spectacle-frames and parts thereof are subject to a duty at the rate of 175 percent if made of precious or rolled precious metal and 110 percent if made of other materials, Keeping the needs of people suffering from deficiency of eye-sights in view, the above two rates are proposed to be reduced respectively to 125 percent and 75 percent;

(d) items such as locks, bolts and similar door and furniture fittings are subject to 150 percent duty. These are proposed to be reduced to 100 percent;

(e) corrugated iron sheet is an important item of house building for the rural population. The ever increasing price of this commodity in the international market is pushing it beyond the purchasing power of the common man. In order to give some relief in this regard, the duty on this item is proposed to

1. 1 crore = 100,000,000.

be reduced from 45 percent to 35 percent.

The measures proposed above will result in a total revenue loss of Tk. 2.94 crore as customs duty and sales-tax.

52. In order to build up the national economy on a firm footing through rapid industrialisation and other development projects, iron and steel products are considered to be an essential item. It is, therefore, proposed that the duty on billet and scraps be reduced from 35 percent and 25 percent respectively to 25 percent and 12.5 percent. The duty on a large number of chemicals used as industrial raw materials is also proposed to be reduced from 115 percent and 65 percent to 50 percent. Besides, the duty on bitumen used in the construction of roads and highways is proposed to be reduced from 100 percent to 75 percent. In addition, the duty on fire extinguishers, gas and water meters has also been proposed to be reduced.

These proposals, if accepted, will entail a revenue loss of Tk. 4.20 crore in customs duty and sales-tax.

53. The import duty on commodities used by the relatively rich section of the population, on the other hand, is proposed to be enhances as follows:

| | Commodity | Present rate % | Proposed rate % |
|---|---|---|---|
| (a) | Video cassette recorder | 100 | 300 |
| (b) | Perfumery and cosmetics | 150 | 200 |
| (c) | Synthetic fabrics | 225 | 250 |
| (d) | Mixed synthetic fabrics | 175 | 200 |
| (e) | Fine and superfine cotton fabrics | 100 | 125 |
| (f) | Marble chips and powder | 50 and nil | 75 |
| (g) | Motor cars: | | |
| | (i) over 1000 cc | 90 | 110 |
| | (ii) over 1300 cc | 125 | 150 |
| | (iii) over 1500 cc | 150 | 200 |
| | (iv) over 1650 cc | 200 | 300 |

(The exemption of sales tax on fine and super fine cotton fabrics will be withdrawn and cars up to 1000 c.c. will continue to be charged at the present rate of 50 percent.)

The above proposed measures will generate an additional revenue of Tk. 5.40 crore as customs duty and sales tax.

54. It is also proposed to enhance the duty of a few items to give some protection to our infant industry from unfair competition with foreign products. For this reason, it has been proposed that the import duty be enhanced on finished plastic goods and coal-tar from 75 percent to 100 percent and from 15 percent to 50 percent respectively.

55. In additions to the above, as in the previous years, it is proposed to simplify, rationalise, readjust and remove anomalies of the rates of duty on a number of items. These will not have any significant effect on revenue earnings.

### C. Excise duties

56. At present excise duty is levied at the rate of Tk. 1.50 per pound of unmanufactured tobacco. Since collection of this duty involves control from growing stage to the end-product, and since tobacco cultivation has been scattered all over the country in addition to a few areas of concentrations, this particular excise has been difficult and cumbersome to administer from the very beginning. Gradually, with the change in people's smoking habits by far the major portion of tobacco is now being consumed in the manufacture of cigarettes, biris, cigars and 'Zarda'. An insignificant portion of it is used in 'hukkah' and as chewing tobacco by the poorer section of the people in the rural areas. Thus, this excise has now come to a stage when it is possible to exempt excise duty on unmanufactured tobacco totally and merge its incidence on the end-products, i.e., cigarettes, biris, cigars and 'Zarda'. I, therefore, propose the following measures:

(a) an addition of Tk. 3.75 per 1000 cigarettes on each slab of excise duty on cigarettes;
(b) an addition of Tk. 3.00 per thousand sticks of biris;
(c) imposition of Tk. 3.00 per hundred cigars; and
(d) imposition of Tk. 5.00 per pound of 'Zarda'.

57. The statutory excise duty on gold, silver and their products at the rate of 25 percent of the retail price has remained exempt since long. These are, however, leviable to a sales tax at the rate of 10 percent. The recommendations of the Taxation Enquiry Commission to transfer the responsibility of levy and collection of taxes on these articles from the Tax administration to the Customs and Excise administration have been accepted in principle. However, in keeping with the policy of rationalisation, I propose to merge the incidence of these two taxes and refix the rate and levy it as a concessional excise duty at 15 percent of the value in case of gold and gold products and 7½ percent of the value in case of silver and silver products. This measure is likely to yield an additional revenue of Tk. 75 lakh [2] annually.

58. Compared with the users of all other varieties of fuel, the users of natural gas are enjoying an inequitable price advantage. They are, therefore, justifiably in a position to pay a bit more for their use of gas. I accordingly, propose to enhance the rate of excise duty on natural gas from Tk. 2.40 to Tk. 3.00 per 1000 cft. This measure is expected to yield an additional revenue of Tk. 1.75 crore.

59. Plastic and rubber products manufactured manually and by using 220 volts of electricity only for heating have also remained exempt from duty since long. In view of the large scale misuse of this concession and considering that the industry has by now achieved a considerable growth, I propose that this exemption be withdrawn. This measure is likely to yield an additional revenue of Tk. 30 lakh.

60. Locally produced cement is leviable to an excise duty at the rate of Tk. 203.00 per ton; imported cement, on the other hand, is subject to a customs duty of Tk. 40.00 per ton and sales tax at the rate of 20 percent on duty paid value. These rates were fixed in 1974 to effect price equalisation between the two. Later on, however, a substantial rise in the import price of cement has totally dislocated the aforesaid price-balance. To restore the balance, I propose the following measures:

(a) sales tax on the imported cement be reduced from 20 percent to 5 percent; and
(b) excise duty on locally produced cement be enhanced from Tk. 203.00 to Tk. 360.00 per ton.

This measure is expected to generate an additional revenue of Tk. 50 lakh.

### D. Income tax

61. In order to provide some relief to the lower income groups in the context of present economic conditions, I propose to raise the minimum taxable limit from Tk. 10,000.00 to Tk. 12,000.00. With this proposal there will no longer be any justification for continuing the very special exemption of Tk. 3,600.00 over and above the minimum non-taxable limit of Tk. 12,000.00 in respect of agricultural income. The resultant incidence of tax will now be on the comparatively well-to-do section of society and the affluent farmers only.

62. In order to control the tendencies of lavish expenditure on publicity and expense account entertainments is has become necessary to put a ceiling on the aggregate of such expenses. I, therefore, propose to put this maximum ceiling at Tk. 15,000.00 and Tk. 10,000.00 respectively. In the case of new concerns, however, this restriction will not apply during the initial 2 years.

63. It is felt necessary that individuals and enterprises in the higher income group should be taxed more to meet the need for generating domestic resources and to pursue the policy of social equity. I, therefore, propose a levy of surcharge at the rate of 7½ percent and 12½ percent on companies

2. 1 lakh = 100,000.

with income between Tk. 50,000.00 and Tk. 1 lakh and on those with income exceeding Tk. 1 lakh respectively. Assessees other than companies with similar income will be leviable to surcharge at the rates of 10 percent and 15 percent respectively. This measure is likely to generate an additional revenue of Tk. 5 crore and 60 lakh.

64. Capital gains out of transfer of property through acquisition by public authorities is exempt from payment of capital gains tax. In order to bring such gains equitably at par with others, I propose to withdraw this exemption. It is also proposed to exempt [3] the capital gains tax now charged on properties purchased before 14-8-1947 inasmuch as such purchases were not speculative in nature. This has been recommended also by the Taxation Enquiry Commission.

65. There is a tendency to avoid payment of stamp duty and income tax on transfer of property in collusion with the purchasers by splitting the property and without obtaining necessary clearance certificates. In order to curb such tendency, I propose to raise the existing limit of clearance certificate from Tk. 20,000.00 to Tk. 50,000.00 and to make the tax liability a charge on the property transferred collusively without obtaining the necessary clearance certificate.

66. There have been many requests and recommendations to set up an Appellate Tribunal Bench at Chittagong in order to expedite disposal of appeal cases. I propose to implement this during the next year.

67. For various reasons, it has become necessary to speedily develop a national merchant navy. To provide necessary incentives, therefore, I propose to allow an accelerated depreciation of 40 percent, 30 percent and 30 percent respectively during the first 3 years in case of newly acquired ocean-going vessels.

**E. Wealth tax**

68. At present a residential house occupied by its owner is exempt from wealth tax irrespective of its value. In order to make this provision progressive, I propose to limit the extent of such exemption up to Tk. 10 lakh.

**F. Estate duty**

69. A residential house up to the value of Tk. 5 lakh is now exempt from estate duty. The value of property has appreciated to a great extent since this limit was fixed. Keeping this in view as well as to provide some relief to the heirs of a deceased person, I propose to raise the above value limit to Tk. 10 lakh.

3. Editor's note: Probably "abolish" is meant.

# BOOK REVIEW

### THE INTERNATIONAL TAX TREATY SERVICE

Edited by Michael Edwardes-Ker
(Dublin, In-Depth Publishing Ltd. 1978)

*£75 for the basic volume*

The basic volume of the Service was first published in 1977 and in the meantime updating material (June and December 1978) has been sent to subscribers.

The Service takes the form of an extensive commentary on the 1977 OECD Model Double Tax Treaty, upon which double tax treaties between developed countries have come increasingly to be based. The starting point is the text of the Model Convention, together with the official OECD Commentary. The Editor makes an editorial comment on each article and there are then reproduced, in full or in summary, the relevant administrative rulings and judicial decisions available to the editor with the assistance of other tax specialists.

In some 650 pages the ITT (International Tax Treaty) Service analyses, in relation to each Article of the Model Convention, 269 court decisions and 242 officials rulings. As a loose-leaf reference work, the ITT Service is designed to be updated and amended regularly.

The material is arranged in alphabetical order by State in which decisions or rulings were issued, with each State's decisions on any particular Article being arranged chronologically. Thus the commentary on Article 4 starts with a 1961 decision in Austria, followed by later decisions in Austria, and then by decisions in Belgium, Canada, etc.

To quote the editor, "this arrangement illustrates one unique feature of the ITT Service, namely that for the first time ever, all court decisions and rulings world-wide which relate to a particular treaty article are assembled and analysed together. The ITT Service is thus an invaluable aid in interpreting double tax agreements."

The reviewer, who is prepared to subscribe to this statement in principle, would like to make a reservation to the word "all", because he has doubts based on his experience in the international field that such a far-reaching statement can be made; even an excellent tax specialist will find it difficult, if not impossible, to find all such court decisions and rulings bearing in mind not only the complexity of tax law in the various countries but also the number of special rulings for certain fields. This issue is taken up later on.

In addition to the publication and updating, the Service apparently entitles subscribers to submit queries relating to the Service which the publishing house promises to handle efficiently. The reviewer, however, has no experience of the quality of this service or its effectiveness in practice.

Mr. Edwardes-Ker, who is well-known to the reviewer, is an English solicitor practising in Paris as an international tax adviser. He requires no introduction for the majority of the members of the International Fiscal Association, having contributed a number of articles to *European Taxation*, the *Financial Times*, the *Banker* and two other journals.

Mr. Edwardes-Ker's first book, the *International Tax Strategy Service*, won him great acclaim; Mr. Alun Davies — who is known as a none too benevolent reviewer — concluded his review by awarding Mr. Edwardes-Ker the medal: Distinguished Tax Writer, first class.

*(continued on page 477)*

# U.S.A.: Model Estate and Gift Tax Treaty

**The Treasury Department's revised model treaty released July 27, 1979**

CONVENTION BETWEEN
THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND
THE GOVERNMENT OF ....................
FOR THE AVOIDANCE OF DOUBLE TAXATION AND
THE PREVENTION OF FISCAL EVASION
WITH RESPECT TO TAXES ON ESTATES, INHERITANCES,
GIFTS, AND GENERATION-SKIPPING TRANSFERS

The Government of the United States of America and the Government of ....... ...................., desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances, gifts, and generation-skipping transfers, have agreed as follows:

**Article 1**
*Scope*

1. Except as otherwise provided in this Convention, this Convention shall apply to:
a) transfers of estates of individuals whose domicile at their death was in one or both of the Contracting States;
b) transfers of property by gift of donors whose domicile at the time of gift was in one or both of the Contracting States; and
c) generation-skipping transfers of deemed transferors whose domicile at the time of deemed transfer was in one or both of the Contracting States.

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

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

4. The provisions of paragraph 3 shall not affect:
a) the benefits conferred by a Contracting State under Articles 11 (Credits), 12 (Non-Discrimination), and 13 (Mutual Agreement Procedure); and
b) the benefits conferred by a Contracting State under Article 15 (Diplomatic Agents and Consular Officers) upon individuals who are neither citizens of, nor have permanent residence in, that State.

**Article 2**
*Taxes covered*

1. The taxes to which this Convention applies are:
a) In the United States: the Federal estate tax; the Federal gift tax; and the Federal tax on generation-skipping transfers.
b) In ...........: ...........
..............................
..............................

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

3. For the purpose of Article 12 (Non-Discrimination), this Convention shall also apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. For the purpose of Article 14 (Exchange of Information), this Convention shall also apply to taxes of every kind imposed by a Contracting State.

**Article 3**
*General definitions*

1. For the purpose of this Convention, unless the context otherwise requires:
a) the term "United States" means the United States of America and, where used in a geographical sense, includes any area outside the territorial sea of the United States which, in accordance with international law and the laws of the United States, has been or may hereafter be designated as an area within which the United States may exercise rights with respect to the exploration and exploitation of the natural resources of the seabed or its subsoil; the term "United States" does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession.
b) the term "......" means ......
...........................
c) the terms "Contracting State" and "the other Contracting State" mean the United States or ........... as the context requires.
d) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an industrial or commercial activity carried on by a domiciliary of a Contracting State and an industrial or commercial activity carried on by a domiciliary of the other Contracting State.
e) the term "international traffic" means any transport by a ship or aircraft, except where such transport is solely between places in a Contracting State.
f) the term "nationals" means:
   i) all individuals possessing the citizenship of a Contracting State;
   ii) all legal persons, partnerships, and associations deriving their status as such from the laws in force in a Contracting State.
g) the term "competent authority" means:
   i) in the United States: the Secretary of the Treasury or his delegate, and
   ii) in ...................
   ......................

2. As regards the application of this Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires and subject to the provisions of Article 13 (Mutual Agreement Procedure), have the meaning it has under the laws of that State concerning the taxes to which this Convention applies.

**Article 4**
*Fiscal domicile*

1. For the purposes of this Convention, an individual has a domicile:
a) in the United States, if he is a resident

or citizen thereof under United States law;

b) in .......... , if ..........
..........................

2. Where by reason of the provision of paragraph 1 an individual was domiciled in both Contracting States, then, subject to the provisions of paragraph 3, his status shall be determined as follows:

a) the individual shall be deemed to have been domiciled in the State in which he had a permanent home available; if such individual had a permanent home available in both States, he shall be deemed to have domiciled in the State with which his personal and economic relations were closer (center of vital interests);

b) if the State in which the individual's center of vital interests was closer cannot be determined, or if he had no permanent home available in either State, he shall be deemed to have been domiciled in the State in which he had an habitual abode;

c) if the individual had an habitual abode in both States or in neither of them, the domicile shall be deemed to be in the State of which he was a citizen;

d) if the individual was a citizen of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where an individual was

a) a citizen of one Contracting State, but not the other Contracting State,

b) within the meaning of paragraph 1 domiciled in both Contracting States, and

c) within the meaning of paragraph 1 domiciled in the other Contracting State in the aggregate less than 7 years (including periods of temporary absence) during the preceding 10-year period, then the domicile of that individual shall be deemed, notwithstanding the provisions of paragraph 2, to have been in the Contracting State of which the individual was a citizen.

4. An individual who, at the time of his death or the making of a gift or deemed transfer, was a resident of a possession of the United States and who had become a citizen of the United States solely by reason of (a) being a citizen of a possession, or (b) birth or residence within a possession, shall be considered as having been neither domiciled in nor a citizen of the United States at that time for the purposes of this Convention.

5. For the purposes of this Convention the question whether a person other than an individual was domiciled in a Contracting State shall be determined according to the law of that State. Where such person is determined to have been domiciled in both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement.

### Article 5
*Real property*

1. Transfers and deemed transfers of real property from an individual domiciled in a Contracting State may be taxed in that other State.

2. The term "real property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources; ships, boats, and aircraft shall not be regarded as real property.

### Article 6
*Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services*

1. Except for assets referred to in Articles 5 (Real property) and 7 (Ships and aircraft), transfers and deemed transfers of assets from an individual domiciled in a Contracting State, forming part of the business property of a permanent establishment situated in the other Contracting State, may be taxed in that other State.

2. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

3. The term "permanent establishment" shall include especially;

a) a branch;
b) an office;
c) a factory;
d) a workshop, and
e) a mine, oil or gas well, quarry, or any other place of extraction of natural resources.

4. A building site or construction or installation project, or an installation or drilling rig or ship being used for the exploration or development of natural resources, constitutes a permanent establishment in a Contracting State only if it has remained in that State more than 24 months.

5. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery.

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods of merchandise, or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e).

6. Notwithstanding the provisions of paragraphs 2 and 3, where a person — other than an agent of an Independent status to whom paragraph 7 applies — is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 5 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

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

8. Except for assets described in Articles 5 (Real property) and 7 (Ships and aircraft), transfers and deemed transfers of assets from an individual domiciled in a Contracting State, pertaining to a fixed base situated in the other Contracting State and used for the performance of independent personal services, may be taxed in that other State.

### Article 7
*Ships and aircraft*

Notwithstanding Article 6 (Business property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal

Services), transfers and deemed transfers of ships and aircraft operated in international traffic from a domiciliary of a Contracting State, and of movable property pertaining to the operation of such ships and aircraft, including containers, shall be taxable only in that State.

### Article 8
*Interest in partnerships*

Transfers and deemed transfers, from a domiciliary of a Contracting State, of an interest in a partnership which owns property covered by Articles 5 (Real property) or 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services) situated in the other Contracting State may be taxed in that other State,but only to the extent that the value of such interest is attributable to such property.

### Article 9
*Property not expressly mentioned*

Transfers and deemed transfers of property other than property referred to in Articles 5 (Real property), 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services), 7 (Ships and aircraft), and 8 (Interests in partnerships), from a domiciliary of a Contracting State, shall be taxable only in that State.

### Article 10
*Deductions and exemptions*

1. Debts that would be deductible according to the internal law of a Contracting State shall be deducted from the gross value of the property the transfer of which may be taxed by that State in the proportion that such gross value bears to the gross value of the entire transferred property wherever situated.

2. The value of property transferred which may be taxed by a Contracting State shall be reduced by the amount of any debts of the transferor or deemed transferor assumed by the transferee or deemed transferee, other than debts allowed as a deduction under paragraph 1.

3. The transfer or deemed transfer of property to or for the use of a corporation or organization of one Contracting State organized and operated exclusively for religious, charitable, scientific, literary or educational purposes shall be exempt from tax by the other Contracting State, if and to the extent that such transfer

a) is exempt from tax on the first-mentioned Contracting State; and

b) would be exempt from tax in the other Contracting State if it were made to a similar corporation or organization of that other State.

4. The tax of a Contracting State with respect to the transfer of property (other than community property) which is transferred from a domiciliary or citizen of the other Contracting State to his or her spouse shall be determined as follows:

a) in the case of tax imposed by . . . . . , such property shall be included in the taxable base only to the extent that the value of the property exceeds 50 percent of the value of all property (after taking into account any applicable deductions) whose transfer may, under this Convention, be taxed by . . . . . . . . . . . . . . . . . . . . . . ;

b) in the case of tax imposed by the United States, the tax shall be limited to the amount of tax that would have been imposed if the transferor were a domiciliary of the United States.

5. Where a Contracting State may tax the transfer of an estate solely by reason of Articles 5 (Real property), 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services), or 8 (Interests in partnerships), that State shall allow a credit against its tax, in addition to any other credits that may be allowed under Article 11 (Credits), in an amount no less than $3,600, or shall allow an equivalent exemption in computing the tax otherwise due.

### Article 11
*Credits*

1. Where the United States imposes tax by reason of an individual's domicile therein or citizenship thereof, double taxation shall be avoided in the following manner:

a) where . . . . . . . . . . . . . imposes tax with respect to a transfer or deemed transfer of property in accordance with Articles 5 (Real property), 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services), or 8 (Interests in partnerships), the United States shall allow as a credit against the tax calculated according to its law with respect to such transfer or deemed transfer an amount equal to the tax paid to . . . . . . . . . . with respect to such transfer or deemed transfer.

b) if the individual was a citizen of the United States and was domiciled in . . . . . . . . . . . . . . at the date of his death, gift, or deemed transfer, then the United States shall allow as a credit against the tax calculated according to its law with respect to the transfer or deemed transfer of property (other than property whose transfer or deemed transfer the Unites States may tax in accordance with Articles 5 (Real property), 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services), or 8 (Interests in partnerships), an amount equal to the tax paid to . . . . . . . . . . . with respect to such transfer or deemed transfer. This subparagraph shall not apply to a former United States citizen whose loss of citizenship had as one of its principal purposes the avoidance of United States tax (including, for this purpose, income tax).

2. Where . . . . . . . imposes tax by reason of an individual's domicile therein or citizenship thereof, double taxation shall be avoided in the following manner:

a) where the United States imposes tax with respect to the transfer or deemed transfer of property in accordance with Articles 5 (Real property), 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services), or 8 (Interests in partnerhsips), . . . . . . . shall allow as a credit against the tax calculated according to its law with respect to such transfer or deemed transfer an amount equal to the tax paid to the United States with respect to such transfer or deemed transfer.

b) if the individual was domiciled in the United States at the date of his death, gift, or deemed transfer, then . . . . . . shall allow as a credit against the tax calculated according to its law with respect to the transfer or deemed transfer of property (other than property which . . . . . . . . . . may tax in accordance with Articles 5 (Real property), 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services), or 8 (Interests in partnerships)), an amount equal to the amount of the tax paid to the United States with respect to such transfer or deemed transfer.

3. If a Contracting State imposes tax upon the transfer of an estate, the credit allowed by paragraph 1 or 2 shall include credit for any tax imposed by the other Contracting State upon a prior gift of property made by, or a prior generation-skipping transfer of property deemed made by, the decedent, if the transfer of such property is subject to tax on the transfer of the estate imposed by the first-mentioned State.

4. The credit allowed by a Contracting State under paragraph 1 or 2 shall not be reduced by any credit allowed by the other Contracting State for taxes paid upon prior transfers or deemed transfers.

5. The credit allowed by a Contracting

State according to the provisions of paragraphs 1, 2, 3 and 4 shall include credit for taxes paid to political subdivisions of the other Contracting State to the extent that such taxes are allowed as credits by that other State.

6. Any credit allowed under paragraphs 1 and 2 shall not exceed the part of the tax of a Contracting State, as computed before the credit is given, which is attributable to the transfer or deemed transfer of property in respect of which a credit is allowable under such paragraphs.

7. Any claim for credit or for refund of tax founded on the provisions of this Article may be made until two years after the final determination (administrative or judicial) and payment of tax for which any credit under this Article is claimed, provided that the determination and payment are made within ten years of the date of death, gift, or deemed transfer. The competent authorities may by mutual agreement extend the ten year time limit if circumstances prevent the determination within such period of the taxes which are the subject of the claim for credit. Any refund based solely on the provisions of this Convention shall be made without payment of interest on the amount so refunded.

### Article 12
*Non-discrimination*

1. Citizens of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which citizens of that other State in the same circumstances are or may be subjected. This provision shall also apply to persons who are not domiciliaries of a Contracting State. However, for purposes of United States taxation of transfers and deemed transfers, United States citizens not domiciled in the United States are not in the same circumstances as citizens of .......... not domiciled in the United States.

2. The taxation with respect to a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied with respect to enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

4. The provisions of this Article shall apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

### Article 13
*Mutual agreement procedure*

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic laws of those States, present his case to the competent authority of the Contracting State of which he is a resident or national. Such presentation must be made within one year after a claim, under this Convention, for exemption, credit, or refund has been finally settled or rejected.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

5. The competent authorities of the Contracting States may prescribe regulations to carry out the purposes of this Convention.

### Article 14
*Exchange of information*

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning the taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; or
c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

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

4. For the purpose of this Article, this Convention shall apply to taxes of every kind imposed by a Contracting State.

### Article 15
*Diplomatic agents and consular officers*

1. Nothing in this Convention shall affect the fiscal privileges of diplomatic agents

or consular officers under the general rules of international law or under the provisions of special agreements.

2. This Convention shall not apply to officials of international organizations or members of a diplomatic or consular mission of a third State, who were established in a Contracting State and were not treated as being domiciled in either Contracting State in respect of taxes on estates, inheritances, gifts, or generation-skipping transfers as the case may be.

**Article 16**
*Entry into force*

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

2. This Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall apply to transfers of estates of individuals dying, gifts made, and generation-skipping transfers deemed made on or after the date of such exchange.

**Article 17**
*Termination*

This convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention at any time after 5 years from the date on which this Convention enters into force provided that at least 6 months' prior notice of termination has been given through diplomatic channels. In such event, the Convention shall have no effect in respect of transfers of estates of individuals dying, gifts made, and deemed transfers occurring after the December 31 next following the date of termination specified in the notice of termination.

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

For the United States of America:

(Seal) . . . . . . . . . . . . . . . . . . . . . . . .

For

(Seal) . . . . . . . . . . . . . . . . . . . . . . . .

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## BOOK REVIEW

*(continued from page 472)*

In his introduction, Mr. Edwardes-Ker explains that the major reason for writing such a service was that in advising on the precise meaning of a tax treaty provision, he found that all too often in the past, only the opaque treaty text was available for study. Materials relevant to its interpretation could only be researched at prohibitive cost and inconvenience. He felt that a practical guide to the interpretation and use of double tax treaties was needed.

Fortunately the reviewer has not been left quite so high and dry; in Germany we have a commentary of long standing on German Tax Treaties (Korn-Dietz, Doppelbesteuerung, Beck'sche Steuerkommentare München) and a handbook on the United States—German Tax Convention published by the International Bureau of Fiscal Documentation with an introduction to and a good explanation of the treaty terms.

In addition thereto, publications and articles on various terms of the Model Tax Treaty are becoming more and more numerous and sometimes can hardly be covered in their entirety by the Tax Counsel in his own particular country.

The editor and his team of tax specialists have done a splendid job in collecting this material and putting it in such good order. No comparable publication is available which enables the tax specialist in one country to look over the proverbial border and judge the development of these particular problems in another country perhaps thereby gaining interesting thoughts and inspiration for the solution of the particular problem in his own country. This is a great merit of this Service and the editor's achievement should be acclaimed and recognised with gratitude.

On the other hand, I must add "two bitter drops to the cup of joy".

It is difficult, even for an author so well informed, to keep abreast of all publications and have this information published and included in the Service so that the reader may be equally fully informed on latest developments.

Permit me to take an example from the editorial comment on Article 9. It is stated that a solution providing for compulsory arbitration was recommended by the EEC Commission in Article 3(1) of its November 25, 1976 "Associated Enterprises" draft directive. This must be amended immediately in the updating material with the information that this proposal unfortunately is "dead" and has no chance of being acted upon by the Council of the EEC in the foreseeable future. However the Directive on the Exchange of Information which was supposed to be a package deal with the former proposal was issued as a Directive on December 19, 1977. A certain weakness of any loose-leaf service is the difficulty of updating in a fast and efficient manner and I have not found any reference to the above case in the two updates mentioned earlier.

Mention must be made of the author's warning that any such service may convey to the reader the illusion that he has the complete material at hand and does not need to go to the specific country or tax specialist there concerned. Although I cannot cite an example where the material is incomplete, the danger does exist that an import ruling, for instance in a certain specialised area, is overlooked. Therefore, it should be made clear to the user of this Service that whilst every effort has been made to collect all pertinent data and decisions, a full guarantee cannot be given and there will always be some particular problem which may and can only be advised upon by competent counsel in the country in question. This comment is not made in order to promote the practice of the reviewer but to cause the limitations of such a service to be considered objectively.

Dr. Jakob Strobl, of
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# Renouncing of U.S. Citizenship for Tax Reasons

## TAX TREATY DOES NOT HELP*

### I. GENERAL EXPLANATION

The provisions of Section 877 of the Code apply to tax gross income, as defined in Section 872(a), of an individual who becomes a resident of a foreign country and renounces U.S. citizenship to avoid U.S. income tax, even though the income tax treaty between the U.S. and the foreign country does not specifically preserve the right of the U.S. to tax under Section 877.

### II. ISSUE

Are the provisions of Section 877 of the Internal Revenue Code of 1954 applicable to tax gross income (as defined in Section 872(a) of the Code) of an expatriate who becomes a resident of a country where the income tax treaty between the United States and such country does not specifically preserve the right of the United States to tax under Section 877?

### III. THE FACTS

Taxpayer was born in country X, immigrated to the United States and became a naturalized American citizen. Taxpayer, who files a federal income tax return on a calendar year basis, is the sole shareholder of corporation Y, a domestic corporation. On April 4, 1977, corporation Y adopted a plan of complete liquidation under which its liquidation was to be completed by April 3, 1978.

Taxpayer left the United States on March 30, 1978, and arrived in country X the next day with the intention of permanently residing in country X. On April 2, 1978, taxpayer voluntarily renounced United States citizenship. One of taxpayer's principal purposes for renouncing United States citizenship was to avoid United States income tax on the capital gain from the proceeds of corporation Y's liquidation. Taxpayer received the liquidation proceeds on April 3, 1978.

The income tax treaty between the United States and country X exempts from United States tax a capital gain received from sources within the United States by a resident of country X who was present in the United States for a period or periods not exceeding a total of 183 days during the taxable year. Such treaty does not specifically preserve the right of the United States to tax under Section 877 of the Code. However, the tax treaty does provide that each country, notwithstanding any other provision of the treaty, in determining the taxes of its citizens or residents may include in the basis upon which such taxes are imposed all items of income taxable under its revenue laws as though the treaty had not come into effect ("saving clause").

### IV. LAW AND ANALYSIS

Section 877(a) provides, with certain exceptions not material here, that every non-resident individual who at any time after March 8, 1965, and within the 10 year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of federal income, estate or gift taxes, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this Section, is imposed pursuant to Section 871.

Section 877(b) provides, in part, that a non-resident alien individual described in subsection (a) shall be taxable for the taxable year as provided in Section 1, 402(e)(1), or Section 1201(b), except that the gross income shall include only the gross income described in Section 872(a).

Section 872(a) of the Code provides that in the case of a non-resident alien individual, gross income includes only—

(1) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and

(2) gross income which is effectively connected with the conduct of a trade or business within the United States.

Section 871(a) of the Code provides a tax of 30 percent on income not connected with a United States business. Section 871(a)(2) of the Code provides, in part, that in the case of a non-resident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year, there is imposed for such year a tax of 30 percent of the amount by which gains, derived from sources within the United States, from the sale or exchange at any time during such year of capital assets exceed losses, allocable to sources within the United States, from the sale or exchange at any time during such year of capital assets.

The taxpayer's gain on corporation Y's distribution is excluded from tax under Section 871(a)(2) of the Code because the taxpayer was not present within the United States for 183 days or more during the 1978 taxable year. However, in light of the fact that one of the taxpayer's principal reasons for expatriation included the avoidance of federal income tax, the provisions of Section 877 are applicable to tax the capital gain on the corporate liquidation, unless such transaction is exempted from United States taxation under the income tax treaty between the United States and country X. Although the treaty contains a clause similar to the provisions of Section 871(a)(2) regarding United States taxation of capital gains, such provision is subject to the treaty "saving clause" reserving the right of the United States to tax its citizens as though the treaty had not come into effect. This aspect of the saving clause is intended to preserve, with certain specific exceptions, United States taxation on the basis of citizenship, notwithstanding the limitations on United States taxation otherwise imposed by the treaty. Taxation under Section 877 is a manifestation of United States taxation on the basis of citizenship: in effect, the section imposes income tax liability, by reason of citizenship, for ten years following a tax motivated expatriation. Consequently, the income tax treaty does not exempt from United States taxation taxpayer's capital gain in the liquidation proceeds because by virtue of Section 877 the taxpayer remains subject to tax as a United States citizen within the meaning of the treaty "saving clause."

This interpretation is in agreement with the legislative intent of Section 877 of the Code which "... was enacted to forestall tax-motivated expatriation". See Kronenberg v. Commissioner, 64 T.C. 428, 434 (1975), in which Section 877 was held applicable by the court to tax United States source capital gains received by a Swiss resident and citizen who had just previously renounced United States citizenship. The legislative intent underlying Section 877 would be defeated with regard to United States citizens who, to avoid paying United States tax on gross income as defined in Section 872(a) of the Code, expatriated and adopted residence in a country whose income tax treaty with the United States does not specifically preserve the right of the United States to tax under Section 877.

### V. HOLDING

The provisions of Section 877 of the Code are applicable to tax gross income (as defined in Section 872(a) of the Code) of an expatriate who, for United States income tax avoidance purposes, becomes a resident of a country where the income tax treaty between the United States and such country does not specifically preserve the right of the United States to tax under Section 877, if the Section 877 tax exceeds the tax otherwise imposed pursuant to Section 871. Thus, the taxpayer in the subject case is taxable under Section 877 on the capital gain from the proceeds of corporation Y's liquidation.

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* Revenue Ruling 79-152, IRB 1979-20 at 14.

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# CUMULATIVE INDEX 1979 ~ Nos. 1-9

# Contents

of the November 1979 issue

# Tax Inspectors Discuss Tax Evasion

A two-day meeting on tax evasion, bringing together over 60 tax auditors and inspectors from 21 OECD Member countries, to discuss detection of false invoicing and ways in which income is transferred abroad to evade tax, has just been concluded. This is the latest in a regular series of meetings organised, by OECD's Committee on Fiscal Affairs.

The discussions concerned the technical problems involved in detecting tax evasion and were based on audit experiences in relation to actual cases, without disclosing the identity of the taxpayers concerned.

Among topics discussed at previous meetings were the way in which cases are selected for audit and methods of detecting tax evasion among traders.

OECD is the main forum where tax officials from different industrialised countries, actually working in the field, exchange views and experiences on tax evasion.

OECD Press Release, October 19, 1979

# TAX CHANGES IN SINGAPORE

## The Income Tax (Amendment) Act, 1979

by Lee Fook Hong, FCIS, FAIA

### INTRODUCTION

The Income Tax (Amendment) Act, 1979 was passed by the Parliament of the Republic of Singapore on March 30, 1979 and assented to by the President on April 7, 1979. It was published in the Government Gazette Act Supplement No. 7 dated April 16, 1979, on which date it became operative.

The Income Tax (Amendment) Act, 1979 seeks to implement the various tax changes announced in the 1978 and 1979 Budget Statements.

The major tax changes effected by the Income Tax (Amendment) Act, 1979 are summarised below:

**Contents**



1. Reduction in rates of tax applicable to individuals and Hindu Joint families (w.e.f.[1] Year of Assessment 1978). The rates applicable to clubs, associations and societies remain unchanged, i.e. 6 percent on the first $2,500 and 55 percent on chargeable income exceeding $100,000.
2. The marginal rate of tax on repatriated profits to be subject to a maximum of 40 percent (w.e.f. Year of Assessment 1978).
3. Extension of the ambit of Section 43A (w.e.f. Year of Assessment 1978). The existing Section 43A authorities the Minister to prescribe a concessionary rate of tax for income derived by approved Asian Currency Units of financial institutions. The new Section 43A provides greater flexibility in the Minister's authority to prescribe the income of an approved Asian Currency Unit to qualify for the concessionary rate of tax.
4. Concessionary rate of tax for income derived by an insurance company from carrying on the business of reinsuring risks outside Singapore (w.e.f. Year of Assessment 1979).
5. Exemption of tax on dividends, in the hands of shareholders, by financial institutions or insurance companies out of income which qualifies for the concessionary rate of tax as prescribed by the Minister (w.e.f. Year of Assessment 1979).
6. Double deduction of operational expenditure incurred:
   (i) in approved overseas trade fairs, exhibitions, trade missions, etc. (previously limited to manufacturers but now extended to banks and traders);
   (ii) by a manufacturer incurred while participating in approved local trade fairs and exhibitions;
   (iii) in maintaining an approved overseas trade office set up exclusively for promoting exports of Singapore manufactured goods.
7. Accelerated depreciation allowances for industrial buildings (w.e.f. Year of Assessment 1979).
8. Increase in annual allowances for industrial buildings in use for the purposes of a trade in intensive pig and poultry production (w.e.f. Year of Assessment 1979).
9. Deduction for expenses and depreciation allowances for motor cars restricted to cars registered as business service passenger vehicles (w.e.f. Year of Assessment 1979).

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1. With effect from.

10. Withholding tax before payment of remuneration to a company director not resident in Singapore (w.e.f. Year of Assessment 1979).
11. Company with accumulated losses precluded from setting off such losses against dividend income received from an associated company (w.e.f. Year of Assessment 1979).

Below are some brief notes on the amendments to the various sections and the respective dates on which such amendments shall have effect.

| | | |
|---|---|---|
| 1. | Section 13B | Effective from Year of Assessment 1979 |

## EXEMPTION OF CERTAIN DIVIDENDS PAID BY FINANCIAL INSTITUTIONS AND INSURANCE COMPANIES

The new Section 13B provides for an exemption from tax for dividends declared by a financial institution or an insurance company from income which is subject to tax at the concessionary rate of 10 percent by the Minister. The effect is that the concessionary rate of tax imposed on such income is the final tax and no further tax is payable by the shareholders on the dividends.

Two points are worthy of attention. The 10 percent concessionary tax paid does not form part of the tax credit under Section 44(3) available for franking dividends. [2] Only the net income after the payment of the 10 percent concessionary tax, i.e. the remaining 90 percent, is available for payment of dividends which are exempt from tax. These provisions are effective from the Year of Assessment 1979 based on income for the year ended December 31, 1978.

| | | |
|---|---|---|
| 2. | Section 14 (l)(e) | Effective dates July 1, 1977 and July 1, 1978 |

## CENTRAL PROVIDENT FUND CONTRIBUTIONS

The proviso to Section 14(l)(e) is amended to provide for the maximum relief allowable to an employer for CPF contributions for an employee which is increased in accordance with the increases in the rates of CPF contributions in 1977 and 1978. The maximum relief in respect of CPF contributions by an employer in respect of an employee is as follows:

| | | |
|---|---|---|
| (a) before July 1, 1977 | — | not exceeding 15 percent of an employee's emoluments |
| (b) commencing on or after July 1, 1977 and before July 1, 1978 | — | not exceeding 15½ percent of an employee's emoluments |
| (c) commencing on or after July 1, 1978 | — | not exceeding 16½ percent of an employee's emoluments |

| | | |
|---|---|---|
| | | Effective from |
| 3. | Section 14(3) | Year of Assessment 1979 |
| | Section 15(j) | Year of Assessment 1979 |
| | Section 19(2D) | Year of Assessment 1980 |

## RESTRICTION ON CAR EXPENSES AND CAPITAL ALLOWANCES ON CARS

The effect of the new Section 14(3) introduced by the 1979 Amendment Act is that, from the Year of Assessment 1979, the restriction on motor car expenses will apply not only to motor cars directly owned by taxpayers but also to motor cars owned by any other person, i.e. an employee or a car leasing company. Consequently, expenses incurred for a motor car leased from a leasing company, or reimbursement of expenses incurred by an employee for the employee's car which is partly used in the employer's business, will also be subject to the restriction imposed by the new provisions.

For proper tax planning purposes, taxpayers should ascertain from the leasing company or the employee concerned the cost of the car for which expenses are claimed for tax deductions when calculating the correct proportion of restriction.

The new Section 15(j) prohibits a claim for a deduction under Section 14 for any motor car expenses *incurred after April 1, 1979* irrespective of whether they are direct expenses or reimbursements, unless the motor car is registered as a business service passenger vehicle (i.e. under "Q" registration) and irrespective of the ownership of the motor car.

Similarly, the new Section 19(2D) disallows, from the Year of Assessment 1980, any capital allowances for any motor car which is not registered as a business service passenger vehicle.

The Motor Vehicles (Registration and Licensing) (Amendment) Rules, 1979 were published in the Government Gazette Subsidiary Legislation Supplement No. 15 on April 2, 1979 and came into operation on the same date. The definition of "business service passenger vehicle" has since been amended to mean a motor car registered in the name of:

(a) a statutory board, company, firm, society, association or club and used for the owners' business; or
(b) an individual and used for the purposes of any trade, business, profession or vocation, but does not include a motor car used:
    (i) for the carriage of goods other than samples;
    (ii) for the carriage of passengers for hire or reward; or
    (iii) for instructional purposes for reward.

---

2. *Editor's note:* There is no "economic double taxation of company income under Singapore tax law. Companies may deduct from their dividend distributions 40 percent income tax. The tax so deducted is compared with the income tax (also 40 percent) due by the company. Any balance in favour of the company is carried over to the next year and any balance in favour of the Government is collected by it.

hus an individual who uses his motor car for purposes f any trade, business, profession or vocation may, as of pril 2, 1979, register his motor car as a business service assenger vehicle.

ompany cars which at present are not registered as usiness service passenger vehicles under "Q" registra-ion may, under the amended registration and licensing ules, re-register such motor cars owned by the Com-any under "Q" registration so as to qualify for a tax eduction for car expenses and capital allowances on uch cars.

n view of the aforesaid amendments, taxpayers may ave to consider whether it is beneficial to re-register ighly-priced motor cars under the "Q" registration. o decide whether re-registration is advantageous clients re advised to compare:

a) the income tax saved by claiming the restricted deductions for car expenses and the restricted capital allowances for cars under "Q" registration with
b) the increased additional registration fee, the high road tax and the double charge for entering into the Central Business District in the morning.

**4. Section 14B** — **Effective dates June 4, 1977, September 13, 1977, January 1, 1978**

## URTHER DEDUCTION FOR EXPENSES ELATING TO APPROVED TRADE FAIRS, ETC.

he existing Section 14B of the Act is repealed and -enacted so as to extend the benefit of the provision r a double deduction of the expenses relating to pproved overseas trade fairs, exhibitions and trade issions. Before the amendment only manufacturers ere eligible to claim double deduction under this ection. Under the amended Section 14B, a trader or ank may also qualify for the double deduction claim.

owever, the new Section 14B provides, as before, that e person, i.e. a manufacturer, a trader or a bank, igible to make such a claim for double deduction must e a person resident in Singapore or having a permanent stablishment in Singapore. The expenses claimed must e for the purposes of promoting the export of Singa-ore manufactured goods.

he new Section also provides that a manufacturer is ntitled to claim a double deduction when he has in-urred expenses for participating in an approved local ade fair or exhibition.

person who has incurred expenses in maintaining an pproved overseas trade office established exclusively r the purposes of promoting the export of Singapore anufactured goods is also eligible to claim a double eduction for such expenses so incurred by him. How-ver, companies which are granted export enterprise centives under the Economic Expansion Incentives Relief from Income Tax) Act (Chapter 135) do not ualify for a double deduction under Section 14B of e Income Tax Act.

Below is a summary of the types of eligible persons and qualifying expenses for double deduction under the new Section 14B with the respective effective dates:

**Before the amendment**

a. Eligible persons: Manufacturers
b. Qualifying expenses: Approved overseas trade fair, exhibition or trade mission.
c. Effective date: April 1, 1973
d. Restrictions: Expenses allowable under Section 14: travelling, accommodation and subsistence expenses or allowances for only two employees participating in the approved trade fair, exhibition or mission.

**After the amendment**

I.
a. Eligible persons: (i) Manufacturers (ii) Traders (iii) Banks
b. Qualifying expenses: Approved overseas trade fair, exhibition or trade mission.
c. Effective date: June 4, 1977
d. Restrictions: Expenses allowable under Section 14: travelling, accommodation and subsistence expenses or allowances for only two employees participating in the approved trade fair, exhibition or mission.

II.
a. Eligible persons: Manufacturers
b. Qualifying expenses: Approved *local* trade fair or exhibition.
c. Effective date: September 13, 1977
d. Restrictions: If export sales (B) do not exceed 50 percent of total sales (C) the qualifying expenses (A) will be apportioned in the ratio of:

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

A = Expenses incurred
B = Export Sales
C = Total Sales

III.
a. Eligible persons: (i) Manufacturers (ii) Exporters
b. Qualifying expenses: Approved overseas trade office established exclusively for purposes of promoting the export of Singapore manufactured goods in a country where the company does not have a permanent establishment which is subject to tax in that country.

c. Effective date: January 1, 1978

d. Restrictions:
(i) Remuneration, travelling, accommodation and subsistence expenses or allowances for only three employees for the approved overseas trade office.
(ii) Expenses for the first two years only.

**5. Section 16** — **Effective from Year of Assessment 1979**

## INDUSTRIAL BUILDING ALLOWANCES

Section 16 of the Income Tax Act has been amended so as to increase the amount of initial and annual allowances to be granted for industrial buildings or structures. Increases which are effective from the Year of Assessment 1979 are as follows:

(a) The rate of initial allowances has been increase from 10 to 25 percent; and
(b) The rate of annual allowances has been increase from 2 to 3 percent of the qualifying expenditure incurred.

Under the amended Section 16, a person who purchase an unused industrial building or structure including th purchase of a leasehold interest therein of not less tha 25 years will also be eligible for an initial allowanc provided:

(a) he acquires the building or structure or interes therein from the person who constructed th building or structure; and
(b) no initial allowance had previously been granted i respect of the building or structure.

Below is a summary of the changes under this Section

| | Buildings constructed by claimant | | Buildings purchased from persons who constructed & who had not claimed initial allowances | | Conditions |
|---|---|---|---|---|---|
| | Present rate | New rate | Present rate | New rate | |
| Initial allowance | 10% | 25% | (not granted before the Amendment) | 25% on the cost of construction of the building, or the net price paid for the building, whichever is less. | If the building is built on leasehold land, the lease must be not less than 25 years and no initial allowance has been previously claimed by any other person for the same building. |
| Annual allowance | | | | | |
| Buildings in use for: | | | based on the residue of expenditure and the age of the building. | Based on the residue of expenditure and the age of the building *or* 3% of the residue of expenditure, whichever is the greater. | |
| intensive pig & poultry production | 2% | 5% | | | |
| other qualifying trades | 2% | 3% | | | |

**6. Section 26** — **Effective from Year of Assessment 1979**

## INSURANCE COMPANIES

A new subsection (1A) of Section 26 has been introduced by the 1979 Amendment Act to provide that separate accounts must be maintained by an insurance company for income derived from carrying on the business (other than the business of life assurances) of reinsuring offshore risks. In ascertaining the gains or profits derived from such business, the following provisions apply:

(a) no income other than income from premiums, dividends and interest is included;
(b) dividends and interest are apportioned in such manner as may be prescribed by regulations;
(c) any expenditure not directly attributable to that

business is apportioned in such manner as may be prescribed by regulations.

A new subsection (5) is inserted by the Amendment Act to define "off-shore risks". "Off-shore risks" mean any risk outside Singapore, and in relation to:

*Facultative general insurance*

(i) the insured is not a resident or a permanent establishment in Singapore; and

(ii) the insurer who issues the original insurance policy is not a resident or a permanent establishment in Singapore;

and in relation to:

*Treaty general re-insurance*

(i) the insurer who issues the original insurance policy is not a resident or a permanent establishment in Singapore; and

(ii) not less than 75 percent of the total risk is outside Singapore.

If any of the above risks is in transit in Singapore, it is deemed to be outside Singapore.

| 7. Section 37A | Effective from Year of Assessment 1980 |
|---|---|

## RESTRICTION ON SET-OFF FOR TRADING LOSSES AGAINST DIVIDENDS

Under the new Section 37A, a company with accumulated losses is precluded from setting off such losses against dividend income received by such tax loss company from an associated company in order to obtain a tax benefit or advantage. However, the Comptroller may exercise his discretion to allow a deduction where he is satisfied that the object or one of the main objects of the declaration of dividends is not for the purpose of securing a tax benefit or advantage.

For the purposes of Section 37A, a company shall be deemed to be an associated company of a tax loss company if:

(i) in the case of a private company, at least 25 percent of its issued capital is beneficially owned directly or indirectly by the tax loss company ("private company" has the same meaning as in the Companies Act);

(ii) in the case of a public company, at least 50 percent of its issued capital is beneficially owned directly or indirectly by the loss company ("public company" has the same meaning as in the Companies Act);

(iii) where a loss company beneficially owns directly or indirectly a fraction of the issued capital of a second company which in turn beneficially owns directly or indirectly a fraction of the issued capital of a third company, the loss company shall be deemed to have a beneficial ownership of the issued capital of the third company equal to such fraction as results from the multiplication of those two fractions; and where the third company beneficially owns directly or indirectly a fraction of the issued capital of a fourth company, the loss company shall be deemed to have a beneficial ownership of the issued capital of the fourth company equal to such fraction as results from the multiplication of those three fractions, and so on.

For example, a tax loss company X holds 50 percent of the issued capital of a private company A which in turn owns 50 percent of the issued capital of another private company B. The beneficial interest which company X holds in company B is therefore

50 percent of 50 percent = 25 percent

Company B is therefore an associated company of Company X.

The anti-avoidance provision under Section 37A(1) does not apply:

(a) in respect of any loss incurred by the loss company after the end of its accounting period during which the relevant date occurs (i.e. during which the associated company first became an associated company of the tax loss company); and

(b) in respect of any dividends paid by the associated company out of the profits of the associated company derived after the end of the accounting period during which the relevant date occurs (i.e. during which it first became an associated company of the loss company).

"The relevant date" for the purposes of Section 37A means the date when the associated company first became an associated company of the loss company. The relevant date in the example mentioned above is the date on which company X acquires a 50 percent interest in company A, or the date on which company A acquires a 50 percent interest in company B, whichever is later.

| 8. Section 40 | Effective from Year of Assessment 1978 |
|---|---|

## NON-RESIDENT RELIEF

Section 40 has been amended so that in determining the non-resident relief, the existing tax rates in Part B of the new Second Schedule to the Income Tax Act will be used. This is but a technical amendment.

| 9. Section 42 | Effective from Year of Assessment 1978 |
|---|---|

## RATE OF TAX FOR INDIVIDUALS AND MAXIMUM RATE ON REMITTED INCOME

The 1979 Amendment Act repeals the existing Section 42 and the Second Schedule to the Act. A new Section 42 and a new Second Schedule are introduced so as to give effect to reduced personal income tax rates applicable to the income of an individual or a Hindu Joint Family (Appendix A).

The new rates of tax for individuals and Hindu Joint Families applicable from the Year of Assessment 1978 are now enacted as Part A of the Second Schedule to the Income Tax Act. The old tax rates applicable for Year of Assessment 1977 are retained as Part B of the new Second Schedule. These old rates still apply to:

(a) non-residents who are Singapore citizens claiming non-resident relief under Section 40; and
(b) clubs, associations and societies (Appendix B).

The maximum rate of tax now applicable to foreign income received in Singapore from outside Singapore by a resident individual or a Hindu Joint Family is limited to 40 percent.

**10. Section 43A** — **Effective from Year of Assessment 1978**

## FINANCIAL INSTITUTIONS – CONCESSIONARY RATE OF TAX FOR SPECIFIED ACU INCOME

Section 43A has been re-enacted, in amended form, to empower the Minister to provide, by regulations, greater flexibility in specifying the types of income derived by approved Asian Currency Units which may enjoy the concessionary tax rate of 10 percent or such other concessionary rate as the Minister may prescribe.

**11. Section 43C** — **Effective from Year of Assessment 1978**

## INSURANCE COMPANIES – CONCESSIONARY RATE OF TAX FOR INCOME FROM OFF-SHORE RE-INSURANCE RISKS

The new Section 43C enables the Minister to provide a concessionary tax rate of 10 percent for income derived by an insurance company (other than a life insurance company) from carrying on the business of re-insuring risks outside Singapore. Under this Section, the Minister has issued The Income Tax (Concessionary Rate of Tax for income from reinsuring offshore risks) Regulations, 1979.

These regulations were published in the Governmen Gazette Subsidiary Legislation Supplement No. 24 dated June 1, 1979.

**12. Section 45B** — **Effective from April 16, 1979**

## NON-RESIDENT DIRECTOR'S REMUNERATION

The new Section 45B extends the application of Sectio 45 of the Income Tax Act to the payment of remunera-tion by a company to any director of the company wh is not resident in Singapore. With effect from April 16 1979, a company is required to deduct tax at 40 percen before making payments of any remuneration to non-resident directors. The tax so deducted must be re-mitted to the Comptroller within seven days. This als applies to cases when remuneration is credited to th account of a non-resident director.

**13. Section 74** — **Repealed w.e.f. April 16, 1979**

## LIST OF PERSONS ASSESSED AND NOTICES OF ASSESSMENTS

Section 74 which requires the Comptroller to prepar lists of persons assessed to tax from notices of assess-ments is repealed.

**14. Section 79** — **Effective from Year of Assessment 1978**

## INCOME TAX APPEALS – OBJECTION TO THE CHAIRMAN OF THE BOARD OF REVIEW

Section 79 has been amended to ensure that no peremp-tory objection can be made to the Chairman of th Board of Review in the hearing of an income tax appeal.

See overleaf for appendices

## APPENDIX A

## REPUBLIC OF SINGAPORE – INCOME TAX TABLE SHOWING TAX ON CHARGEABLE INCOME PART A, SECOND SCHEDULE, INCOME TAX ACT (CHAPTER 141, 1970 EDITION)

| RESIDENT INDIVIDUALS | YEARS OF ASSESSMENT | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1961 to 1964 | | | 1965 | | | 1966 to 1977 | | | 1978 onwards | | |
| | $ | % | $ | $ | % | $ | $ | % | $ | $ | % | $ |
| On the first | 1,500 | 5 | 75 | 2,500 | 6 | 150 | 2,500 | 6 | 150 | 2,500 | 5 | 125 |
| On the next | 500 | 6 | 30 | 2,500 | 9 | 225 | 2,500 | 9 | 225 | 2,500 | 8 | 200 |
| On the first | 2,000 | | 105 | 5,000 | | 375 | 5,000 | | 375 | 5,000 | | 325 |
| On the next | 1,000 | 7 | 70 | 2,500 | 12 | 300 | 2,500 | 12 | 300 | 2,500 | 10 | 250 |
| On the first | 3,000 | | 175 | 7,500 | | 675 | 7,500 | | 675 | 7,500 | | 575 |
| On the next | 1,000 | 8 | 80 | 2,500 | 15 | 375 | 2,500 | 15 | 375 | 2,500 | 12 | 300 |
| On the first | 4,000 | | 255 | 10,000 | | 1,050 | 10,000 | | 1,050 | 10,000 | | 875 |
| On the next | 1,000 | 10 | 100 | 5,000 | 20 | 1,000 | 5,000 | 20 | 1,000 | 5,000 | 15 | 750 |
| On the first | 5,000 | | 355 | 15,000 | | 2,050 | 15,000 | | 2,050 | 15,000 | | 1,625 |
| On the next | 2,000 | 12 | 240 | 5,000 | 23 | 1,150 | 5,000 | 23 | 1,150 | 5,000 | 20 | 1,000 |
| On the first | 7,000 | | 595 | 20,000 | | 3,200 | 20,000 | | 3,200 | 20,000 | | 2,625 |
| On the next | 3,000 | 15 | 450 | 5,000 | 25 | 1,250 | 5,000 | 25 | 1,250 | 5,000 | 25 | 1,250 |
| On the first | 10,000 | | 1,045 | 25,000 | | 4,450 | 25,000 | | 4,450 | 25,000 | | 3,875 |
| On the next | 5,000 | 18 | 900 | 10,000 | 30 | 3,000 | 10,000 | 30 | 3,000 | 10,000 | 30 | 3,000 |
| On the first | 15,000 | | 1,945 | 35,000 | | 7,450 | 35,000 | | 7,450 | 35,000 | | 6,875 |
| On the next | 10,000 | 25 | 2,500 | 15,000 | 40 | 6,000 | 15,000 | 40 | 6,000 | 15,000 | 35 | 5,250 |
| On the first | 25,000 | | 4,445 | 50,000 | | 13,450 | 50,000 | | 13,450 | 50,000 | | 12,125 |
| On the next | 10,000 | 30 | 3,000 | | | | 50,000 | 50 | 25,000 | 50,000 | 40 | 20,000 |
| On the first | 35,000 | | 7,445 | | | | 100,000 | | 38,450 | 100,000 | | 32,125 |
| On the next | 15,000 | 40 | 6,000 | | | | | | | 100,000 | 45 | 45,000 |
| On the first | 50,000 | | 13,445 | | | | | | | 200,000 | | 77,125 |
| On the next | 50,000 | | 25,000 | | | | | | | 200,000 | 50 | 100,000 |
| | 100,000 | | 38,445 | | | | | | | 400,000 | | 177,125 |
| | Over $100,000 @ 55% | | | Over $50,000 @ 50% | | | Over $100,000 @ 55% | | | Over $400,000 @ 55% | | |

## APPENDIX B

## REPUBLIC OF SINGAPORE – INCOME TAX TABLE SHOWING TAX ON CHARGEABLE INCOME PART B, SECOND SCHEDULE, INCOME TAX ACT (CHAPTER 141, 1970 EDITION)

a. Non-residents who are Singapore citizens claiming non-resident relief under Section 40
b. Clubs, associations and societies

| | $ | % | $ |
|---|---|---|---|
| On the first | 2,500 | 6 | 150 |
| On the next | 2,500 | 9 | 225 |
| On the first | 5,000 | | 375 |
| On the next | 2,500 | 12 | 300 |
| On the first | 7,500 | | 675 |
| On the next | 2,500 | 15 | 375 |
| On the first | 10,000 | | 1,050 |
| On the next | 5,000 | 20 | 1,000 |
| On the first | 15,000 | | 2,050 |
| On the next | 5,000 | 23 | 1,150 |
| On the first | 20,000 | | 3,200 |
| On the next | 5,000 | 25 | 1,250 |
| On the first | 25,000 | | 4,450 |
| On the next | 10,000 | 30 | 3,000 |
| On the first | 35,000 | | 7,450 |
| On the next | 15,000 | 40 | 6,000 |
| On the first | 50,000 | | 13,450 |
| On the next | 50,000 | 50 | 25,000 |
| On the first | 100,000 | | 38,450 |
| | | Over $100,000 @ 55% | |

# TAXATION AND SAVINGS:
## Some New Empirical Evidence in the Indian Economy, 1960 - 1976

BY N.R. VASUDEVA MURTHY, Ph. D.*

## I. INTRODUCTION

The vital role of fiscal policy as a means of mobilizing savings to promote economic growth in a capital-scarce economy is of paramount significance. For a capital-scarce economy which aims at increasing its productive capacity, an increasing government or public sector saving ratio accelerates the rate of economic growth. The growth-accelerating role of government as a saver has been stressed by many economists and is accepted by a number of experts on planning. Heller [1], Kaldor [2], Kurihara [3], Ranis [4], and Reynolds [5] have, in a variety of ways, emphasized the fiscal role of the public sector in an underdeveloped economy's increasing appetite for maximum economic growth. Even Keynes, writing in a different context, highlights the role of the state as a saver. He contends that: "... in the event of the individual propensity to consume proving to be of such a character that net saving in conditions of full employment comes to an end before capital has become sufficiently abundant. But even so it will still be possible for communal saving through the agency of the state to be maintained at a level which will allow the growth of capital." [1]

The importance of government saving and the fiscal role of the state in economic development cannot be overemphasized. In the context of a mixed economy, Indian planning documents have seriously assigned a positive role to taxation to determine the course of economic growth. As is evident from Table 1.1 and the equations in Table 1.2, though the share of public sector (government) saving in net domestic saving has been declining over the period 1960-1976, it still forms a sizable proportion and ranks only behind the household sector. Hence, a study of public sector saving and the effect of taxation on over-all saving deserves special consideration.

The need for some estimates of public saving propensities for the areas of tax policy guidance and policies designed to increase the over-all saving propensity, in India, has stimulated some empirical studies. However, some of the existing studies in this area are addressed to different issues, for example Singh's cross-sectional investigations, whose usefulness to an economy with different economic and institutional structures may be questioned for policy formulations and guidance [6]. Time series studies on India by Thimmaiah [7, 8] that cover a relatively short period of annual observations (1960-73) are also not sufficient for policy formulation. Besides this, Thimmaiah includes in his empirical model such a large number of independent variables so that we are actually left with less degrees of freedom. [2] In this context, one wonders whether strong theoretical assertions and statements regarding hypotheses-testing

**TABLE 1.1**

**PUBLIC SECTOR SHARE IN NET DOMESTIC SAVING: INDIA**

| Years | Household Sector $\frac{Sh}{S}$ | Corporate Sector $\frac{Sc}{S}$ | Public Sector $\frac{Sg}{S}$ |
|---|---|---|---|
| 1960- 61 | 67.90 | 8.82 | 23.28 |
| 62 | 61.12 | 10.54 | 28.34 |
| 63 | 64.44 | 9.13 | 26.43 |
| 64 | 62.30 | 8.17 | 29.53 |
| 65 | 64.61 | 5.19 | 30.20 |
| 66 | 73.03 | 3.86 | 23.11 |
| 67 | 83.48 | 3.44 | 13.08 |
| 68 | 85.54 | 2.38 | 12.08 |
| 69 | 80.11 | 2.56 | 17.34 |
| 70 | 80.82 | 3.56 | 15.62 |
| 71 | 78.04 | 4.55 | 17.41 |
| 72 | 79.85 | 5.42 | 14.73 |
| 73 | 81.86 | 4.70 | 13.44 |
| 74 | 78.22 | 6.70 | 15.08 |
| 75 | 66.54 | 8.75 | 24.71 |
| 1975- 76 | 71.21 | 3.74 | 25.05 |

S = Net Domestic Saving.

*Source:* For Years 1961-70, Central Statistical Organization, National Income Statistics, October 1976, pp. 32-3. For the remaining period, Central Statistical Organization, National Income Statistics, January 1978, pp. 22-3. (In current prices).

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1. See Keynes [20].
2. The concept of "degrees of freedom" refers to the number of variables that can vary freely.

can in fact be made. Thimmaiah's findings should be viewed with some reservation for another econometric reason. Although he applies theoretical and statistical tests to evaluate his empirical results, he fails to apply an econometric test. He does not report the Durbin-Watson statistics. 3 It can be seen that he has in his models less than 15 observations; however, a serious minded econometrician can point out that if, indeed, the error terms are serially correlated, the efficiency of the ordinary least squares (OLS) estimators can be questioned. There might arise a tendency to reject the null-hypothesis, when, in fact, it should not be rejected. The strength of the present paper lies in using the extended and revised data on the variables used in this study. To this extent the nature and scope of this study is different from Krishnamurthi's [9].

The objectives of the present paper are the following:

(1) What is the relationship between an increase in taxes and the overall level of saving in the Indian economy during the sample period, 1960-76?
(2) What is the relationship between an increase in taxes and public sector saving in India over the period under econometric observation?

These objectives stem from the imminent need for the production of some estimates that show the public sector saving propensities which will assist in the areas of public policy gudidance and policies designed to step up the aggregate saving propensity.

## II. SPECIFICATION OF THE RELATIONS

In general, existing economic theory, earlier empirical studies, data constraints and the simplicity of the model heavily dictated the specification of the implied relations. In particular, the underlying relations are based on the specification presented by Landau [10] and further surveyed by Mikesell and Zinser [11] with some minor modifications by the author. In light of the above references, the following relations are specified:

$$S/Y = \alpha_0 + \alpha_1 \ (T/Y) + \varepsilon_1 \qquad [1.4]$$

$$Sg/Y = \beta_0 + \beta_1 \ (T/Y) + \varepsilon_2 \qquad [1.5]$$

$$S/Y = \gamma_0 + \gamma_1 \ (Yg/Y) + \varepsilon_3 \qquad [1.6]$$

Where
S = net domestic saving
Sg = tax revenue
Y = gross national product
Yg = public revenue

$\varepsilon_1$, $\varepsilon_2$ and $\varepsilon_3$ are the error terms. It is assumed that these error terms satisfy the classical least-squares assumptions. Further, it is assumed that error terms are not related across the relations specified in [1.4] through [1.6]. On this issue, see Zellner [12].

## III. DATA AND METHOD

In order to estimate the relations specified in the previous section, data on the relevant variables are gathered from two official sources. The most recent, revised and uniform data on net domestic savings, public sector savings, public revenue, tax revenue, and gross national product are from *National Income Statistics: 1970-76* (January 1978) and *National Income Statistics: 1960-75* (October 1976) published by the (Indian) Central Statistical Organization [13, 14]. In the present study public revenue is defined to include income from public sector entrepreneurship and property, direct taxes, indirect taxes and miscellaneous receipts. Tax revenue is an aggregate of both direct and indirect tax revenues. The data used in the analysis are considered as reliable [13, 15] and pertain to the sample period 1960-1976. The data are converted into 1970 prices by using the consumer price index given in the *International Financial Statistics: 1977 Supplement* (May 1977), published by the International Monetary Fund [16]. Annual time period is the time unit employed in this study. The ordinary least-squares (OLS) method is chosen as the estimating technique.

## IV. EMPIRICAL FINDINGS

This section presents the estimated results using OLS. Table 1.3 contains the statistical results. Here, t — values of the regression coefficients are shown in parentheses. The main focus of this study is on the estimated equations [1.7], [1.9] and [1.11]. Equation [1.8] can be treated as a supplementary regression. Equation [1.7]

**TABLE 1.2**

**LINEAR TREND MODEL: SECTORAL SAVING IN INDIA**

| Sectors | Equations |
|---|---|
| [1.1] Household Sector | $\frac{Sh}{S} = 66.62 + 0.83t$ (2.1); $R^2 = 0.23$ |
| [1.2] Corporate Sector | $\frac{Sc}{S} = 7.62 - 0.22t$ (1.7); $R^2 = 0.17$ |
| [1.3] Public Sector | $\frac{Sg}{S} = 25.77 - 0.61t$ (2.0); $R^2 = 0.21$ |

t — values are in parentheses.
s = domestic saving in current prices and t = time.
*Source:* Table 1.1

3. Durbin and Watson have suggested a test for the incidence of autocorrelation. Here autocorrelation refers to the relationship between the successive values of the same variables used to estimate a relation. For details, see J. Durbin and G.S. Watson, "Testing for Serial Correlation in Least-Squares Regression", *Biometrica*, 1950 and 51.

appears to be the preferred equation in terms of both statistical and econometric criteria. The regression coefficient of T/Y is of a considerable magnitude and appears to be statistically significant at the 1 percent level. Equation [1.7] with its significant regressor, a relatively high $R^2$ and absence of autocorrelation shows that an increase in the tax rate has a positive effect on the over all saving rate. Although this study cannot be compared strictly with other related studies, its results are consistent with some findings of Bhatia [17], Krishnamurthi [9], Morss [18], and Singh [19] which do not support the general contention of Stanley Please that "in several cases increased taxation may have led to reduced national saving". [4] The general findings of this study differ from those of Landau [10] and Thimmaiah [7, 8]. An examination of the supplemental regression contained in equation [1.8], although not corrected for autocorrelation, reveals that the rate of household saving increases with an increase in the tax rate. This positive significant relationship between the household savings rate and the tax rate in the Indian economy during the period under study appears somewhat paradoxical and requires more research work to be performed in the future. A similar observation on the relationship between taxation and private savings was made by Houthakker [21]. It is plausible that increased taxation might lead to a decrease in consumption. In underdeveloped economies, indirect taxation plays a vital role in the tax structure and economic development.

In equation [1.9] we find that an increase in public revenue induces an increase in overall saving rate in the economy. The regression coefficient in [1.9] is positive and of a considerable size. With its statistical significance at the 1 percent level, the variable, Yg/Y, explains about 60 percent of the total variation in the dependent variable S/Y. There is no evidence of autocorrelation in this equation.

In order to test whether government savings and taxation are related, equation [1.10] is estimated. Equation [1.10] shows poor statistical and econometric results. The presence of autocorrelation in equation [1.10] prohibits us from drawing any meaningful statistical inferences. Therefore, using the Theil-Nagar procedure [22], equation [1.11] is estimated. It is apparent from equation [1.11], which shows improvements in terms of t — value, $\bar{R}^2$ and DW, that the saving propensity on the part of the Indian public sector is significant and positive. This finding reveals that an increase in the tax rate results in an increase in the public sector saving rate, which might have a far reaching consequence on public sector capital formation.

## V. POLICY IMPLICATIONS AND CONCLUSION

The present study provides some statistical evidence for the hypothesis that in a developing economy like India, the government through its fiscal policy can play a key role in increasing both private and public capital formation. Through various regressions it is found in this study that in the Indian economy over the sample period, taxation and public revenue do exert some positive influence on both over-all savings and public sector savings. This empirical evidence, besides providing us with some insights into the nature and significance of taxation and public revenue, stresses the feasibility of taxation in mobilizing both public and household savings and thereafter capital formation for economic growth. The positive effect of taxation on savings, found in this paper, can be attributed to an improvement in the allocation of resources, factor proportion, distribution, and enhancement of the incentive and ability of various sectors of the economy to save more with the expectation of greater output in the future. One may even have to plunge into a study of some institutional factors that contribute to an increase in national saving. Finally it can be concluded that further sophisticated research using more relevant data is highly desirable in this field and only then can we make progress and propose remedies and policies. To close with the words of Henry Teil, "it is my conviction that substantial progress in economics requires the work of those who are willing and able to handle theory and data with equal sophistication. The marginal product of such a combined effort is bound to be greater than that of theoretical work without regard to data and that of data analysis without any effort to question the theory. [5]"

**TABLE 1.3**

**SAVINGS REGRESSIONS: INDIA 1961-76**

| | | |
|---|---|---|
| [1.7] | S/Y = −2.41 + 1.09 (T/Y)<br>(6.25)* | $\bar{R}^2$ = 0.72; $R^2$ = 0.74<br>DW = 1.50 ** |
| [1.8] | Sh/Y = −2.69 + 0.85(T/Y)<br>(3.89)* | $\bar{R}^2$ = 0.47; $R^2$ = 0.50<br>DW = 0.58 |
| [1.9] | S/Y = −3.51 + 1.04(Yg/Y)<br>(2.15)** | $\bar{R}^2$ = 0.60; $R^2$ = 0.63<br>DW = 1.28* |
| [1.10] | Sg/Y = 0.04 + 0.17(T/Y)<br>(1.48) | $\bar{R}^2$ = 0.07; $R^2$ = 0.13<br>DW = 0.61 |
| [1.11] | Sg/Y = 0.29 + 0.25(T/Y)<br>(2.42)** | $\bar{R}^2$ = 0.24; $R^2$ = 0.29<br>DW = 1.41 (Corrected)** |

*Note:* t — values are presented in the parentheses.
DW = Durbin-Watson statistic (* and ** show no autocorrelation at the 1% and 5% levels of significance).
* Indicates the significance at the 1% level.
** Indicates the significance at the 5% level.
Sh = household saving. For other symbols, see the text.
$\bar{R}^2$ = adjusted $R^2$; strictly speaking there is no need for the adjustment in the case of simple regression. For emphasis, $R^2$ is reported.
$R^2$ = coefficient of determination, i.e. $r^2$ which measures the proportion of the total variation in the dependent variable explained by the model.

4. Mikesell and Zinser, [11], p. 15 and Please [24].
5. See Friedman [23].

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# Nigeria: BUDGET 1979~80

## Extract of the Statement on the 1979~80 Budget

BY MAJOR-GENERAL J.J. OLULEYE,
FEDERAL COMMISSIONER FOR FINANCE

TABLE OF CONTENTS



1. I welcome you to this meeting which has been convened to enable me to elaborate on the important measures just announced by the Head of the Federal Military Government and Commander-in-Chief of the Armed Forces in his 1979-80 Budget Speech.

2. It was clear from his broadcast that the economy has by and large, responded positively so far to the measures announced last year, and that most economic indicators are showing favourable trends.

*Mr. Oluleye referred to the problem of inflation, which has been brought under control, as reflected in the downward trend of the prices of major food items and some consumer goods. He continued as follows:*

### I. FISCAL MEASURES

3. The over-riding consideration in this year's fiscal measures is the concurrent need to save foreign exchange by placing on import licence some of those goods that can be locally produced in adequate, or near adequate quantities, and to promote local employment. These measures are designed to further encourage the mobilisation of local resources to increase product in both industry and agriculture. The tariff rates have been carefully fixed to ensure that while locally produce goods are protected from cheap competing imports, the raw materials needed by local industries shall be admitted into the country at rates that would ensure moderate prices for the finished products so as to contain the pressures of inflation. The highlights of the measures are as follows:

### II. AGRICULTURE

4. You will recall that last year in order to encourage foreign investment in agriculture, government approved the re-scheduling of Agriculture Production and Processing from Schedule II to Schedule III of the Nigerian Enterprises Promotion Decree. In addition to this, Capital Allowance of 10 percent was allowed to companies engaged in agricultural production in respect of their expenditure on plant and equipment. Such companies could also carry forward their losses from year to year without the limitation which is normally placed for pioneer projects. In my view, these incentives should facilitate greater investment in agriculture. It is unfortunate that the response to these concessions has not been very encouraging. Government must however persist in promoting our agriculture and to this end, additional concessions have been approved in the 1979/80 fiscal year.

5. (a) *Machinery for Irrigation:* In many parts of the Federation, tremendous potential exists for raising agricultural production through irrigation. Already, machinery and equipment imported for use in agriculture can be imported duty-free by Approved Users. This dispensation has now been carried further to include irrigation machinery. I must however emphasize that this concession can only be enjoyed by Approved Users directly engaged in agriculture.

6. (b) *Fresh Fish and Shrimps (Live or Dead):* Fish caught and landed in Nigeria, by Nigerian-owned vessels registered in Nigeria and flying the Nigerian flag shall no longer be treated as imports subject to duty payment and remittance of foreign exchange. Instead they will be landed and cleared free of duty; by the same token, there will be no foreign exchange implications, except with regard to remittances for the purchase of the vessels.

7. When caught and landed by foreign vessels chartered by Nigerian companies, a 2k per kg. duty will be payable, while the charter fee for such vessels shall, for foreign exchange purposes, be deemed to be not more than 60 percent of the value of the landed fish. Fish landed by any other type of vessel shall attract 4k per kg. import duty. This arrangement is designed to encourage the development of an active local fishing industry.

### III. MANUFACTURING INDUSTRY

8. This year the Federal Military Government has carried still further its policy of encouraging local manufacturing through fiscal and physical protection. To this effect, a number of tariff measures have been approved, and these are to be found in the Extra-Ordinary Gazette dated 1st April, 1979. Some of the changes are as follows:

9. (i) *Local assembly of refrigerators:* The time has come to encourage a greater incorporation of locally manufactured parts in the assembly of imported components of foreign goods. A goods start has been made by some assemblers of refrigerators, and to underscore Government's desire that local parts should gradually replace the imported ones, it has been decided that C.K.D. (completely knocked down) Refrigerator components shall now be imported at 20 percent duty (instead of 5 percent), but that raw materials needed for the actual local manufacturing of the parts should be admitted at 5 percent duty. If some factories can endeavour to manufacture most of their parts, so should others; but a company that insists on assembly when adequate incentives for manufacturing exist should now do so at some cost. The duty differential will make it more attractive to manufacture the parts in Nigeria, and correspondingly, less lucrative to import all components from abroad.

(ii) *Plastic pipes:* The import duty has been increased from 20 percent to 33 1/3 percent to protect local manufacturers.

(iii) *Tubes and pipes of cast iron or steel:* The protective import duty has been raised from $33^1/_3$ percent to 40 percent.
(iv) *Flat galvanized iron sheets:* To protect local manufacturers of corrugated, galvanized roofing sheets, the duty on flat sheets has been raised from 10 percent to 20 percent.
(v) *Fabricated steel/aluminium structures:* The protective duty of 25 percent has been found inadequate and has been raised to 30 percent.
(vi) *Recorded tapes (excluding master tapes):* In order to discourage unnecessarily large imports, and partly to bring the rate of duty in line with that from grammophone records, it has been raised from 20 percent to 50k each or $66^2/_3$ percent.
(vii) *Refuse disposal vehicles:* The former duty of 15 percent has been reduced to 5 percent for Approved Users to encourage environmental sanitation.
(viii) *Mobile clinics:* To help in health care, these will now attract 5 percent duty, as against the previous 15 percent, when imported by recognized hospitals and clinics.

## IV. EXCISE DUTY

10. Most local industries now enjoy generous tariff incentives as well as protection through import restriction and prohibition. This naturally reduces the revenue accruable to Government. In order to recoup some of the lost revenue so as to be financially strong to channel resources to needy sectors that are in crying need, a number of locally produced goods will now attract a nominal excise duty of 5 percent. These include sound recorders, reproducers and record players, kerosene cookers, gas cookers, clocks and watches, socks and stockings, mattresses and pillows, glassware, and calendars and greeting cards.

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## V. EXPORT PROMOTION

17. In his Budget Speech last year, the Head of the Federal Military Government announced that the Federal Military Government would take steps to reduce Nigeria's dependence on oil for financing essential services as well as its national development programmes. One of the steps taken so far to realise this objective is the evolvement of a new export promotion strategy. In the new fiscal year, due cognisance will be given to the development and exploitation of our export potentials. To this end, government has identified a number of industries which can be encouraged through fiscal and other measures to export their products. Details on implementation of these measures are now being worked out and will be announced in due course.

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## VI. TAXATION

19. Last year, the Federal Military Government set up a Task Force on Tax Administration to review the sources of Tax Revenue and the structure of Tax Administration in Nigeria. The Task Force has since submitted an interim report: Government had considered the report and those recommendations of the report which it accepted and came into force with effect from 1st April, 1979 are contained in a separate annex to my Statement.

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## VII. MANAGEMENT AND TECHNICAL SERVICES FEES, ROYALTIES, ETC.

29. A maximum of 3 percent of net profit after tax is now fixed for remittances under management and technical services agreements in place of 3 percent of gross profit hitherto allowed. Additionally, management agreements as opposed to consultancy agreements will no longer be entertained from existing, well-established companies. Such companies should institute specific training programmes for their staff, and engage the necessary staff where specialised services are required. Existing agreements will however be allowed to run through to their expiry dates.

## VIII. CONSULTANCY FEES

30. Considering the alarming number of consultancy agreements executed so far, it has been decided that the proportion of consultancy fees remittable abroad to foreign associates be reduced from the present maximum of 50 percent to 30 percent. Additionally, ability to perform locally without undue dependence on foreigners outside Nigeria would be one of the major criteria for the award of contracts to professionals and consultants by both the public and the private sectors.

## IX. LOCAL OVERDRAFT FACILITIES

31. Henceforth, Government will ensure that, as far as possible, companies enjoying local overdraft facilities are not at the same time remitting their earnings overseas before such facilities are cleared.

## X. DIRECTORS' FEES

32. Large increases in these fees have become noticeable since the restriction on dividends. The maximum fee which a non-resident director of a Nigerian company can be paid from Nigeria has now been fixed at ₦4,000 per annum.

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## XI. GUIDELINES ON THE REPATRIATION OF THE PROCEEDS OF SALE OF SHARES

35. Now that many foreign Companies have complied with the Nigerian Enterprises Promotion Decree, 1977, Government has considered the question of sale of shares transferred to Nigerians. It is Government's wish that in view of the potentials of the Nigerian economy, as much as possible of the proceeds of sale should be reinvested in the Economy. However, Government appreciates that some companies for one reason or the other may wish to repatriate the proceeds of the sale of their investment.

36. Accordingly, the following guidelines have been approved by the Government for such repatriation:
(i) Repatriation will be on instalmental basis;
(ii) the rate of repatriation shall be as follows:
(a) amounts not exceeding ₦300,000 shall on approval be transferred once;
(b) the excess over ₦300,000 shall be transferred at the rate of ₦300,000 every six months;
(iii) To qualify for repatriation as above, applications should be supported by documentary evidence of Approved Status or evidence of Capital importation;
(iv) On reinvesting in Nigeria, enterprises already enjoying Approved Status will have Approved Status also conferred on their new investments;
(v) All enterprises that cannot produce evidence of Approved Status would, on reinvesting not less than 50 percent of the proceeds of the sale of their shares in new enterprises in the Nigerian economy, qualify for transfer of dividends for both their old and new investment, thus rationalising their position.

37. By the decision in paragraph 36(v) above, Government has removed the distinction that has so far existed between sterling and non-sterling area investments made in Nigeria before the Exchange Control Act, 1962, thus demonstrating in practical terms its policy of parity of treatment for all investments of whatever origin and its desire to improve the investment climate for those enterpirses affected by indigenisation in order to facilitate the reinvestment of proceeds due to the foreign shareholders of the enterprises.

## XII. STATE AND LOCAL GOVERNMENT FINANCES

38. Out of the federally-collected revenue of about ₦6.8 billion in the 1978/79 financial year, a total sum of about ₦2.8 billion — about a third — was passed on to the States as statutory and non-statutory appropriations and Capital grants. In spite of this favourable proportion relative to the allocation of functions between the States and the Federal Military Government, however, the States still found themselves in a financial indebtedness arising from contractual obligations.

39. A number of measures have been adopted in order to widen the sources of State Government's revenue. For example, the report of the Task Force on Tax Administration set up by the Federal Military Government has been accepted and passed on to the States for speedy implementation, and it is hoped that the implementation of the approved measures would yield substantial additional revenue for the States.

40. In view of its revenue implication for the States, the Federal Government has withdrawn the tax concession on Capital Allowance on loans on Owner-occupier property up to the value of ₦100,000. The concession on interest on loan for developing such property will, however, be retained.

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## XIII. NEW REVENUE ALLOCATION SYSTEM

47. Arising from the Report of the Technical Committee on Revenue Allocation, federally collected revenue shall now be shared as follows by the three tiers of Government:

| | |
|---|---|
| Federal Government | 60% |
| States Joint Account | 30% |
| Local Government Fund | 10% |

The critical criteria for allocation of funds among the States from States Joint Account as well as the weighting assigned to each criterion, are as follows:

| *Criteria* | *Weights* |
|---|---|
| 1. Equality of access to Development opportunities | 0.27 |
| 2. National Minimum Standards for National Integration | 0.28 |
| 3. Absorptive Capacity | 0.20 |
| 4. Independent Revenue and Minimum Tax Efforts | 0.12 |
| 5. Fiscal Efficiency | 0.13 |
| | 1.00 |

48. The Federal Military Government is aware of the possible disruptive effects on the balance of the finances of individual States which the new formula could engender and because of this it has been decided to implement it in stages. For purposes of the 1979/80 financial year, therefore, the formula shall apply to incremental revenue over and above the 1978/79 figure. This increment, which is estimated at ₦1.99 billion, shall be shared as follows:

| | |
|---|---|
| Federal Government | ₦1.234 billion |
| State Joint Account | ₦0.597 billion |
| Local Government Fund | ₦0.150 billion |

49. Recognising the fact that the Local Governments are unlikely to be fully mobibised in 1979/80 to fully assume all their additional responsibilities, such as U.P.E., Basic Health Service Scheme, etc., it has been decided that, for the purpose of the 1979/80 Budget, the total allocation to the Local Governments Fund shall shall not exceed ₦300 million.

50. The totality of Revenue that will accrue to each tier of Government from the federally collected revenue of ₦8.805 billion in 1979/80 shall thus be as follows:

| Level of Government | 1978/79 Receipt (₦ billion) |
|---|---|
| Federal Government | 5.028 |
| States Joint Account | 1.637 |
| Local Government Fund | 0.150 |

| Level of Government | Incremental change in 1979/80 (₦ billion) |
|---|---|
| Federal Government | 1.243 |
| States Joint Account | 0.597 |
| Local Government Fund | 0.150 |

| Level of Government | Total Receipt in 1979/80 (₦ billion) |
|---|---|
| Federal Government | 6.271 |
| States Joint Account | 2.234 |
| Local Government Fund | 0.300 |

## XIV. CONCLUSION

51. Ladies and gentlemen, I must stress, as the Head of the Federal Military Government has himself stressed on a number of occasions, that the era when oil revenues would continue to meet most of our expenditure is gone, and although the performance of the petroleum sector this year is likely to be better than it was last year, government financial resources remain inadequate when viewed against our existing commitments and future resource requirements. It is therefore necessary that henceforth we should continue to widen our revenue base in order to enable use to generate, as much as possible internally the resources that are necessary for our development. Every sector of the economy and every citizen of this country has a role to play in this task because there is no doubt that in the final analysis, it does not matter what resources may be available to us as a nation, there can be no substitute for hard work, sacrifice and discipline if we are to realise our objective of sustained and balanced economic development.

## APPENDIX I

### Government Decisions on Changes in Taxation Proposed by the Task Force on Tax Administration

1. Last year, the Federal Government set up a Task Force on Tax Administration which has since submitted an interim report. After deliberating on the report, Government took the following decisions as they affect taxation generally.

2. The various tax Laws of the country with their numerous amendments are to be codified.

3. Where a partnership is registered in more than one territory, the State of registration should supply the state of residence of the partners with particulars of the registration, accounts and income of partners for tax purposes.

4. (a) All the State Tax Laws are to be unified under one single personal income tax law which will be applicable throughout the country. This is to ensure uniformity in personal income tax law and practice.

(b) The uniformity will also ensure that notices of assessment are sent out at the same time throughout the country and this will be so prescribed in the law.

5. In order to remove some difficulties of identification of taxable persons:

(a) All Local Government Authorities should devise ways of numbering streets and houses within their areas.

(b) Registration of all business names an business premises must be renewed annually with a token fee. Furthermore, registration of business names will be decentralised.

c) Registration of professionals in private practice must henceforth be notified by the appropriate Registries to the relevant tax authorities where the professionals are resident.

d) The registration of births and deaths are now mandatory, States Ministries of Health, Local Government Areas are required to organise this immediately.

e) The proviso in Section 28(3) of ITMA 1961 limiting information from banks to interest is being amended to enable Tax Authorities obtain any information regarding income etc. of any taxpayer from anybody, including all banks and bank managers, and failure to respond to such request for information will constitute an offence with appropriate penalties.

f) The presentation of Tax Clearance Certificate covering the preceding three years will be a prerequisite for any business transaction with government. This will be extended gradually to deserving transactions with the private sector. In this connection, the following are the various circumstances for which such tax clearance certificate will be demanded:

1. From non-government applicants (e.g. loans for small business etc.) for government loan.
2. From persons registering and licensing vehicles (only on first registration).
3. From persons applying for gun licence.
4. From applicants requiring exchange control permission to remit funds.
5. From person applying for Certificate of Occupancy.
6. From tenderers for government contract.
7. From traders requiring trading licence.
8. From applicants for property transfer documents.
9. From applicants for approval of building plans.
10. From electoral candidates.
11. From applicants for plots.
12. From applicants for imports/export licences.
13. From applicants for Buying Agents licences.
14. From applicants for pools or gaming licences (as and when applicable).
15. From applicants for registration as contractors by government.
16. Application for distributorship.
17. Application for Approved Users Certificate.

. All Government Agencies or functiona-es should from now on notify the tax uthorities of financial transactions with axable persons.

. Tax Authorities will soon prescribe the ecessary records to be kept compulsorily y businessmen and women who do not eep complete accounting records. The Institute of Chartered Accountants in liaison with the Federal Board of Inland Revenue will work out the machinery for up-dating the new system of record keeping.

8. Businessmen, tradesmen who keep no satisfactory records of their businesses will now pay a standardised rate of tax for each year of assessment to be determined by relevant tax authorities. This will cover, market women, road-side mechanics, petty traders with or without known or specific business or residential addresses.

9. A 10 percent tax relief on rents paid will be allowed to tenants who declare and disclose the correct amount of rent they pay to their landlords' representatives. Such disclosures shall however have to be substantiated to the satisfaction of the tax authorities concerned before such relief is granted. The production of a rent book or rent receipt may not be conclusive evidence of true rent paid.

10. The Foreign Exchange Departments of the Central Bank and Federal Ministry of Finance will now provide to the tax authorities returns of foreign exchange approvals for remittances abroad in respect of individuals. Such returns shall be rendered at regular intervals to appropriate tax authorities.

11. Professionals in private practice will henceforth be assessed at least on an assumed minimum net income of their counterparts in the public sector in terms of post-qualification experience. Professionals who are evidently earning more than their counterparts in the public sector, that is more than the assumed minimum, will be assessed on such increased income accordingly.

12. To expedite the trial of tax cases, Revenue Courts are to be established in all States.

13. (a) Tax authorities have been directed to ensure that notices of assessment reach all taxable persons between 1st May and 30th September of each year of assessment, failing which any person who fails to receive a notice should demand for same from the relevant tax authority.
(b) Direct assessment taxpayers will now be allowed to make payments in advance or instalmentally as the case may be.
(c) It will henceforth be a punishable offence for any taxable person not to pay his tax by 1st February of any year of assessment.
(d) Policemen will now assist tax authorities in the enforcement of tax laws and in the preservation of peace, law and order in tax offices.

14. The present system of regarding both the company and the shareholder as one and the same person for tax purposes is abolished. Henceforth:
(a) Tax will be imposed on companies at 45 percent, while dividends paid to shareholders will attract a withholding rate of 12.5 percent.
(b) Companies paying dividends should ensure that the tax withheld is paid over to the tax authorities of the States in which the shareholders are respectively resident. Tax on the profits must have been paid before dividends are paid out in accordance with present practice.
(c) In the case of non-resident shareholders, the tax withhold by the paying companies will be remitted to the Federal Board of Inland Revenue as final settlement of the shareholders tax liability to the Federal Government of Nigeria.

15. A central information centre or data bank for internal revenue services will be established. All information affecting taxable person will be sent to this data bank. The bank will further disseminate such information received to the relevant State or Federal Tax Authority. It is expected that this will enhance flow of information.

16. More area tax offices will be opened to facilitate the delivery of mails to taxpayers.

17. A commercial rate of interest will henceforth be imposed on the sum of the tax liability outstanding plus 10 percent penalty. Thereafter, a criminal sanction will be imposed on any company for failure to pay the tax due after two years.

18. In order to combat tax evasion by property holding companies,
(a) only expenses directly attributable to the sustenance and maintenance of the properties should be allowed as a deduction in the ascertainment of rental income;
(b) Director's remuneration allowable for tax purposes will be limited for such companies to ₦3,000.00 per annum with a maximum of two directors;
(c) Extraneous expenses normally found in the accounts of such companies will henceforth be disallowed in arriving at rental income.

19. Companies paying rents to other companies or individuals are now to deduct from such rents a withholding tax of 12.5 percent of gross rent and pay over the amount deducted to the appropriate tax authorities:
(a) in the case of Companies to the Federal Board of Inland Revenue Office in the State in which the Company receiving the rent is located;
(b) in the case of individuals to the State in which the individual receiving the rent is resident.

In both cases the rent received will be grossed up to form part of the aggregate income of the recipient for tax purposes and tax already deducted will be allowable as credit against the total tax due on the aggregate income including such rents.

20. Management fees, technical assistance fees, will now be taxed gross at standard company tax rate and any agreement purporting to exempt such fees from Nigerian tax shall be regarded as null and void.

21. To avert the indiscriminate grant of tax exemption and reliefs to business transactions and contractors by government agencies, all Government Agencies will henceforth clear with Federal Ministry of Finance all proposals for such tax exemp-

tions and reliefs and any such exemptions or reliefs purported to have been granted in any agreement without prior approval of the Federal Ministry of Finance shall be null and void.

22. The exemption of the first ₦6,000.00 of every Nigerian company's total profits from tax as provided for in Section 33 of the Companies Income Tax Act is now withdrawn.

23. Section 21 of the Companies Income Tax Act is to be amended to render taxable any excess life assurance premium transferred to the profit and loss Account by Life Assurance Companies.

Federal Ministry of Finance,
Koyi, Lagos.
1st April, 1979

## APPENDIX II

## 1978-80 Budget Notes for Guidance On Companies Income Tax etc.

### Introduction

1. As usual, the Federal Inland Revenue Department has prepared these notes as guidance to Taxpayers, their advisers and the general public. The major areas on companies taxation covered in the Head of State's Budget Speech on 31st March, 1979 and the Commissioner for Finance's Budget Statement on 2nd April, 1979 are on management and technical services fees, royalties, etc. consultancy fees, non-resident Director's fees, rates of companies, tax, identification of taxable persons and tax relief on rents paid. Other aspects covered relate to property holding companies, grant of tax exemption; the withdrawal of ₦6,000 exemption under section 33 of Companies Income Tax Act 1961 and Capital Transfer Tax.

### Rate of Company Tax

2. (a) With effect from 1st April, 1979 the rate of Company Tax has been reduced from 50 percent to 45 percent;
   (b) In addition to the above, dividends paid to shareholders will also attract a withholding tax rate of 12.5 percent. Further details would be found in the paragraph on dividends.

### Cancellation of the ₦6,000 Exemption on Taxable Profits

3. The exemption of the first ₦6,000 of every Nigerian Company's total profits from tax as provided for in section 33 of the Companies Income Tax Act is now withdrawn. For the avoidance of doubt no tax relief is now available under this Section.

### Amendment to section 21 of Companies Income Tax on Life Assurance Companies

4. Section 21 of the Companies Income Tax has been amended to render taxable, premiums transferred to the profit and loss account by Life Assurance Companies.

### Management Fees

5. (a) Management fees, technical fees and consultancy fees will now be taxed gross at standard company tax rate and any agreement purporting to exempt such fees from Nigerian Tax shall be regarded as null and void.
   (b) A maximum of 3 percent Net Profit after tax is now fixed as the amount remittable outside Nigeria under management and technical services agreements in place of 3 percent of gross profit hitherto allowed. Additionally, Management Agreements will no longer be entertained from existing well-established companies. Such companies should institute specified training programme for their staff and engage the necessary staff where specialised services are required. Existing Management fees agreements that have been notified to the Board or to Federal Ministry of Finance will however, be allowed to run through to their expiring dates, but payments under such agreements will now be liable to tax at standard rate without allowance for any expenses.
   (c) *Consultancy Fees* — Considering the alarming number of consultancy agreements executed so far, it has been decided that the proportion of consultancy fees remittable abroad to foreign associates be reduced from the present maximum of 50 percent to 30 percent. Additionally, ability to perform locally without undue dependence on foreigners outside Nigeria will be one of the major criteria for the award of contracts to professionals and consultants by both the public and the private sectors. Payment of fees in excess of this amount to foreign partners or associates will require Federal Executive Council approval.

### Property Holding Companies

6. In order to combat tax evasion by property holding companies:
(a) Only expenses directly attributable to the sustenance and maintenance of the property should be allowed as a deduction in the ascertainment of rental income;
(b) Director's remuneration allowable for tax purposes would be limited for such property holding companies to ₦3,000 per annum with a maximum of two Directors;
(c) Extraneous expenses normally found in the accounts of such companies will henceforth be disallowed in arriving at rental income.

### Restriction of Non-Resident Director's Fees

7. The maximum fee which a non-resident Director of a Nigerian Company can be paid from Nigeria has now been fixed at ₦4,000 per annum. This limitation is in respect of amount remittable only. The Director may earn other remuneration or have other expenses paid on his behalf in Nigeria.

### Companies to deduct and pay to the proper Tax Authority withholding Tax of 12.5 percent on Gross Rents Paid

8. Companies paying rents to other companies or individuals are now to take from such rents a withholding tax of 12.5 per cent on gross rent and pay over the amount deducted to the proper tax authority. Receipts for such deductions should be obtained from the tax authority receiving the deductions.
(a) In the case of companies rent deducted should be remitted to Federal Board of Inland Revenue office in the State in which the company receiving the rent is located.
(b) In the case of individuals, such deductions should be remitted to the State in which the individual receiving the rent is resident. In both cases, the rent received will be grossed up to form part of the aggregate income of the recipient for tax purposes and tax already deducted will be allowable as credit against the total tax due on the aggregate income including such rents.
(c) In all cases remittance to relevant tax authority must be accompanied by a statement showing gross rents payable, deduction made at 12.5 percent the name and address of recipient and the location of property and for what period payment is made.

### 10 Percent Tax Relief to Tenants

9. 10 percent tax on rents paid will be allowed to tenants who declare and disclose the current amount of rents paid to their Landlords or Landlord's represen-

atives. Such disclosures shall however, have to be substantiated to the satisfaction of the tax authorities concerned before such relief is granted. Tax Authority may refuse to grant relief if the information disclosed is otherwise already known to the Tax Authority.

**mposition of Commercial Rate of Interests on outstanding Tax Liabilities**

10. With effect from 1st April, 1979 a commercial rate of interest will henceforth be imposed on the sum of tax liabilities outstanding in addition to 10 percent penalty normally charged thereon. Thereafter, a criminal sanction will be imposed on any company for failure to pay tax due after two years.

**Withholding Tax of 12.5 percent on Dividends**

11. The present system of regarding both the Company and the Shareholders as one and the same person for tax purposes is abolished. Henceforth:

a) Tax will be imposed on Companies at 45 percent while dividends paid to shareholders will attract a further withholding tax at the rate of 12.5 percent.

b) Companies paying dividends should ensure that the tax withheld is paid over to the tax authorities of the States in which the shareholders are respectively resident. Both the Tax on the appropriate portion of profits and on the dividend distributed must have been paid before dividends are paid out in accordance with present practice.

c) *Dividends.* — From 1st April, 1979, no company should declare or pay dividends in excess of 50 percent of its after tax profits in that current financial year.
In effect, *all* companies cannot pay dividends from retained earnings nor calculate their profit to be distributed by adding any accumulated profit or transfer from reserve.
The purpose of government action is to encourage efficiency in all the sectors of the economy and to pay dividend based on the true performance of the company each year.

d) In the case of non-resident shareholders, the tax withheld by the paying company will be remitted to the Federal Board of Inland Revenue as final settlement of the shareholder's tax liability to the Federal Government of Nigeria.

) In all cases, remittance to relevant tax authorities must be accompanied by details of the gross dividend, name and address of shareholder, the amount deducted and remitted. Such remittances must be receipted by the receiving tax authorities.

**Assessment Notices to be served on Tax Payers between 1st of May and 30th September each Year**

12. (a) Tax authorities are to ensure that notices of assessment in respect of Personal Income Tax reach all taxable persons between 1st of May and 30th September of each year of assessment, failing which any person who fails to receive a notice should demand for same from the relevant tax authority;
(b) direct assessment taxpayers will now be allowed to make payments in advance or by approved instalments as the relevant tax authority may agree;
(c) it will henceforth be a punishable offence for any taxable person not to pay his tax by 1st February of any year of assessment, e.g. failure to settle 1979-80 assessment by 1st February, 1980 becomes punishable under the law;
(d) Policemen may now be requested to assist tax authority in the enforcement of tax laws and in the preservation of peace, law and order in tax offices.

**Assessment of Businessmen and Professionals in Private Practice**

13. (a) Businessmen and tradesmen who keep no satisfactory records of their business will now pay an assumed minimum tax on a standardised income for each year of assessment to be determined by the relevant tax authorities. This will cover market women, road-side mechanics, petty traders with or without known or specific business or residential address.
(b) Also professionals in private practice will henceforth be assessed at least on an assumed minimum net income of their counterparts in the public sector in terms of post-qualification and experience. Professionals in the private sector, who are evidently earning more than the assumed minimum income will be assessed on such increased income accordingly.

**Tax Exemptions to receive prior Approval of the Federal Ministry of Finance and the Federal Board of Inland Revenue**

14. In order to avert the indiscriminate grant of tax exemptions and reliefs to business transactions and to some contractors by Government Agencies, all Government Agencies will henceforth clear with Federal Ministry of Finance all proposals for such tax exemptions and reliefs and any such exemptions or reliefs purported to have been granted in any agreement without the prior approval of the Federal Ministry of Finance shall be Null and Void.

**All Government Agencies of Functionaries to notify Tax Authorities of Transactions with Taxable Persons**

15. (a) With effect form 1st April, 1979 all Government Agencies or Functionaries should notify the tax authorities of financial transactions, contracts and agreements with taxable persons; such information should include award of contracts, grant of import and export licence, grant of pioneer certificate, approved users certificate, permission or approval of remittances, loan assistance.

(b) The Foreign Exchange Department of the Central Bank and the Federal Ministry of Finance will now provide the tax authorities returns of foreign exchange approvals for remittance abroad in respect of individuals and companies on request. However, such returns shall be rendered at regular intervals to the Federal Board of Inland Revenue. Returns should state name and address of taxpayers, amount of remittance approved, date and nature of such remittance.

**Tax Clearance Certificate**

16. The presentation of Tax Clearance Certificate covering the preceding three years will be a prerequisite for any business transaction with Government. This is to be extended gradually to deserving transactions with the private sector.

In this connection, the following are some of the various circumstances and transactions for which such Tax Clearance Certificate will be demanded:
(1) From non-government applicants (e.g. loans for small business, etc.) for government loan.
(2) From persons registering and licensing vehicles (only on first registration).
(3) From persons applying for gun licence.
(4) From applicants requiring exchange control permission to remit funds.
(5) From persons applying for certificate of occupancy.
(6) From tenderers for Government Contracts.
(7) From traders requiring trading licence.
(8) From applicants for approval of building plans.
(9) From applicants for property transfer documents.
(10) From electoral candidates.
(11) From applicants for import/export licences.
(12) From applicants for plots.
(13) From applicants for buying Agents licences.
(14) From applicants for pools or gaming licences (as and when applicable).
(15) From applicants for registration as contractors by government.
(16) Application for distributorship.
(17) Application for Approved Users Certificate.

### Unification and Codification of various Personal Income Tax Laws of the Country

17. (a) All the State Tax Laws are to be unified under one single personal income tax law which will be applicable throughout the country. This is to ensure uniformity in personal income tax law and practice.
(b) The uniformity will also ensure that notices of assessment are sent out at the same time throughout the country and as prescribed under No. 12 above.

### Partnership

18. Where a partnership has establishments in more than one territory, the State of registration or where it has its registered office should supply the other States of residence of the partners with particulars of the registration, accounts and income of partners for tax purposes.

### Amendment of Section 28(3) of Income Tax Management Act, 1961

19. The proviso in sub-section 28(3) of ITMA limiting information from Banks to interest is being amended to enable tax authorities obtain for tax purposes any information regarding income, etc. of any taxpayer from anybody, including all banks and Bank Managers and failure to respond to such request for information, will constitute an offence with appropriate penalties.

### Identification of Taxable Persons

20. In order to remove some difficulties of identification of taxable persons:
(a) all Local Government authorities are to arrange for the naming and numbering of Streets and houses within their areas;
(b) registration of all business names and business premises must be renewed annually with a token fee. Furthermore, registration of business names will be decentralised so that States and Local Governments can now partake;
(c) registration of professionals in private practice must henceforth be notified by the appropriate registries to the relevant tax authorities where the professionals are resident. Tax authorities may however, ask the appropriate bodies for the list of professionals in their areas;
(d) the registration of birth and deaths are now mandatory. States Ministries of Health and Local Government areas are required to organise this immediately.

### Necessary Records to be kept by Businessmen

21. Tax authorities are to prescribe the appropriate records to be kept compulsorily by businessmen and women who do no keep complete accounting records. Th Institute of Chartered Accountants o Nigeria in liaison with the Federal Boar of Inland Revenue will work out the typ of records to be kept for this purpose This will be made available for purchas by taxpayers.

### Introduction of Capital Transfer Tax

22. Capital Transfer Tax has been in troduced with effect from 1st April, 1979 The tax is at a graduated rate on chargeabl transfers made both during lifetime, e.g gifts and on death. The rates of Capita Transfer Tax will vary from 10 percen to 60 percent on the value of transfer exceeding ₦100,000. The tax will b administered by State Tax Authorities

### Legislation

23. As usual, the provisions in the Budge Statement will where appropriate be em bodied in the decree with retrospectiv effect from 1st April, 1979.

Federal Inland Revenue Departmen
Lagos
April 1979.

**In next issues**

A review of the Ethiopian fiscal system
— by *M. Fissehatsion*

Taxation in Macao
— by *M.P. Dominic*

Indonesia: Tax Incentive Package to support the third five year development plan (1979-1984)
— by *Jap Kim Siong*

Nigerian Income Tax: Construction companies
— by *George E. Tickner*

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

United States: Proposed Internal Revenue Service Regulations
on the creditability of taxes

# Nigeria's 1979~80 Budget and The 1975~79 Import Boom

y LAWRENCE A. RUPLEY*

he 1979-80 Nigerian Federal government budget that as introduced on April 1, 1979, is noteworthy because is the final budget to be prepared by the military overnment in Nigeria. Since the return to civilian overnment is scheduled for October 1, 1979, the last alf of the 1979-80 budget will be carried out under the vilian regime. The major revenue and expenditure atures of that budget are shown in Table 1 alongside omparative data beginning in April of 1973. Total ecurrent revenue collected (exclusive of grants or loans or capital projects) for 1979-80 is expected to be ₦8,805 illion.[1] The Federal government is to retain ₦6,271 illion of that total after statutory sharing of revenues ith state and local governments. Total Federal recurrent and capital expenditure amounts to ₦9,510 million, hich implies a budget deficit of ₦3,239 million.

nsofar as government finance in Nigeria is concerned, it impossible to overstate the importance of the 1973 nd 1974 OPEC pricing and taxation decisions. As a onsequence, Federally collected revenue increased by early two and one-half times over the space of one scal year, from 1973-74 to 1974-75. Government venue has remained at levels very much in excess of ose prior to 1974 as the OPEC actions have been stained and extended since 1974 (see Table 1).

e decision to spend most of that much enlarged vernment revenue caused a four-fold increase in deral expenditure from 1973-74 to 1975-76; brought e launching of the Third National Development Plan at called for 1957-80 capital expenditure of ₦30,000 illion (nearly nine times larger than the 1970-74 Plan); nabled the establishment of a new federal finance evenue allocation system in April, 1975, whereby state overnments immediately doubled their expenditure; d to the hasty introduction of an extremely expensive niversal Primary Education program in 1976; permitted civil service wage and salary increases of 30 to 00 percent to be paid in 1975; and contributed significantly to an inflation rate in 1975 of 30 to 40 percent.

ince the euphoria of 1975, however, it has become lear that Nigerian government revenues from petroleum re not infinitely large, and that government dependence on revenues from such a single industry makes the overnment budget vulnerable to downward fluctuations in that single source. That vulnerability is particularly pronounced when virtually all the government ceipts are being expended. Upward movements in etroleum revenue have been a cause for rejoicing in igeria since 1970, but the last several years have seen velling off and some downward movements as well. he dependence on petroleum has prompted a search for alternative government revenue sources as tax, royalty and sales revenues have levelled off or declined. That dependence has also intensified the official intention in Nigeria to diversify the economy's output. The extremely rapid growth in the value of petroleum exports and foreign exchange earnings after 1973 led to virtually unrestrained growth in imports in 1975 and thereafter; that growth culminated in a foreign trade current account deficit of ₦656 million in 1977 which swelled to ₦2,300 million in 1978.[2]

As a result of the desire to curb inflation, correct the worsening balance of payments situation, and compensate for the levelling off of government revenue, the two most recent Federal budgets in Nigeria have been considerably more restrained than those from 1975-78. General Obasanjo's 1979-80 Budget Speech refers to the need to "tighten our belts", and the budget contains a number of features of restraint on the expenditure side despite the projected deficit of ₦3,239 million. The first feature is the fact that Federal recurrent expenditure for 1979-80 is 10 percent lower in real terms than in the 1978-79 budget and is lower than such actual expenditure in 1977-78 (see Table 1). The second is the decision to hold ₦1,100 million of capital expenditure in abeyance until financing can be found (however, loan financing will not reduce the budget deficit). A third feature is the reduction by ₦76 million and by ₦104 million of estimated recurrent and capital defence expenditure, respectively, which is a 14 percent reduction from the 1978-79 estimate. Fourth is the announcement that the government will no longer make motor vehicle loans nor provide motor vehicle basic allowances to civil servants (although half the basic allowance will be granted as a salary increment to ease the effect on take-home pay).[3] Budgeted expenditure for 1979-80 is shown in Table 2.

On the government revenue side there are several features of fiscal restraint and of an attempt to diversify away from petroleum taxation in the two most recent budgets, although petroleum is still expected to provide 75 percent of Federally collected government revenue for 1979-80. In April of 1978 the company profits tax rate was raised from 45 percent to 50 percent, an excess profits tax on banks was introduced, a Ports Develop-

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1. The Naria exchange rate in April, 1979, was ₦ 1 = US$ 1.54.
2. 1979-80 Budget Speech. See *West Africa*, April 9, 1979.
3. Nigeria, *Official Gazette*, Vol. 66, No. 18, April 12, 1979. Private employers are to follow suit.

## TABLE 1

### RECENT TRENDS IN NIGERIAN FEDERAL GOVERNMENT REVENUE AND EXPENDITURE

| | 1973-74 Actual | 1974-75 Actual | 1975-76 Actual | 1976-77 Actual | 1977-78 Actual | 1978-79 Appr. estimate | 1979-80 Appr. estimate |
|---|---|---|---|---|---|---|---|
| Total Federally collected recurrent revenue | 2,171.4 | 5,177.1 | 5,861.5 | 7,070.6 | 8,359.0 | 6,815.2 | 8,805.0 |
| Less statutory allocations: | | | | | | | |
| to state governments | 323.8 | 833.7 | 963.1 | 1,414.9 | 1,491.8 | 1,637.1 | 2,234.0 |
| to local governments | – | – | – | – | – | 150.0 | 300.0 |
| Total Federally retained Revenue | 1,847.6 | 4,343.4 | 4,898.4 | 5,655.7 | 6,867.2 | 5,028.1 | 6,271.0 |
| Total recurrent expenditure (net of transfers to Development Fund and statutory allocations) | 795.7 | 808.6 | 2,466.6 | 2,158.6 | 2,933.0 | 2,650.0 | 2,900.0 |
| Total capital expenditure (net of loans on-lent to State Governments) | 766.4 | 1,683.9 | 3,822.7 | 4,913.1 | 5,627.5 | 5,200.0 | 6,610.0 |
| Total expenditure | 1,562.1 | 2,492.5 | 6,289.3 | 7,071.7 | 8,560.5 | 7,850.0 | 9,510.0 |
| Budget surplus/(deficit) | 285.5 | 1,850.9 | (1,390.9) | (1,416.0) | (1,693.3) | (2,821.9) | (3,239.0) |

*Source:* Various *Official Gazettes* of the Federation of Nigeria and 1979-80 Budget Speech. Fiscal year from April 1 to March 31.

ment Surcharge of 5 percent of the duty on imports was imposed,[4] the airport tax was increased, some highway tolls were introduced, and measures to speed up the payment of some taxes by firms were instituted.[5] In addition, the termination of double taxation agreements with nine countries was announced in late April, 1978.[6] As of April 1, 1979, a capital transfers tax was announced.[7] Finally, in both 1978 and 1979 there were increases in the rates of import duty on a considerable number of items, and an extension of the use of import licensing (quotas) and outright import prohibitions on some items.

The major features of import duty revenue over the past six years in Nigeria deserve examination because of the importance of the behavior of imports following the expansion in petroleum production after the end of the civil war. As can be seen in Table 3, such revenue more than doubled from 1973-74 to 1975-76 and the 1978-79 estimates exceeded the 1973-74 level by more than four times. The great consumer import boom was most spectacular in 1975 (which is split between fiscal 1974-75 and 1975-76 in Table 3). The suddenness and severity of that import boom is partially indicated by the extent to which the actual import duty revenue exceeded the estimates. For 1974-75 (including January-March, 1975) total import duty was ₦364 million compared with the anticipated ₦184 million, while in 1975-76 ₦705 million was more than double t ₦313 million estimate and was virtually twice that the previous year. Such divergence between estimat and actual revenue is good evidence as to how une pected was the import expansion, because customs du has typically been one of the more accurately estimat of revenue items.

If one examines some of the more detailed impo categories shown in Table 3, one sees that custom revenue from machinery, mechanical appliances an electrical equipment more than doubled in 1975-7 Such revenue on chemical products was double the est mate in 1974-75, and doubled again in the following yea One also sees that the 1975-76 import duty of ₦2 million from beer exceeds the estimate by ten time while the duty from wine and spirits was ₦13 millio compared to ₦3 million estimated. Customs revenu

4. A surcharge on customs and excise duties had previous been in effect from October, 1967 to April 1, 1974.

5. 1978-79 Budget Speech, March 31, 1978.

6. Denmark, The Gambia, Ghana, New Zealand, Norway, Sier Leone, Sweden, United Kingdom, United States of Americ Nigeria, *Official Gazette*, Vol. 65, No. 27, June 15, 1978.

7. Nigeria, *Official Gazette*, Vol. 66, No. 18, April 12, 197 Only personal estates and gifts in excess of ₦ 100,000 a affected.

om food imports in 1975-76 was five times its anticipated level for 1974-75, while that on manufactured goods was three times larger. Duty from vehicle imports was virtually twice the estimate in 1974-75 and then more than doubled again in 1975-76. The number of cars imported (including those imported completely

## TABLE 2

### NIGERIAN FEDERAL GOVERNMENT
### 1979-80 BUDGETED EXPENDITURE

(₦ million)

| Recurrent Expenditure | | Capital Expenditure | |
|---|---|---|---|
| State House/Dodan Barracks | 1.4 | Agriculture | 183.5 |
| Cabinet Office | 38.1 | Livestock | 17.8 |
| Police | 197.9 | Forestry | 15.7 |
| Police Force Service Commission | .2 | Fisheries | 2.8 |
| Agriculture and rural development | 34.4 | Mining and quarrying | 726.2 |
| Federal audit | 3.5 | Manufacturing and craft | 1,365.6 |
| Civil aviation | 28.3 | Power | 540.0 |
| Communications | .8 | Commerce and finance | 38.8 |
| Defence | 520.0 | Land transport system | 962.3 |
| Economic development | 27.6 | Water transport system | 159.3 |
| Education | 326.1 | Air transport system | 122.8 |
| Establishments | 20.4 | Communications | 320.5 |
| External affairs | 37.0 | Education | 391.1 |
| Finance | 70.4 | Health | 80.2 |
| Health | 97.2 | Information | 17.5 |
| Industries | 6.8 | Labour | 2.1 |
| Information | 76.2 | Social development, youth and sports | 4.8 |
| Internal affairs | 50.8 | Water resources | 359.6 |
| Judicial | 4.9 | Environment | 6.3 |
| Justice | 4.3 | Housing | 84.2 |
| Labour | 63.4 | Town and country planning | 13.8 |
| Mines and power | 7.6 | Co-operatives and supply | 1.7 |
| National Science and Technology Development Agency | 33.0 | Prisons | 13.8 |
| Public Complaints Commission | 2.3 | Police | 28.8 |
| Federal Public Service Commission | 3.2 | Defence | 602.0 |
| Trade | 11.9 | General administration | 373.8 |
| Transport | 14.5 | External financial obligations | 175.3 |
| Works and housing | 105.6 | | |
| Federal electoral commission | 26.3 | Total | 6,610.0 |
| National Assembly | 8.7 | | |
| Contingencies | 30.3 | | |
| Non-statutory grants | 5.0 | | |
| Grants for UPE | 548.2 | | |
| Grants for secondary education | 40.0 | | |
| Public debt charges | 358.3 | | |
| Consolidated Revenue Fund charges | 95.7 | | |
| Total | 2,900.0 | | |

*Source:* "Statement on the 1979-80 Budget" by Federal Commissioner for Finance, *West Africa*, April 16, 1979, pp. 660-662. Items may not add to total due to rounding.

knocked down for assembly in Nigeria) was 37,681 in 1973, 43,898 in 1974, and more than 100,000 in 1975.[8] The expansion in customs revenue is unequivocally the result of increased value of imports inasmuch as there were general decreases in the rates of import duty on April 1, 1974, and again on April 1, 1975.[9]

Consumer goods, without doubt, played a predominant role in the imports of 1975. At least 50 percent of the customs duty revenue for 1975-76 can be directly attributed to consumer good imports, while raw materials or component parts for the local manufacture or assembly of consumer goods — many of which were granted concessionary rates of duty — constituted a sizeable proportion of the remainder. It is fair to point out that in 1974 and 1975 some imports of food were thought necessary as a result of the Sahelian drought of the early 1970s. It was not yet so clear that a longer-term deterioration in Nigerian agriculture was in progress. However, many of the imported goods were not food: customs duties on radios, television sets, and cars were reduced on April 1, 1974. Until the import resurgence of 1975, most of the beer sold in Nigeria was locally brewed, although with heavy dependence on imported raw materials and equipment. It seems that even apparently complete import substitution was no match for the desires and thirsts of Nigerian consumers when abett by government petroleum-financed permissiveness wi regard to public sector wages and salaries, imports, a foreign exchange availability.[10]

The import boom was fueled to a very significant exte by the government's own policies. Following the OP price increases of late 1973 and early 1974, and response to increasing pressure from within the ci service, the Report of the wages and salary review co mission (chaired by Chief Jerome Udoji) went to t Federal government in late 1974. Although the Co mission Report was sensitive to the inflationary implic

8. Nigeria, *Review of External Trade, 1975.*
9. The rates of customs duties were not generally increase until April, 1978.
10. It has been suggested that the wage and salary increases o early 1975 and the introduction in April, 1975, of the new federal finance revenue allocation formula, the Third Nationa Development Plan, and further import liberalization were al intended by the Gowon regime to secure the country's acquiesc ence to an indefinite delay in the return to civilian governmen That delay was announced October 1, 1974. R.A. Joseph "Affluence and Underdevelopment: The Nigerian Experience" *Journal of Modern African Studies*, June, 1978, p. 237.

## TABLE 3

**SOME DETAILS OF IMPORT DUTY REVENUE IN NIGERIA: SELECTED ITEMS AND YEARS**

(₦ million)

| | 1973-74 | 1974-75 | | 1975-76 | | 1977-78 | 1978-79 |
|---|---|---|---|---|---|---|---|
| | Actual | Estimate | Actual | Estimate | Actual | Actual | Estimate |
| TOTAL[a] | 299.8 | 183.9 | 364.0 | 312.8 | 704.7 | 1059.0 | 1263.3 |
| Beer | 1.0 | .8 | 3.0 | 2.0 | 20.3 | 18.2 | 43.0 |
| Wine and spirits | 2.5 | 1.5 | 3.8 | 3.0 | 13.3 | 16.4 | 17.6 |
| Food and live animals[b] | 28.6 | 7.0 | 21.1 | 23.4 | 36.0 | 70.2 | 92.9 |
| Manufactured goods | 111.1 | 111.9 | 190.7 | 134.8 | 327.9 | 421.1 | 466.8 |
| Vehicles } | 131.8 | 23.4 | 44.5 | 39.0 | 116.9 | 176.1 | 218.4 |
| Machinery and mechanical applicances and electrical equipment } | | 33.2 | 48.3 | 48.0 | 110.7 | 234.3 | 208.6 |
| Products of the chemical and allied industries | 6.0 | 10.0 | 21.5 | 20.8 | 39.5 | 61.5 | 65.6 |
| Mineral fuels, lubricants, oil and bituminous substances | 4.3 | 2.0 | 16.8 | 20.0 | 16.1 | 4.1 | 28.7 |

*Source:* Nigeria, *Official Gazettes,* various dates.

a Items shown are an incomplete list, and do not add to total shown.
b Omits animal and vegetable fats and oils.

tions of large and sudden wage increases, the Government White Paper granted wage and salary increases to some 750,000 civil servants that ranged from 30 to 100 percent with immediate effect. In addition, the government granted a lump-sum payment in early 1975 of those increments for the preceding nine months. [11] It is no wonder that there was a deluge of imports. [12] Thus, the Federal government's 1978 and 1979 measures to restrict imports and conserve foreign exchange are certainly necessary and wise. Neither military nor civilian governments have a monopoly on wisdom or error. However, the legacy contained in the last two Federal budgets is vitally important to any incoming civilian government. One hopes that that legacy will be maintained by fiscal and foreign exchange measures that are consistent with the present government revenue and foreign exchange realities.

11. No sooner were the contents of the White Paper announced than private sector employees of large manufacturing and commercial firms asked for the same increments as those granted in the public sector. In general, such requests were successfully obtained.

12. The government's own spending in preparation for the International Festival of Black and African Arts and Culture and for large numbers of construction projects — perhaps most vividly remembered by the prominence of the "cement ship armada" in the queue of ships waiting to berth in Lagos during the port congestion of 1975 — also contributed significantly to that import volume.

# IFA NEWS

## FRENCH BRANCH OF IFA

The French Branch of IFA announced that it would organize a meeting on November 19, 1979 in the Cercle Interallié, 33 rue Faubourg St.-Honoré, Paris (8), to discuss problems connected with the creation of an enterprise. Mr. Corrèze, deputy director at the "Direction générale des impôts", will chair the panel. The next meeting will be held at the head offices of A.N.S.A. on December 10, 1979.

The French Branch also announces some changes in the program for the 1981 IFA Congress. The farewell banquet was initially planned for Friday, September 19, 1980. It appears that this date coincides with Jewish New Year and a number of Jewish IFA members have requested that the farewell banquet be moved to Thursday 18, 1980.

The new program is as follows:

Sunday, September 14, 1980
Registration and welcoming cocktail.

Monday, September 15, 1980
Opening ceremony/Discussion of subject I/City tours for ladies: the Sainte Chapelle, the Latin Quarter, St. Germain des Prés/Official reception at the Hôtel de Ville in the evening.

Tuesday, September 16, 1980
Discussion of subject I (end) and subject II/Tours for ladies: Château of Vaux le Vicomte and Fontainebleau/Concert at Notre Dame of Paris in the evening.

Wednesday, September 17, 1980
Excursions.

Thursday, September 18, 1980
Discussion of subject II (end)/Seminar A/Guided tours of museums for ladies: Rodin, Louvre, Jeu de Paume, Sèvres, etc./Gala dinner at Versailles.

Friday, September 19, 1980
Seminar B/Conclusion of subjects I and II/General Meeting.

Subject I: The dialogue between tax administration and the taxpayer up to the filing of the tax return

Subject II: Rules for determining income and expenses as domestic or foreign

Seminar A: Recourse to tax havens: use and abuse

Seminar B: Specifics on French fiscal questions.

Arthur J. Mann*:

# The Evolution of Mexico's Public Expenditure Structure, 1895–1975

The absolute and relative growth of public expenditures in developed and developing countries is a theme which has been amply analyzed in both theoretical and empirical terms.[1] Most of the empirical work postdates World War II, and this is especially true with respect to the developing areas. However, much of the analysis done on developing countries is cross-sectional in nature, often reflecting the absence of pre-World War II historical data series.[2] Moreover, many cross-sectional (and even time-series) studies have limited their analyses to a study of public expenditure growth at the central or federal government levels, thereby not accounting for expenditure variations at lower governmental levels and/or in the often more rapidly expanding public enterprise sector.[3]

**This article represents, in part, the continuation of a study previously published in this journal. By combining the two papers, both sides of the historical Mexican budget process may be observed, although the methodology employed is not comparable. For the revenue side of the budget, see Arthur J. Mann, "The Evolution of Mexico's Public Revenue Structure, 1877-1977", 32 Bulletin for International Fiscal Documentation (1978), pp. 294-300.**

*This article examines the relative and absolute growth of expenditures in Mexico's public sector over the first three-quarters of the 20th century. Defining public sector spending as the net disbursements of the federal government, the federal entities, and the decentralized enterprises, it is shown that constant peso per capita outlays and total expenditures as a proportion of GDP increased over the time period covered. These rises were especially evident after the decade of the 1940s, as pubic policy transferred more and more responsibilities to the semi-autonomous decentralized enterprises. The composition of aggregate expenditures was also modified, as relative capital outlays (as opposed to current expenditures) and relative spending on economic and social functions (as opposed to expenditures of purely administrative character) took on greater proportional magnitudes.*

*The applicability of some leading public expenditure hypotheses to the Mexican experience is discussed. While Wagner's Law and the concentration effect were found to be generally applicable to public expenditure behavior in 20th century Mexico, the displacement effect postulate appears to hold no explanatory power. However, even in the case of the former two hypotheses, their relative vagueness of exposition limits their usefulness in explaining Mexican public expenditure trends. Perhaps the best explanation for the observed rising trend in public sector spending is simply that the overall concept of the role of the state has changed, thereby leading to increased public intervention in social and economic matters. This is certainly a universal phenomenon in this century, and in developing countries is reinforced by the fragility of private sector structures to meet demanding socio-economic problems.*

This paper presents a time-series analysis of expenditures in the public sector of Mexico over the period 1895-1975. Although reliable expenditure data for the Mexican *federal* government are extant back to 1877, the 1895 starting point is dictated by the availability of a gross output measure (the gross domestic product). All expenditure date presented represent actual disbursements, as opposed to budgeted outlays. The expenditure totals are further broken down into rather broad functional and economic categories in a attempt to better explain and summarize growth patterns. In addition to briefly explaining how the data generally correspond to Mexico's social, political, and economic history over the 80 year period, comparisons against some well-known public expenditure hypotheses are also carried out.

A broad definition of what constitutes Mexico's public sector has been adopted. All tabular presentations have broken down the public sector into its three basic components: the federal government, the federal entities (state, municipal, and federal district), and the decentralized enterprises ("organismos descentralizados" and "empresas paraestatales"). It has been argued that the activities of these decentralized enterprises should not be included in the definition of public sector activity, for their production is either profit-motivated or affect-

* The research for this paper was done while the author was Fulbright Professor of Economics in the Facultad de Economía of the Universidad de Nuevo León in Monterrey, Mexico, on leave from the University of Puerto Rico. He is presently employed as an economist in the International Labour Office.

1. Among the many published studies in this area are those of S. Andic and J. Veverka, "The Growth of Government Expenditure in Germany since the Unification", *Finanzarchiv*, V.23 (1964), pp. 169-277; R. Bird, *The Growth of Government Spending in Canada* (Toronto: Canadian Tax Foundation, 1970); D. Mahar and F. Rezende, "The Growth and Pattern of Public Expenditure in Brazil, 1920-1969", *Public Finance Quarterly*, V.3 (1975), pp. 380-399; A. Peacock and J. Wiseman, *The Growth of Public Expenditure in the United Kingdom* (Princeton: Princeton Univ. Press, 1961).
2. See, for example, S. Gupta, "Public Expenditure and Economic Development — A Cross Section Analysis", *Finanzarchiv* V.27 (1968), pp. 26-41; and R. Musgrave, *Fiscal Systems* (New Haven: Yale Univ. Press, 1969).
3. See, for example, I. Goffman and D. Mahar, "The Growth of Public Expenditures in Selected Developing Nations: Six Caribbean Countries, 1940-1965", *Public Finance/Finances Publiques* V.26 (1971), pp. 57-74; and A. Mann, "Public Expenditure Patterns in the Dominican Republic and Puerto Rico, 1930-1970", *Social and Economic Studies*, V.24 (1975), pp. 47-82.

ed by market criteria.[4] While this may certainly be the case for some of Mexico's decentralized agencies, such affect or motivation is not true for all. Mexican development policy, especially since the 1940s, has come to rely more and more on these semi-public agencies to carry out socio-economic development objectives. Moreover, many public enterprises have become increasingly dependent upon federal government transfers and borrowing to execute their investment programs, and there are strong indications that foreign lenders tend to mentally lump together notes from the several Mexican public sector components when taking the decision to lend. Thus, a broad definition of public sector activity is justifiable, especially so in Mexico where many decentralized agencies, although not directly subject to federal budgetary control, are certainly subject to varying degrees of policy control as decided upon by the nation's political authorities.[5] Nevertheless, in this study only the *capital* expenditures of the decentralized enterprises are accounted for,[6] since they are generally determined by national policy considerations; it is assumed that *current* expenditures are covered by income usually originating from the sale of goods and services to the private sector.

## AGGREGATE EXPENDITURE TRENDS

The growth of absolute expenditures in Mexico's public sector by level of government over the period 1895 to 1975 can be viewed by using text Table 1 in conjunction with Appendix Tables A-1, A-2, and A-3. These tables yield public expenditure data in terms of current pesos, constant (1960) pesos, and per capita constant (1960) pesos. Perusal of Table 1 indicates that federal government current peso outlays rose from 42 million pesos in 1895 to 134,328 million pesos in 1975, a jump of over 3000 times. However, after removal of the 'permanent influences" of inflation and population growth from the current peso data, the increases are reduced to approximately 53 times and 11 times respectively. In other words, the Mexican federal government in 1895 spent, on all its functions, 72 pesos per head (in terms of constant 1960 pesos). By 1975 this same level of government was spending 828 pesos per capita (again in terms of 1960 pesos).[7] The disbursements of the federal entities increased in a like manner but in a reduced magnitude.

4. These views are expanded upon in Bird, op.cit., and in Peacock and Wiseman, op.cit.
5. Support for this statement is found in C. Reynolds, *The Mexican Economy: Twentieth-Century Structure and Growth* (New Haven: Yale Univ. Press, 1970), pp. 269-271.
6. Both the current and capital expenditures of the national social security agencies are included, for there is a direct tax charge which finances their disbursements.
7. Current and constant peso (pesos of 1950) expenditure data for Mexico's federal government between the years 1900 and 1963 are presented in J. Wilkie, *The Mexican Revolution: Federal Expenditure and Social Change since 1910* (Berkeley: Univ. of California Press, 1970, second edition). However, his gross expenditure figures differ widely from the net figures used here. For an explanation of this difference refer to note "a" of Table A-1.

### Table 1

**NET EXPENDITURES[a] OF THE MEXICAN PUBLIC SECTOR, SELECTED YEARS, 1895-1975**

| Year | Level of government | | | | |
|---|---|---|---|---|---|
| | Federal government | Federal entities[e] | Decentralized enterprises[f] | Government subsector[g] | Public sector[h] |
| **1895** | | | | | |
| Current expenditures[b] | 42 | 33 | – | 75 | 75 |
| Constant expenditures[c] | 909 | 713 | – | 1622 | 1622 |
| Per capita constant[d] | 72 | 56 | – | 128 | 128 |
| **1925** | | | | | |
| Current expenditures[b] | 287 | 105 | 45 | 392 | 437 |
| Constant expenditures[c] | 1889 | 689 | 296 | 2578 | 2874 |
| Per capita constant[d] | 124 | 45 | 19 | 170 | 189 |
| **1950** | | | | | |
| Current expenditures[b] | 2796 | 949 | 1685 | 3745 | 5430 |
| Constant expenditures[c] | 5306 | 1802 | 3197 | 7108 | 10,305 |
| Per capita constant[d] | 206 | 70 | 124 | 276 | 400 |
| **1975** | | | | | |
| Current expenditures[b] | 134,328 | 53,127 | 86,568 | 187,455 | 274,023 |
| Constant expenditures[c] | 48,476 | 19,173 | 31,241 | 67,649 | 98,890 |
| Per capita constant[d] | 828 | 327 | 534 | 1155 | 1689 |

a Double-counting eliminated. See note "a" to Table A-1.
b Millions of current pesos.
c Millions of 1960 pesos.
d 1960 Pesos.
e States, municipalities, and Federal District.
f Capital expenditures only. See note "c" to Table A-1.
g Federal Government and Federal entities.
h Decentralized enterprises and government subsector.
Horizontal summation may not be exact due to rounding.

**Sources:** Appendix Tables A-1, A-2, and A-3.

By far the largest expenditure jumps are evidenced in the decentralized enterprises sector, which did not exist in 1895. Beginning with a constant per capita expenditure of 19 pesos in 1925 (exclusively on the Ferrocarriles Nacionales de México), this sector was spending 534 pesos per capita (in constant terms) by 1975 over a large gamut of areas.[8] Taking into account the overall public sector, the upward increase over the eight-decade period in constant per capita expenditure is noteworthy, as this figure rose from 128 pesos in 1895 to 189 pesos in 1925 to 1689 pesos in 1975. On the basis of this general evidence alone, it can be concluded that the average Mexican has been increasingly influenced by public sector spending activities.

As a summary presentation of Tables A-1, A-2, and A-3, Table 1 does not reveal the time patterns of Mexican public expenditure growth. In terms of constant peso per capita disbursements (Table A-3), it may be noted that a slight reduction in expenditures occurred between 1895 and 1910, with an effective doubling of public sector spending occurring over the 1895-1940 period. It is after 1940 that overall public sector spending began to increase by leaps and bounds, with the semi-autonomous decentralized sector leading the way. Those five-year intervals that were particularly instrumental in pushing public outlays to higher levels were those falling between 1945-1950, 1960-1965, and 1970-1975.

Although the absolute expenditure data in Table 1 do serve to throw light upon the essence of Mexican public sector expenditure growth, they nevertheless fail to gauge the relative (or proportional) growth. There exists an obvious interrelationship between public expenditures and national income; increased public spending serves to increase national income (ceteris paribus), while rising real national income levels may serve to increase relative public income levels and, in the context of economic underdevelopment, most likely require rising public investment outlays. Thus, in order to measure *relative* Mexican public expenditure growth over the 1895-1975 time span, expenditure to gross domestic product (GDP) percentages are presented in Table 2.

The first column for each governmental level in Table 2 gives the expenditure to GDP ratio in terms of the current peso value for each variable; each second column percentage calculates the same proportion, with both the numerator and denominator values in terms of constant (1960) pesos. This is in line with a recent article by Beck,[9] which illustrates the importance of deflating both series in order to obtain more accurate measures of *real* public sector magnitudes. Expenditures at all levels have been translated into 1960 pesos by use of wholesale price index over the 1895-1955 period and by the national accounts implicit price deflator for the governmental sector for the 1960-1975 time span (see Appendix Table A-4 for sources).

The relatively high percentages corresponding to the years 1895 and 1900 should probably be discounted, for although the numerator value is reliable and consistent, the GDP values give every indication of being underestimated (independently of the Table 2 proportions).[10] Focus on the proportions presented in the second column at each governmental level reveals a slow upward trend over the years with respect to federal government and government subsector activities. Only in the last five years of the eight-decade span (1970-1975) can any "dramatic" jump in the real proportion be discerned. While federal relative spending slowly crept upward between 1925 and 1975, federal entity proportional outlays outline a U-shaped pattern from 1935 to 1975. Decentralized enterprise relative spending, while remaining steady throughout the depression years of the 1930s, began an essentially steady upward climb after 1940. All in all, overall public sector relative expenditures have risen around an upward trend line since 1925, with the only rather spectacular jumps taking place between 1955-1960 and 1970-1975.

## Table 2

**NET EXPENDITURES OF THE MEXICAN PUBLIC SECTOR AS PERCENTAGES OF GDP, SELECTED YEARS, 1895-1975**
[(current (1) and constant (2) prices)]

| Year | Federal government (1) | Federal government (2) | Federal entities[a] (1) | Federal entities[a] (2) | Decentralized enterprises[b] (1) | Decentralized enterprises[b] (2) | Government subsector[c] (1) | Government subsector[c] (2) | Public sector[d] (1) | Public sector[d] (2) |
|---|---|---|---|---|---|---|---|---|---|---|
| 1895 | 8.4 | 7.0 | 6.6 | 5.5 | – | – | 15.1 | 12.5 | 15.1 | 12.5 |
| 1900 | 6.0 | 7.0 | 4.0 | 4.7 | – | – | 10.0 | 11.6 | 10.0 | 11.6 |
| 1905 | 5.7 | 6.3 | 3.8 | 4.1 | – | – | 9.5 | 10.4 | 9.5 | 10.4 |
| 1910 | 3.6 | 4.7 | 2.3 | 3.0 | – | – | 5.9 | 7.7 | 5.9 | 7.7 |
| 1925 | 5.8 | 5.1 | 2.1 | 1.8 | 0.9 | 0.8 | 7.9 | 6.9 | 8.9 | 7.7 |
| 1930 | 6.1 | 5.6 | 2.8 | 2.6 | 1.0 | 0.9 | 8.9 | 8.2 | 9.9 | 9.0 |
| 1935 | 6.7 | 5.8 | 3.3 | 2.9 | 1.0 | 0.8 | 10.0 | 8.7 | 11.0 | 9.5 |
| 1940 | 7.1 | 6.8 | 2.7 | 2.6 | 1.8 | 1.8 | 9.8 | 9.4 | 11.6 | 11.1 |
| 1945 | 6.8 | 6.3 | 2.3 | 2.1 | 2.1 | 1.9 | 9.1 | 8.3 | 11.1 | 10.2 |
| 1950 | 7.0 | 6.4 | 2.4 | 2.2 | 4.2 | 3.8 | 9.4 | 8.5 | 13.7 | 12.4 |
| 1955 | 7.8 | 7.2 | 2.1 | 2.0 | 3.3 | 3.0 | 9.9 | 9.1 | 13.2 | 12.1 |
| 1960 | 7.9 | 7.9 | 2.4 | 2.4 | 5.7 | 5.7 | 10.4 | 10.4 | 16.0 | 16.0 |
| 1965 | 9.3 | 9.6 | 2.4 | 2.5 | 6.7 | 6.8 | 11.7 | 12.1 | 18.3 | 18.8 |
| 1970 | 9.5 | 9.1 | 3.2 | 3.1 | 6.7 | 6.5 | 12.7 | 12.2 | 19.4 | 18.7 |
| 1975 | 13.4 | 12.4 | 5.3 | 4.9 | 8.7 | 8.0 | 18.7 | 17.3 | 27.4 | 25.3 |

a States, municipalities, and federal district.
b Capital expenditures only.
c Federal government and federal entities.
d Decentralized enterprises and government subsector. Horizontal summation may not be exact due to rounding.

**Sources:** Appendix Tables A-1, A-2, and A-4.

An alternative method of measuring public expenditure relative growth patterns is by means of elasticity coefficients; such coefficients simply gauge the percentage change in public expenditure (over time) as a proportion of the percentage change in (this case) GDP. It has been

8. Some of the more important (in terms of expenditure levels) of the myriad enterprises comprising this sector are Caminos y Puentes Federales, Comisión Federal de Electricidad, Ferrocarriles Nacionales de México, Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado (ISSSTE), Instituto Mexicano del Seguro Social (IMSS), Petróleos Mexicanos (PEMEX), and the Banco Nacional Hipotecario Urbano y de Obras Públicas.
9. M. Beck, "The Expanding Public Sector: Some Contrary Evidence", *National Tax Journal*, V.29 (1976), pp. 15-21.
10. See the source discussion to Table A-4.

argued that elasticity coefficients give a more useful interpretation of public expenditure changes than do the simple ratios of Table 2.[11] They are therefore presented in Table 3 for different time spans. The periods have been intentionally selected. The 1895-1975 period obviously is included since it covers the entire span of this study; the 1895-1910 period covers the last decade and a half of the Porfirio Díaz regime that preceded the Mexican Revolution. Given the problem mentioned above regarding the underestimation of GDP for the year 1895, the coefficients pertinent to these two periods should not be accepted with a great deal of confidence.

However, all years following (and including) 1925 may be taken as quite reliable, based as they are on consistent expenditure data and on the most recent revisions of current and constant price GDP figures. The year 1940 is included given that Mexican economic growth dates from approximately this time; 1960 represents a watershed era in terms of expenditure priorities (as will be pointed out subsequently), as does 1970 in terms of an excessively debt-financed expenditure take-off.

### Table 3

**ELASTIC COEFFICIENTS OF NET PUBLIC EXPENDITURES BY GOVERNMENTAL LEVEL, SELECTED PERIODS, MEXICO, 1895-1975**

A. Coefficients based on current prices

| Period | Level of government | | | | |
|---|---|---|---|---|---|
| | Federal government | Federal entities[a] | Decentralized enterprises | Government subsector[b] | Public sector[c] |
| 1895-1975 | 1.58 | 0.80 | – | 1.24 | 1.81 |
| 1895-1910 | 0.28 | 0.18 | – | 0.24 | 0.24 |
| 1925-1975 | 2.32 | 2.50 | 9.53 | 2.36 | 3.10 |
| 1925-1940 | 1.61 | 1.72 | 3.79 | 1.64 | 1.86 |
| 1940-1975 | 1.90 | 1.98 | 4.73 | 1.92 | 2.37 |
| 1940-1960 | 1.12 | 0.90 | 3.18 | 1.06 | 1.40 |
| 1960-1975 | 1.82 | 2.39 | 1.63 | 1.95 | 1.84 |
| 1970-1975 | 1.71 | 2.14 | 1.49 | 1.82 | 1.70 |

B. Coefficients based on constant prices

| Period | Level of government | | | | |
|---|---|---|---|---|---|
| | Federal government | Federal entities[a] | Decentralized enterprises | Government subsector[b] | Public sector[c] |
| 1895-1975 | 1.80 | 0.89 | – | 1.40 | 2.07 |
| 1895-1910 | 0.25 | – 0.03 | – | 0.13 | 0.13 |
| 1925-1975 | 2.61 | 2.84 | 11.08 | 2.68 | 3.54 |
| 1925-1940 | 2.74 | 3.00 | 7.17 | 2.81 | 3.26 |
| 1940-1975 | 1.94 | 2.03 | 5.03 | 1.97 | 2.45 |
| 1940-1960 | 1.24 | 0.93 | 4.21 | 1.16 | 1.64 |
| 1960-1975 | 1.92 | 2.65 | 1.68 | 2.09 | 1.95 |
| 1970-1975 | 2.50 | 3.50 | 1.98 | 2.75 | 2.49 |

a States, municipalities, and federal district.
b Federal government and federal entities.
c Decentralized enterprises and government subsector.

**Sources:** Data presented in Tables A-1, A-2, and A-4.

Taken together, the figures of Tables 2 and 3 fit very well the historical backdrop. Although the Constitution of 1917 conceived of the state as an entity having the power to broadly intervene in the nation's economic life, the socio-economic views of Mexico's leaders during the 1920s and into the mid-1930s did not differ greatly from the laissez-faire views held under the Porfiriato. Nevertheless, even after the mid-1920s certain measures were taken which were later to prove significant in the financing of economic development. For example, an income tax was introduced, which by the 1970s provided close to half the federal government's recurrent income; a central bank, the Banco de México, was created, and internal debt bonds to finance public works were first issued.

By the mid-1930s public investment in the national infrastructure began to lay the bases for the economic growth take-off, a process which maintained momentum through the early 1970s. These capital expenditures on the economic infrastructure werd made by reordering federal government spending patterns (see Tables 4 and 5) without, until the 1960s, appreciably increasing the relative spending of the federal fisc. Increasingly after 1940 capital outlays were channeled through the decentralized enterprises, the most important of which were Petróleos Mexicanos (PEMEX), the Comisión Federal de Electricidad, the national railway system, and the national social security systems. This is evidenced in Table 2 by the jumps in the expenditure/GDP ratio after 1935 and in Table 3 by the high elasticity coefficients of the decentralized enterprise sector in comparison with the other sectors.

While by the late 1950s federal government spending began to move away from heavily emphasizing economic spending towards more spending on social objectives, expenditures in the 1960s and into the 1970s came more and more to depend on deficit financing. From 1940 to the mid-1950s capital spending was financed internally, basically via debt monetization; both inflation rates and money supply rates of increase were high. After 1954-1955 increasing reliance came to be placed on external debt emissions, a process which reached its culmination by the mid-1970s. Especially after 1971 the federal debt rose in absolute and relative terms; whereas in 1960 the federal government's monetary deficit represented 0.5 percent of GDP, by 1970 and 1975 it had grown to 1.6 percent and 5.8 percent respectively.

## EXPENDITURE COMPOSITION TRENDS

In order to provide greater insight into the evolutionary growth pattern of public sector spending in Mexico, disaggregated expenditure data are presented in Tables 4 and 5.[12] Table 4 breaks down total outlays at each

11. I. Goffman, "On the Empirical Testing of Wagner's Law: A Technical Note", *Public Finance/Finances Publiques,* V.23 (1968), pp. 359-364.

12. In order to reduce the size of the tables, spending breakdowns for only five different years of the 1895-1975 period are presented in these two tables. Breakdowns for each five-year interval are available from the author upon request.

governmental level into current and capital expenditure categories. Such a distinction is especially significant to the process of economic growth, for the capital disbursements are durable asset-creators. All current and capital transfers between governmental levels are counted only once as expenditures at the level they are originally made. Table 5 has broken down the same total spending figures into three rather broad functional categories.[13] The administrative category is a catch-all classification in the sense that any outlay not clearly belonging to the other two categories is placed here; this heading includes expenditure on the armed forces, general government functions, and public debt interest (excluding debt amortization). The economic heading includes all disbursements on transportation and communication, industry and commerce, and most outlays on the agricultural sector. Social expenditures incorporate outlays on education, social security, health and welfare, labor, and housing. Again, all transfers between levels are counted only once.

In conjunction, Tables 4 and 5 clearly demonstrate the passage of the Mexican public sector from a late 19th century laissez-faire non-interventionist entity toward an activist promotor of economic and social development. As late as the early 1930s, well over four-fifths of government subsector outlays went toward current expenses. However, by the decade of the 1940s both federal and decentralized enterprise capital expenditures took the lead in promoting the development of Mexico's basic infrastructure. And by 1975 fully 40 percent of total public sector spending (excluding the current outlays of the decentralized enterprise sector) was on capital account.

Table 5 reveals a strictly passive (and administrative) functional expenditure structure in the late 19th (and early 20th) century. As the decades of the 1930s and 1940s progressed, relative economic category spending surpassed that of the remaining two classifications. As proportional administrative expenditures fell, due in large part to the easing out of the military from a significant role in Mexico's political life, economic growth-oriented expenditures were given precedence over socially oriented disbursements, although this latter category was certainly not ignored. After the late 1950s a more balanced system of expenditure priorities was implemented, as spending on both social and economic objectives was given more or less equal priority.[14]

13. As far as possible an effort has been made to follow Wilkie's (op.cit., p. 13) functional classification. However, given the difference in expenditure concepts (especially administrative expenditures) between this paper and the Wilkie study, the federal government figures are not strictly comparable.

14. These trends, in terms of federal government functional expenditure categories, are discussed by Wilkie (op.cit., Part I). For an overview of Mexican economic policy during the 20th century, see Reynolds (op.cit.) and L. Solís, *La realidad económica mexicana: retrovisión y perspectivas* (México: Siglo Veintiuno, 1976, 6th edition).

## Table 4

**CURRENT AND CAPITAL EXPENDITURES[a] OF THE MEXICAN PUBLIC SECTOR, SELECTED YEARS, 1895-1975**

(Millions of current pesos (1) and percentage breakdown (2))

| Year | Federal government (1) | Federal government (2) | Federal entities[b] (1) | Federal entities[b] (2) | Decentralized enterprises (1) | Decentralized enterprises (2) | Government subsector[c] (1) | Government subsector[c] (2) | Public sector[d] (1) | Public sector[d] (2) |
|---|---|---|---|---|---|---|---|---|---|---|
| **1895** | | | | | | | | | | |
| Current | 39 | 93 | N.A. | – | – | – | 39 | 93 | 39 | 93 |
| Capital | 3 | 7 | N.A. | – | – | – | 3 | 7 | 3 | 7 |
| **1925** | | | | | | | | | | |
| Current | 250 | 87 | 93 | 89 | – | – | 343 | 88 | 343 | 78 |
| Capital | 37 | 13 | 12 | 11 | 45 | 100 | 49 | 12 | 94 | 22 |
| **1940** | | | | | | | | | | |
| Current | 405 | 73 | 164 | 78 | 2[e] | 1 | 569 | 75 | 571 | 63 |
| Capital | 147 | 27 | 45 | 22 | 142 | 99 | 192 | 25 | 334 | 37 |
| **1960** | | | | | | | | | | |
| Current | 9150 | 77 | 2675 | 73 | 2900[e] | 34 | 11,825 | 76 | 14,725 | 61 |
| Capital | 2778 | 23 | 995 | 27 | 5599 | 66 | 3773 | 24 | 9372 | 39 |
| **1975** | | | | | | | | | | |
| Current | 92,562 | 69 | 43,534 | 82 | 27,864[e] | 32 | 136,096 | 73 | 163,960 | 60 |
| Capital | 41,766 | 31 | 9593 | 18 | 58,704 | 68 | 51,359 | 27 | 110,063 | 40 |

N.A. Not available.

a In those cases where a transfer is not classifiable, it is assumed to be a current expenditure. All transfers are counted as expenditures only at the level at which they are initially made.
b States, municipalities, and federal district.
c Federal government and federal entities.
d Decentralized enterprises and government subsector.
e Current expenditures of social security agencies.

**Sources:** See sources to Table A-1.

## Table 5

**NET EXPENDITURES OF THE MEXICAN PUBLIC SECTOR BY FUNCTIONAL CATEGORY[a], SELECTED YEARS, 1895-1975**

(Millions of current pesos (1) and percentage breakdown (2))

| | Level of government | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Year | Federal government | | Federal entities[b] | | Decentralized enterprises | | Government subsector[c] | | Public sector[d] | |
| | **(1)** | **(2)** | **(1)** | **(2)** | **(1)** | **(2)** | **(1)** | **(2)** | **(1)** | **(2)** |
| **1895** | | | | | | | | | | |
| Administrative | 36 | 86 | N.A. | – | – | – | 36 | 86 | 36 | 86 |
| Economic | 4 | 9 | N.A. | – | – | – | 4 | 9 | 4 | 9 |
| Social | 2 | 5 | N.A. | – | – | – | 2 | 5 | 2 | 5 |
| **1925** | | | | | | | | | | |
| Administrative | 163 | 57 | N.A. | – | 0 | 0 | 163 | 57 | 163 | 49 |
| Economic | 98 | 34 | N.A. | – | 45 | 100 | 98 | 34 | 143 | 43 |
| Social | 26 | 9 | N.A. | – | 0 | 0 | 26 | 9 | 26 | 8 |
| **1940** | | | | | | | | | | |
| Administrative | 227 | 41 | N.A. | – | 4 | 3 | 227 | 41 | 231 | 33 |
| Economic | 206 | 37 | N.A. | – | 137 | 95 | 206 | 37 | 343 | 49 |
| Social | 119 | 22 | N.A. | – | 3 | 2 | 119 | 22 | 122 | 18 |
| **1960** | | | | | | | | | | |
| Administrative | 2998 | 25 | 1965 | 53 | 212 | 2 | 4963 | 32 | 5175 | 21 |
| Economic | 5264 | 44 | 467 | 13 | 3620 | 43 | 5731 | 37 | 9351 | 39 |
| Social | 3666 | 31 | 1241 | 34 | 4667 | 55 | 4907 | 31 | 9574 | 40 |
| **1975** | | | | | | | | | | |
| Administrative | 34,101 | 25 | 36,542 | 69 | 266 | 0 | 70,643 | 38 | 70,909 | 26 |
| Economic | 58,712 | 44 | 5311 | 10 | 38,735 | 45 | 64,023 | 34 | 102,758 | 37 |
| Social | 41,515 | 31 | 11,274 | 21 | 47,567 | 55 | 52,789 | 28 | 100,356 | 37 |

N.A. Not Available.

a The administrative category is residual in the sense that any outlay not classifiable under the economic and social categories was placed in it.

b States, municipalities, and federal district.

c Federal government and federal entities.

d Decentralized enterprises and government subsector.

**Sources:** See sources to Table A-1.

## EXPENDITURE POSTULATES AND THE MEXICAN EXPERIENCE

Numerous hypotheses have been developed in an effort to explain the growth patterns of public expenditures. Probably the best known of these postulates are Wagner's Law and the Peacock-Wiseman displacement effect and concentration effect. What follows is a brief assessment of the relationship between these hypotheses and the Mexican public expenditure experience.

Wagner's Law of expanding state activity advances the postulate that, in the process of industrialization and "economic progress", government expenditures will increase as a percentage of some national gross output measure. The "law" would most likely operate under conditions of increasing real per capita income, institutional and technological change, and broader political participation. Wagner reasoned that the law and order function of the state would have to be expanded due to the increased complexity and tensions created by the modern state; the regulation of economic relationships would also become a growing necessity. Moreover, the state would more and more have to enter the realm of the actual production of goods and services, as private monopoly power increased and private corporations were unable to acquire the capital funds required for large-scale investment. Finally, social expenditures would increase in relative importance given the income elastic nature of the demand for publicly provided social goods (e.g. education).

Mexico, at least from around 1940 through 1975, certainly seems to meet the general conditions under which it is expected that Wagner's Law would operate. In terms of 1960 pesos, per capita GDP rose from 2376 pesos in 1940 to 6666 pesos in 1975. A greater proportion of the population became at least indirectly involved in the political process; institutional, technological, and structural change took place; and industrialization moved forward.

Empirically, many different formulations have been used to "test" the Wagner hypothesis. If, as Michas[15] suggests, the correct measure to test the postulate is the per capita income elasticity of public expenditures, Wagner's Law, in the aggregate, appears to hold in the Mexican context over the 1940-1975 period. Using GDP as the income measure, during this time span the current

15. N. Michas, "Wagner's Law of Public Expenditures: What is the Appropriate Measurement for a Valid Test?", *Public Finance/Finances Publiques*, V.30 (1975), pp. 77-83.

peso elasticity coefficients for federal government expenditures and for overall public sector outlays were 1.92 and 2.39 respectively; the constant peso elasticity coefficients were 2.29 and 2.99 respectively. With respect to a functional disaggregation of the entire public sector's disbursements between 1940 and 1975, the per capita income elasticity coefficients corresponding to the administrative, economic, and social expenditure classifications are estimated at (in current pesos) 2.42, 2.36, and 6.52 respectively. Certainly, then, in both an aggregate and compositional sense, the Mexican data appear to support Wagner's Law. This interpretation should be accepted with caution, however, for as Bird [16] has pointed out, Wagner's theoretical construct is neither clear nor does it have a meaningful empirical counterpart. Since the pertinent variables are not specifically delimited, the end result is "not a substantive theory but a philosophical theme", highly dependent upon Wagner's own view of the nation state and its "duties".

The displacement effect, a term originally coined by Peacock and Wiseman, [17] implicitly postulates an unsated demand for publicly provided goods, and refers to the stepwise fashion in which government expenditures as a proportion of an aggregate output measure increase (or decrease) over time. Public expenditure, dependent to a large extent on tax revenues, is constrained by the prevailing consensus as to tolerable tax levels. However, under the influence of a "social disturbance" (e.g. war, depression), tolerance restraints are lifted, thereby providing the mechanism by which a new proportional level (or plateau) of public expenditure may be reached. Thus, the displacement effect hypothesis may be used to explain the irregular time pattern of relative public expenditure changes.

Although the advent of World War II did generate the beginnings of Mexico's industrialization push, Mexico remained relatively unaffected by it. It would appear that the only period which could be categorized as one of social disturbance (over the 1895-1975 time span) is that of the Revolution (1910-1917). Thus, if displacement was a phenomenon in Mexican fiscal history, it would be expected to have occurred during or subsequent to this period.

Unfortunately, there are no Mexican GDP estimates for the tumultuous 1911-1920 epoch. Nevertheless, as pointed out above, the Constitution of 1917 adopted an interventionist view of the state in national economic and social affairs. Therefore, if the social upheaval of the Revolution were to produce a lagged displacement effect, it would most likely occur in the decades of the 1920s and 1930s.

The data presented in Table 2 do not reveal the presence of a Mexican displacement effect. Instead of an irregular growth pattern of expenditure plateaus, what appears is a rather steady upward drift of the public expenditure/ GDP proportion. Both the current and constant peso data yield a similar conclusion. Moreover, there is no accompanying evidence of sudden changes in tax tolerability (or tax threshold) levels. Federal government and federal entity tax revenues as a percentage of GDP also show a steady upward movement over the 1920-1975 period. In fact, especially in the past two decades relative public expenditure levels have risen at a faste rate than relative tax revenue levels, for the federa government (and the overall public sector) has recurre more and more to deficit financing. What seems to hav conditioned the proportional expenditure rises evi denced in Table 2 between 1960 and 1975 is more th availability of internal and external credit than dramati upward shifts in tax threshold limits. Certainly one o the major causes of the 1976 peso devaluation was th growing gap between public expenditures and publi recurrent revenues.

Thus, there appears to be little or no indication that th displacement effect hypothesis can be used to explai Mexican public expenditure patterns. Given th vagueness of the hypothesis, it does not easily lend itsel to statistical testing. Moreover, its very existence ha been seriously questioned, for it may only represent temporary interruption in a longer-run trend pattern.

The names of Peacock and Wiseman are also linked t another public expenditure hypothesis — the concentra tion effect. This postulate sustains that public secto and economic growth produce a centralization of publi spending toward higher levels of government. Such phenomenon results from the economies of scal created by the centralization process, economies spurre by nationwide improvements in transportation and com munication facilities. These improvements, in turn, mee a demand for greater uniformity in the provision o public goods and services.

A percentage breakdown of the data presented in Tabl A-1 may be employed to observe two different version of this hypothesis. Taking the government subsector b itself (i.e. excluding the decentralized enterprises), ove the entire 1895-1975 period there has occurred concen tration in the sense that federal government expendi tures as a proportion of total government subsecto disbursements increased. From 1895 to 1910 the federa government accounted for around three fifths of govern ment subsector outlays; from 1925 to 1975 the federa share roughly fluctuated between two thirds and fou fifths. In the past decade or so revenue sharing by th states and municipalities under federally imposed ta statutes had become a more important source of federa entity recurrent incomes. For the purposes of the dat presentation of Table A-1, these revenues are considere "owned" federal entity income, and therefore serve t buoy the expenditure figures of these lower govern mental levels. Thus, the process of concentratio appears to have been arrested toward the end of th eight-decade period. This is not surprising, for seriou efforts have been made to fortify the fiscal capacities o the states and municipalities.

Taking the broader view of total public sector spendin and the concentration effect, it is obvious that th outlays of the decentralized enterprises have dramatic ally risen as a proportion of aggregate disbursements Employing the definition of decentralized enterpris

16. R. Bird, "Wagner's Law of Expanding State Activity", *Publi Finance/Finances Publiques,* V.26 (1971), pp. 1-26.
17. Peacock and Wiseman, op.cit.

spending adhered to in this study (i.e. capital spending with the exception of social security), these semi-autonomous agencies increased their relative expenditures from one tenth to over one third of the aggregate during the 1925-1975 span of years. If, despite the fact that many decentralized enterprises operate outside direct federal government budgetary control, it is assumed that these agencies form part of the federal government policy structure, the degree of fiscal concentration (vis-à-vis the federal entities) is markedly greater than shown by the government subsector data. Nevertheless, at the national level (excluding the federal entities) decentralization has occurred, in the sense that the direct budgetary functions of the federal government fell as a percentage of the spending of both the semi-autonomous agencies and the federal polity itself. This latter process has been referred to as "decentralized centralization".[18]

Whichever version is accepted of the concentration effect in Mexico, any link with the Peacock-Wiseman hypothesis is tenuous. Communications and transportation networks have certainly improved since 1925 (and before), and there does today exist greater regional public service uniformity. But it is difficult to move from such generalities to a definite case of cause and effect. All that may be ventured is to state that an expenditure concentration effect did occur in Mexico over the period under analysis.

18. See Mahar and Rezende, op.cit.

See for appendices overleaf.

# Conference Diary

## DECEMBER 1979

*AMR International:* Creating captive insurance companies and managing their portfolios (including the impact of taxation), London (United Kingdom), December 5-6 (English).

*British Branch of I.F.A.:* Transfer pricing in the U.S. and Germany (Tax Workshop), London (United Kingdom), December 11 (English).

*Management Centre Europe:* International cash management (including international tax aspects in cash management), London (United Kingdom), December 12-14 (English).

## JANUARY 1980

*British Branch of I.F.A.:* The limits of tax avoidance (Tax Workshop), London (United Kingdom), January 8 (English).

*Business Perspectives:* 6th International Tax Conference (including the unitary system of taxing corporations in the U.S.A.; The legal and tax conditions of trading with the People's Republic of China; Taxes on oil, gas, shipping and natural resources), Singapore, February 3-8 (English).

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

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

## MARCH 1980

*British Branch of I.F.A.:* Exchange of information and extra territorial claims by Revenue Authorities (Tax Workshop), London (United Kingdom), March 6 (English).

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

## SEPTEMBER 1980

*34th Annual Congress of I.F.A.:* I. The dialogue between the tax administration and taxpayer up to the filing of the tax return; II. The determination of the source of income. For the seminars the subjects are (a) the flight to tax havens, their use and abuse and (b) specifics on French fiscal questions. Paris (France), September 14-19 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

AMR International, 6/10 Frederick Close, Stanhope Place, London W2 2 HD, (United Kingdom).

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

Business Perspectives, 11 Alexander Place, London, SW 7 2SG (United Kingdom).

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

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

## TABLE A-1

### Net expenditures[a] of the Mexican public sector, selected years, 1895-1975

(millions of current pesos)

| | Level of government | | | | |
|---|---|---|---|---|---|
| Year | Federal government | Federal entities[b] | Decentralized enterprises[c] | Total government subsector[d] | Total public sector[e] |
| 1895 | 41.8 | 32.8 | – | 74.6 | 74.6 |
| 1900 | 56.6 | 37.7 | – | 94.3 | 94.3 |
| 1905 | 75.6 | 50.0 | – | 125.6 | 125.6 |
| 1910 | 89.2 | 56.9 | – | 146.1 | 146.1 |
| 1925 | 287.2 | 104.7 | 45.0 | 391.9 | 436.9 |
| 1930 | 269.1 | 124.1 | 42.0 | 393.2 | 435.2 |
| 1935 | 284.7 | 142.9 | 41.0 | 427.6 | 468.6 |
| 1940 | 552.0 | 209.0 | 143.1 | 761.0 | 905.1 |
| 1945 | 1320.0 | 437.1 | 397.0 | 1757.1 | 2160.1 |
| 1950 | 2796.0 | 949.4 | 1684.6 | 3745.4 | 5430.0 |
| 1955 | 6591.0 | 1801.0 | 2802.0 | 8392.0 | 11,194.0 |
| 1960 | 11,928.0 | 3670.0 | 8499.0 | 15,598.0 | 24,097.0 |
| 1965 | 23,475.0 | 6048.0 | 16,537.0 | 29,523.0 | 46,060.0 |
| 1970 | 39,791.0 | 13,388.0 | 28,227.0 | 53,179.0 | 81,406.0 |
| 1975 | 134,328.0 | 53,127.0 | 86,568.0 | 187,455.0 | 174,023.0 |

a The concept of net expenditures corresponds to the Mexican government's use of the term "gastos presupuestales efectivos". As such, this net figure is less than gross expenditures ("egresos presupuestales ejercidos"). Wilkie employed the gross concept, and by doing so overstated (especially after 1940) the total amounts expended by the Mexican federal government. For example, Wilkie's figure for actual federal government expenditures in the year 1960 came to 20,150 million (current pesos), whereas the net figure employed in this study is 11,928 millions of current pesos. The large difference between the two concepts can be accounted for by many items which are not conceptually net disbursements. The following breakdown presents the components of the gross vs. net expenditure gap for the year 1960 (data in millions of current pesos):

| | |
|---|---|
| Gross expenditures | 20,150 |
| Less: Tax-compensated subsidies | 753 |
| Notes under account of PEMEX | 1770 |
| Revolving debt amortization | 535 |
| Investment and amortizations Compensated for by sales and Capital recoveries | 833 |
| Debt amortization | 3469 |
| Others | 862 |
| Net expenditures | 11,928 |

Wilkie does logically support his inclusion of debt amortization payments in his expenditure figures (only debt interest payments are included in this study), but the other inclusions are less justifiable. As far as possible, double-counting has been eliminated in terms of monetary transfers between the different levels of government. These transfers have been counted as expenditures at that level which makes the initial transfer. Nevertheless, there probably remains some degree of double-counting at the lower governmental levels and in the decentralized enterprise sector. This concept of transfers relates to monetary transfers of the "owned" funds of one sector to another; the expenditures of lower governmental levels (especially the states) financed by their income from revenue-sharing are considered made from "owned" funds, and are not therefore included in the transfer concept.

b States, municipalities, and the federal district. A breakdown by entity at five-year intervals over the 1895-1975 period is not presented here in order to reduce the number of tables, but is available upon request from the author.

c Includes the capital spending of the Mexican "organismos descentralizados" and the "empresas paraestatales" together with the capital and current expenditures of the national social security agencies (IMSS and ISSSTE).

d Federal government and federal entities.

e Decentralized enterprises and government subsector.

*Sources:*

Numerous primary and secondary sources were used. Given that these sources (especially the secondary ones) often varied, the difficult problem of reconciliation cropped up.


1. Anguiano Equihua, R. (1968) ***Las finanzas del sector público en México.*** Mexico City: UNAM.

2. Banco de México. ***Indicadores económicos*** (monthly since 1972).

3. Idem ***Informe anual*** (1950-1963).

4. Idem (1977) ***Estadísticas de la oficina de cuentas de producción, 1960-1976.*** Mexico City.

5. Colegio de México. (1965) ***Estadísticas económicas del Porfiriato: Fuerza de trabajo y actividad económica por sectores.*** Mexico City.

6. Comisión Mixta, (1953) ***El desarrollo económico de México y su capacidad para absorber capital del exterior.*** Mexico City: Nacional Financiera.

7. ***Cuenta pública del Distrito Federal.*** Various years.

8. Reynolds, C.W. (1970) ***The Mexican Economy: Twentieth-Century Structure and Growth.*** New Haven: Yale Univ. Press.

9. Rosas Figueroa, A. and Santillán López, R. (1962) ***Teoría general de las finanzas públicas y el caso de México.*** México City: UNAM.

10. Secretaría de Hacienda y Crédito Público. ***Cuenta de la hacienda pública federal.*** Various years.

11. Idem Dirección General de Estudios Hacendarios. Departamento de Estudios Económicos. Work sheets and data specially prepared for the author.

12. Secretaría de Industria y Comercio. ***Anuario estadístico.*** Various years.

13. Secretaría de la Presidencia. (1964) ***México: Inversión pública federal.*** Mexico City.

14. Secretaría de Programación y Presupuesto. (1977) ***Información económica y social básica.*** Mexico City.

15. Idem Dirección General de Estadística. Oficina de Finanzas. Work sheets.

16. Servin, A. (1956) ***Las finanzas públicas locales durante los últimos cincuenta años.*** Mexico City.

17. Wilkie, J.W. (1970) ***The Mexican Revolution: Federal Expenditure and Social Change since 1910.*** Berkeley: Univ. of California Press.

## TABLE A-2

### Net expenditures[a] of the Mexican public sector, selected years, 1895-1975

(millions of 1960 pesos)

| | Level of government | | | | |
|---|---|---|---|---|---|
| Year | Federal government | Federal entities[b] | Decentralized enterprises[c] | Total government subsector[d] | Total public sector[e] |
| 1895 | 909 | 713 | – | 1622 | 1622 |
| 1900 | 1155 | 769 | – | 1924 | 1924 |
| 1905 | 1260 | 833 | – | 2093 | 2093 |
| 1910 | 1088 | 694 | – | 1782 | 1782 |
| 1925 | 1889 | 689 | 296 | 2578 | 2874 |
| 1930 | 1922 | 886 | 300 | 2808 | 3108 |
| 1935 | 2224 | 1116 | 320 | 3340 | 3660 |
| 1940 | 3172 | 1201 | 822 | 4373 | 5195 |
| 1945 | 3917 | 1297 | 1178 | 5214 | 6392 |
| 1950 | 5306 | 1802 | 3197 | 7108 | 10,305 |
| 1955 | 7979 | 2180 | 3392 | 10,159 | 13,551 |
| 1960 | 11,928 | 3670 | 8499 | 15,598 | 24,097 |
| 1965 | 20,360 | 5245 | 14,343 | 25,605 | 39,948 |
| 1970 | 27,069 | 9107 | 19,202 | 36,176 | 55,378 |
| 1975 | 48,476 | 19,173 | 31,241 | 67,649 | 98,890 |

a Net expenditures defined as in note "a" to Table A-1.
b States, municipalities, and federal district.
c See note "c" to Table A-1.
d Federal government and federal entities.
e Decentralized enterprises and government subsector. Horizontal summation may not be exact due to rounding.

*Sources:* Each figure of Table A-1 is adjusted by the price index presented in column 3 of Table A-4.

## TABLE A-3

### Constant peso per capita net expenditures[a] of the Mexican public sector, selected years, 1895-1975

(1960 pesos)

| | Level of government | | | | |
|---|---|---|---|---|---|
| Year | Federal government | Federal entities[b] | Decentralized enterprises[c] | Total government subsector[d] | Total public sector[e] |
| 1895 | 72 | 56 | – | 128 | 128 |
| 1900 | 85 | 57 | – | 141 | 141 |
| 1905 | 87 | 58 | – | 145 | 145 |
| 1910 | 72 | 46 | – | 118 | 118 |
| 1925 | 124 | 45 | 19 | 170 | 189 |
| 1930 | 116 | 54 | 18 | 170 | 188 |
| 1935 | 123 | 62 | 18 | 185 | 202 |
| 1940 | 161 | 61 | 42 | 223 | 264 |
| 1945 | 176 | 58 | 53 | 234 | 287 |
| 1950 | 206 | 70 | 124 | 276 | 400 |
| 1955 | 266 | 73 | 113 | 339 | 452 |
| 1960 | 341 | 105 | 243 | 446 | 689 |
| 1965 | 492 | 127 | 347 | 619 | 966 |
| 1970 | 551 | 186 | 391 | 737 | 1128 |
| 1975 | 828 | 327 | 534 | 1155 | 1689 |

a Net expenditures defined as in note "a" to Table A-1.
b States, municipalities, and federal district.
c See note "c" to Table A-1.
d Federal government and federal entities.
e Decentralized enterprises and government subsector. Horizontal summation may not be exact due to rounding.

*Sources:* Each figure of Table A-2 is divided by the population corresponding to each selected year.

## TABLE A-4

### Gross domestic product and price index, Mexico, selected years, 1895-1975

| Year | Gross domestic product (millions of current pesos) | Gross domestic product (millions of 1960 pesos) | Price index (1960=100) |
|---|---|---|---|
| 1895 | 495 | 13,005 | 4.6 |
| 1900 | 944 | 16,548 | 4.9 |
| 1905 | 1317 | 20,140 | 6.0 |
| 1910 | 2497 | 23,272 | 8.2 |
| 1925 | 4937 | 37,402 | 15.2 |
| 1930 | 4399 | 34,364 | 14.0 |
| 1935 | 4279 | 38,549 | 12.8 |
| 1940 | 7774 | 46,693 | 17.4 |
| 1945 | 19,382 | 62,608 | 33.7 |
| 1950 | 39,736 | 83,304 | 52.7 |
| 1955 | 84,870 | 111,671 | 82.6 |
| 1960 | 150,511 | 150,511 | 100.0 |
| 1965 | 252,028 | 212,320 | 115.3 |
| 1970 | 418,700 | 296,600 | 147.0 |
| 1975 | 1,000,900 | 390,300 | 277.1 |

*Sources:*
GDP in current and constant pesos for the years 1895-1910 was taken from L. Solís, op.cit. The conversion to 1960 pesos was made by the writer of this article. The current and constant peso GDP data for 1925-1975 were taken from the most recent historical revisions made by the Banco de Mexico (1977 – see Table A-1 sources). These revisions reveal that the 1925-1935 data presented in Solís (from estimates made by the Banco de México a decade ago) were seriously underestimated (and the data after 1940 overestimated). The 1925-1935 revision thus corroborates a criticism made by C. Reynolds (op.cit., Appendix C). These revisions and Appendix C in Reynolds may also be used to support the argument that the 1895 and 1900 GDP estimates are understated.
The price index presented in the last column is a combination of the 210 item wholesale price index for Mexico City (years 1895-1955) and the implicit price deflator for the government sector from the Mexican national accounts (years 1960-1975). The 1895-1910 index values were taken from Colegio de México (see Table A-1 sources). This index provides a link with the Mexico City wholesale price index which, for the years 1925-1955, was taken from Nacional Financiera, ***Statistics on the Mexican Economy*** (Mexico City: 1977). All conversions to the base year were made by this writer; the implicit price deflator data were taken from the Banco de México (1977) source.

# TAX GLOSSARY

*by H.W.T. PEPPER**

**MONETARY CORRECTION** — Where the currency of a country has been subject to exceptional inflation so that the profit of a business in money terms would be a misleading representation of its real income, adjustments are sometimes made by allowing taxpayers to revalue or write up the values of their plant, machinery, etc., and sometimes trading stocks, to figures which are more realistic in terms of money. In circumstances of rapid currency depreciation, i.e. inflation, gilt-edged loans issued by the government and in some cases money borrowed in the private sector may contain, in addition to normal commercial interest, a monetary correction factor as an inducement to investors to lend money at current values which will ultimately be repayable only in depreciated currency. In such cases, the monetary correction factor would not normally be regarded as taxable for income tax purposes. Allowances are also sometimes made to allow taxpayers to write-up the cost of assets disposed of, for the purpose of calculating capital gains tax.
Where a taxpayer is able to defer paying his taxation liabilities beyond the due date in conditions of rapid inflation, he may obtain an undue benefit by being able to pay liabilities incurred in terms of one currency value by using a depreciated value. Some countries have accordingly attempted to add a monetary correction and/or interest factor to increase the sum nominally due in overdue taxes to avoid this undue benefit to laggards in tax payments. (See also STOCK RELIEF.)

**MONEY'S WORTH** — A term sometimes used in taxing statutes (Japan, U.K.) regarding the taxing of FRINGE BENEFITS (q.v.), to denote those benefits which can actually be converted into cash and are normally taxable.

**MONTHLY ASSESSMENT** — A direct tax originally levied by Cromwell in Britain which was based on tax quotas imposed upon each district. In effect, the levy became a form of land tax.

**MORE DEVELOPED COUNTRIES (MDC'S)** — See LESS DEVELOPED COUNTRIES (LDC's).

**MORTGAGE TAX** — Taxes, usually in the form of stamp duties, are sometimes levied on mortgages. Such levies are a relic of the days when taxes tended to be levied on legal instruments of most kinds, i.e., on the form rather than on the substance of a transaction, the raison d'être being that such documents were usually under the control of lawyers, or the courts, who could be relied on to ensure compliance. In the case of mortgages, the duty tends to put a further burden on the borrower, compared with the man who can buy real or other property for cash. The trend is to eliminate such levies.

**MORTON'S FORK** — The name given to the fiscal technique used by Archbishop Morton to raise revenue for Henry VII of England (1485-1509) at a time when the Treasury was empty after a period of civil war. The rich were compelled to contribute on the ground that they could clearly afford to. The nobility who avoided any show of wealth or conspicuous spending were also constrained to contribute to the royal revenue on grounds that by their economies they must have accumulated resources enabling them to pay up.

**MOST-FAVOURED-NATION TREATMENT** — Trade agreements between two countries may contain a "most favoured nation" clause by which each party to the agreement pledges that any trade concession given to any other country will henceforth be applied also to the other party to the agreement. The tendency of such clauses is thus to liberalise trade and accordingly "most favoured nation" clauses are approved by G.A.T.T. as helping to carry out the objectives of that Agreement.

**MOST RECENT PURCHASE METHOD** — The method of valuing stock-in-trade (inventory) where all goods of the same kind may be valued at the price paid for those most recently purchased. (See also VALUATION LIFO.)

**MOVABLE PROPERTY** — The term is applied not only to physical property such as vehicles, furniture, and portable equipment such as typewriters and hand-drills, but also financial documents of title, e.g., share and loan certificates. Tax treatment may vary between movables and immovables for example, some countries exclude foreign immovable property from the incidence of their death duties (knowing it is sure to be taxed in the situs country) but do tax foreign movables.

**MOVEMENT OF GOODS, AS TAXABLE EVENT** — As regards sales taxes, the TAX POINT (q.v.) is sometimes taken as the moment the goods are removed from the factory or warehouse of the seller for delivery to the buyer. This practice serves as a form of anti-evasion measure since tax officials charged with preventing evasion are able to make more effective checks on goods in transit, e.g., on highways, rail, rivers, or canals, to determine whether tax has been accounted for, without having to prove that there is an actual sale by one party to another.

**MOVING EXPENSES** — In many countries the expenses of an employee in moving to a new place to take up a new job are often not allowable for income tax as not incurred in earning the remuneration of any particular employment. In the U.S.A., moving expenses including fares for the family, carriage of household and personal effects may usually be deducted whether incurred by a *new* employee or self-employed person, or someone merely changing his occupation.

**MULTI-SHIFT USAGE, DEPRECIATION** — Where standard rates of depreciation have been agreed for certain types of plant and machinery to cover normal usage, some countries permit enhanced allowances for tax where the assets are used for abnormally long hours, e.g., on multi-shift working.

**MULTI-STAGE TAXATION** — Indirect taxes which are charged on the same goods at successive stages of production and distribution. (See also CASCADE TAX, TRANSACTIONS TAX.)

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

**MUNICIPAL TAXATION** — Taxes levied by a municipality to provide revenue to cover the cost of carrying out public services rendered by the municipality within its administrative area. (See also LOCAL RATES AND TAXES, PROPERTY TAX.)

**MUNITIONS LEVY** — A tax introduced in Britain in 1916 upon armament manufacturers who had to pay either this levy or EXCESS PROFITS DUTY (q.v.), whichever was the greater.

**MUTATION TAX** — A tax on the assets of a deceased person, the ownership of which passes to others as a result of his death. (See also ESTATE DUTY.)

**MUTUAL FUND** — See REGULATED INVESTMENT COMPANIES

**MUTUALITY PRINCIPLE** — Where individuals as a body or group jointly provide services for themselves, which are not available to those who are not members of the group, trading profits do not normally arise, for the reason that a man (or a group of persons in a mutual relationship) cannot make a profit out of himself. The typical example of mutuality is that of a members' club where the members come together for the purpose of providing services, especially facilities for sport and recreation, for their own enjoyment only, to the exclusion of the public at large. The mutuality principle is broken if non-members are allowed to use the club's facilities on payment of fees (in which case the club is trading, at least to the extent of its dealings with outsiders), and difficulties sometimes arise when a club allows outsiders to become members for a day, or even shorter periods.
Mutual "trading" is carried on by co-operative societies, which were pioneered in 1844 in Britain, initially for the purpose, inter alia, of purchasing goods for resale to members at retail. The "profits" from such activities are usually largely distributed to members in the form of discounts on their purchases. Legislation was, however, enacted in 1933 in Britain to make co-operative societies taxable, in effect, on their undistributed surpluses, deemed to be "profits" for income tax purposes.

# N

**ACHSTEUER** — A special tax imposed on non-distributed exempt dividends received by a German company. (See also SCHACHTELVERGUNSTIGUNG.)

**NATIONAL DEFENCE CONTRIBUTION (NDC)** — An additional income tax introduced in Britain in 1937 to help finance rearmament. The tax was initially levied at 5% on the profits of corporate and other bodies, the profits being computed upon a somewhat different basis from that used to calculate income tax. The tax was superseded in 1947 by PROFITS TAX (q.v.) which took various forms. During the period when EXCESS PROFITS TAX (q.v.) was in operation, NDC was only charged where the amount chargeable exceeded what would have been charged as Excess Profits Tax. NDC provides an interesting example of a tax the first governmental proposals for which were withdrawn, after heavy criticism of their complexity, the actual form of tax adopted being based broadly on suggestions by the private sector.

**NATIONAL HEALTH CONTRIBUTION** — A payroll tax on employees and employers in the U.K. which provides a minor part of the revenue (the remainder coming from general taxation and charges on patients) to finance State medical and other welfare services.

**NATIONAL INTEREST** — Works of art, historic buildings, etc., the preservation of which is regarded as in the national interest, are exempt from CAPITAL TRANSFER TAX in the U.K. on certain conditions. The principle is also followed in some other countries, e.g., the national heritage relief in Canada.

**NATURAL RESOURCES** — Economically valuable resources, such as mineral including oil and gas deposits, virgin forests and grasslands, which occur naturally and are capable of exploitation for the national benefit.

**NEDSLAG, KRAV OM** — (Denmark) Claim for relief.

**NEGATIVE INCOME TAX** — See INCOME TAX, NEGATIVE.

**NEGLECT ASSESSMENT** — An assessment of tax liability made after the usual time for making assessments, but within certain time limits, the delay having occurred through the neglect of the taxpayer to declare his taxable income (or to declare it in full) at the proper time.

**NET ACCRETION METHOD** — A method of computing income by having regard to the taxpayer's accretion of assets over a year or a period of years and allowing for his expenditure on his private and domestic requirements in that period.

**NET OPERATING LOSS DEDUCTION** — For U.S.A. tax purposes, losses incurred in operating a trade or business may be carried back 3 years or carried forward 5 years. The same applies to a CASUALTY LOSS (q.v.), or a loss on sale of depreciable property or real property used in a trade where there is a surplus of such loss over the income of the year in which the loss was incurred.

**NET WORTH (WEALTH) METHOD** — See NET ACCRETION METHOD.

**NET WORTH TAX** — Another term for WEALTH TAX (q.v.), the tax being computed annually as a percentage of the net wealth or "worth" of a taxpayer as represented by his total assets less liabilities. In some tax systems there is formal authority for computing income using the NET ACCRETION METHOD (see above) where the taxpayer's declaration is not considered satisfactory. In most countries, however, the technique is used administratively as a check on unsatisfactory declarations. (See also EXTERNAL INDICIA OF WEALTH.)

**NEUTRALITY, TAX** — The term tax neutrality has several connotations, mostly with regard to indirect taxes. For example, one of the E.E.C. directives to its members counsels them to apply the same criteria for determining the taxable base for imports as for locally-produced goods so as to ensure tax neutrality between them. A single stage sales tax at a flat rate is often regarded as a more neutral tax than a multi-stage (cascade) tax which may have an uneven incidence on the same goods passing through different rates for different commodities. On the other hand, it is arguable that, to be truly neutral, indirect taxation should be levied on goods and services at rates variable in strict proportion to the relative elasticities of demand (reflecting the degree to which they were regarded by consumers as necessities) for the products or services, a concept, however, which would be quite impracticable to implement and administer. Even where a fixed rate percentage of ad valorem duty or tax is applied to the same commodity, there is likely to be some un-neutrality where the lower income groups buy their requirements in small quantities at higher prices per unit than the rich who can buy in larger quantities at bulk, or discounted, prices. As far as income taxes are concerned, neutrality is best secured by taxing the aggregate income of resident taxpayers whether drawn from local or foreign sources, and with due regard for DOUBLE TAXATION RELIEF (q.v.).

**NEWSPAPER TAX** — Generally speaking, taxes on newspapers are nowadays eschewed as taxes on "knowledge" or "freedom of expression", although such taxes were levied in Britain in the 19th century.

**"NO NEW PREFERENCES" PRINCIPLE** — In order to achieve the objectives of G.A.T.T. (q.v.), it is desirable that no new trade agreements should be made which, by giving special privileges to one country, restrict trade with others and accordingly G.A.T.T. has adopted the principle that there should be "no new preferences" granted. On the other hand, an extension of MOST FAVOURED NATION TREATMENT (q.v.), which tends to broaden trading opportunities by extending to other countries trading privileges already granted to some, is favoured by G.A.T.T.

**NO REPRESENTATION WITHOUT TAXATION** — The obverse of the better known expression NO TAXATION WITHOUT REPRESENTATION (q.v.), relating to the somewhat dubious principle sometimes enunciated (and occasionally operated) that no one should be entitled to vote in elections unless he is a payer of direct taxes. The principle has historically been employed (e.g., in post-Civil-War-U.S.A., and in early U.K. franchises) to provide that only those who had paid some form of poll tax or property tax could vote.

**NO TAXATION WITHOUT REPRESENTATION** — The principle that one should not be forced to pay a tax imposed by a government without having had the opportunity to vote for or against the tax measure, either directly or through elected representatives. The principle has been invoked in history, notably in the course of the Peasants' Revolt in 1381 (inter alia against a poll tax); in the "ship money" dispute in which Hampden and others refused to pay this defence levy imposed by Charles I. This dispute, among other causes, led to the Civil War in England in 1642. The plea was one of the arguments raised by the North American colonies in the reign of George III of Britain against paying stamp, tea and other duties arbitrarily imposed by Britain, which led to the American War of Independence (1775-1783).

**"NON BIS IN IDEM" RULE** — The rule in Belgium (literally "not twice on the same thing") whereby the shareholder, when taxed on dividends received, is granted relief for tax paid by the company on the income out of which the dividends are paid. (See also IMPUTATION SYSTEM and ECONOMIC DOUBLE TAXATION.)

**NON-CUMULATIVE TAXATION** — See SINGLE STAGE TAX.

**N.O.P.'s** — See NOT OTHERWISE PROVIDED FOR.

**"NOT OTHERWISE PROVIDED FOR" (N.O.P.)** — A catchall phrase in, e.g., a customs tariff (such as that of Canada). After listing dutiable (or exempt) goods (see also BRUSSELS TARIFF NOMENCLATURE) a clause may be inserted to charge a flat rate of duty on all other goods, i.e., goods "not otherwise provided for", which in common official jargon may be referred to as "N.O.P.'s". (See also MATERIAL OF CHIEF VALUE.)

**NOTCH PROVISION** — A provision in Canadian estate tax law to the effect that the estate in Canada of a foreign domiciled person must not be reduced by estate tax below a certain sum. The provision is somewhat similar to a basic exemption from tax of the same minimum sum.

**NOTHINGS** — In Canada the term "nothings" is commonly used to describe certain expenditures made for the purpose of producing business income which are neither deductible as an expense nor eligible for CAPITAL ALLOWANCES (q.v.). "Nothings" include the cost of acquiring goodwill and intangible rights, such as franchises for indefinite periods.

# O

**OASIS, TAX** — A tax haven.

**OBLIGATION** — Bond, debenture. (Denmark)

**OBSOLESCENCE ALLOWANCE** — An allowance, introduced in Britain in 1918, in respect of the difference between the WRITTEN DOWN VALUE (q.v.) and sale proceeds of plant and machinery replaced as obsolescent. The allowance was replaced by BALANCING ALLOWANCES (q.v.) when the Capital Allowances system was introduced in 1945.

**OCCUPANCY TAX** — A tax on occupied property either in the form of (a) LOCAL RATES (q.v.), a contribution to local government expenditure normally levied on occupiers of premises in the local administrative area, or (b) property taxation which is levied either on the owner or occupier of premises which are occupied or which are held in readiness for occupation (see VOID RELIEF).

**OCCUPATION, BENEFICIAL** — Where a person is permitted to occupy residential, or other accommodation rent-free he is said to be in beneficial occupation of the property. For tax purposes the beneficial occupier, rather than the owner, may be assessed and required to pay property taxes or RATES, and in some income tax systems the annual benefit may be assessed and taxed along with the occupier's other income.

**OCCUPATION, REPRESENTATIONAL** — In contrast to BENEFICIAL OCCUPATION, where an employee is required by his employer to reside rent-free in a place he would not himself choose, there is said to be "representational" occupation. Such accommodation might be an apartment in a factory complex occupied by a maintenance engineer, rooms over a bank or shop occupied by the manager. There is precedent in U.K. case law for holding that such "benefit" is not taxable because it suits the employer rather than the employee.

**OCTROI** — A mediaeval levy, on the goods entering a town or city to be consumed there, which took the form of a kind of municipal customs duty. In France the octroi survived until well into the twentieth century.

**OFFENCES, TAX** — Tax offences may either be specified in the tax laws covering such matters as lateness of filing or rendering tax declaration forms, lateness in paying tax, omission to declare taxable income or transactions, neglectful or fraudulent misstatements in tax declarations. Some offences committed in connection with taxation, e.g., perjury or conspiracy to defraud, may, however, be punishable under the general laws of the country.

**OFFSHORE BANKS** — Some banking enterprises are set up in TAX HAVENS (or FINANCIAL CENTRES q.v.) so as to enjoy the benefits of freedom from income tax on profits and exchange control on international operations. Instead of taxes, such banks, e.g., in the Cayman Islands may be called on to pay substantial annual registration fees. Another development is the favourable treatment some countries afford to *resident* banks which have offshore activities. In the Philippines the overseas profits of local banks are taxed at only 5 percent and in Singapore the corresponding rate is 10 percent. In Hong Kong all foreign profits of resident companies were formerly exempt, but it has recently been decided that overseas banking profits should be taxed at 17 percent, the same rate as local profits.

A fairly new development is the setting up by large international corporations of "captive" offshore banks to perform some of their overseas banking operations for them, taking advantage of kindlier haven laws on income tax and exchange control to reduce the cost of such operations.

**OFFSHORE COMPANIES** — The term usually applied (see, however, also LETTER BOX COMPANY) to companies registered abroad, usually in a tax haven, either as a PERSONAL HOLDING COMPANY (q.v.), to hold investments, or for some specific trading purpose, e.g., banking (see OFFSHORE BANKS) or insurance (in the form of a "captive" insurance company).

**OFFSHORE TRUST** — A settlement or family foundation established in one country (often a tax haven) by a person who is resident in another. The settler usually sets up such a trust to avoid, at least to some extent, the tax laws in his country of residence. Sometimes the trust may be set up to hold foreign assets and/or provide for members of the family who are not resident in the settler's country so that the tax laws of the latter's country are in any event not necessarily appropriate to apply to the assets (or income therefrom) of the beneficiaries.

**OMS** — (Denmark) Sales Tax, Purchase Tax.

**OMZETBELASTING** — (Holland) Turnover Tax.

**ONROERENDE VOORHEFFING** — (Belgium) Advance payment of tax on income from real property.

**ONUS ON TAXPAYER** — A very widely adopted principle in the tax laws of most countries is that the taxpayer has the basic responsibility of declaring his taxable income or transactions. It is not usually possible for a tax system to operate successfully unless the onus is thus placed upon the taxpayer to give an account of his taxability since the alternative, which would be for the taxing authority to guess or estimate the tax liability in all cases would place an impossible burden on the administration and appear somewhat arbitrary in practice.

**ONZUIVER INKOMEN** — Income less deductible expenses, but before deduction of (i) "persoonlijke verplichtingen", (ii) "buitengewone lasten" and (iii) deductible gifts; for purposes of personal income tax.

**OPCENTIEMEN** — (Belgium) A surcharge expressed as a percentage.

**OPDECIME** — (Belgium) A 10 percent surcharge.

**OPEN-END FUNDS** — (U.S.A.) See REGULATED INVESTMENT COMPANIES.

**OPEN MARKET PRICE** — See VALUATION.

**OPTION TO BE TAXED** — While the ideal of optional taxation is dear to the hearts of taxpayers, it is only in connection with certain forms of sales tax where some such option is usually granted. Where a trader or professional is exempted from V.A.T., he may nevertheless have purchased supplies or equipment which have been subjected to the tax and if he is completely exempt from the operation of the tax he will not be able to recover the tax thus borne. Accordingly, some V.A.T. systems provide an option for exempt taxpayers to claim to be subjected to a nil or zero rate of tax. Since they have already borne tax on their purchases, the appropriate credit for such tax will entitle them to a refund and hence to practical as well as theoretical exemption. (See also ZERO RATE and OPTIONAL TAX.)

**OPTIONAL TAX** — A system in the U.S.A. whereby taxpayers with incomes below a fairly modest ceiling may opt to pay income tax according to figures in a statutory table. The tabled tax would be lower than that to which the taxpayer would ordinarily be liable, especially if he had little to claim in the way of additional reliefs. The option is similar in substance to SMALL INCOME RELIEF operated in some countries in favour of those with modest incomes.

**OPTIONS, STOCK, for DIRECTORS and OTHERS** — Some companies allow directors and key employees an option whereby they may opt, within a period of years, to buy shares in the company employing them at a price fixed at the time the scheme is commenced (usually at the then market value). The idea is that the director, etc. will then have an incentive to ensure that the company prospers so that the value of its shares increases and a capital gain will result when the option is taken up. Tax administrations look on these arrangements with varying degrees of benevolence if they comply with certain conditions, e.g., in the U.K. the beneficiary must be a full-time director or employee, and there is a minimum period which must elapse (both in the U.K. and the U.S.A.) before a profit is taken. If the conditions are met the usual result is that the gain is charged as a capital gain, i.e. at a lower rate than if it were treated as remuneration of an employment.

**ORDERLY MARKETING ARRANGEMENTS (OMA)** — See QUOTAS, IMPORT.

**ORDINARY RESIDENCE** — The concept of "ordinary residence" is different from that of "residence". Anyone may be "resident" in a country for a particular tax year, almost certainly if he resides in the country for the whole of the tax year, and usually if he resides for more than 6 months of the year. Such residence may, however, be for a specific purpose, e.g., for medical treatment or convalescence or to carry out a particular business or professional task, whereas the taxpayer *ordinarily* lives in some other country.

In income tax systems, it is fairly usual to tax a resident taxpayer on his world income in the country where he normally or "ordinarily" lives, but a taxpayer who comes to live in the country for a limited period only, if domiciled or ordinarily resident somewhere else, is usually required to pay only on the income he derives from the taxing country in the year of residence, although this liability may be increased by taxing any remittances he makes from his foreign income to the taxing country during his stay there.

[to be continued]

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# CUMULATIVE INDEX 1979 - Nos. 1 - 10

# Contents

of the December 1979 issue

## In next issues

Brazil: The supplementary income tax
— by *Paulo Kantor*

Indonesia: Tax Incentive Package to support the third five year development plan (1979-1984)
— by *Jap Kim Siong*

Nigerian Income Tax: Construction companies
— by *George E. Tickner*

Estimation of tax potential and tax efforts of State and Local governments
— by *G. Thimmaiah*

United States: — Proposed Internal Revenue Service Regulations on the creditability of taxes

— VAT before Congress

# Recent Developments in Latin America

# THE MEXICAN VALUE ADDED TAX

by Pedro F. Massone*

## 1. INTRODUCTION

Contents



At the end of 1978 Mexico enacted several laws introducing various amendments to direct and indirect taxation. The changes cover a broad spectrum and include the following measures:

(i) Enactment of a Law of Fiscal Coordination (Ley de Coordinación Fiscal) and other provisions in order to control and further the avoidance of internal double taxation (e.g. taxation of the same matter by both the Mexican Federation and one of the States). In order to avoid this kind of double taxation, conventions can be concluded by the Federation and a particular State under which taxation powers of the State are restricted and revenue from taxes collected by the Federation shared with the State.

(ii) Introduction of a special deduction to be made in the computation of taxable income of enterprises. This deduction can be said to represent a partial adjustment of income for inflation: the deduction is related to depreciation allowances, long term financial assets and liabilities, and is linked to a factor established in the Revenue Law which is enacted every year.

(iii) Repeal of the Complementary Tax on Extraordinary Gross Income (Tasa Complementaria sobre las Utilidades Brutas Extraordinarias). This Tax had been established in Mexico by a tax law of December 31, 1976 in order to curb price increases by means of taxation.

(iv) Replacement of provisions governing income taxation of individuals. The new regime stresses the importance of global taxation and narrows the scope of exceptions to this rule. Changes in income taxation of individuals also affect capital gains, dividends, interest and personal tax rates.

(v) Introduction of a value added tax effective as from January 1, 1980. As from the same date the Tax on Commercial Receipts and 17 minor taxes are revoked. This paper will cover only the first mentioned change which is, perhaps, the most important.

In order to get a better understanding of the reform, it is useful to remember that the Tax on Commercial Receipts was a turnover tax devised under the "cascade" system. It was levied on "commercial receipts" arising from the transfer of goods, the leasing of goods, the rendering of services and the making of conditional sales, provided that the transaction was conducted or produced effects in Mexico. The Tax on Commercial Receipts was levied at a general rate of 4 percent and at five special rates of 5, 7, 10, 15 and 30 percent.

The enactment of the new legislation concerning indirect taxation takes place after 10 years of discussion about replacing the old cascade taxation with a value added tax according to the model of the European Economic Community. Moreover, the new system follows a world-wide trend and is adopted after the introduction of the value added tax in many other Latin American countries (i.e. Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Honduras, Ecuador, Panama, Peru and Uruguay).

The Mexican VAT covers a broad spectrum of economic activities and is not limited by the business or non-business nature of the transaction involved. In fact, the scope of the new tax includes transfers of goods, rendering of independent services, leasing agreements, and importation of goods and services, irrespective of a profit making purpose.

The Mexican VAT is governed by a Law of December 22, 1978, published in the Official Journal of December 29, 1978.[1] The main features of the new tax are discussed below.

## 2. TAXABLE PERSONS

The Mexican VAT is levied on individuals, legal entities

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1. Mexican laws are not numbered.

and economic units carrying out taxable transactions in Mexico. The tax must be, however, specifically and separately shifted by the taxable persons to the persons acquiring goods, temporarily using or deriving advantage from goods, or receiving services which are the object of taxable transactions.

Where a non-resident carries out taxable transactions in Mexico by means of a representative, the representative is under the obligation to file the tax returns and to pay the VAT on behalf of the principal. Moreover, the representative and the non-resident principal are severally liable for the payment of the tax. [2]

The Federation, Federal District, States, Municipalities, decentralized bodies thereof, private charity institutions and associations, cooperative societies and other persons carrying out taxable transactions are subject to the tax or must accept the shifting of same by suppliers, as the case may be, irrespective of exemptions established in laws other than the VAT law.

Nevertheless, the Federation, Federal District, States and Municipalities are exempt from the VAT as regards the discharging of their duties as established in public law.

## 3. TAXABLE TRANSACTIONS

The Mexican VAT is levied on any transfer of goods, rendering of independent services, granting of temporary use or right to use tangible goods (leasing arrangements), and importation of goods and services, provided the transaction is not covered by an exemption granted by the law.

Where an exchange or a payment in kind takes place the tax is levied on each good transferred or granted and on each service rendered, irrespective of the fact that the different transactions are included in a single contract.

In order to be taxable a transaction must be carried out in Mexico. This rule is further elaborated for each kind of transaction.

As regards tangible property, a transfer is deemed to be carried out in Mexico if: (i) a physical delivery of the property by the transferor takes place in Mexico; (ii) the property is located in Mexico at the moment of its remittance to the acquirer; or (iii) the property is subject to registration in Mexico. As regards intangible property, a transfer is deemed to be carried out in Mexico if the transferor and the acquirer are residents of Mexico.

Similarly, a service is deemed to be rendered in Mexico if it is performed, wholly or partially, by a resident of Mexico. In case of international transportation, the service is considered to be rendered in Mexico if the corresponding trip is started in Mexico, irrespective of the residence of the operator. The same standard applies to round trips. A special rule provides that in case of international transportation by air (even to border areas), only 25 percent of the service is deemed to be rendered in Mexico.

Finally, the temporary use or right to use tangible goods is deemed to be granted in Mexico if the property is located in Mexico at the moment of being physically delivered to the person to whom the use or right to use it is granted.

Exportation of goods and services is not subject to the Mexican VAT. An exportation is deemed to occur where: (i) there is a final transfer of goods or services abroad; (ii) intangible property is transferred by a resident of Mexico to a non-resident; (iii) the temporary use or right to use intangible property abroad is granted by a resident of Mexico; and (iv) services rendered by a resident of Mexico are used abroad.

The different taxable transactions mentioned at the beginning of this Section are discussed in separate Sections below. For each group, provisions defining the transactions, the taxable base and exemptions are dealt with.

## 4. TAXABLE TRANSFERS

As stated before, the Mexican VAT is levied on any transfer of goods, unless otherwise provided for.

Under the wording of the Mexican VAT law, taxable transfers include the following activities: (i) any transfer of goods not made by means of inheritance or company merger; (ii) gifts made by an enterprise which cannot deduct the gift for income tax purposes; (iii) sales where the seller retains the title to the property (if the transfer never occurs the tax is refunded); (iv) assignment of goods to the creditor or to another person; (v) trusts (fideicomisos) involving a transfer of goods under the Fiscal Code; and (vi) any unjustifiable lack of goods from the enterprise's stocks.

The taxable transfer is deemed to be carried out and the tax is due when: (i) the property is physically delivered to a person who is under the obligation to receive or acquire it; (ii) the property is remitted to the acquirer provided he is under the obligation to receive it; (iii) the price is wholly or partially paid; and (iv) the relevant document covering the transfer is issued.

As regards the taxable base of transfers, the law provides that VAT is calculated on the price inclusive of any sum added to same, such as taxes, fees, interest, arrears and penalties. The VAT and the tax on the transfer of new cars are not, however, included in the taxable base of VAT.

If there is no price (e.g. gifts), the tax is calculated on the market value or, in the absence of a market value, on the appraisal value of the goods. A similar rule applies where the consideration received by the taxpayer is not represented by money but consists wholly or partly of other goods or services. If this is the case, the market value or, in the absence of a market value, the appraisal value is taken as the value of goods and services forming part of the consideration.

The law provides for a list of transfers which are exempt from the VAT, either because of the nature of the trans-

2. This means that if the non-resident principal is not available to pay the tax, the tax administration may charge the tax to the representative.

action itself or because of the nature of the item involved. The list includes:

(i) inheritances and mergers of companies;
(ii) gifts made by individuals, and gifts made by an enterprise which can deduct the gift for income tax purposes;
(iii) the soil, as well as constructions adhering to the soil, provided the construction is used for dwelling homes (hotels are taxable);
(iv) machinery and equipment used only in agriculture or cattle raising (machinery and equipment for processing products is taxable);
(v) fertilizers, animals, non-processed vegetables, and meat in its natural state;
(vi) loafs (tortillas), pasta, flour, bread, natural milk, eggs, sugar, salt and water (effervescent water, compound water and ice are taxable);
(vii) books, periodicals, and copyrights belonging to the author:
(viii) property belonging to credit institutions and transferred by same (constructions adhering to the soil other than those mentioned in (iii) above and property received in trust are taxable);
(ix) used personal property provided it is not sold by an enterprise;
(x) Mexican and foreign currency, company shares (partes sociales), and bonds (títulos de crédito); and
(xi) tickets for authorized lotteries, raffles, casting lots and games, as well as the relevant prizes.

Consumption of food in the same place or establishment where it is sold is treated as a taxable service, irrespective of the exemptions listed above.

## 5. TAXABLE SERVICES

As stated before, the Mexican VAT is also levied on the rendering of independent services.

According to the Mexican VAT law, taxable services include the following activities: (i) consumption of food in the same place or establishment where it is sold; (ii) transportation of persons and goods; (iii) mandate, commission, mediation, agency, representation, brokerage, consignment and distribution services; (iv) insurance, reinsurance and guarantees; (v) technical assistance and transfer of technology; (vi) any activity performed in order to discharge an obligation to do something; (vii) any obligation to give something, to abstain from doing something, or to allow another person to do something, provided the transaction is not taxed under other provisions of the Mexican VAT law.

The taxable service is deemed to be carried out and the tax is due upon maturity of the consideration contracted for the service. Maturity of part of the consideration and advance payments also make the relevant part of the tax payable.

As regards services, the taxable base is similar to that used for transfers. In fact, for the rendering of services, the VAT is calculated on the whole value of the consideration contracted, inclusive of any sum added to same, such as taxes, fees, traveling expenses, other expenses, reimbursements, interest, arrears, and penalties. The VAT is never included in the taxable base of same.

If there is no price (e.g. gifts) the tax is calculated on the market value or, in the absence of a market value, on the appraisal value of the services. A similar rule applies where the consideration received by the taxpayer is not represented by money but consists wholly or partly of goods and other services. If this is the case, the market value or, in the absence of a market value, the appraisal value is taken as the value of goods and services forming part of the consideration.

The Law provides for a rather long list of services which are exempt from the value added tax, including:

(i) any service rendered directly by the Federation, Federal District, States and Municipalities;
(ii) services rendered by public institutions of social security;
(iii) services provided by certain specified institutions (political parties; unions; religious, scientific and cultural institutions; etc.) within the scope of same to their members;
(iv) teaching services rendered by decentralized bodies or by private establishments authorized under the law;
(v) free services;
(vi) specified services rendered directly to farmers or cattle raisers;
(vii) milling of flour or pasta and pasteurization of milk;
(viii) services rendered by the stock exchange and by credit institutions;
(ix) insurance of risks of agriculture and cattle raising as well as insurance and reinsurance covering death risks or granting life pensions or annuities;
(x) public transportation of persons except where a concession or permit for operation is required;
(xi) public spectacles provided for an admittance ticket (spectacles rendered in restaurants, bars, cabarets, saloons and night centers are taxable);
(xii) dependent services;
(xiii) professional services for which a title is required provided they are rendered by individuals, professional organizations, associations or civil companies;
(xiv) services rendered by an author under the Federal Law on Copyrights; and
(xv) services rendered by entertainers, speakers, bullfighters or athletes.

## 6. TAXABLE USE OR RIGHT TO USE

The scope of the Mexican VAT also covers the granting of a temporary use or right to use tangible goods (leasing arrangements).

The temporary use or right to use tangible goods which is taxed under the Mexican VAT law includes specifically the leasing, right to use, and any other transaction by means of which a person grants for a consideration to another person the temporary use or right to use tangible goods.

Where the temporary use or right to use tangible goods is granted, the tax is due upon maturity of the relevant consideration. Maturity of part of the consideration and advance payments also make the relevant part of tax payable.

As regards the granting of the use or right to use tangible goods the VAT is also calculated on the whole consideration contracted inclusive, in this case, of any sum added to same, such as taxes, fees, maintenance expenses, construction costs, reimbursements, interest, arrears and penalties. The VAT is never included in the taxable base of same.

If there is no price (e.g. gifts) the tax is calculated on the market value or, in the absence of a market value, on the appraisal value of the use or right to use which is being granted. A similar rule applies where the consideration received by the taxpayer is not represented by money but consists wholly or partly of goods or services. If this is the case, the market value or, in the absence of a market value, the appraisal value is taken as the value of goods and services forming part of the consideration.

The temporary use or right to use tangible goods is exempt from the Mexican VAT where it refers to:

(i) the soil;
(ii) real property used for dwelling homes (if the real property is furnished or if the real property is used as a hotel or boarding house, the transaction is taxed);
(iii) farms devoted to or used only for agriculture or cattle breeding;
(iv) machinery and equipment that can be used only for agriculture and cattle breeding (the use or right to use machinery and equipment for processing products is taxed); and
(v) books, periodicals and magazines.

## 7. TAXABLE IMPORTATION

Finally, the Mexican VAT is levied on importation of goods and services.

Taxable importation includes the following activities: (i) introduction into Mexico of foreign goods; (ii) the acquisition by a resident of Mexico of intangible property which is being transferred by a non-resident; (iii) the temporary use or right to use intangible property in Mexico where such property has been actually delivered abroad; (iv) the utilization in Mexico of services rendered by non-residents (international transportation is not treated as importation into Mexico).

The importation of goods and services is deemed to be carried out and the tax is due: (i) upon customs clearance; or (ii) when a temporary importation becomes final.

Nevertheless, regarding the acquisition of intangible property from a non-resident and the temporary use or right to use granted by a non-resident, the importation is deemed to be carried out and the tax is due: (i) when the property is used in Mexico; (ii) when the relevant consideration is wholly or partially paid; or (iii) when the appropriate documentation is issued. Where the consideration is paid in installments the tax becomes due upon maturity of each installment.

Finally, where services performed abroad are used in Mexico, the rules provided for services apply.

The VAT levied on the importation of tangible property is calculated on the value taken for the computation of ordinary customs duties as increased by the same duties and other duties paid on importation. It is useful to remember that VAT is never included in the taxable base of same. As regards the importation of goods and services listed from (ii) through (v) at the beginning of this Section, the taxable base of the VAT is that which would be appropriate to transfers of goods, rendering of services, or use or right to use goods in Mexico, as the case may be.

The following imports are exempt from the Mexican VAT:

(i) temporary imports, return of goods temporarily exported, and goods in transit or transshipment;
(ii) baggage and household furniture specified in the Customs Code;
(iii) importation of those goods the transfer of which is exempt from VAT [3] (importation of used personal property is taxable); and
(iv) utilization in Mexico of international transportation services.

## 8. TAX RATES

The VAT is calculated by applying the tax rate provided by the law to the taxable base. The liability resulting after that calculation is reduced, where appropriate, by offsetting against such liability the tax credit arising from inputs.

The Mexican VAT is levied at a 10 percent rate, the only rate for the greatest part of the country. However, taking into consideration that certain regions of Mexico have special characteristics, the law provides for a reduced rate of 6 percent. This rate is applicable to transactions other than imports carried out within specified areas by residents of the same areas.

The areas which benefit from the 6 percent reduced rate are: (i) a strip 20 kilometers wide on the northern international border of Mexico; and (ii) the Free Zones of "Baja California y Norte de Sonora" and "Baja California Sur".

## 9. TAX CREDIT

Taxpayers can offset against their liability to the VAT (calculated either at the general 10 percent rate or at the reduced rate of 6 percent) the VAT invoiced by suppliers or paid by the taxpayer on imports. This means that there are instances in which the liability is calculated at a 6 percent rate (transactions carried out within specified areas by residents of the same areas) while the credit is calculated at a 10 percent rate (inputs from outside the area).

3. See Section 4 above.

The Mexican VAT law further elaborates the conditions under which the credit is granted. The credit is available only if it arises from any one of the following situations:

(i) The credit arises in connection with goods or services which are strictly necessary to carry out transactions subject to VAT. Certain specified items can meet this condition only if the relevant expenditure is deductible for income tax purposes. The items to which this limitation applies are the following: the importation, acquisition, and temporary use or right to use cars, aircraft, boats, houses or goods or services connected therewith, as well as lodging, meals, gifts and entertainment. If only part of the taxpayer's activity is subject to the VAT, the credit is available only in connection with that part.

(ii) The credit arises in connection with machinery and equipment that can be used only in agriculture or cattle raising (machinery and equipment for processing products are not included in this group). However, the credit so arising can be taken only upon a sale of similar property (i.e. sale of machinery and equipment that can be used only in agriculture and cattle raising). Moreover, the credit is limited to 10 percent of the value of each transfer of similar property; any balance is deferred until a subsequent transfer of similar property is made.

(iii) The credit arises in connection with goods or services which are exported. [4] In this case the credit is available even for goods and services which are exempt from the VAT. Moreover, the credit is specifically granted for tangible property which is exported in order to be sold abroad or to grant the use or right to use it abroad. For tangible property the credit can be taken once the exportation is completed under customs laws; for intangible property the credit can be taken upon the payment of the consideration. The credit is limited to 10 percent of the value of goods and services actually exported; any balance of credit is deferred until a subsequent export is made.

In addition to the rules mentioned above, it is necessary to take into account that for the taxpayer to be entitled to the credit it is also necessary that the VAT giving right to the credit be specifically shifted to him by his suppliers and shown separately in the appropriate documentation. Although the law does not state so, it should be understood that the aforegoing rule does not apply to credits arising from imports where it is more appropriate to require the receipts proving the payment of the tax.

The entitlement to the credit is a personal one and cannot be transferred to other persons except in case of a merger of companies.

Under a temporary provision, taxpayers who as of January 1, 1979 acquire goods to be included in their fixed assets can offset from their liability to the new VAT 50 percent of the Federal Tax on Commercial Receipts paid upon the acquisition of such goods.

## 10. TAX ADMINISTRATION AND PAYMENT

Taxpayers of VAT must keep accountancy books and records as established in the regulations to the law. Taxable transactions must be shown separately from exempt transactions. Likewise, transactions giving rise to credits must be shown separately from those not giving rise to credit.

Taxpayers are also under the obligation to issue the appropriate documentation stating the value of transactions and showing specifically and separately the VAT which is being charged.

The Mexican VAT is normally calculated in fiscal periods which are the same as those used for income tax purposes. If the taxpayer of the VAT is not subject to income tax, then the fiscal period is the calendar year.

Taxpayers must, within the first 20 days of each month, file a tax return reporting taxable transactions carried out during the preceding month and pay the VAT arising from those transactions. Moreover, taxpayers must, within 3 months following the end of each fiscal (annual) period, file a tax return for the whole period and pay any balance of tax due.

Where taxpayers have several establishments they shall file a single return for all the establishments.

For imports of tangible property the value added tax must be paid before customs clearance. For occasional transactions other than imports the tax must be paid within 15 days after the payment of the consideration.

## 11. TAX REFUND

If credits in a month exceed the liability to VAT the balance must be normally carried forward to the next month.

There are, however, some instances in which the taxpayer can apply for a tax refund, as follows:

(i) If a balance credit appears in an annual tax return the taxpayer may choose to apply for a refund or to carry the credit forward.

(ii) If the credit arises in connection with goods or services which are exported the taxpayer can choose to take the credit or to have the tax refunded. In this case the benefit is available even for goods and services which are exempt from the VAT. Moreover, the benefit is specifically granted for tangible property which is exported in order to be sold abroad or to grant the use or the right to use it abroad. For tangible property the credit can be taken or the tax refunded once the exportation is completed under customs law; for intangible property the credit can be taken or the tax refunded upon payment of the consideration. The credit or refund is limited to 10 percent of the value of goods and services actually exported; any balance of credit is deferred until subsequent exports are made.

4. For the concept of exportation, see Section 7 above.

(iii) If the credit arises in connection with investments made under plans approved by the tax administration (Secretaría de Hacienda y Crédito Público).

(iv) If the credit arises in connection with machinery and equipment that can be used only in agriculture and cattle breeding the taxpayer can choose to take the credit or have the tax refunded. Nevertheless the credit so arising can be taken or the tax refunded only upon the sale of similar property (i.e. machinery and equipment that can be used only in agriculture and cattle breeding). Moreover the credit or refund is limited to 10 percent of the value of each transfer of similar property; any balance is deferred until a subsequent transfer of similar property is made;

(v) If the credit arises in connection with transactions carried out in areas entitled to the reduced rate of 6 percent. [5]

## 12. SPECIAL REGIME FOR SMALL TAXPAYERS

Small taxpayers commonly constitute a particular problem from the point of view of taxation. The computation of actual transactions or profits is, or can be, encumbered by lack of proper accounting records. In addition, small taxpayers are usually reluctant to comply voluntarily, making the control and enforcement of taxation more complex.

These reasons have led governments to introduce special tax treatment for small taxpayers.

Following this trend, a special regime of taxation is provided by the Mexican VAT law for those small taxpayers considered to be "minor taxpayers" (causantes menores) under the Mexican Income Tax Law. [6]

It is emphasized that the special regime is only applicable to individuals and that the tax administration possesses discretionary power to grant it to the taxpayers. Moreover this special regime shall come into effect gradually to be fully effective only as of 1982.

Under the special regime, minor taxpayers keep simplified records covering only those transactions specified by the tax administration. Moreover, minor taxpayers are exempt from the obligation to file monthly returns reporting taxable transactions.

The taxable base for minor taxpayers is established by the tax administration by means of an appraisal. This appraisal is made taking into account purchases, stock of merchandise, machinery and equipment, rent paid for the premises, number of workers and wages of same, social security contributions, taxes, electricity and telephone bills, self-deliveries, personal expenses, location of the business, and any available data. There are, however, certain transactions the taxable base of which cannot be appraised, namely, the transfers of immovable property, the granting of the use or right to use goods, and some specified services (mandate, commission, mediation, agency, representation, brokerage, consignment and distribution services).

The appraisal conducted by the tax administration is valid until a new appraisal is made. A new appraisal is made if the tax administration comes to the conclusion that the amount of actual transactions is above the amount of transactions resulting from the appraisal in force by more than 20 percent. Where a new appraisal is made the tax administration may claim differences of taxes plus legal charges for arrears. A new appraisal is also made upon request of the taxpayer. In this last case no legal charges for arrears may be made.

For more taxpayers the tax is calculated by applying the tax rate (10 or 6 percent as the case may be) to the appraised base. The resulting liability can be reduced by offsetting the VAT charged to the taxpayer, provided the taxpayer has the appropriate documentation. The balance of tax must be paid to the treasury during the first 15 days of each month.

## 13. MEASURES TO AVOID INTERNAL DOUBLE TAXATION

The fact that in Mexico both the Federation and the States are invested with taxation powers can cause, and in fact does, internal double taxation.

In order to avoid this internal double taxation, the Federation and the States can conclude bilateral conventions under which taxation powers of the States are restricted and taxes collected by the Federation are shared with the States.

Where these conventions are concluded, the contracting State must agree not to levy local taxes on: (i) transactions or activities subject to the VAT; (ii) transfers of goods or rendering of services which are exported; (iii) goods forming part of the business property of an enterprise; (iv) the capital of an enterprise; and (v) interest paid to banks or credit institutions located abroad.

Under the VAT law, the Federal District shall not levy the local taxes mentioned above. In this case, the provision is effective without it being necessary for a convention to be signed.

## 14. ENFORCEMENT OF THE TAX

The Mexican VAT law includes several provisions aimed at insuring compliance and enforcement of the tax.

Under one of these provisions, where one or more tax returns is skipped, the tax administration can charge a tax equal to that appearing in any of the six last monthly returns, or in the annual return, as the case

5. See tax rates in Section 8 above.

6. Individuals acting as enterprises whose gross receipts in the fiscal year do not exceed 1,500,000.00 pesos are considered to be "minor taxpayers" (causantes menores) and their taxable income is calculated under special rules as a percentage (ranging from 3 to 30 percent) of gross receipts.
Other enterprises are deemed to be "major taxpayers" (causantes mayores) and their taxable income is calculated under the general rules.
Individuals receiving commissions, brokerage fees, income from the transfer of property or from granting the use or right to use property are always treated as "major taxpayers".

may be, and even increase the tax so charged with any corrections introduced to such returns by the tax administration under its control powers.

The tax charged under the special procedure mentioned above can be further corrected, where appropriate, by the tax administration under its other control powers. Moreover, the taxpayer is not discharged from his obligation to file the return or returns he skipped by the fact that the tax administration avails itself of the special procedure. If the pending return or returns is subsequently filed by the taxpayer, the tax collected under the special procedure discussed above can be credited against the liability resulting from the tax return.

The Mexcian VAT law includes another provision which grants the tax administration the power to make an appraisal of the amount of taxable transactions in the same instance where the tax administration has the power to do so for income tax purposes. In this way the VAT law enables the tax administration to coordinate control of both taxes (i.e. Income Tax and VAT).

Under the aforementioned provisions the appraisal of the amount of taxable transactions can be made in the following instances: (i) if tax returns are omitted; (ii) if accounting books, documents sustaining tax returns, or reports are not produced by the taxpayer; (iii) if accounting records are not properly kept; or (iv) if the taxpayer is an individual the gross receipts of whom are below 1,500 pesos.

Where one of the instances listed above is present, the amount of transactions subject to VAT can be specifically taken from accounting records and documents or from income tax returns filed for the same period or for a previous period, inclusive of corrections made to same by the tax administration under its control powers. The amount of transactions can also be established through indirect methods, such as an economic survey. The tax resulting from the appraisal can be reduced by deducting normal credits if the appropriate proof is provided.

Under still another provision, where acquisitions of goods have been omitted by the taxpayer, it shall be assumed that the goods which were the object of such acquisitions have been transferred. Moreover the transfer value of same goods is deemed to be equal to the acquisition value increased by the "rate of gross income" of the taxpayer. The rate of gross income is taken in this case from the income tax return filed by the taxpayer for the relevant period or from his last income tax return. If the taxpayer has not filed an income tax return, the rate of gross income is deemed to be 50 percent.

A similar procedure is used in order to establish the value of goods missing from inventories. In this case, if the acquisition value cannot be established, the acquisition value of similar goods acquired by the taxpayer in the relevant period is taken into account; if that value is not available, the market value or the appraisal value is taken.

## 15. FINAL REMARKS

In all countries where "cascade" sales taxes have been changed into a value added tax, it has been difficult to calculate the yield of the new system. The Mexican government has declared, however, that the replacement of the Tax on Commercial Receipts and other indirect taxes by the VAT system should be neutral from the point of view of revenue.

If the Mexican government is right and revenue does not change, there is no justification for an inflationary pressure arising from the inception of the new tax. However the new tax is prone to produce sectoral changes, namely, it is expected that prices of processed goods will go up and, alternatively, prices of clothing should go down.

Moreover, it has been stated that all changes included in the tax reform mentioned at the beginning of this paper are aimed at making the Mexican tax system more equitable and simple and also better suited to current conditions of the Mexican economy.

The Mexican VAT can represent a valuable contribution to those purposes. By removing the distorting effect of previous cumulative taxation, the new tax brings about an improvement in the structure of indirect taxation which in turn can promote a better allocation of resources. Moreover, the fact that the new system is more linked to direct taxation can improve the control of taxpayers.

The special regime for taxation of small taxpayers and provisions concerning the enforcement of the law represent a practical approach which can help to deal satisfactorily with problems arising in these areas.

On the other hand, the fact that the Mexican law provides for a general rate of 6 percent which is applicable only to specified areas involves some problems and risks.

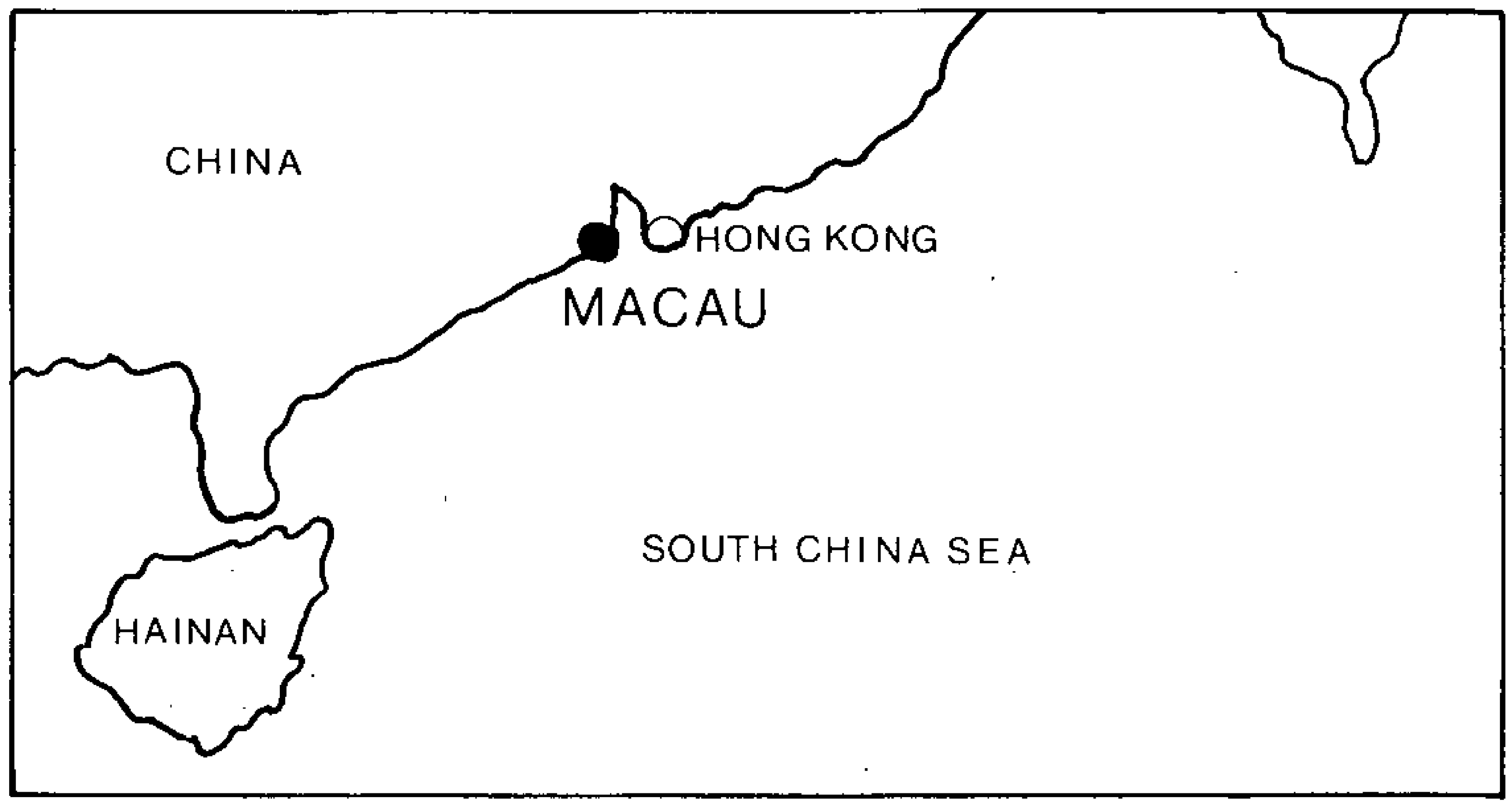
First, it is difficult to forecast part of the revenue from the tax due to lack of regional information.

Moreover a real or fictitious incentive is created to carry out taxable transactions in the eligible areas.

Finally, the reduced rate is not applicable to imports for final consumption in the border areas, giving ground for the argument that the Mexican VAT is discriminatory against imported products, violating the General Agreement of Tariffs and Trade (GATT), the Treaty of Montevideo and the Accord between Mexico and the European Economic Community (1975), all of which establish that internal taxes have to be the same for domestic and imported goods.

**See also table on page 549**

# Taxation 'n Macau




by Drs. M.P. Dominic

## I. INTRODUCTION

*Macau is about 60 kilometers west of Hong Kong and comprises a small peninsula occupied entirely by the town of Macau and the two islands of Taipa and Coloane. The peninsula is linked by a narrow isthmus to the large Chinese island of Chung Shan. The total land area is 15.5 square kilometers.*

*Macau is a Portuguese colony and acquired autonomy on February 17, 1976. The major manufacturing industry is textiles. Other industries are wood and furniture, optical and photographic goods and ceramics. The government favours the establishment of industries to make subsidiary products for the textile and garment industries, construction materials, cement, plastics, tools, shipyards, electronics, watches, jewellery, medicines, furniture and canned foods. An industrial licence is required to establish any industry in Macau. Application for the licence must be made to the Chief of the Economic Department. There are no exchange control restrictions. Tourism is another important source of income.*

*The tax system is rather simple and the tax burden is comparatively low. In 1976, direct taxes made up 18.6 percent of the Goverment's total revenue, indirect taxes 33.6 percent.*

## II. TAXATION ON INCOME.

The Macau tax system is of the schedular type. There are three categories of taxes: Salaries tax, Profits tax and Property tax. All other income such as dividends, interest and capital gains is not taxable.

### A. Salaries tax

Professionals and employees are subject to Salaries tax. No distinction is made between residents and non-residents. It is imposed on all professional and employment income arising in or derived from Macau. No tax is imposed on foreign income. Taxable income includes salaries, wages, fees, commissions, perquisites, bonuses, gratuities, leave pay, the value of free quarters and car transportation, pensions and all income derived from services rendered in Macau. Medical benefits, family allowances, birth allowances, retirement payments and food allowance up to $ 12 Patacas per day are exempt.

The tax rates applicable to employees are:

| | |
|---|---|
| Up to Ptc $13,000 .......... | 1% |
| Up to Ptc $15,000 .......... | 2% |
| Up to Ptc $20,000 .......... | 3% |
| Up to Ptc $30,000 .......... | 4% |
| Up to Ptc $40,000 .......... | 5% |
| Up to Ptc $50,000 .......... | 6% |
| Up to Ptc $60,000 .......... | 7% |
| Up to Ptc $70,000 .......... | 8% |
| Over Ptc $70,000 .......... | 9% |

Those who earn up to Ptc $12,000 a year are exempted.

Tax payable by the employees must be deducted at source by the employers at the time of payment.

The tax rates applicable to professionals are the same as for employees, but with a minimum fixed salary tax of $ 120 patacas to Ptc $ 1,200, depending on the profession. Tax on the professionals is imposed on a previous year basis. Receipts must be issued by the professionals for all income received by them.

The salaries tax paid is deductible from profits tax.

### B. Profits tax

Profits tax is imposed on single proprietors, partnerships, corporations and other persons carrying on any trade, profession or business in Macau and employees. No distinction is made between residents and non-residents. Tax is imposed only on profits and salaries arising in or derived from the territory of Macau. Foreign income is not subject to tax.

All expenses incurred by a taxpayer wholly for the production of chargeable profits are deductible. As noted earlier, salaries tax is deductible. Bad and doubtful debts actually written off and annual registration fees are deductible. Carry forward of unabsorbed losses is allowed for three years. For industrial buildings and structures, machinery and plant an initial depreciation deduction of 20 percent is permitted in the first year. Annual depreciation deductions are permitted on the basis of the declining balance method. The annual deductions are:

1. *Tangible assets:*

| | |
|---|---|
| Industrial and commercial buildings ........ | 4% |
| Machinery, tools and other equipment for: | |
| — Textile industry ........ | 15% |
| — Precision industry ........ | 12.5% |
| — Others ........ | 10% |
| Other machinery, tools and equipment | |
| — Electronic equipment ........ | 16.66% |
| — Engines ........ | 10% |
| — Others ........ | 10% |
| Vehicles or other means of transport | |
| — Light ........ | 14.28% |
| — Heavy ........ | 16.66% |
| Furniture and untensils ........ | 10% |

2. *Intangible assets:*

| | |
|---|---|
| Incorporation expenses ........ | 33.33% |
| Patents ........ | 10% |

For individuals, personal deductions are granted:

| | |
|---|---|
| Personal deduction | — Ptc $ 12,000 |
| Wife deduction | — Ptc $ 6,000 |
| Children under 21 years | |
| — over 16 | — Ptc $ 3,000 |
| — over 11 to 16 | — Ptc $ 2,500 |
| — over 7 to 11 | — Ptc $ 2,000 |
| — under 7 | — Ptc $ 1,500 |
| Educational deduction for each child under 26 years who is studying abroad | — Ptc $ 6,000 |
| Dependent parents or parents-in-law | — Ptc $ 1,500 |

The tax rates vary from 2 to 15 percent. The maximum rate applies when the taxable income exceeds Ptc $300,000.

Tax is imposed on a previous year basis. The income of a wife is aggregated with that of her husband.

Companies limited by shares (quotas) with a capital over Ptc $ 300,000 or an average profit over the last three years of more than Ptc $100,000 are required to submit a balance sheet certified by registered accountants or auditors.

## C. Property tax

Property tax is levied on the rent or rateable value of buildings situated in Macau, therefore no tax is imposed on buildings situated outside the Colony. The tax is imposed on the owners of such buildings and no distinction is made between residents and non-residents. No tax is imposed on land.

No tax is imposed on industrial buildings occupied by the owner for industrial purposes and on buildings occupied by non-profit making schools. Exemption is given for new residential or commercial buildings for a period of four years in Macau town and six years in the two islands, and for new industrial buildings for five years in Macau town, and ten years in the two islands.

A 15 percent deduction is allowed for repairs and maintenance.

In addition, the following allowances are deductible.

| | |
|---|---|
| Electricity for lifts (for each floor served) ........ | Ptc $200 |
| Porters (for buildings over a certain height) ........ | Ptc $600 |
| Lighting for stairways (for each floor) ........ | Ptc $100 |
| Central heating ........ | Ptc $900 |
| Air conditioning (for each floor) ........ | Ptc $900 |

The tax rates are as follows:

| | |
|---|---|
| Up to Ptc $120,000 ........ | 16% |
| Up to Ptc $240,000 ........ | 18% |
| Over Ptc $240,000 ........ | 20% |

Other taxes include annual industrial registration fee, estate duty, duty on sale of property, stamp duty, excise duties, welfare tax, export duty and fixed consumption tax. There are no customs duties on imports.

## D. Annual Industrial Registration Fees

Corporations, bodies of persons and partnerships carrying on a trade or business in Macau are subject to this tax. The tax rates vary according to the economic activity (categorized into three classes) and the location of the industry. The rates for factories vary from Ptc $ 40 to Ptc $ 5,000 in Macau and from Ptc $ 20 to Ptc $2,500 in Taipa and Coloane Islands.

## E. Estate duty

Estate duty is imposed on that part of the estate of a deceased person which is situated in Macau. The rates vary from 4 to 33 percent, according to affinity and value of the estate.

## F. Duty on sale of property

This duty is imposed on the value of any land or buildings transferred in Macau. The duty is 6 percent in Macau and 4 percent in the two islands.

## G. Stamp duty

Stamp duties may be fixed duties or ad valorem, depending on the documents.

## H. Excise duties

Sugar, alcohol, motor vehicles, coffee, hydrocarbon oils, wines and spirits, beverages, rice, cement, matches, tobacco and listed machineries are subject to excise duties.

## I. Welfare tax

This tax is equivalent to 5 percent of the room and meal bill and is imposed on hotels, guest houses and restaurants.

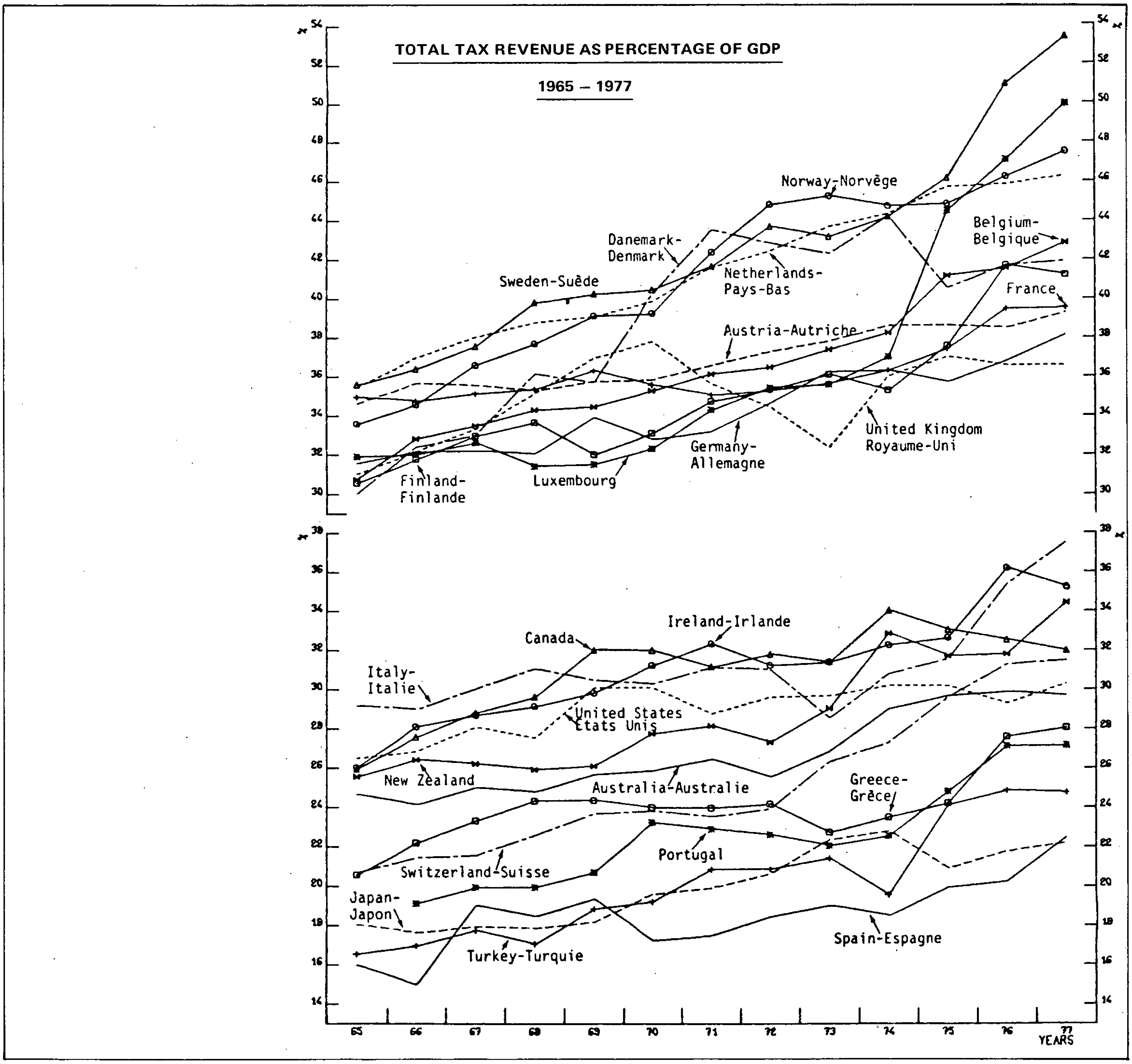
## J. Export duty

The duty is 1 percent on the CIF value of exports to quota-limited countries (Federal Republic of Germany, Belgium, Austria, France, Netherlands, Luxembourg, Italy, Irish Republic, Denmark, United Kingdom, Canada, Sweden, Norway, United States of America and Finland) and 0.5 percent on the CIF value of exports to other countries.

### K. Fixed consumption tax

Imported goods are subject to a fixed consumption tax, depending on the item group. A preference rate is imposed on Portuguese goods. Exemption is given for ancillary machinery, spare parts for the assembly or alteration of equipment and the expansion of industries, as well as raw materials used in industrial production. Reductions of 80 and 70 percent are given for imports of fuel and salt for the fishing industry. Special exemptions may be granted by the Governor, on the advice of the Economic Department.

# Tax Levels and Structures in OECD Member Countries



The OECD has just published its annual statistical bulletin on tax levels and structures in OECD Member countries. The bulletin contains the most comprehensive information that is at present available on an internationally comparable basis, concerning the amounts of tax receipts collected by OECD Member countries and the varying ways in which these receipts are raised. Though the data refer to the years 1965-1978, the figures for 1978 are provisional estimates which may be subject to change and are accordingly not shown in most of the comparative tables.

The 35 comparative tables contained in the report, as well as the numerous country tables, show how countries differ in the proportion of their Gross Domestic Product taken in taxes and the different reliance that they place on the various kinds of taxes: income taxes, social security contributions, consumption taxes, etc. The commentary which accompanies the tables draws attention to how the level and composition of tax revenues have changed. For the OECD area as a whole, the average proportion of GDP accounted for by taxation rose from 28 percent in 1965 to 36 percent in 1977. The increase was especially large in Northern Europe (the Nordic countries, Belgium, Luxembourg and the Netherlands). Between 1977 and 1978, however, for the first time since 1965 when the series began, provisional 1978 figures for the 16 countries for which data are available, indicate a levelling off of this trend and an actual decline in a number of countries (see attached table).

As regards tax structures, the main tendencies have been to increase reliance on the personal income tax and, in most countries, social security contributions, whilst reducing overall reliance on consumption taxes, and especially excises on tobacco and alcoholic drinks. Taxes on corporate incomes and on property have also continued to decline steadily in most countries.

Data on the allocation of tax revenues by levels of government during the years 1973-76 are provided in an annex to the publication. The annex highlights the wide differences in the proportion of tax revenues accruing to each level of government and the varying methods that are used to finance local government.

A table attached to this press release compares the total taxes in OECD Member countries, as a ratio of GDP, in 1977 and 1978 and a graph indicates how this ratio has changed since 1965.

"Revenue Statistics of OECD Member Countries 1965-1978". 235 pages, OECD, Paris 1979. ISBN 92-64-01959-6. Available from OECD Sales Agents.

**Total Tax Revenue (including social security contributions) as percentage of GDP ***

| | | 1977 | ** 1978 |
|---|---|---|---|
| Sweden | – | 53.4 | 53.1 |
| Luxembourg | – | 50.0 | n.a. |
| Norway | – | 47.5 | 47.3 |
| Netherlands | – | 46.3 | 46.7 |
| Belgium | – | 42.9 | 44.4 |
| Denmark | – | 42.0 | 43.2 |
| Finland | – | 41.2 | 38.9 |
| France | – | 39.6 | 39.4 |
| Austria | – | 39.3 | 41.3 |
| Germany | – | 38.2 | 38.0 |
| Italy | – | 37.6 | 34.5 |
| United Kingdom | – | 36.6 | 35.2 |
| Ireland | – | 35.2 | 33.7 |
| New Zealand | – | 34.5 | 32.3 |
| Canada | – | 32.0 | 32.3 |
| Switzerland | – | 31.5 | 31.5 |
| United States | – | 30.3 | 30.4 |
| Australia | – | 29.7 | n.a. |
| Greece | – | 28.1 | n.a. |
| Portugal | – | 27.2 | n.a. |
| Turkey | – | 24.8 | n.a. |
| Spain | – | 22.5 | n.a. |
| Japan | – | 22.2 | n.a. |

* Ranked by 1977 figures
** Provisional Estimates
n.a. not available

## VAT RATES IN LATIN AMERICA

| *country* | *tax coverage* | *common rates (%)* | *other rates (%)* |
|---|---|---|---|
| Argentina | sales and services | 16 | –– |
| Bolivia | sales | 5 | –– |
| Brazil | | | |
| Federal VAT | sales at producer level | –– | 3 to 365.6 |
| State VAT | sales | 13-14-15 depending on region | –– |
| Chile | sales and services | 20 | –– |
| Colombia | sales and services | –– | 4-6-10-15-35 |
| Costa Rica | sales and services | 8 | –– |
| Honduras | sales | 3 | –– |
| Ecuador | sales | 5 | –– |
| Mexico | sales and services | 10 | 6 |
| Panama | sales and services | 5 | –– |
| Peru | sales | 22 | 3-5-42 |
| Uruguay | | | |
| current rates | sales and services | 18 | 7 |
| pending project | sales and services | 14 | 8 |

# U.S.A.:

# A Look at the Limitations on State Power to Tax Foreign Commerce

**(Japan Lines Ltd. v County of Los Angeles)**

by Phyllis Culp*

## I. INTRODUCTION

In a majority opinion decided on April 30, 1979, the United States Supreme Court held in *Japan Lines Ltd v County of Los Angeles* —— U.S. ——, 47 LW 4477 (1979) that the city of Los Angeles and the county of Los Angeles, political subdivisions of the state of California, could not impose an ad valorem property tax on Japanese cargo shipping containers used exclusively in foreign commerce between Japan and the United States. This decision further defines the limits of a state's power to enact taxing legislation under the Commerce Clause of the United States Constitution. While a state may tax instrumentalities (i.e. means, methods or vehicles by which goods or products are transported) of *interstate commerce* under specific criteria previously formulated by the Court, if it imposes a tax on instrumentalities of *foreign commerce* two additional tests must be met: the tax must not place a substantial risk of international multiple taxation on the property taxed and it must not prevent federal uniformity in the regulation of commerce with foreign governments.

The effect of this decision is twofold: first it provides a new test to determine the constitutional limitations upon a state to impose a tax on foreign-owned and operated instrumentalities of *foreign commerce* and secondly it reiterates the absolute and exclusive power to Congress to regulate foreign commerce. Thus while Congress' power to regulate *interstate commerce* has been held to be restricted by considerations of federalism and state sovereignty, congressional power to regulate foreign commerce will not be so limited. [1]

## II. HISTORY OF THE CASE

Six Japanese shipping companies who engage in trade with the United States and are incorporated under the laws of Japan were held liable for property tax by the city of Los Angeles and county of Los Angeles, on cargo containers they owned. The companies have their principal places of business and commercial domiciles in Japan and they operate vessels, registered in Japan, which are exclusively used in foreign commerce. The ships have their home ports in Japan and are specifically designed and constructed to accommodate large shipping containers. [2] These containers not only have their home port in Japan but are also taxed on their full value in Japan.

Although the cargo containers are in constant motion except for periods of time when they are either undergoing repairs or waiting for the loading or unloading of cargo, there are always several containers in the state of California at all times during a given year. Under California property law, [3] property present in California on March 1 of any given year is subject to an ad valorem property tax on the assessed value of the property in question. Since a number of the cargo containers were physically present in California on March 1 of 1970, 1971 and 1972, property tax was levied on the assessed value of the containers for the years in question by the city of Los Angeles and county of Los Angeles.

After paying under protest the taxes of over $550,000, the companies sued for their refund in the Superior Court for the County of Los Angeles, the trial court in that jurisdiction. In a non-jury trial the court granted the recovery of the taxes together with interest and court cost to the companies.

The city and county of Los Angeles then appealed the trial court decision in the California Court of Appeal. The Appeal Court reversed the judgment of the lower court and held that a state may impose an ad valorem property tax on moving instrumentalities of commerce (i.e. cargo containers) on an apportioned basis in order to meet expenses such as road, bridges and other services within the taxing state's jurisdiction.

The companies then appealed from the California Court of Appeal decision to the Supreme Court of California which in a unanimous opinion upheld the Court of Appeal decision. Finally, the companies appealed to the United States Supreme Court which reversed the decision of the Californian Supreme Court and found the tax to be unconstitutional under the Commerce Clause of the United States Constitution.

## III. THE LAW

The United States Constitution is one of enumerated powers. The Tenth Amendment to the United States Constitution declares that "powers not delegated to the United States by the Constitution nor prohibited by it to the states are reserved to the states... or to the people". One such right granted to Congress under what is known as the *Commerce Clause* of the Constitution states that "Congress shall have power... to regulate commerce with foreign nations and among the several states." [4]

The U.S. Supreme Court, which is the final interpeter of the Constitution, has held that both the United States and the individual states have power to enact legislation with respect to traffic or trade that passes beyond the borders of an individual state. In defining the limits of the power of an individual state to enact taxing legislation that affects commerce *between* the states, the U.S. Supreme Court has only sustained those laws that do not disadvantage trade from other states so much so that the flow of traffic between the individual states would suffer as a result.

The Supreme Court of the United States has held that such traffic must bear "its fair share of the tax burden" and even the instrumentalitites used in *interstate commerce* are subject to state tax and property taxes on the various forms of transportation equipment. [5]

Legislation that apportions taxes levied upon instrumentalities of *interstate com-*

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* J.D. Graduate of Case Western Reserve University, Staff member of the International Bureau of Fiscal Documentation.

1. See *National League of Cities v Usery*, 426 U.S. 833 (1976).

2. "A container is a permanent reusable article of transport equipment...durably made of metal, and equipped with doors for easy access to the goods and for repeated use. It is designed to facilitate the handling, loading, stowage aboard ship, carriage, discharge from ship, movement and transfer of large numbers of packages simultaneously by mechanical means to minimize the cost and risks of manually processing each package."
Simon, *The Law of Shipping Containers*, 5 J. Maritino L. Comm. 507,513 (1974) (the Court's footnote 1).

3. Cal. Rev. and Tax Code Ann §§ 117, 405, 2192 (West 1970 and Supp.) 1978.

4. U.S. Const. Art. I, Sec. 8, cl.3.

5. 47 LW 4477, 4480 *Washington Revenue Dept. v Association of Wash. Stevedoring Cos.*, 435 U.S. 734, 750 (1978).

*merce* has been regularly upheld as a method of insuring their contribution of a fair share, but not more than one tax may be levied on the full value of the items assessed.

Mathematical precision has not been required and reasonable methods of apportionment of the tax have become the practice by which a risk of possible multiple taxation of the instrumentalities has been resolved. By apportioning the tax among the jurisdictions, the risk of a tax on more than the instrumentalities' full value is eliminated and "multiple burdens logically cannot occur".[6] No one jurisdiction can tax the instrumentality in full, thus instrumentalities from other states are not unfairly burdened and placed at a disadvantage by being taxed fully in their state of domicile and perhaps again when engaged in interstate commerce.

In determining whether a particular state tax law is constitutional in that it does not place a burden on commerce and hinder the flow of traffic *between* the states, the U.S. Supreme Court has formulated a four-prong test to apply to such legislation. First the instrumentality must have a substantial nexus with the taxing state, secondly the tax must be fairly apportioned, thirdly the tax must not discriminate against out of state property and finally the tax must be fairly related to the services provided by the State.[7] Had the cargo containers been engaged in *interstate commerce* (i.e. between the individual states) the four-prong test provided by the U.S. Supreme Court would have been sufficent to insure that the constitutional considerations under the Commerce Clause were satisfied. However, since the containers were engaged in *foreign commerce* the Supreme Court of the United States found that "a more extensive constitutional inquiry [was] required".[8]

## IV. THE OPINION OF THE LOWER COURTS

### I. The trial court

The question of a state's power to enact taxing laws that affect *foreign commerce* is not a new one.

Federal courts had "consistently held that vessels which are instrumentalities of foreign commerce and engaged in foreign commerce can be taxed in their home port only",[9] and this principle had become known as the *home port doctrine.* When the Japanese companies sued for a tax refund, the trial court applied the "home port doctrine" and granted the refund. The trial court reasoned that since the cargo containers (the property being taxed) were instrumentalities of *foreign commerce* and were taxed in Japan (their home port), the California tax was invalid. The application of the home port doctrine, the court reasoned, was necessary to avoid multiple taxation of instrumentalities engaged in commerce with foreign nations. While apportionment of taxes was used in *interstate commerce* to prevent such duplication of taxes it is "not practical" when one of the taxing entities is a foreign sovereign power.[10] In such cases "[t]here is no tribunal that can adjudicate (competing) rights unless it be the International Court and to invoke its services jurisdiction must be consented to by all parties".[11] The trial court then held that to apply the tax in derogation of the home port doctrine would subject international commerce to multiple taxation and thus was unconstitutional under the Commerce Clause. In so holding the court followed *Scandinavian Airlines System, Inc. v County of Los Angeles*[12] where it was held that an ad valorem property tax levied by California upon aircraft owned, based and registered abroad and used exclusively in international commerce was unconstitutional under the Commerce Clause because it subjected instrumentalities engaged in foreign commerce to a risk of multiple taxation that could be avoided by apportionment domestically, but not when a foreign nation was involved.

### 2. The California Court of Appeal

When, however, the city and county appealed to the California Court of Appeal this court appeared to conclude that SAS was no longer controlling, believing it to have been effectively overruled by a subsequent California Supreme Court decision.[13] In the field of *interstate commerce*, apportionment of taxes has replaced the home port doctrine as a method of eliminating discrimination by the taxing state against out of state property. This method avoids multiple taxation of the instrumentalities by their domiciliary state and other states with which it has contact. While the U.S. Supreme Court has discarded the home port doctrine for an apportionment of the tax levied by a non-domiciliary state and states with which it has contact it has consistently distinguished the treatment of ocean going vessels in the field of *foreign commerce* and has continued to use the home port doctrine to prevent multiple taxation of these vessels.

The basis of the U.S. Supreme Court's approval of the apportionment theory in the domestic area, in *interstate commerce*, has been the court's power "to enforce full apportionment by all potential taxing bodies".[14] In the international context, however, when the entity is owned by a foreigner, domiciled in a foreign country and engaged only in *foreign commerce* with the United States, the U.S. Supreme Court does not have the power to prescribe a fair apportionment of the taxes. A division of tax can only be accomplished by treaty or other international agreement between the taxing authority and those subject to the tax. The power to enter such agreements is prohibited under the U.S. Constitution to the individual states as only the federal government may engage in foreign relations. The California Court of Appeal, however, rejected the shipping companies' argument that, in light of this inability to apportion, a distinction should be made in the constitutional analysis given to taxes that affect international commerce. It found that the home port doctrine should not shield a taxpayer "even if...engaged in foreign commerce" from a "fairly apportioned ad valorem tax levied by a non-domiciliary jurisdiction with which the taxpayer has sufficient contacts......The possibility of international double taxation of instrumentalities of foreign commerce... [was] no reason to limit the local power to tax them upon a non-discriminatory apportioned basis."[15]

### 3. The California Supreme Court

The Califonia Supreme Court granted a hearing. It reversed the judgment of the trial court and essentially adopted the opinion of the Califonia Court of Appeal. In sustaining the validity of the tax, the California Supreme Court found that the same test that was applied to taxes on *interstate commerce* was also to be used to test the constitutionality of taxes involving *foreign commerce.* Unlike the trial court, the California Supreme Court "concluded that the threat of double taxation from foreign taxing authorities has no role in commerce clause considerations of multiple burden... [therefore] the containers' foreign ownership and use [were] irrelevant for the purposes of constitutional analysis".[16]

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6. 47 LW 4477, 4481.
7. 47 LW 4477, 4480 *Complete Auto Transit, Inc. v Brandy,* 430 U.S. 274, 279 (1977).
8. Ibid.
9. 47 LW 4477, 4478.
10. Ibid.
11. Ibid.
12. 56 Cal.2d, 11 363 P d Cert. denied, 368 U.S. 899 (1961).
13. *Sea-Land Service Inc. v County of Alemeda,* 12 Cal. 3rd 722, 528 p.2d 56 (1974). In that case the California Supreme Court not only criticized the use of the home port doctrine as a basis of taxation by labelling it "anachronistic" but also upheld an apportioned property tax on containers owned by a domestic corporation used in both intercoastal and foreign commerce.
14. LW 4477, 4481.
15. *Japan Line Ltd. v County of Los Angeles,* 20 Cal. 3rd 180, 185 (1977).
16. 20 Cal. 3rd 180, 187.

Since an individual state of the union cannot levy an import or export duty on goods entering or leaving its territory, the companies maintained that, in addition to the Commerce Clause violations, the tax also violated this prohibition. The taxing of the containers, they maintained, was an indirect tonnage duty prohibited under Article I, section 10, clause 3 of the United States Constitution. Under this provision, individual states are prevented from denying access to their territories by the imposition of duties. The California Supreme Court dismissed this argument and found that the U.S. Supreme Court had held in previous decisions that individual states may impose an apportioned property tax on moving instrumentalities of *interstate commerce* to meet the expenses of the services within the taxing jurisdiction. It reasoned that the property tax on the cargo containers was not levied while they were in transit since there were always some containers within the state at all times. It was the continuous presence of the containers that was being taxed on an apportioned basis. Therefore the tax was not imposed as a duty upon entering or leaving the state, but was levied on an apportioned basis for use of the state's harbor facilities, roads, bridges, water supplies, fire and police protection as well as other services. [17]

The shipping companies made a final appeal to the U.S. Supreme Court. The issue that was presented to the Supreme Court was if a state within the limits of the Commerce Clause of the United States Constitution may impose a non-discriminatory ad valorem property tax on foreign owned instrumentalities (cargo containers) of international commerce.

## V. U.S. SUPREME COURT OPINION

Under Volume 28 of the United States Code, section 1257(2), the U.S. Supreme Court has appellate jurisdiction to review a final judgment rendered by the highest court of a state when such adjudication determines that a state statute did not vilate the Constitution, treaties or laws of the United States. Since the validity of California's apportioned ad valorem property tax levied on the cargo containers was sustained by the California Supreme Court and deemed not to be repugnant to the Commerce Clause of the Constitution, the U.S. Supreme Court has appellate jurisdiction over the case, to hear and decide the issue placed before it.

In formulating the constitutional inquiry required to determine the validity of a law that imposes a tax on instrumentalities engaged in *foreign commerce*, the U.S. Supreme Court found that in the Commerce Clause analysis "two additional considerations" beyond those required when a law affects *interstate commerce* "come into play". The first of these is whether, notwithstanding an apportionment of the tax, it enhances the risk of multiple taxation of the property engaged in foreign commerce. The second, equally important, issue is the necessity of maintaining federal uniformity in the area of foreign relations and foreign commerce.

Under the Commerce Clause, multiple taxation of commercial transportation vehicles or instrumentalities of commerce used in trade not only between the individual states of the union but also between the United States and foreign nations is not permitted. In interstate commerce, in order to eliminate any unfair treatment that may result from the imposition of a tax on property by both its domiciliary state and those states through which it travels, the Supreme Court has required an apportionment of the tax by all the possible taxing jurisdictions. This allocation of tax assures that no one of the jurisdictions taxes the property on more than its full value. Therefore those engaged in interstate trade will not be penalized for their activities. The basis for sustaining apportioned property taxes, however, has been the Court's ability to enforce this division among the individual taxing bodies.

In the area of *foreign commerce* this is not possible. Neither the U.S. Supreme Court nor the federal government can ensure that tax levied on property domiciled in another country will be divided among the potential taxing bodies. The country of domicile may well impose a tax on the full value of the property. When one among the taxing entities is another sovereign nation, the court's power and ability to enforce a distribution of the burden is impaired. Consistent with the customs of nations the country of domicile has the right to impose a tax on the full value of the property. [18]

A state tax, even though "fairly apportioned", may subject foreign commerce to a multiple tax burden to which interstate commerce is not subject. Apportionment of the tax is not a solution when there is no administrative body that can insure that, in the aggregate, the taxes imposed would not be on more than the full value of the property subject to the tax. The tax in California as sustained not only created a risk of multiple taxation but does in fact result in double taxation.

As foreign commerce is primarily a matter of national concern, international relations with foreign nations must be conducted through a single administrative body. The national government must have full and adequate power to "speak with one voice when regulating commercial relations with foreign governments". [19] Therefore the second consideration looked at by the U.S. Supreme Court is that a state tax must be in conformity with the United States national government's policy and philosophy. The taxation of foreign commerce of necessity may require a uniform national rule and only the U.S. government can formulate this rule.

The court reasoned that this need for federal uniformity in the area of *foreign commerce* may be frustrated in several ways by state tax legislation that affects foreign property. If, for example, an individual state imposed an apportioned tax, an international dispute over the formulae used in the apportionment might arise; therefore, any resolution of the disagreement has to involve the United States national government and not the individual taxing state. Or if a state creates an asymmetric taxing system, those nations placed at a disadvantage by the tax could retaliate by taxing all American instrumentalities in their jurisdiction and not just those from the individual state that may have imposed the tax. "Such retaliation of necessity would be directed at American transportation equipment in general not just that of the taxing state, so that the nation as a whole would suffer." [20]

The Court then proceeded to analyze the California tax under this test. It found that the California tax did result in multiple taxation of the containers, once in Japan and again in the United States. Secondly, it found that the tax prevented the nation from following a uniform treatment of containers used in foreign commerce and therefore there was an inconsistency in the policy between state and federal government. As evidence of this the Court cited a Customs Convention on Containers to which the United States and Japan are signatories. Its purpose is to remove any impediments to the use of containers as "instruments of international traffic". The California tax would hinder this uniformity and create a risk of retaliation in Japan. [21]

Therefore, "because California's ad valorem tax as applied to appellants' containers, results in multiple taxation of the instrumentalities of foreign commerce, and because it prevents the Federal Government from 'speaking with one voice' in international trade, the tax is inconsistent with Congress's power to 'regulate commerce with foreign nations'. We hold the tax, as applied, unconstitutional under the Commerce Clause and reverse the judgment of the Supreme Court of California". [22]

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17. Ibid.
18. 47 LW 4477, 4481.
19. Ibid.
20. Ibid.
21. 47 LW 4477, 4482.
22. Ibid.

# ANALYSIS

The international consequences that would have flowed from the judgment rendered by the California Supreme Court were abruptly halted by the U.S. Supreme Court in this recent decision. Due to the fact that the U.S. Supreme Court found that the California property tax violated the Commerce Clause and therefore based its judgment on this clause it never reached several other constitutional arguments that were raised in the lower court. Because of this, the validity of these arguments in terms of the power of the states to impose taxes on moving instrumentalities of foreign commerce remains unresolved. The following analysis of the U.S. Supreme Court opinion will attempt to give some indication of the current status of the law as a result of the U.S. Supreme Court's opinion in this case.

## I. TREATY QUESTIONS

### 1. U.S. Friendship, Commerce and Navigation Treaty with Japan

Under the supremacy clause of the United States Constitution, treaties between the United States Government and foreign countries take precedence over state laws. When, however, the companies maintained that the California property tax violated United States treaty obligations with Japan, both the California Supreme Court and the U.S. Supreme Court rejected this argument.

The *Treaty of Friendship, Commerce and Navigation Between the United States of America and Japan*, dated April 1, 1953, prohibits discrimination against Japanese nationals by the imposition of more burdensome or greater tax on them than on American nationals. Both the lower court and the U.S. Supreme Court found that the California tax in no way violated the provision cited by the companies. The property tax was applied equally to American as well as Japanese property located in the state without regard to its ownership. The purpose of the provision was to insure like treatment for the citizens of both countries and this the courts found had been done. The state tax law did not contravene this treaty provision and therefore was not invalidated under the supremacy clause of the U.S. constitution.

### 2. GATT

In addition the companies argued that the state tax was a violation of the *General Agreement on Tariffs and Trade* (GATT) to which the United States is a signatory. The U.S. Supreme Court deemed this argument to be frivolous. Article III, Sections 1 and 2, of GATT declares that imported products may not be subject to heavier taxes or less favorable treatment than like products of a domestic origin. The cargo containers were not imported products for they were designed to be used repeatedly for transportation. The U.S. Supreme Court noted, however, that even if the containers could be considered to be imported within the meaning of the GATT provisions cited by the companies, they only prohibit discriminatory treatment. There was absolutely no evidence that the Japanese containers were treated any differently than domestic containers which were also subject to the state property tax. Under this treaty as under the FCN Treaty the California tax applied equally to all containers so that this provision was not violated and therefore this Agreement could not be used as a limitation on the power of a state to impose a property tax on foreign owned cargo containers.

## II. TONNAGE DUTY PROHIBITIONS

Under Article I, Section 10, clause 3 of the United States Constitution the individual states are prohibited from taxing access to their territories by levying a tonnage duty. In the lower court, the companies argued that the California tax contravened this clause for its application resulted in a tonnage duty indirectly imposed upon the cargo containers. The companies argued that the tax, although ostensibly levied on the cargo containers, was in reality a tax on their capacity to carry goods, which tax was prohibited by the Constitution. The lower court rejected this argument completely. It found that whereas tonnage duties or taxes on the transported goods are prohibited, the clause does not totally prevent the state from imposing taxes on transportation vehicles. The states are permitted under the Constitution to charge the instrumentalities of commerce for their services rendered and enjoyed by the instrumentalities. It therefore characterized this tax not as a duty but as a charge for various state services from which the instrumentalities benefitted. The U.S. Supreme Court never reached this question due to its adjudication of the case nor can it be seen whether this constitutional clause will prevent or limit the states' power to tax foreign owned instrumentalities engaged in foreign commerce.

## III. THE IMPORT-EXPORT CLAUSE

The lower court also rejected the companies' argument that the tax was an impost or duty that violated Article I, Section 10, clause 2 of the U.S. Constitution, which prohibits the states from levying an impost or duty on imports to or exports from its territory. The U.S. Supreme Court opinion never considered this issue due to its disposition of this case.

The lower court maintained that imports and duties are taxes on the commercial privilege of bringing goods into a country.[1] The Constitution prohibits duties on the importation of goods and not a tax upon the means of transporting the goods into the territory. Clearly the goods that the containers were transporting come under the protection of the import-export clause, as well as the tonnage duty prohibition. However, the question still remains as to whether the cargo containers or other vehicles of transportation are likewise protected from state taxation under these clauses. According to the lower court, neither clause

1. 20 Cal. 3rd 180, 186.

protects the instrumentalities of transportation from state taxes levied upon them. However, it is unclear as to whether the U.S. Supreme Court also holds this view.

In a footnote to this case, the U.S. Supreme Court stated that the policies underlying both the Commerce Clause and the import-export clause are very much alike.[2] The criteria established for determining the constitutionality of laws affecting the import-export clause were found by the court to be similar to those affecting the Commerce Clause. The three-prong test enunciated by the U.S. Supreme Court under the import-export clause challenge held that a state law violated this prohibition if it prevents the federal government from speaking with one voice when regulating commercial relations with foreign governments, diverts import revenue to the states and lastly disrupts the harmony between the states.

Similar aims were found to underly the Commerce Clause prohibitions; in fact the first test, a uniform national policy for regulating foreign trade, was adopted by the U.S. Supreme Court in this case. In the import-export clause case[3] the court upheld a state tax as not preventing the federal government from speaking with one voice. However, it specifically noted in the case that this was true except in those instances when state taxes were imposed on foreign businesses or vessels.

In contrast to the likelihood of the Tonnage Duty clause being used to limit a state's power to tax foreign owned instrumentalities of foreign commerce, the import-export clause and all the policies emanating therefrom seem to be possible grounds for a constitutional challenge.

## IV. THE HOME PORT DOCTRINE

Several theories have been used by the courts to prevent the multiple taxation of moving instrumentalities used in commerce. One such theory which was raised in the lower court and could have been used by the U.S. Supreme Court in the disposition of this case is the home port doctrine. Because this doctrine is based upon the common law right to tax and not upon the U.S. Constitution, the U.S. Supreme Court chose to rest its analysis of this case on the Constitution and not the common law. However, as a result of its decision, the status of this doctrine remains unclear.

The home port doctrine developed as a theory of taxation that defined the jurisdiction of a state to tax moving equipment of commerce. It allowed for the taxation of moving vehicles of transportation in the place in which they were not only registered and owned but also where they were based, that is in their home port. Gradually in the domestic context, apportionment of the taxes imposed on vehicles of transportation, whereby each taxing jurisdiction was empowered to tax a portion of the value of the instrumentality, has replaced the home port doctrine as a method of eliminating the risk of multiple taxation in interstate commerce.

Both in the lower court and again in the U.S. Supreme Court, the companies argued that in the field of international or foreign commerce the home port doctrine had not been replaced by apportionment but was still a valid limitation on the state's jurisdiction to tax ocean-going vessels and the instrumentalities associated with them.

The U.S. Supreme Court declined to answer whether under the home port doctrine an ocean-going vessel could only be taxed in its home port by its state of domicile regardless of whether it was engaged in foreign or domestic commerce, or whether its ownership was an important element in any analysis undertaken under this doctrine. It is not clear from this opinion whether the new test formulated by the Court will replace the home port doctrine as a method of defining the state's power to tax foreign owned vehicles of transportation or whether the immunity granted under this doctrine to ocean-going vessels engaged in foreign commerce may still exist.

## V. THE CURRENT STATUS OF THE LAW

Although some unanswered questions remain due to the fact that the U.S. Supreme Court failed to reach several issues raised in the lower court, a pattern seems to be emerging in the current status of the law that defines the limits of a state's power to tax instrumentalities of commerce. Ownership of the vehicle is the critical factor in the determination of the constitutional protection afforded vehicles of transportation engaged in foreign commerce against the imposition of state property taxes.

A case which was discussed extensively in the California Supreme Court opinion, *Sea-Land*, appears to be dispositive of the state's power to tax domestically owned instrumentalities of commerce even though engaged in foreign commerce. Although the U.S. Supreme Court never reached this question in its reasoning in this case, this appears to be the current law with regard to domestically owned vehicles.

In *Sea-Land* the California Supreme Court upheld an apportioned property tax on a shipping company's cargo containers used in both interstate and foreign commerce. In that case the California Supreme Court not only rejected the home port doctrine as a method of limiting the state's power to tax but also rejected the contention that any possible international double taxation of these containers might be a reason to limit the state's power to tax them on an apportioned basis. It was irrelevant to this court that foreign and not interstate commerce was involved, for these domestically owned containers used in both intercoastal and foreign commerce were held subject to the state's apportioned property tax despite their international activities.

The California court in the Japanese Lines case found that the threat of any multiple taxation due to the instrumentalitites' foreign ownership was not to be considered in the court's reasoning under the Commerce

2. See 47 LW 4477, 4481 footnote 14: *Michelin Tire Corp. v Wages*. 422 U.S. 276 (1976).
3. Ibid.

Clause. Since this risk of possible double taxation was not due to any discrimination on the part of the taxing jurisdiction the California court found that the multiple tax burden should not be considered in its analysis of the state laws' constitutionality under the Commerce Clause.

Using this case as precedent the California court found that the Japanese cargo containers' foreign ownership was irrelevant in its analysis and the challenge of the tax as being unconstitutional under the Commerce Clause was rejected. In the appeal to the U.S. Supreme Court, however, the U.S. Supreme Court found that the ownership of the vehicle subject to state tax seems to be critical to its determination of the power of the state to levy such a tax.

Foreign ownership of the property subject to state law impairs the power of the court to ensure a fair apportionment of the tax which would eliminate the risk of multiple tax burdens under the Commerce Clause. When a vehicle is not only owned by an entity incorporated in a foreign country but also used exclusively in foreign commerce there is no administrative body that can enforce an international apportionment of a state tax so as to eliminate the risk of multiple tax burdens that is required under the Commerce Clause of the Constitution. Therefore, a different constitutional analysis is required when a state law is challenged as being unconstitutional under the Commerce Clause and the instrumentality subject to the tax is foreign owned. The distinction granted to foreign owned instrumentalities seems to reflect the U.S. Supreme Court's awareness that federal policy in the area of international commerce must be dealt with on a national level unfettered by state laws. Foreign policy and any laws affecting foreign relations must remain a federal domain.

Throughout this opinion the U.S. Supreme Court made reference to the fact that ocean-going ships and now the instrumentalities connected with them, their cargo containers, traditionally have been given special treatment when state laws attempted to impose taxes upon them. In the cases that upheld apportionment of state taxes on various forms of transportation, ocean-going ships have usually been exempted from their imposition. It remains unclear from this case whether other forms of transportation equipment will be immune from state taxation under the new test formulated by the court or whether this test is an extension of this exception.

Since local taxes have become a question of some importance for domestic as well as foreign companies engaged in foreign commerce, immunity from these taxes would be advantageous to these companies. The difference in the tax liability of foreign owned as opposed to domestically owned vehicles of transportation can be a decisive factor in the business planning of companies engaged in foreign commerce with the United States. Prognosis of further constitutional limitations on the state's power to tax instrumentalities engaged in foreign commerce is difficult from this opinion. One thing does appear to be clear from this opinion: the U.S. Supreme Court seems to feel that the federal government and the federal government alone must establish foreign policy unrestricted by any state laws and any notions of federalism when dealing with laws that affect foreign commerce.

## I.F.A. IN THE COMMISSION OF THE EUROPEAN COMMUNITIES

On September 6, 1979 Mr. Damseaux, Member of the European Parliament, submitted the following question to the Commission of the European Communities:

> *Has the Commission sent one or more experienced officials to the Congress of the IFA, whose activities are conducted at a high level and allow the various trends in international fiscal law to be closely followed?*

The Commission's reply followed on October 18, 1979:

> *The Commission agrees with the Honourable Member that the International Fiscal Association makes an important contribution to the search for solutions to problems arising in connection with tax harmonization in the Community. Accordingly, it is regularly represented at the Association's annual congresses by high-ranking officials from the Directorate-General for Financial Institutions and Taxation.*

*Source: Official Journal of the European Communities No. C 288 of November 19, 1979 at 19.*

# Pakistan Budget 1979~80

Extract from the Budget Speech pronounced on June 28, 1979 by the Minister for Finance and Coordination, Mr. Ghulam Ishaq Khan.

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

## NO GENERAL TAX RELIEF

70. Various proposals were made before the budget was finalised, seeking tax relief, more concessions and more reliefs, more concessions and more subsidies. I am afraid that these suggestions were based on an incomplete and partial understanding of the economic situation.

Let me reiterate that the dictate of the economic situation is for a total national effort which is in excess of what we have ever done in the past. It would be the height of irresponsibility for a finance minister to provide general relief at this stage.

It would be taking an easy option not to do anything and leave the situation to deteriorate for the next government to handle. The present government has adopted the only course possible for a responsible government.

71. However, the government is conscious that it would be unfair to subject the already impoverished to a further burden. In this connection, I will be announcing selective measures aimed at relieving the burden for lower income groups.

At this, point I would refer to the introduction of Zakat and Ushr [1] in the next fiscal year. As you are well aware, this injunction is the Islamic instrument of redistribution, equitable sharing and removal of poverty. Through organising it at the state level we hope to fully provide for those who are not in a position to meet their minimum needs.

The government earnestly hopes that Zakat and Ushr would emerge as effective mechanism for meeting the basic needs of the poor aside from ensuring a more equitable distribution of income and wealth.

## BUDGET DEFICIT

79. I shall now briefly outline the budgetary picture for 1979-80. Gross revenue receipts in the next fiscal year at existing rates of taxation are estimated at Rs.33,220 million which represent a climb of 9.7 percent over the revised estimates for the current year. Net federal revenue receipts for 1979-80 after transfers to provinces are estimated at Rs. 28,631 million as compared to Rs. 26,142 million in the current year.

80. Non-development revenue expenditure for 1979-80 is estimated at Rs. 29,140 million.

81. There is thus an estimated revenue deficit of Rs. 509 million. The major increases in non-development revenue expenditure projected in 1979-80 are in debt services (Rs. 878 million), defence (Rs. 1,243 million), grants to provinces and local bodies (Rs. 187 million), subsidy on edible oil (Rs. 246 million).

82. Net capital receipts for 1979-80 are estimated at Rs. 855 million, which would represent a decrease of Rs. 48 million over the revised estimates of the current year. This decrease is attributable to higher repayment of foreign debt.

83. Self-financing by autonomous bodies and external resources for 1979-80, as already indicated are estimated at Rs. 1,294 million and Rs. 10,258 million respectively.

84. It is quite obvious that a gap of the indicated magnitude cannot be adequately covered without recourse to a substantial tax effort. Along with the need to mobilise additional resources changes are also called for in our taxation structure and the pricing policies in respect of goods and public services with a view to increasing the rate of investment and savings, maximising agricultural and industrial production, curbing non-essential consumption, strengthening the balance of payments by encouraging exports and stimulating viable import substitution, removing price distortions, improving efficiency of public services, reducing inequalities in income and wealth, promoting and imparting greater flexibility to the tax system. The various proposals that I shall presently outline have been designed to service one or more of these purposes. A sincere effort has also been made to make the tax system simpler, rational, less complicated and to reduce the area of discretion of the tax collector.

## HIGHER TAXATION

85. It is an established fact that a developing country in its journey on the path to attainment of self-sustaining growth requires large and expanding resources, which have primarily to be mobilized by syphoning off through taxes increments in national income resulting from development.

It is, however, also an unfortunate fact that an underdeveloped economy is also underdeveloped in the field of taxation.

The preponderance of low level incomes and the widespread prevalence of self employment sharply restrict the tax base. The tax payers in a poor country are also understandably allergic to suffer cuts even in incremental incomes effected through fiscal imports. This attitude is conditioned by a variety of factors such as low per capita income in relation to aspirations, inadequate awareness of the beneficient effects of tax financed expenditures, lack of development consciousness and knowledge of development requirements and certain psychological and political attitudes largely inherited from colonial days when government was looked upon as an alien exploiter.

These characteristics of underdevelopment, need not be taken to be immutable and irremediable. These need to be positively changed if equity promised economic growth in a milieu of stability is to be ensured. The alternatives to additional taxation in our present economic predicament are either to interrupt the nation's progress towards self-reliant growth of to have excessive resource to regressive and destabilising deficit financing which even though it may not be commonly realised as such is the more cruel form of taxation or to resort to still greater external borrowing, which if unmatched by adequate resource mobilisation effort at home is generally possible only on terms which place the nation's future in permanent bondage and compromises its sovereignty and honour. I am convinced that given these choices, the nation would gladly accept a higher fiscal contribution.

## TAXATION PROPOSALS

86. I would now like to briefly indicate my taxation proposals, the full details of which may be seen in the summary of financial measures which is being released to the press simultaneously.

## WEALTH TAX ON URBAN PROPERTY

87. We are all aware of the boom in urban construction. This would have been all right had this process taken care of the housing needs of the low and middle in-

1. See M.P. Dominic, "Towards an Islamic Order in Pakistan: Introduction of Islamic Taxes (Zakat and Ushr)" in 33 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 183 (April 1979).

come groups. But instead we see massive resources being diverted to luxurious plazas and palatial houses completely out of place in our present setting. I, therefore, propose to levy wealth tax of 2½ percent on the value of urban property in the possession of each family in excess of Rs. 5 lakh.[2] Since all other wealth is liable to Zakat, we had made it clear in the Zakat and Ushr Order that wealth tax shall not be levied on assets paying Zakat.

This wealth tax remains applicable only to urban and such other properties in the case of Muslims which are outside the purview of Zakat and Ushr Orders and to all assets presently so taxable in the case of non-Muslims.

## ABOLITION OF ESTATE DUTY

88. Estate duty which in the Western world had been brought in as a battering ram against inherited wealth has in our context of Islamic system of inheritance largely become irrelevant. Considering its low yield over the years it was also serving more as an irritant than a source of revenue or serving any social objective and is accordingly being abolished.

## INCREASE OF IMPORT BILL

89. Dut to the construction boom that I referred to earlier, we have to import annually one million tons of cement from abroad out of our scarce foreign exchange resources. The import of cement has led to the emergence of a two-tier price structure and a thriving black-market in the commodity.

To remedy this situation it is accordingly proposed to unify the prices of imported and domestically produced cement at Rs. 900 per ton ex-factory or bulk sale godowns through an increase in excise duty and development surcharge.

This, apart from curbing the large-scale black market in this item will also discourage its wasteful low social priority use and make the new capacity which is being established at six to seven times the cost of old units and which will soon be coming on stream, financially viable.

90. Another critical item in which we are deficit and which is being imported at an enormous cost is POL products. It will be sometime before the full effects of our accelerated programme for petroleum exploration and development will be felt. In the interim period oil imports will continue to place a heavy burden on the economy during 1979-80.

Earlier in December 1978 the OPEC had announced an overall increase of 15 percent in crude prices spread over a period of four quarters starting January 1, 1979. However, in March 1979 the entire increase of 15 percent earlier announced which was to be fully realised from 1st October, 1979 was instead made effective from 1st April, 1979. In addition, market premiums ranging from dollar 1.90 to dollar 2.42 per barrel have also been levied by most of the suppliers.

Similarly, the price of deficit products which we import inreased by 15 percent by 1st April, 1979, as against the original estimate of 7 percent made in December 1978. The overall increase in the price of imported refined products until yesterday ranged from 29 percent to 33 percent according to today's inflation the price of crude will go up by at least around 24 percent for US dollar 14.46 to a maximum of US dollar 18 per barrel.

91. As a result of the unexpected increase, our import bill has sharply increased from the previously estimated figure of dollar 522 million to dollar 605 million for the year 1978-79.

However, the full impact of the increases will be felt in the financial year 1979-80. The crude and the deficit product import bill will on the basis of present prices and taking into account the latest increase of 24 percent during the year will rise from dollar 605 million in 1978-79 to over dollar 874 million in 1979-80.

However, due to increase in export earnings from our own surplus products such as fuel oil and naptha and the commissioning of the Additional Refining capacity of 5,000 BPD in the lst quarter of the financial year to process increased indigeneous crude, the net import bill for the year 1979-80 is estimated to be around dollar 693 million.

92. In view of these developments it has become necessary to increase the product prices by 25 to 45 paisa per litre in order to be able to meet the increased cost of the imported crude and the refined products.

The revised price of motor spirit has accordingly been fixed at Rs. 3.61 per litre, that of kerosene oil at Rs. 1.25 per litre and of HSD and LDO at Rs. 1.97 and Rs. 1.40 per litre respectively. Even with these adjustments the price of kerosene oil and light diesel oil will be less than their actual landed cost by about 50 paisa and 56 paisa per litre respectively. I may also mention that despite the increases of 25-45 paisa per litre the prices of all the essential petroleum products in Pakistan will continue to be lower than in the neighbouring countries. For instance, as compared to India petrol will be cheaper by Rs. 1.50 per litre, kerosene by Rs. 0.63 per litre. In most of the developed countries also petrol is being sold for not less than Rs. 20 per gallon compared to the revised price of Rs. 16.25 per gallon in Pakistan. Because of the rising prices of oil, the rest of the world is trying to conserve energy and measures have been taken to cut down consumption by 5-10 percent in most countries. Considering our deficiencies in alternative sources of energy in certain areas and for certain purposes, we have not been able to emulate the example of those countries but I must emphasise that it is the national duty of each and every Pakistani to economise the use of petroleum products so that the growing bill on this account can be contained.

93. With the same objective of conserving energy and to discourage the import of luxurious cars, I propose to increase customs duty on all cars above the engine capacity of 1600 cc to 350 percent. The duty structure of other vehicles and all cars of 1600 cc capacity and below remain unchanged.

94. Natural gas is an energy substitute and its price has to move in step with the POL to ensure its economic use and also to avoid price distortions. We, therefore, propose to enhance the duty on natural gas from 57 paisa per deca cubic meter to 86 paisa per deca cubic meter and on liquified petroleum gas from 41 paisa per deca cubic meter to 86 paisa per deca cubic meter. Certain adjustments are also being made in the rate of development surcharge in such a manner that the consumer's price of natural gas does not exceed by more than 58 paisa per deca cubic meter. The consumer's price of natural gas will still be very low if its price based on calorific value is compared with that of POL products.

*After announcing various measures with respect to customs duties and excises, many of which will be increased in order to conserve foreign currency and to curb non-essential consumption, the Minister turned to measures to stimulate domestic production and investment.*

## INCENTIVES FOR DOMESTIC PRODUCTION

In this behalf I may mention that our capital goods industry has to compete with imported machinery which is subject to 40 percent rate of duty. To increase the competitiveness of the domestic industry one way would be to increase substantially the import duty on machinery but this would come in conflict with our investment objectives. We have, therefore, decided that import of raw materials and components for the production of capital goods should be allowed at the rate of 30 percent instead of 40 percent. A further 10 percent concession has been extended to intermediate goods like enamelled copper wire, tubings, and bolts and nuts. Such industries will get repayment of duty and sales tax paid in excess of 20 percent on supplies made to the local capital goods industry. In case where

2. 1 lakh = 100,000.

locally fabricated machinery is supplied to areas paying 20 percent customs duty on imports, the concession will be further enhanced to repayment of duty in excess of 15 percent on the imported raw materials and components. Unity supplying machinery to duty exempt areas like Baluchistan and Azad Kashmir, will be allowed a refund of entire customs duty and sales tax on components and raw materials. These are very substantial incentives to the local engineering industry and I expect them to increase their production and ensure high quality of the machinery fabricated by them.

107. As a general incentive for industrialization of backward areas, I propose adding to the list of duty exempt areas, the districts of Mansehra and Kohistan also.

108. Further relief to industry has been provided as following:
(i) Reduction of customs duty on import of gas cylinders from 90 percent to 40 percent and abolition of 10 percent sales tax now leviable.
(ii) Reduction of customs duty on imported components of air conditioners and refrigerators to 40 percent and abolition of sales tax on such components at the import stage.
(iii) If any industrial unit imports its urgently needed spares by air, only 20 percent shall be added to the full value of such items for the purpose of assessing duty which is roughly equal to the sea freight.

111. Exemption has been granted from central excise duty for slack wax used as fuel by the refineries.

112. The scope of cottage industry for exemption from central excise duty has been liberalised in order to provide relief to small manufacturers. According to the revised definition the limit of capital employed has been raised from Rs. 10,000 to Rs. 50,000, that of number of persons employed from 6 to 15 workers on single shift basis and the use of mechanical and electrical energy has been permitted.

113. Production in the cycle industry has been stagnating. In order to give a fillip to the industry it has been decided to decontrol the prices and replace the present subsidy of Rs. 150 per cycle given last year by a rebate in full of all duties and taxes paid at the time of import on the raw materials and components.

114. Past changes in the duties and taxes have resulted in a number of fiscal anomalies which in some cases are inhibiting the growth of local industry. To rectify the situation the following changes have been made:
(i) Duty on import of cassettes, has been changed to Rs. 10 per cassette instead of the present rate of 60 percent ad valorem plus 20 percent sales tax.
(ii) Import duty on cone winding machines which are also being manufactured locally has been raised to 50 percent from the present rate of 40 percent.
(iii) In case of rings and spindles locally fabricated, the industry shall receive full rebate of customs duty and sales tax on the raw material and components imported for the manufacture of these items.
(iv) Import duty on dyes has been raised to 70 percent to protect and encourage the local manufacturers. As a measure of uniformity, central excise duty at 22 percent of retail price leviable on sulphur black has been restored to bring it on par with other dyes.
(v) Import duty on typewriter ribbons has been raised to 70 percent and on raw material for the manufacture of ribbons locally, duty has been reduced to 40 percent.
(vi) Full rebate of customs duty has been granted on the raw materials for local manufacture of vials and ampoules as well as collapsable tubes to be supplied to the pharmaceutical industry, glass vials, glass ampoules and collapsable tubes have also been exempted from excise duty when used in the local pharmaceutical industry.
In the field on agriculture, we are maintaining the subsidization of key imputs like fertilisers, pesticides and water rate.

As a further incentive to agriculture it has been decided to give complete rebate of customs duty and sales tax on the local manufacture of agricultural implements and machinery.

Customs duty and sales tax have also been abolished on fruit grading and polishing machinery to stimulate fruit exports.

Import of bulbs, tubers, tuberous roots and live plants has been made duty free.

Relief has been given in the case of a number of items of common use. In the field of customs, we had last year abolished customs duty on the import of second hand clothing but it did not include used woollen caps, blankets etc. These items have now been exempted from customs duty. Customs duty has also been abolished on the equipment imported for storage and use of solar energy to encourage development in this field for which Pakistan has a big potential. It has also been decided to abolish the central excise duty on Henna and glass bangles, which are items of exclusive use by our womenfolk. Exemption from sales tax has also been extended to locally manufactured metal fittings, doors and windows, electrical machinery, account books and registers, dicalcium phosphate and plastic tubular films as well as imported aircraft spares and engines. Customs duty on travellers cheques and airline tickets and stage has also been abolished. Customs exemption has also been accorded to hospitals providing free medical treatment in respect of refrigerators and window type air conditioners.

## INCOME TAX

115. Coming to Income-tax, of late both the law and the Department have come in for quite a bit of criticism. Certain quarters have suggested that the Income-tax system be abolished altogether. This, in my opinion, would be a highly retrograde and unjustified act. In our present fiscal system, income-tax is the only significant direct tax which can be progressively geared to take into account the 'capacity to pay' of the citizens. Its abolition would make our taxation system almost entirely dependent on indirect taxes.
It would deprive the government of a very effective and useful instrument of reducing inequalitities of incomes. It is our misfortune that we have not been able to achieve greater flexibility and buoyancy in our taxation structure mainly because of the low proportion of direct taxes. The government has addressed itself seriously to rectifying this imbalance between direct and indirect taxation. It has also been in response to public criticism of the department and the system taken radical steps to simplify the process of assessment and collection as well as reduce the area of discretion of the tax collector. With this end in view a new income tax law has been promulgated with the following main features:

(a) All provisions relating to the assessment of a particular class of income have been 'aggregated', simplified and rationalised in the light of the decisions of the superior courts.

(b) The rate of tax for which a tax-payer has at present to look into the various finance acts and ordinances have for his convenience now been incorporated in the new law itself.

(c) Provisions regarding reliefs, exemptions, etc., which are at present scattered over different places in the Act of 1922 and a large number of notifications (which are not always easily traceable) have been consolidated and made part of the new law.

(d) The procedural provisions have been simplified and vexatious and unnecessary requirements done away with.

(e) The keynote of the new ordinance is self-assessment and voluntary compliance. Over 95 percent of the assessments will now be made on 'self-assessment' basis, without requiring the attendance of the taxpayer or his authorized representative.

(f) The discretionary powers of the income tax officers have been reduced to the minimum.

(g) Imposition of fiscal penalties will be resorted to only with the approval of superior officer not below the rank of assistant commissioner and decision to intitiate prosecution proceedings for fraud, etc will be taken at the level of the central board of revenue.

## SELF ASSESSMENT

116. With the introduction of the comprehensive self-assessment scheme and other modifications in the law and procedures, the hall mark is now squarely in the court of the taxpayer. The straight forward tax-payer making an honest return of his income will have nothing to fear. At the same time I must warn that procedures are being devised to effectively deal with those who betray the confidence being reposed in them.

117. Coming now to specific income-tax measures:

(1) The rate structure has been revised. The main features of the new structure are:
(a) Tax shall be levied on the excess of income over Rs. 12,000 by giving a straight line deduction of this amount without having to compute various allowances.
(b) In case of income from salaries, tax on income exceeding Rs. 12,000 and up to Rs. 21,000 shall, subject to marginal adjustment, be Rs. 120 without investment allowance and Rs. 84 if full investment is availed.
(c) For non-salary income of Rs. 21,000 tax would be Rs. 1,350 without investment allowance and Rs. 945 if full investment allowance is claimed.
(d) Both in the case of salary and non-salary incomes up to Rs. 21,000 the new tax liability is lower than the existing liability.
(e) The rate structure has been so designed that for income exceeding Rs. 21,000 and up to Rs. 40,000 tax payable for salary and non-salary income will more or less be the same as before. On incomes beyond Rs. 60,000 per annum, the rates have been made more progressive.
(f) It may be of interest to note that up to an income of Rs. 21,000 tax burden for business income varies between 0 to 4.5 percent and for salary income varies between 0 to 0.56 percent. Tax on an income of Rs. 50,000 for business income would be 16.1 percent and for salary income 10.10 percent.

(2) Super-tax on companies excepting banking companies has been raised from 20 percent to 25 percent.

(3) Surcharge on income-tax and super-tax at the existing rates shall continue.

(4) Advance deduction of tax at source at the rate of 3 percent shall henceforth be extended to those contractors as well who supply goods or services to companies listed on stock exchange or companies owned or managed by government and foreign associations declared as companies under the income-tax act.

(5) Deduction of tax at source on imports has been made gradual from 1 percent to 3 percent depending on the value of licence.

(6) Addition to the trading account made by income-tax authorities during the last four assessment years in respect of income-tax will be permitted to be credited in the books on payment of a composition fee of 10 percent.

118. It may have been noted that comparing to the existing tax burden incomes up to Rs. 21,000 will get substantial relief. In addition the following further concessions are being given:

(1) Exemption limit of interest on savings bank account has been increased from Rs. 500 to Rs. 1,000.

(2) Computed income from self-occupied property which hitherto was exempt only if the annual letting value of the property did not exceed Rs. 6,000 has now been totally exempted.

(3) Loss or gains due to exchange rate fluctuations will now be adjusted against the written down value of the imported plant and machinery and depreciation allowed thereon. This concession will take effect from 1975.

(4) Limit of claiming depreciation allowance of original cost of motor vehicles has been increased from Rs. 75,000 to Rs. 100,000.

(5) Compartmentalised investment allowance has been done away with and the allowance will now be available on all approved investments without any distinction as to their nature.

(6) The limit of investment allowance has been increased from 30 percent of income subject to a maximum of Rs. 30,000 to the same 30 percent but with a maximum of Rs. 35,000.

(7) Industries located in Azad Kashmir, northern areas, tribal areas and districts of Mansehra and Kohistan which hitherto enjoyed partial exemption have been given total tax holiday.

(8) Industries set up in under-developed areas whose income equal to 5 percent of the paid up capital was hitherto exempt from tax will now qualify for tax exemption on income equal to 10 percent of the paid up capital.

(9) The date of establishment of industries enjoying the afore-mentioned tax holiday and tax concession has been extended from 30th of June 1981 to 30th June 1983.

(10) Concession of tax credit for modernisation of machinery has been made co-extensive with the five year plan i.e. up to 30th June 1983.

(11) Deduction from income is being made permissible for an amount equal to the actual payment of Zakat or wealth tax in computing income-tax.

(12) The present provision that income-tax and wealth-tax can not exceed the total income of an assessee has been relaxed so that these taxes will not now exceed 75 percent of the total income.

(13) Preferential treatment accorded to dividends received from NIT and ICP Mutual Funds has been done away with and now dividends received from any company listed on stock exchange or from NIT or ICP shall be exempted up to Rs. 15,000 in the hands of the recipient.

(14) At present tax rebate is available at 50 percent of the income accruing from exports. This rebate is being enhanced to 55 percent. Aside from the enchancement of the existing 50 percent rebate to 55 percent on export income as a further measure to stimulate exports of certain manufactured products, it has been decided to grant compensatory rebate at 12½ percent of fob value to all engineering goods including electrical appliances and machinery, light and heavy engineering goods, construction materials and transport equipment. It has also been decided to extend the coverage of compensatory rebate on textile to canvas footwear. Export of canvas footwear is at present ineligible for compensatory rebate since its textile component (canvas) is less than 50 percent of the product by weight althoug the canvas uppers is the principal component in value.

(15) For delay and default in payment of advance tax penalty leviable at 15 percent over and above the penal interest at a rate of 24 percent per annum has been withdrawn.

# NEPAL: BUDGET 1979/80

Extracts from the Budget Speech 1979/80 delivered by the Finance Minister, Mr. Surya Bahadur Thapa, to the Rastriya Panchayat on July 9, 1979 (unofficial translation). Only those parts which pertain to taxation have been reproduced.

Honourable Chairman, I have mentioned earlier that His Majesty's Government is engaged in the task of making the tax system more simple and scientifically and socially justifiable. The Economic Commission within the short period of time available has also made some suggestions for changes in the existing tax structure of the country. I have taken these suggestions into consideration while formulating my tax proposals for the next year. I have proposed some changes in direct taxes as well as indirect taxes to provide some relief to the people who have contributed so generously to the development of the country.

I now submit the proposals for indirect taxes. While maintaining the same relief for customs duties for export promotion, I have made changes in the export schedule for leather, dry ginger and turmeric, in order to encourage the export of processed goods. I have proposed to increase customs duties on exports of some forest-based products in view of the importance of forest resources of the country. I have also proposed to impose new taxes on the export of wool and woollen goods for the protection of domestic industries.

On the import side, I have raised duties on the import of goods like polythene pipes and sheets for the protection of our domestic industries. I have made a proposal to reduce customs duties on imports from India for necessities like various kinds of cloth and clothing materials, vests, socks, and underwear as well as some daily consumption goods like spices (cumin seeds and pepper), milk for children, etc. Similarly, I have reduced customs duties on medicines to be imported from India as well as from overseas. In addition, I have reduced surcharges on some imports from India under AR 1 forms. From these changes it is expected that the people will have some relief. It is also expected that this measure will help the Tarai market to flourish. Similarly I have proposed a reduction in the customs duties on imports of agricultural goods like tractors, powertillers and their accessories and spare parts for providing incentives to the development of the agricultural sector. To conserve fuel consumption, customs duties on small cars with a capacity of 1,000 CC and below will be reduced to 60 percent from the existing rate of 125 percent. Similarly, import duties on motorcycles will be reduced to 35 percent. Besides, import duty on spare parts for small cars and motorcycles including tyres and tubes and also on electrical household goods and appliances like heaters and cooking ranges will also be lowered. I have introduced some adjustments in customs duties to be levied on goods imported from overseas with a view to receive full refund on excise duty from India under the AR 1 form. Other duties not mentioned in schedule are retained as before. These adjustments will reduce the revenue from customs duties by Rs 8.89 million.

With respect to excise duties, a flat duty will be levied on rice and oil mills of 10 hp and above. The rice and oil mills of 10 to 25 hp will also be exempted from maintaining accounts of their production as required by the existing excise rules. Duties on rice and oil mills will be levied on a flat rate basis from the next year as per below:

| *HP. capacity of mills* | *Annual rates* |
|---|---|
| (a) Up to 10 hp | Rs. 600/- |
| (b) From 11 to 18 hp | Rs. 2100/- |
| (c) From 19 to 25 hp | Rs. 3900/- plus Rs. 1100/- for each additional hauler. |
| (d) From 25 to 30 hp | Rs. 4400/- plus Rs. 1100/- for each additional hauler. |

Duties on rice and oil will be unchanged.

Cottage and rural industries with a total fixed capital of up to Rs. 200,000 were exempted from excise and sales taxes. Because of the difficulty in assessing the fixed capital of these industries I have proposed to classify cottage and small scale industries according to their nature in specific schedules for the purpose of excise duty and sales tax exemptions. Only those industries which are scheduled for this purpose will be exempted from the sales tax and excise duty.

I have made a proposal to levy excise duty on synthetic and artificial textiles as follows:

a) *Suitings*

1) Per meter (up to 148 centimeter width) Rs. 7/-.
2) Above 148 centimeter width; for each additional width or part thereof Rs.-/50 would be charged on top of the rate stated as in (1) above.

b) *Shirtings*

1) Per meter (up to 90 centimeter width) Rs. 1/40.
2) Above 90 centimeter width; for each additional width or part thereof Rs.-/16 would be charged on top of the rate stated as in (1) above.

Wheat flour and parqueting have been exempted from excise duty. All other excise duties will remain unchanged.

Road cess for all kinds of vehicles (jeep, car, bus, truck etc.) will be removed from the next fiscal year. Revenue loss from this measure will be Rs. 18.5 million.

I have waived the imposition of royalties levied on the generation of electricity from the coming year. The revenue estimates shown under this sub-heading are only the dues to be collected for the current year.

I now submit proposals for direct taxes. In view of difficulties encountered by small taxpayers with fixed incomes, I have changed the exemption and income tax schedules. For administrative simplicity I have categorized income taxpayers into single persons and married couples or families. From the next fiscal year the exemption limit on income for single persons and married couples or families and income tax rate schedules would be as follows:

| | |
|---|---|
| a) Exemption for individuals | Rs. 7,500 |
| b) Exemption for married couples or families | Rs. 10,000 |

Thereafter the tax rate is:

| | | % |
|---|---|---|
| First | Rs. 5,000 | 5 |
| Next | Rs. 5,000 | 10 |
| Next | Rs. 10,000 | 15 |
| Next | Rs. 20,000 | 20 |
| Next | Rs. 20,000 | 30 |
| Next | Rs. 30,000 | 40 |
| And above | Rs. 90,000 | 50 |

For firms, companies, corporate bodies and non-resident, there would be no income tax exemptions. The rate of income tax would be as follows:

| | | % |
|---|---|---|
| On income up to | Rs. 5,000 | 5 |
| Next | Rs. 5,000 | 10 |
| Next | Rs. 10,000 | 15 |
| Next | Rs. 20,000 | 20 |
| Next | Rs. 20,000 | 30 |
| Next | Rs. 30,000 | 40 |
| And above | Rs. 90,000 | 50 |

From the proposed changes in income tax

ceiling and rates, income tax collection is estimated to decline by Rs. 7 million. But in the coming year receipts will be reduced by Rs. 4.5 million only.

In respect of urban housing and land tax the exemption limit as applied to the value of property has been increased. Besides, tax rates have also been changed. For the coming year the exemption limit and tax rates would be as follows:

| | *Value of urban houses and land* Rs. | *Tax rate as percentage of the value* |
|---|---|---|
| Exemption limit | 100,000 | — |
| Thereafter | 100,000 | 0.5 |
| Thereafter | 100,000 | 1.0 |
| And above | | 2.0 |

As a result of the proposed change, revenue is estimated to decline by Rs. 2.7 million.

In order to make the system of depreciation rates for urban houses more realistic and to provide facilities to buildings, godowns, industrial shades and labour quarters used by industries, necessary amendments will be made in the relevant Act.

A deposit equivalent to 50 percent of the tax assessed and another 50 percent in the form of either bank guarantee or against the pledge of property is required in the present system to appeal to the Revenue Court against income tax assessments. It is proposed to make a deposit of only 50 percent of the assessed amount in cash. Arrangement would be made for an alternative system of appeal which would be entertained by the Tax Department. Under this arrangement no such deposit would be required.

Separate commissions will be constituted under the Tax Settlement Act for collecting the back dues-one for income tax and the other for house tax. Necessary arrangements will be made for a simplified assessment procedure for small income taxpayers having less than Rs. 25 thousand income per annum including those who fall in the same category and who have not cleared up the back dues for a long time.

In land revenue, the present structure of land revenue on land holdings from 3 to 10 bighas by 40 percent and holdings exceeding 10 bighas by 60 percent will be inoperative from the coming fiscal year. The existing rates of land revenue in Terai and inner Terai districts and the hilly regions where land survey has not been conducted will remain unchanged in the coming fiscal year. The present rebate of 50 percent of revenue on the holdings of one bigha or equivalent will be retained.

In view of the higher amount paid by landowners in the hilly districts after the cadastral survey, I have proposed to reduce the rates of land revenue so as to lessen the heavy economic burden of the landowners in the hilly districts where the cadastral survey is completed. Likewise revenue rates have been reduced for those hilly areas of the Terai and the valley districts where the cadastral survey is completed.

In order to collect the back dues of land revenue effectively, arrangement would also be made in the coming year without any extra fine and interest to those persons who pay the dues before mid-April 1980.

In view of the problems that have cropped up due to the lack of proper implementation of the Panchayat Development and Land Tax which now operates in the fifteen districts of the Kingdom, it has become imperative to evaluate the experience that we have had so far. Hence, the collection of this tax will be suspended. In those fifteen districts where the collection of this tax has been suspended, land revenue will be collected as in other districts of the Kingdom from the next fiscal year. In these fifteen districts, the dues for the fiscal years 1977/78 and 1978/79 of Panchayat Development and Land Tax will, however, be collected by the Land Revenue Offices without extra fine to those who pay the tax before mid-April 1980. Taxes thus collected would be made available to the concerned Panchayats as their share, retaining 35 percent by His Majesty's Government as per PDLT Act.

Private persons will not be required to pay land revenue on their lands acquired for public works, such as roads, dams, canals, public buildings, etc. by His Majesty's Government and/or district and local panchayats. The land records will also be adjusted accordingly. This measure will be promptly enforced.

As the seventh amendment of Mulki Ain requires compulsory registration of deed, I have proposed as an additional measure to that effect requiring a registration fee of one percent for all deeds up to Rs. 500. Apart from this no change has been made in the existing registration fees.

In view of the existing problems in respect of water cess, I have proposed to set up a committee including a local representative for the preparation of records in assessing water cess. Water cess will be assessed on the basis of actual utilisation of water.

As trucks and buses are exempted from vehicle tax, I have proposed to exempt mini-buses also from the next fiscal year, because of increased use of them as public transport. The effect in revenue from this proposal would be insignificant.

From the changes in the tax proposals mentioned above there will be an actual deficit of Rs. 16.28 million in the total revenue estimates. There will be no change in other direct and indirect taxes whatsoever.

The resource gap for the coming fiscal year would now be Rs. 186.35 million which would be met through internal borrowings.

Necessary measures will be undertaken to make the revenue administration efficient, capable, simple and healthy during the coming fiscal year. In this context, apart from imparting training to improve management capabilities, preliminary works towards the establishment of revenue services as a separate cadre under the administrative services of His Majesty's Government have already been undertaken.

**See for Government revenue the table on p. 562.**

## GOVERNMENT REVENUE
(In Million Rupees)

| | Mid-July 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1977/78 I | II | III | IV | Annual |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. Tax Revenue | 466.7 | 518.8 | 647.6 | 841.6 | 901.0 | 1104.3 | 180.5 | 237.5 | 330.7 | 495.2 | 1243.9 |
| A. Customs Duties | 198.6 | 238.9 | 276.0 | 328.5 | 354.1 | 386.2 | 75.3 | 104.7 | 123.2 | 153.0 | 456.2 |
| a. Export | 27.3 | 16.3 | 22.6 | 28.8 | 39.1 | 47.8 | 7.2 | 8.3 | 11.0 | 12.2 | 38.7 |
| b. Import | 117.4 | 126.2 | 125.0 | 177.9 | 195.7 | 220.0 | 47.5 | 73.4 | 87.5 | 125.7 | 334.1 |
| c. Indian Excise Refund | 50.9 | 85.1 | 116.5 | 108.2 | 112.0 | 117.4 | 20.4 | 22.9 | 24.5 | 15.0 | 82.8 |
| d. Miscellaneous | 3.0 | 11.3 | 1.9 | 13.6 | 7.3 | 1.0 | 0.2 | 0.1 | 0.2 | 0.1 | 0.6 |
| B. Excise | 63.6 | 68.0 | 78.2 | 119.7 | 131.1 | 167.8 | 26.2 | 41.1 | 45.2 | 54.5 | 167.0 |
| C. Sales Tax | 69.1 | 79.6 | 97.9 | 190.5 | 161.6 | 220.9 | 51.8 | 60.5 | 72.1 | 88.7 | 273.1 |
| D. Income Tax | 22.0 | 23.3 | 32.9 | 46.9 | 89.3 | 134.5 | 7.3 | 9.4 | 23.8 | 96.4 | 136.9 |
| E. Other Taxes | 11.3 | 18.4 | 22.7 | 29.1 | 36.1 | 51.6 | 11.1 | 14.3 | 20.0 | 22.6 | 68.0 |
| F. Land Revenue | 83.2 | 70.9 | 110.9 | 89.4 | 89.0 | 97.9 | 2.0 | 1.5 | 25.2 | 59.9 | 88.6 |
| G. Registration | 18.9 | 19.7 | 29.0 | 37.5 | 39.8 | 45.4 | 6.8 | 6.0 | 21.2 | 20.1 | 54.1 |
| 2. Non-tax Revenue | 86.7 | 93.4 | 128.5 | 165.4 | 211.0 | 227.2 | 32.8 | 96.6 | 65.4 | 114.7 | 309.5 |
| A. Forest | 22.5 | 35.7 | 47.5 | 44.7 | 30.4 | 44.4 | 12.3 | 3.4 | 9.6 | 38.3 | 63.6 |
| B. Public Utilities | 9.2 | 10.8 | 13.2 | 13.5 | 26.2 | 41.0 | 11.1 | 13.8 | 14.5 | 18.9 | 58.3 |
| C. Interest and Dividend | 32.9 | 23.3 | 32.5 | 76.1 | 124.1 | 98.5 | 2.6 | 66.6 | 4.0 | 7.9 | 81.1 |
| D. Civil Administration | 11.1 | 12.4 | 19.7 | 19.0 | 19.6 | 31.2 | 6.1 | 11.3 | 35.3 | 23.3 | 76.0 |
| E. Miscellaneous | 11.0 | 11.2 | 13.5 | 12.1 | 10.7 | 12.1 | 0.7 | 1.5 | 2.0 | 26.3 | 30.5 |
| TOTAL (1 + 2) | 553.4 | 612.2 | 776.1 | 1007.0 | 1112.0 | 1331.5 | 213.3 | 334.1 | 396.1 | 609.9 | 1553.4 |

*Source:* Nepal Rastra Bank. Quarterly Economic Bulletin, Volume XIII, Mid-October 1978, Number 1.

# Conference Diary

## JANUARY 1980

*British Branch of I.F.A.:* The limits of tax avoidance (Tax Workshop), London (U.K.), January 8 (English).

## FEBRUARY 1980

*Business Perspectives:* 6th International Tax Conference (including : The unitary system of taxing corporations in the U.S.A.; The legal and tax conditions of trading with the People's Republic of China; Taxes on oil, gas, shipping and natural resources), Singapore, February 3-8 (English).

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

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

## MARCH 1980

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

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

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

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

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

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

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

Business Perspectives, 11 Alexander Place, London, SW7 2SG (U.K.).

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

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

# FOREIGN OIL TAX CREDITS:

# A U.S. Treasury Proposal

On June 11, 1979 the United States Treasury issued a statement explaining its proposals regarding its foreign oil tax credit proposals, which are expected to close some loopholes in current legislation. The text of this statement — which was prepared as a briefing paper for the Members of the House Ways and Means Committee — is reproduced below:

### Present law

Under present law, a U.S. taxpayer can claim a foreign tax credit for oil and gas extraction taxes of up to 46 percent of its current "foreign oil and gas extraction income." This rule imposes an "overall" limitation on the credit: the world is divided into the United States, on the one hand, and all foreign countries, on the other hand, and the high taxes of some foreign countries are averaged with the low taxes of others.

Moreover, "foreign oil and gas extraction income" has a special definition for the purpose of this rule: if a taxpayer has a loss with respect to foreign oil or gas extraction activities in one or more countries, such loss does not reduce "foreign oil and gas extraction income." Thus, the amount of foreign oil and gas extraction taxes available for credit may be substantially greater than U.S. tax liability on foreign oil and gas extraction income, because the latter takes per country losses into account, and the former does not.

Present law also provides that foreign oil and gas extraction taxes equal to an additional 2 percent of "foreign oil and gas extraction income" may be carried back or carried forward to other years in which the taxpayer has such income.

Taxes available for credit either currently or by reason of a carryback or carryforward can be offset only against the U.S. tax liability on "foreign oil related income." Such income includes foreign oil and gas extraction income (net of losses) plus income from transporting, processing, and marketing oil and gas. The per country extraction losses which are taken into account here protect low tax extraction or other oil related income from U.S. tax. Such losses and the U.S. tax benefits they generate are generally not recaptured if the taxpayer later earns taxable income in the country in which the loss was incurred. (Per country extraction losses are only recaptured, under present law, if they are part of an overall foreign oil related loss.)

### Reasons for change

The proposal will build upon concepts in present law but will close some evident loopholes in that law. It will strictly limit the U.S. credit for a foreign country's oil and gas extraction taxes to the income on which those taxes are imposed. Under present law, foreign tax credits or extraction losses from one country can easily shelter income from other countries and other activities from U.S. taxation. Present law thus allows income which is taxed by a foreign country at a low rate or which is not subject to an income tax in the U.S. sense (e.g., because the country uses a posted price) to escape U.S. taxation. The proposal, which is technical in nature but important in substance, will bring U.S. law into closer conformity to the thrust of Congressional intent as expressed in prior changes in the tax law in 1975 and 1976.

### Explanation of proposal

The proposal will revise the computation of foreign tax credits for foreign oil and gas extraction income. The proposal will: limit the foreign tax credit for extraction taxes to extraction income; repeal the loophole allowing per country losses to generate extra usable credits; cause U.S. tax benefits generated by extraction losses in a country to be recaptured when extraction gains are realized in subsequent years in that country; and repeal the special rules relating to oil related, but nonextraction income. The new computation of the credit for such taxes will limit the credit to the lesser of:

- The credit computed with respect to overall foreign oil and gas extraction income (net of losses); or
- The credit computed with respect to such income calculated on a country-by-country basis.

This double computation, coupled with the recapture of tax benefits attributable to per country extraction losses, will prevent excess credits or losses from foreign oil and gas extraction activities in one country from spilling over to offset U.S. tax with respect to (a) similar activities in other countries and (b) other oil related activities. The recapture of tax benefits attributable to per country extraction losses applies whether the computation of credit for any given year is on the per country or overall basis.

The proposal will also remove the separate limitation with respect to the broader category (foreign oil related income), and the 2-percentage-point limitation on carrybacks and carryforwards of excess extraction credits. Within a country the normal rules for carrybacks and carryforwards of unused extraction credits will apply. Foreign oil related income other than extraction income will be included in the same limitation as other business income. It will still be necessary to determine on a case-by-case basis whether any particular payment to a foreign country is a creditable income tax. Finally, the proposal will amend as necessary the definition of "foreign oil and gas extraction income." In the case of an affiliated group any member of which has foreign oil and gas extraction income, the limitation on the credit will be computed as if a consolidated return had been filed.

### Effective date

The proposal will be effective for taxable years beginning after December 31, 1978. Any U.S. tax benefit attributable to a per country extraction loss will be recaptured (to the extent possible) in the first taxable year (beginning after the year of the loss) in which there is extraction income in the country in question. Such a loss incurred in a taxable year beginning in 1979, will be recaptured in the first taxable years beginning after December 31, 1978, to the extent of 50 percent of the extraction income arising in the country in which the loss was incurred.

**Revenue estimates**

**Change in calendar year tax liabilities**
(millions of dollars)

| 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| 514 | 772 | 636 | 706 | 777 | 848 | 914 |

**Change in fiscal year receipts**
(millions of dollars)

| 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| 77 | 784 | 711 | 668 | 738 | 809 | 878 |

# IFA NEWS

## COPENHAGEN CONGRESS 1979

# Resolutions on Subjects Discussed

At the end of the Copenhagen Congress of IFA the following resolutions were issued which reflect the results of the two topics discussed.

**Subject I: The taxation of transfers of family-held enterprises on death or inter vivas**

*Resolution* (original version)

In consideration of

a. the generally recognized socio-economic importance of enterprises held and operated by individuals or families
b. the significant role played by these enterprises particularly in the areas of innovation, production, employment and capital investment
c. the ensuing desirability of permitting the continuation of such enterprises, irrespective of their legal form, beyond the death of their owners

*the Congress is of the opinion that*

1. The national tax system should not impose wealth, income, capital gains and gift, estate or inheritance taxes resulting in such a financial burden as to threaten the continuation of these enterprises beyond the death of their owners.
2. Against a tax burden so jeopardizing the continuity of these enterprises, relief may be sought by
   a. appropriate methods of valuation of the property subject to transfer taking into account e.g. latent taxes on income and wealth and the effects of inflation
   b. rates fixed in consideration of family relationship and/or the nature of the property as relating to an enterprise
   c. facilitation of payments which can be accomplished by permitting deferral or payment by instalments or by granting favourable terms and conditions.
3. In the international field rules should be adopted unilaterally by the taxing authorities or by bilateral or multilateral treaties to avoid double taxation of assets of these enterprises. Further studies of the difficult problems related thereto should be undertaken by IFA in the light of the work of organizations such as the OECD.

**Subject II: The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities**

*Resolution* (original version)

The problem is important because restrictions on the relief of losses impede economic relations between countries.

These restrictions result from the interplay of three principles — tax sovereignty, annual basis of assessment and the separate juridical personality of companies. Each of these principles may conflict with the realities of international economic life. Further conflicts of principle develop:

— the principle of symmetry between the tax treatment of profits and losses versus taxation on the basis of economic capacity;
— one concept of neutrality or symmetry versus another;
— the world-wide income basis versus the territorial principle;
— the tax-credit method versus the exemption method of relief from international double taxation.

These conflicts explain the complexity of the subject. There are different methods of transferring profits and losses from one taxable entity to another, differences at national level in the treatment of losses of different kinds and differences between countries in the computation of profits and losses, with consequent difficulties of proving to the authorities in one tax jurisdiction facts located in another.

The major problems, however, concern the relationship between parent and subsidiary rather than between head office and branch. These problems are accentuated by the formal and informal pressures put on international enterprises to incorporate their branches, so that in practice the choice between branch and subsidiary is often not free.

The Congress accordingly *recommends:*

1. That the problem be mitigated by an extension of provisions for carry forward and carry back of losses both nationally and for purposes of the tax credit method of relief from international double taxation;
2. That provisions be made for an extension of the "indirect" method of relief for the parent against losses of the subsidiary, for example by fiscal recognition of subventions or writing off the investment;
3. That in countries where world-wide consolidation is not practised the parent company be entitled to exercise an option for all its subsidiary companies to be treated as permanent establishments for purposes of the parent company's taxation, such option to be subject to restrictions in order to avoid misuse.

# TAX GLOSSARY

*by H.W.T. PEPPER**

**ORGANSCHAFT** — The term applied to the system, used at one time in Germany, and also in Austria and Luxembourg, whereby sales (cascade) tax was not imposed on transactions between companies under common control, i.e., what was granted was a form of "group treatment" for sales tax purposes. It may be noted that the rule is logical in respect of "horizontal" combinations of enterprises engaged at the same stage of production or distribution but where there is vertical integration within a single company or a group of companies, tax is avoided where more than one stage of the production/distribution process takes place "internally" within the enterprise. This type of avoidance by integration has sometimes been countered by a ZUSATZSTEUER (q.v.) or by FORFAITAIRE (q.v.) treatment, and is of course nowadays quite eliminated in V.A.T. systems.

**OUTPUT TAX** — The term is used in connection with V.A.T. to denote the tax payable on the sales of goods or services by those who are subject to the tax and in contrast to the INPUT TAX (q.v.) for which a credit will be available.

**OVERDRACHTSBELASTING** — Turnover tax (Belgium); tax on the transfer of real property (Holland).

**OVERSEAS EMPLOYMENT** — An employee who is resident in one country but employed in another is treated in different ways for income tax in different countries. One method, formerly used in the U.K. and still used in some countries, is to tax the foreign earnings in the "home" country only to the extent to which they are remitted there. Australia exempts foreign earnings if they are taxed in the country of origin. The U.S.A. allows exemption of the first $ 15,000 of foreign earnings if the employee is overseas for 17 out of 18 months while earning, but taxes the remainder, subject to double tax relief — relief for excess housing, living and education costs are also allowable following the Ribicoff amendment (now section 913 of the Tax Code).

The U.K. taxes foreign earnings but allows a deduction for travel and board and lodging expenses, and also a deduction for absence overseas while earning the emoluments which varies from 25 percent when at least 30 days are spent abroad to 100 percent if 365 consecutive days are spent away.

**OVERSEAS MARKETS, DEVELOPMENT OF, DEDUCTION FOR** — A Japanese corporation engaged in export trade may deduct sums put in reserve equal to the cost of developing overseas markets. The reserve is subject to over-riding limitations of (a) a percentage of the corporate capital, and (b) a percentage of the value of the goods exported.

One fifth of the amount of the reserve has to be re-credited in each of the 5 years following the year the original deduction was made.

**OVERSEAS TRADE CORPORATION (OTC)** — Overseas Trade Corporation (OTC) status was accorded from 1957 in the U.K. to U.K. companies the whole of whose trading income came from abroad. Tax was charged on foreign income only if it was distributed to shareholders (see, by contrast — WESTERN HEMISPHERE TRADE CORPORATION (WHTC)). The status was abolished with the introduction of CLASSIC (q.v.) corporation tax in 1965, but the loss was modified by granting OVERSPILL RELIEF (q.v.).

**OVERSPILL RELIEF** — The transitional relief, on a diminishing scale, granted to OVERSEAS TRADE CORPORATIONS (OTCs) (q.v.) in the U.K. during the period 1965 - 1977 when OTC status was abolished with the introduction of classic corporation tax in 1965. Subsequently, classic corporation tax was superseded by a form of corporation tax with an element of IMPUTATION (q.v.) on the EEC model.

**OWNER-OCCUPIED RESIDENCE, TAXATION OF** — In order to preserve equity between two taxpayers whose incomes are the same, but one of whom owns his residence and the other does not, some countries have included in the computation of total income for income tax purposes the annual value of the owner-occupied residence. This accords with the principle of taxation according to the ability to pay, since the owner-occupier does not have to pay rent and if he has to pay interest on a mortgage he is usually granted tax relief for the interest payments. Some countries have exempted owner-occupied residences as a tax incentive, with the object of encouraging a "property-owning democracy", since the intangible income from an investment in the purchase of a house would be tax-free whereas investment of a similar amount in stocks and shares would produce taxable dividends. In Britain, exemption was granted partly, it appears, for administrative reasons since many property owners incurred considerable expenditure on maintaining their residences, the annual values of which were usually assessed at much less than true current values, and a great deal of administrative work had to be done in processing "maintenance claims" for very little net yield in taxation. (See also SCHEDULE A.)

## P

**PACKAGE TAX** — A moderate tax usually on the lines of a "customs handling charge" levied at so much per "package" imported, generally without regard to the actual size of the package.

**PARADIS FISCAL** — The French term for a TAX HAVEN (q.v.).

**PARI-MUTUEL SYSTEM** — A system used mainly on race-tracks whereby bets on a race are accepted, totalled, and divided, less a proportion for expenses and tax, for distribution to those who bet on the winner and the 2nd and 3rd in the race. The "odds" are calculated after the race according to (a) the total amount staked, and (b) the total amounts staked on the winner and those placed 2nd and 3rd. The calculations are done by mechanical or electronic devices (see also TOTALISATOR) and the system is fair to the punter, and convenient to the tax administration which can collect its tax at the source, effortlessly.

**PARTNERSHIP** — A partnership is the relationship which exists between persons (who may include companies) in business together for the purpose of making profits. For tax purposes,

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

while the partnership may be assessed as an entity, and the precedent acting partner made responsible for declarations and payments, there is usually recourse for payment to any of the partners, and tax is normally calculated on a "conduit" basis, i.e., by looking through the partnership to tax each individual partner on his share of the profits, whether or not actually drawn, according to his personal circumstances. Interest on partners' capital is treated merely as part of their shares of the profits, and as qualifying for treatment as EARNED INCOME (q.v.).

**PASSENGER TAX** — A tax on passengers, usually those leaving a country by air (see AIRPORT TAX) or sea, and usually levied as a contribution to the administrative costs of maintaining an airport or seaport passenger terminal.

**PATENTE** — A registration tax on businesses or professions, as levied in France.

**PATENTES, CONTRIBUTION DES** — (France) Business tax.

**PATENTRETTIGHEDER** — (Denmark) Patent rights.

**PATRONAGE "DIVIDENDS"** — In Canada such "dividends" are in the nature of discounts to customers and are fully deductible in computing profits if paid at the same rate to all customers, subject to a restriction if necessary that the deduction should not reduce the payer's taxable income below a certain percentage of capital employed. Other restrictions may apply where the rate of dividend varies or where some recipients have voting rights in the payer's business. The U.S.A. has somewhat similar provisions regarding such "dividends" which are usually paid by "cooperative" enterprises.

**PAUSCHBESTEUERUNG (also PAUSCHALIERUNG)** — The system in Germany whereby income tax is levied in a lump sum.

**P.A.Y.E. (PAY AS YOU EARN)** — The letters P.A.Y.E. were first applied to the British Pay-As-You-Earn system whereby tax was levied on the current salaries and wages of employees in such a way that the deductions were a reasonably accurate computation of the tax currently due. The phrase has been extended to other schemes for deducting income tax from salaries or wages, even where the deductions have to be corrected by an end of the year adjustment or have to be supplemented by an additional tax where the taxpayer's total income exceeds certain limits.

**PAYMENTS, SPRADING OF** — Some tax administrations spread the due dates of payment for tax to a limited extent either by reference to the alphabetical order of taxpayers' names, by reference to different types of trade or profession, or according to tax reference numbers, in order to spread the administrative work. The method is used, e.g., in France and Brazil, in connection with V.A.T. usually by arranging that payments are made by various sections of taxpayers, divided as indicated, who are to pay in different parts of the month during which payments are required by law. A fairly usual arrangement is to divide the month into three periods and the taxpayers similarly into three groups, each group henceforth paying in the particular part of the month allocated to it. In the U.K. version of V.A.T. the tax periods are spread or staggered within each quarter of the year according to the trade classification of the business.

**PAYROLL TAXATION** — Tax charged on an employer's payroll, usually without reference to the individual circumstances of employees. The tax may constitute a contribution from the employer to general Government revenue, occasionally specifically that part devoted to social welfare benefits. Another application is the imposition by cities of such a tax, usually at a low percentage rate (e.g. ¼ percent in New York City), on payrolls of employers whose employees are commuters, i.e., persons who live outside the city limits and thus do not contribute to city taxes although gaining their livelihood by working in the city.

**PENALTIES** — For tax offences, including neglect to make timely declarations or payments, and the making of false returns or statements, penalties may either be in terms of money which, in the case of late payments, may include interest for the period the tax has been in default. A prison sentence may be imposed in the case of more serious tax frauds or where a taxpayer refuses to pay a monetary penalty imposed upon him for a less serious offence. See also COMMUTATION; OFFENCES, TAX.

**PENSION SCHEMES, DIRECTORS OF CLOSE COMPANIES** — Since it is socially desirable that employers and employees should provide for maintenance of employees when they retire, most tax administrations provide deductions for tax purposes from employers' profits and from employees' remuneration in respect of contributions to approved pension funds. In principle, some of the employees' current earnings are, in effect, being put aside for future consumption, and it is logical that only the net earnings are currently taxed, and that in due course the pension, or deferred earnings, should be fully taxed. This, in fact, is the effect of the usual tax treatment of the subject. Formerly, however, many countries lacked provisions whereby the self-employed could obtain tax relief on similar provisions for a retirement income, and there were restrictions on directors of close companies. In the last decade or so, however, there has been a general realisation of the justice of including a more liberal relief in tax statutes for retirement provisions for taxpayers in general. Accordingly, both directors of close companies and self-employed business men and professionals are able to make suitable, tax-deductible, provisions for retirement.

**PERCENTAGE DEPLETION** — See DEPLETION.

**PERFECTION OF ENTRY** — The term used, e.g., in Canada, to refer to the completion of documentation, etc. on imported goods, which have been permitted to be brought into the country urgently by the Customs Dept. on a SIGH ENTRY (q.v.).

**PERFORMANCE RATIO** — The term "performance ratio" is sometimes applied to the percentage which a country's tax yield bears to the national income or G.N.P. The idea that there is a better tax performance if taxes collected represent a higher properion of national income is, of course, an over-simplification since the per capita income has to be taken into account. The wealthier a country's taxpayers, i.e., the higher their per capita income, the higher is the proportion of national income, other things being equal, that can be extracted in taxation.

**[to be continued]**

# Bibliography

# Books

*The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.*

## BRAZIL

### ELEMENTOS DE DIREITO TRIBUTARIO

Notas taquigráficas do III Curso de Especializacão em Direito Tributário. Coordinated by Geraldo Ataliba. Sao Paulo, Editora Revista dos Tribunais, 1978. 476 pp.
Compilation of courses on fiscal law. (B. 15.888)

## BRITISH VIRGIN ISLANDS

### INCOME TAX IN THE BRITISH VIRGIN ISLANDS

By McWelling Todman and Milton Grundy. Tortola, Tortola Trust Corporation, Ltd., 1978. 30 pp.
Description of the income tax law in the British Virgin Islands as stated on March 1, 1978. (B. 15.877)

## CANADA

### ABC ASSISTANCE TO BUSINESS IN CANADA

The Federal Government's directory of business assistance programs, services and incentives. Ottawa, Board of Economic Development Ministers, 1979. 283 pp.
Handbook designed to help businessmen keep abreast of federal economic development programs, as well as those tax incentives and services which encourage economic development in Canada. A French version is also available. (B. 101.981)

## COSTA RICA

### TAXATION IN COSTA RICA

International Tax and Business Service. New York, Deloitte Haskins & Sells, 1979. 56 pp.
Comprehensive guide to taxation in Costa Rica. After an introduction to the tax system, income taxes and other taxes are featured. (B. 15.882)

## ECUADOR

### TAXATION IN ECUADOR

International Tax and Business Service. New York, Deloitte Haskins & Sells, 1979. 63 pp.
Comprehensive guide to taxation in Ecuador. After an introduction to the tax systems, income taxes and other taxes are featured. (B. 15.890)

## EL SALVADOR

### RECOPILACION DE LEYES DEL RAMO DE HACIENDA

Volumen IV. San Salvador, Ministerio de Hacienda, 1976. 310 pp.
Compilation of various taxation laws, including the selective tax on consumption law. (B. 15.893)

## FRANCE

### L'IMPOSITION DES BENEFICES DES SOCIETES FRANÇAISES AUX ETATS-UNIS

Les rapports entre droit fiscal interne et convention fiscale internationale. By Guy Gest. Paris, Librairie Générale de Droit et de Jurisprudence, 1979. 441 pp., 151 Frfrs.
Study describing the profit taxation of French companies in the U.S.A. arising from the tax implications between national and international treaty law. (B. 101.978)

### MEMENTO PRATIQUE FRANCIS LEFEBVRE

Social 1979; securité sociale, droit du travail. A jour au 15 avril 1979. Paris, Editions Francis Lefebvre, 1979. 1035 pp.
Annual publication containing an explanation of French labour and social legislation; supplements are issued regularly in order to keep the material up to date. (B. 101.986)

## GERMAN FEDERAL REPUBLIC

### DAS EINKOMMENSTEUERRECHT

Band II. 12. verbesserte und erweiterte Auflage. By Eberhard Littman and Georg Grube. Stuttgart, Fachverlag für Wirtschafts- und Steuerrecht Schäffer & Co GmbH., 1979. 1386 pp.
This is the second part of a revised and updated comprehensive, extensive commentary on Section 13-55 of the German Income Tax Law (Einkommensteuergesetz), on the Berlin Promotion Law (Berlin-förderungsgesetz) and on the Foreign Tax Law (Aussensteuergesetz). The Tax Amendment Law 1979 is worked into the revised commentary. (B. 101.975)

## HANDBUCH DER FINANZWISSENSCHAFT

Dritte, gänzlich neubearbeitete Auflage unter Mitwirkung von Norbert Andel und Heinz Haller. Herausgegeben von Fritz Neumark. Lieferung 20/21. Tübingen, J.C.B. Mohr (Paul Siebeck), 1979. 160 pp., 33.60 DM.
Third, revised edition of a handbook on public finance. This supplement deals especially with the theory of personal taxes (income taxes, net worth tax, inheritance tax). (B. 101.985)

## KÖRPERSCHAFTSTEUERGESETZ 1977

Kommentar. By Günther Felix and Michael Streck. Munich, Verlag C.H. Beck, 1979. 531 pp., 62 DM.
Comprehensive commentary on the German corporation income tax law of 1977. The commentary contains a detailed glossary concerning disguised profit distributions. (B. 101.996)

## SCHACHTELBETEILIGUNG BEI DER KÖRPERSCHAFTSTEUER, VERMÖGENSTEUER UND GEWERBESTEUER IN NATIONALER UND INTERNATIONALER SICHT

By Ulrich Moebus. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1979. 134 pp., 27.50 DM.
Monograph explaining the tax consequences of major shareholdings for the corporate income tax, the net worth tax and the business tax. (B. 101.966)

## 16 SCHAUBILDER ZUM BEWERTUNGSGESETZ UND ZUM VERMÖGENSTEUERGESETZ

5. Auflage. By K. Heisel. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1978. Schriftenreihe "Optisches Steuerrecht", Heft 5. 34 pp., 15 DM.
In 16 graphs an overview of the principles of valuation for the purpose of assessing the net worth and land tax and an overview of the taxation of net worth is given. The new provisions of the tax amendment law (Steueränderungsgesetz) 1977 are taken into account. (B. 101.989)

## 20 SCHAUBILDER ZUM INTERNATIONALER STEUERRECHT

By Perygrin Warneke. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1976. Schriftenreihe "Optisches Steuerrecht", Heft 12. 44 pp., 21 DM.
In 20 graphs an overview of international taxation law from a German perspective is given. The book deals with the general principles of international taxation law, unilateral measures, the German foreign tax law (Aussensteuergesetz), the foreign investment law (Auslandsinvestitionsgesetz), developing country tax law (Entwicklungsländersteuergesetz) and double taxation treaties. (B. 101.994)

## 20 SCHAUBILDER ZUM STEUERSTRAF- UND STEUERORDNUNGSWIDRIGKEITENRECHT NACH DER AO'77 ZUGLEICH ZUM ZOLLSTRAF- UND ZOLLORDNUNGSWIDRIGKEITENRECHT

3., erneuerte Auflage. By J. König. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1977. Schriftenreihe "Optisches Steuerrecht", Heft 6. 44 pp., 18 DM.
In 20 graphs the basic principles of criminal and non-criminal sanctions against fiscal violations as contained in the new fiscal code (Abgabenordnung) 1977 are illustrated (covering also the sanctions against customs violations). (B. 101.990)

## 26 SCHAUBILDER ZUR ABGABENORDNUNG 1977

5., völlig neu bearbeitete und erweiterte Auflage. By W. Pierchalla. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1976. Schriftenreihe "Optisches Steuerrecht", Heft 1. 52 pp., 18 DM.
In 26 graphs the central principles of the fiscal code (Abgabenordnung) 1977 and of the code of fiscal procedure (Finanzgerichtsordnung) are presented systematically. (B. 101.987)

## 24 SCHAUBILDER ZUR BESTEUERUNG DER PERSONENGESELLSCHAFTEN

By Erwin Kobs. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1978. Schriftenreihe "Optisches Steuerrecht", Heft 9. 52 pp., 24 DM.
In this book which consists of 24 graphs first the general problems relating to fiscal balance sheets (Steuerbilanzen) of partnerships are outlined, then the continuous taxation of the separate forms of partnerships are explained. Finally the effects on the fiscal balance sheet of extraordinary events, e.g. founding, change of partners, division, are shown. (B. 101.992)

## 18 SCHAUBILDER ZUR EINKOMMENSTEUER

6. Auflage. By H.W. Stoppkotte. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1978. Schriftenreihe "Optisches Steuerrecht", Heft 2. 36 pp., 18 DM.
In 18 graphs all aspects of the West German income tax system are illustrated. The revised income tax law (Einkommensteuergesetz) and the income tax executive order (Einkommensteuer Durchführungsverordnung) as of December 5, 1977, are taken into consideration. (B. 101.988)

## 22 SCHAUBILDER ZUR KÖRPERSCHAFTSTEUER

By F. Lammsfuss and K. Mielke. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1978. Schriftenreihe "Optisches Steuerrecht", Heft 13. 47 pp., 22 DM.
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# NDEX 979



## I. ARTICLES

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## III. IFA NEWS



## IV. CONFERENCE DIARY



## V. BIBLIOGRAPHY