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The objectives of the Foundation are to set up and maintain an international documentation bureau for the purpose of disseminating information concerning tax legislation and the application of taxation law, as well as for furthering the pursuit of knowledge about taxation.

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d. by producing publications;
e. by cooperating with the publications of others;
f. by all other lawful means.

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

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

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

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Developments in Latin America

Adjustment of Profits for Inflation

by Pedro Massone P. *

I. INTRODUCTION

The President of the United States of America, Jimmy Carter, in a recent economic message pointed out that virulent inflation has become a worldwide problem.[1]

The Organization for Economic Cooperation and Development predicts that during the year 1980 the average inflation rate for industrialized countries is going to be 12.5 percent.[2]

Some developing countries, especially Latin American countries, suffer from a much higher inflation. Recent data show Argentina leading the group with 123.5 percent inflation in one year, followed by Israel with 121.4 percent and Zaire with 97.7 percent.[3]

Inflation disrupts social life and economic development. Inflation also affects the legal system by distorting contracts, claims, debts, obligations, liabilities, etc.

Taxation does not escape the undesirable effects of inflation. On the contrary, it seems that taxation is one of the fields of law which suffers most from those effects and where measures aimed at neutralizing them are or can be complex and even risk, if not properly devised, creating new problems.

The effects of inflation on taxation and the possibility of introducing measures for eliminating the aforesaid effects were extensively studied during the 31st Congress of the International Fiscal Association held in Vienna in 1977. Many national reports appearing in the relevant *Cahiers* cover a wide range of valuable experiences from different countries. In the general report the principal issues and different measures are clearly shown and discussed.

It seems, however, worthwhile to review the Latin American experience with the adjustment of taxation for inflation, or more specifically the adjustment of taxable profits for inflation. This view is based on the following:

(i) several Latin American countries have suffered long periods of high inflation and have been, somehow, forced by facts and reality to adjust law and taxation for inflation;
(ii) several Latin American countries have introduced measures to adjust taxation for inflation to an extent perhaps unknown in other areas of the world;
(iii) the adjustment of taxable profits for inflation has been the subject of several meetings held in Latin America and has also been discussed in books and articles published in that area;[4]
(iv) reports submitted to the Vienna Congress were limited to four Latin American countries (namely, Argentina, Brazil, Mexico and Uruguay) all of which introduced, after the Congress, important changes on the subject; and
(v) the adjustment of taxable profits for inflation is both the most complex area within the adjustment of taxation for inflation and an area where several Latin American countries have enacted provisions which can be of interest for countries faced with similar problems and circumstances.

The aforesaid considerations taken into account, this article covers and is limited to the Latin American experience with the adjustment of taxable profits for inflation.

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* Professor of Tax Law, Valparaiso.
1. *Time*, March 31, 1980, at 28.
2. Ibid..
3. Ibid.
4. Some Argentine and Latin American contributions in this area appear in the Bibliographical Appendix of the Argentine national report for the 1972 IFA Congress and are analyzed in: Fowler Newton, Enrique, *El Ajuste de estados contables por inflación* (Adjustment of financial statements due to inflation) (Buenos Aires, Ediciones Contabilidad Moderna, 1976). See also Bibliography at the end of this article.

II. THE DECISION TO ADJUST FOR INFLATION

The review of the General Report of the Vienna Congress, and especially the consideration of the Latin American experience with adjustment of taxation for inflation, shows some features and suggests some ideas which should be taken into account when a country, especially a developing one, considers the possibility of adjusting taxable profits for inflation.

For many years, law and accountancy were based on the assumption that the acquisition power of money was not subject to substantial changes and that currency was therefore an accurate standard for measuring values.

Nevertheless money is not really an effective and sure standard because in fact its own value changes, especially when social disruptions occur. If under such circumstances money is used and accepted as a constant and common unit of measurement, reported values and financial statements can be misleading because they are expressed in units with different acquisition power.

The problem of adjusting taxation for inflation and the coverage and degree of the adjustment is a matter of political decision. It is necessary to point out that this decision is not always limited to taxation itself but is part of a broader set of issues involving the adjustment of law, claims, debts, liabilities, taxation, wages, salaries, social security benefits, social security contributions, etc.

When governments are first faced with the problem of inflation they are reluctant to take measures involving the adaptation of law to take the results of inflation into account. The adjustment of law for inflation is tantamount to admitting a deficient economic policy and a renunciation of the principle of nominal value.[5]

The adjustment for inflation represents, to a certain extent, the recognition that inflation is going to stay for a long period. Governments, however, are prone to regard inflation as a temporary development which must be corrected and not as a reality to which it is necessary to adapt.

The decision as to whether adjustment measures must be taken is, however, strongly influenced by the rate of inflation and by the duration and persistence of the phenomenon. The higher the rate of inflation, the more likely adaptation measures are requested, accepted and taken. Even more commanding is when inflation, or high inflation, is present for a long period.

The influence of the rate and permanence of inflation is well illustrated by the Chilean case. Historically, Chile seems to be one of the most, if not the most, serious victims of virulent and chronic inflation both in Latin America and in the rest of the world.

Some data are really astonishing. The Chilean inflation began at the end of the last century. Between 1930 and 1940 inflation reached an aggregate 100 percent rate. During the decade of the 1940s inflation accelerated to an aggregate 445 percent rate. During the last 30 years inflation amounted, according to the American economist and monetary expert Professor Frank Pick, to an appalling 56 million percent.[6]

It is not, therefore, surprising that Chile was, at the same time, a leading country in introducing measures to adjust law and taxation for inflation and to shift from partial adjustment of income to more sophisticated methods, namely the global adjustment and the integral adjustment.[7]

Although lower than the Chilean inflation, the abruptness of the Argentine one has also been astonishing, especially in the last years. Argentina has experienced a constant inflationary trend since the beginning of the 1940s with annual price increases generally increasing in multiple digit figures. During the period 1966-1975 the cost of living index increased by 2,106 percent and the wholesale price index by 2,067 percent.[8]

Argentina has, accordingly, introduced adjustment measures. Furthermore, inflation has prompted interest in the subject both in meetings and publications. The accounting profession has developed a bibliography and has continuously discussed the matter of adjustments in preparing the financial statements of business enterprises. Many international and local congresses, business association meetings and government committees have made recommendations to introduce these adjustments.[9]

Other Latin American countries with permanent high inflation have also undergone similar developments (e.g. Brazil and Uruguay).

As regards specifically the tax field, measures taken by governments have had at first a temporary nature and a limited scope. When those measures proved to be useful but at the same time incomplete, subsequent steps were taken, making the impact of the measures broader and deeper.

It would be, however, a mistake to think that adaptation measures are an exclusive product of government provisions. In fact, society and courts can create trends which influence government decisions.

When private enterprises and individuals become sufficiently aware of the distorting effects of inflation, they introduce corrective measures in their contracts and dealings. Likewise, Courts can realize more acutely the unfairness of certain effects of inflation and shift from approaches based on the nominal value of money to views taking real values into account.

The approach of the Chilean courts is a good example.

5. *Cahiers de droit fiscal international*, Volume LXIIa (1977), at 93. The principle of nominal value can be defined as: The rule that a monetary unit is always taken as equivalent to the same monetary unit irrespective of changes in its purchasing power over a period of time. Under the *principle of real value* a monetary unit is not taken to be automatically equivalent to the same monteary unit at a different point of time, but the difference in their purchasing power has to be taken into account in order to reduce them to a common denominator.

6. *Diario el Mercurio*, Valparaiso, April 28, 1980, at 5.

7. Developments in the tax field are found in Sections VII.D, VIII.E and IX.B below. In other fields, measures were taken even earlier as shown, for instance, by Law 7,064 of 1941 which established an annual adjustment of salaries for employees.

8. *Cahiers de droit fiscal international*, Volume LXIIa (1977), at 181.

9. Id., at 185.

In fact, Chilean courts have gradually accepted the adjustment of compensations, debts and other items for inflation, even in the absence of specific provisions or where it was previously understood that such adjustment was forbidden. Thus Chilean Courts have ruled that:

(i) compensation for expropriation is to be adjusted for inflation even in the absence of a specific provision establishing such an adjustment;[10]

(ii) the increase of debts derived from contractual provisions devised to correct the effects of inflation does not represent interest above legal limits and the beneficiary of those provisions does not commit a crime;[11]

(iii) compensation for damages is to be adjusted for inflation, a specific provision in the law not being necessary;[12]

(iv) late payments are to be adjusted for inflation, a specific provision in the law not being necessary;[13]

(v) the adjustment of compensations is to be calculated as from the very date on which the damage was caused and not from the filing of the claim;[14] and

(vi) the adjustment of debt claims for inflation is to be awarded even if the relevant party has not requested such an adjustment.[15]

Brazilian courts make a distinction between "liabilities of value" and "liabilities of currency", considering that in the first instance a certain acquisition power is involved (e.g. alimony, compensation of damages) while in the second instance only a certain amount of money is due. The adjustment of liabilities of value in accordance with changes in the cost of living or in the value of Adjustable Bonds of the National Treasury was accepted on the grounds of analogy or equity. The adjustment of liabilities of currency instead was first accepted only when specifically provided by law but was subsequently also accepted if provided for in a contract and for late payments.[16]

Moreover, the Federal Supreme Court of Brazil has upheld the understanding that monetary restatements (correção monetária) are deemed to be included in claims for losses and damages and that such restatement can be awarded in a court sentence even if not claimed in the initial complaint.[17]

Likewise, the Argentine courts accepted corrective measures allowing the traditional principle of the nominal value to be put aside. Decisions of the courts first referred to civil or commercial relations between contracting parties and recognized the right to adjust the amount of the "liabilities of value", distinguishing these from the "liabilities of currency" to which similar adjustment was not considered applicable. Later, this distinction was gradually abandoned and in some cases updating of liabilities was admitted for both types.[18]

Formerly, these decisions barely covered all types of credits and referred mainly to payments for services due (fees, indemnities etc.) or for rentals derived from leases. For tax purposes only legislation was considered able to take the matter into account.

Argentine Courts later ruled that:

(i) the adjustment of debt claims for late payments due to fault of the debtor must be accepted on the basis of constitutional principles providing that justice must be insured and property preserved, the absence of a specific provision on the subject being irrelevant; and

(ii) amounts to be refunded must be restated even in the absence of a specific provision on the grounds that nobody can without reason be enriched at the cost of another person, a rule which is also applicable to the government.[19]

III. INFLATION RATES IN LATIN AMERICA

Recent rates of inflation in Latin American countries appear in the following charts, based on the cost of living indexes.

LAFTA COUNTRIES

Cost of Living Indexes[20]

(percentage change over previous year)

Country and City	1976	1977	1978	1979
ARGENTINA				
Buenos Aires	+ 347.5	+ 174.8	+ 169.8	+ 139.7
BOLIVIA				
La Paz	+ 5.5	+ 10.5	+ 13.4	+ 45.7
BRAZIL				
Rio de Janeiro	+ 44.8	+ 43.1	+ 38.1	+ 75.9
São Paulo	+ 38.0	+ 41.2	+ 39.9	+ 67.1
CHILE				
Santiago	+ 174.3	+ 63.5	+ 30.3	+ 38.9
COLOMBIA				
National Index	+ 25.9	+ 29.3	+ 17.8	+ 29.8
ECUADOR				
Quito	+ 13.1	+ 9.7	+ 11.7	+ 9.0
MEXICO				
National Index	+ 27.2	+ 20.7	+ 16.2	+ 20.0
PARAGUAY				
Asunción	+ 3.4	+ 9.4	+ 16.8	+ 35.7
PERU				
Lima and Callao	+ 44.7	+ 32.4	+ 73.7	+ 66.7
URUGUAY				
Montevideo	+ 40.0	+ 57.3	+ 47.6	+ 81.2
VENEZUELA				
Caracas	+ 7.0	+ 8.1	+ 7.1	+ 20.5

10. Fueyo Laneri, Fernando, *Corrección Monetaria y Pago Legal* (Bogota, Editiorial Temis, 1978), at 48.
11. Id., at 50.
12. Id., at 52, 54.
13. Id., at 56.
14. Id., at 59, 62 and especially 65.
15. Id., at 67.
16. *Revista Fiscal*, Rio de Janeiro, October 30, 1979, Editorial Page.
17. *Legal letter* (Pinheiro Neto & Cia., Advogados, São Paulo) April, 1980, at 4.
18. *Cahiers de droit fiscal international*, Volume LXIIa (1977), at 183.
19. *Derecho Fiscal*, No. 338, Año XXIX, August 1979, at 173.
20. *Bank of London & South America Review*, Volume 14, No. 2/80, at 151, 152; Volume 14, No. 3/80, at 218, 219.

CENTRAL AMERICA, DOMINICAN REPUBLIC AND PANAMA

Cost of Living Indexes

(percentage change over previous year)

Country and City	1976	1977	1978	1979
COSTA RICA				
San José	– 2.7	+ 5.3	+ 8.1	+ 13.1
DOMINICAN REPUBLIC				
Santo Domingo	+ 7.0	+ 8.5	+ 1.9	+ 26.2
EL SALVADOR				
San Salvador	+ 5.3	+ 14.8	+ 14.7	+ 14.8
GUATEMALA				
Guatemala City	+ 17.6	+ 7.4	+ 9.1	+ 13.7
HONDURAS				
Tegucigalpa	+ 5.6	+ 7.4	+ 6.5	+ 17.7
NICARAGUA				
Managua	+ 6.3	+ 10.1	+ 10.5	+ 58.9
PANAMA				
Panama City	+ 3.3	+ 8.4	+ 2.4	+ 10.0

IV. THE SCOPE OF THE ADJUSTMENT OF PROFITS

Inflation changes the distribution of the tax burden as originally intended by the law and disrupts the equity of the tax system, producing negative effects on savings and investments.

In the field of the personal income tax, inflation distorts the "vertical" equity because the tax burden is changed differently for the particular bracket applicable to a single taxpayer.

As regards the corporate income tax, "horizontal" equity and neutrality are affected by inflation because taxpayers can be treated differently, depending on the specific composition of their assets and liabilities.

During inflationary periods, the corporate income tax can discourage savings and investments because the tax is normally levied on nominal or illusory profits which do not represent real profits. In fact, under traditional accounting methods, current company receipts are compared with costs based on original or historic values which do not reflect subsequent changes in prices. In this way nominal or illusory profits may result which are above real profits, namely, above profits from which the distorting effects of inflation have been removed.

Moreover, where the income tax is levied on nominal or illusory profits, the enterprise can be compelled to consume part of its capital. If the effects produced on income by inflation are to be taken into account it is therefore necessary that the capital of an enterprise remain untouched by the income tax and the computation of taxable profits be so devised as to prevent the possibility that the income tax be levied on capital or that its integrity be affected.

In order to correct the undesirable effects of inflation and stimulate investment, the adjustment of profits has been firstly used to reduce income tax by restating: (i) the value of fixed assets and/or depreciation allowances; and (ii) the cost of merchandise and raw materials.

The aforesaid measures represent, however, a partial or limited adjustment aimed only at reducing income taxation. This partial adjustment can affect tax neutrality by favoring some taxpayers more than others, depending on the composition of their assets and liabilities. In fact this kind of adjustment benefits to a higher degree those industries using capital more intensively.

This means that partial adjustment can promote capital-intensive industries, especially those using capital in the form of fixed assets, and discourage labor-intensive industries. This feature does not make much sense in areas where labor supply is abundant and the need for employment strong.

Inflation, however, not only can produce illusory or fictitious profits, but it can be the source of real profits or losses for enterprises. This happens because inflation affects all the accounts of a balance sheet and particularly monetary assets (claims and debts). Depending on whether the enterprise is a net debtor or a net creditor, it can actually benefit from inflation or be damaged by it, especially if correction mechanisms are not used.

Actual results are strongly influenced by the creditor or debtor position of the enterprise. If the enterprise's monetary assets (e.g. cash, bank deposits, receivables, etc.) exceed monetary liabilities (e.g. debts, obligations, etc.), the enterprise is damaged by inflation and real profits will be below nominal profits. On the other hand, if monetary assets are in excess of monetary liabilities the enterprise will obtain a real benefit from inflation due to the fact that the real value of debts diminishes as the level of prices increases. In other words, in the absence of a special adjustment, enterprises financing their activities with capital belonging to third parties derive a benefit from inflation while enterprises with large equity will be damaged.

The effects mentioned above can be remedied for taxation purposes by means of an *integral* or *complete* adjustment. This adjustment can result in taxation which is higher or lower than that calculated without the adjustment. In other words, this adjustment is not solely aimed at reducing the tax but can also result in an increase of same.

Also a *global* or *intermediary* adjustment can be so devised as to cover profits produced by inflation. This method has been, however, basically aimed at reducing the taxable income and protecting the net worth of enterprises.

V. ADJUSTMENT METHODS

Inflation destroys the assumption that money is stable which is the basis of classic accountancy. In such circumstances, historic values registered in accountancy books become heterogeneous amounts measured in different units. The use of such data under traditional accountancy methods, without a previous correction, makes no sense and leads to results which are void of meaning.

Real profits exist only if the effective purchasing power of the enterprise is increased and a balance of receipts is left after deducting all expenses, such amounts being calculated in accordance with their real values and measured with currency of the same purchasing power.

No real profits exist if consumption of tangible assets during production is measured incorrectly and the enterprise is deprived of fixed assets and inventories and put into a position where it is unable to replace them. Neither will real profits exist if the use of monetary assets to carry on the enterprise's business results in a depreciation of such resources.[21]

In fact tangible and monetary resources are at the enterprise's disposal in order to be utilized but both must be preserved and saved. Moreover, if the enterprise is placed, as regards monetary items, in a net credit position it will lose money with inflation. On the other hand, if the enterprise is placed, as regards the same items, in a net debit position, it will make a profit from inflation.

It therefore becomes necessary to use correction measures in order to offset the effects of changes suffered by monetary units and to reestablish in that way the accuracy of the information provided by accountancy.

The main components of profits which can or must be corrected by adjustment measures are the following:

(i) *The computation of depreciation allowances calculated with respect to fixed assets.* Such allowances are, in fact, charged to the cost of the goods to be sold. If depreciation allowances are calculated on values which are not current, then production costs are artificially reduced; furthermore, results will appear which do not reflect the value of money at the moment in which sales are concluded and income arises.

(ii) *The valuation of inventory.* Valuation methods used by enterprises or accepted by tax laws influence business results, especially during inflationary periods. If during such period valuation is made under historical costs then nominal or fictitious profits may result.

(iii) *The monetary assets and liabilities.* If the enterprise holds monetary assets during inflationary periods the purchasing power of such monetary assets declines and a loss is incurred by the enterprise. On the other hand, if the enterprise has monetary liabilities, the real value of such liabilities also declines but in this case a real profit arises for the enterprise.

(iv) *The value of the capital.* The original value of the capital is eroded by inflation. If the taxpayer is not given the opportunity to recover such value free from income taxation, the very concept of income as something different from capital is distorted.

The different measures which have been devised and used in the Latin American area in order to adjust taxable profits for inflation can be grouped and included within the following main adjustment methods:

(i) A *partial adjustment* aimed at protecting the initial capital through the computation of the replacement cost of certain items, especially fixed assets, stock-in-trade and raw materials. The protection of the initial capital can also be achieved through correction of the book value of the assets using indexes specified by the law. The partial adjustment represents an incomplete measure aimed only at avoiding or alleviating taxation on nominal or illusory profits. Among the different methods which can be devised, the partial adjustment is obviously the simplest one and has had widespread use in Latin American countries suffering inflation. Under this method the book value of fixed assets is updated, depreciation allowances are increased and taxable profits are reduced. Partial adjustment can also cover inventories the value of which is usually corrected according to replacement costs. This method is, however, limited in scope in the sense that it only reflects changes in the value of certain items, usually fixed assets and sometimes inventories. Moreover, partial adjustment can affect neutrality because it favors taxpayers diversely depending on the composition of their assets and liabilities.

(ii) A *global adjustment* representing an intermediate or eclectic approach aimed at correcting the owner's equity (capital propio) or the working capital (capital de giro). This method is more complex than the partial adjustment. It was first and mainly used to reduce taxable profits (e.g. in Chile and Brazil) but it has been subsequently so devised as eventually to reflect an increase in profits produced by inflation (e.g. Argentina and Uruguay). The global method first introduced in Chile (1959) and Brazil (1968) and replaced by an integral method in both countries, was recently introduced in Argentina (1978) and Uruguay (1979).

(iii) An *integral adjustment* or price level accounting aimed at correcting the nominal values of all items involved and taking into account the fact that inflation not only can produce nominal or illusory profits which exceed real profits but can also produce real profits or losses representing disguised transfers of wealth from creditors to debtors. The starting point of the integral adjustment method is the assumption that the only way of both correcting the illusory or nominal income and including real results derived from inflation in financial statements and in taxable profits is the adjustment of all accounts of the balance sheet through a price index.

The integral method is the most complex one. This method is aimed at correcting the effects produced by inflation on assets and liabilities; furthermore it is not limited to the possibility of reducing taxable profits but can eventually result in their increase. The integral method of adjustment was introduced in Chile (1974) and Brazil (1977) and is currently in force in both countries.

VI. PARTIAL ADJUSTMENT

Partial adjustment is aimed at neutralizing the effects of inflation on certain non-monetary assets. The method allows for the revaluation of tangible fixed assets (e.g. buildings, installations, machinery, equipment, etc.) and inventories (e.g. merchandise, raw materials, etc.). As a consequence of the revaluation of these items, depreciation allowances calculated on tangible fixed assets and

21. Recamonde Capelo, Emilio, "Analise da fidedignidade do lucro em uma economía inflacionaria", *Revista Economica do Nordeste*, Vol. 7, No. 2, at 234.

the costs of sales are increased, the taxable profits being in this way reduced.

A. Restatement of fixed assets

As regards fixed assets, partial adjustment may cover: (1) both the residual value of assets and depreciation allowances; or (ii) only depreciation allowances.

In Latin America the adjustment has normally covered both the residual value of eligible assets and depreciation allowances calculated thereon, but there are instances where the correction has been limited to depreciation allowances.

In order to avoid taxation on nominal or fictitious income and to make the replacement of fixed assets easier, several Latin American countries hit by inflation allow or have allowed the restatement of the residual value of fixed assets as well as the adjustment of relevant allowances to the new value of these assets.

Under either approach depreciation allowances are increased and thus taxable profits reduced making the difference a formal one. However, if the residual value of assets is increased, the change is reflected in the enterprise's net worth and consequently net worth taxes, inheritance taxes, business licences and similar levies are increased. On the other hand, if the adjustment is only applied to depreciation allowances and not to the residual value of assets, the nominal amount of the taxes mentioned above remains unchanged while taxes on capital gains and excess profits can be artificially increased because fixed assets and capital remain undervalued.

The adjustment of depreciation allowances enables enterprises to establish reserves for the replacement of fixed assets. Enterprises can in this way recover the real value of their capital and replace fixed assets once their service life is over.

By updating depreciation as mentioned above, taxable profits become closer to the idea that income is an amount that can be withdrawn from the enterprise by the owner, without reducing the real value of capital.

The adjustment of fixed assets and/or depreciation allowances can be linked to replacement costs or indexes reflecting changes in the price of fixed assets. Latin American countries use price indexes for capital assets or for industrial products. Some countries, however, use general price indexes such as consumer price indexes.

B. Restatement of inventories

If traditional inventory valuation methods are used during periods of inflation and, during the same periods, the cost of sales is deemed to be the acquisition cost without any adjustment, then nominal or fictitious profits will result. These profits are higher than real profits, because acquisition or historical costs are less than replacement costs.

The problem is particularly serious if the FIFO method is used and the cost is allocated under the assumption that sales are made out of the oldest purchases. On the other hand, if the LIFO method is followed and the merchandise which is sold is assumed to be the last purchased then costs are nearer replacement values and the profits of the enterprise are less affected.

The FIFO method, however, makes the problem of inventory valuation worse because inventories will appear more and more undervalued as compared with replacement costs. In fact, under the FIFO method the oldest and lowest costs will be reflected in inventories. Moreover it must be pointed out that the FIFO method of inventory valuation is not accepted by most of the Latin American countries.[22]

In order to neutralize the distorting effects of inflation and to avoid the disadvantages of having inventories increasingly undervalued, it is necessary that inventories at the beginning and at the end of the period be valued in monetary units having the same purchasing power, namely according to the price level current at the end of the period. The same criterion must be applied to changes which have occurred during the taxable period, and specifically to the cost of goods sold during that period. In this way, inventory valuation under old and outdated values is avoided and taxation of nominal or fictitious profits avoided.

In order to update the value of inventories, the price of the last purchase or the replacement cost can be taken. The amount of the correction (i.e. the difference between the old book value and the new updated value) is then deducted in calculating the taxable profits. It is necessary, however, to point out that a special tax has frequently been levied on the difference.

C. Occasional partial adjustment

There are two kinds of partial adjustment, namely: (i) discretionary or occasional adjustment; and (ii) automatic or permanent adjustment.

Partial adjustment of an occasional or discretionary nature is used from time to time during periods of high inflation and particularly the devaluation of the national currency.

Discretionary adjustment is particularly useful to neutralize the effects produced by an inflation which is present, or is assumed to be present, temporarily or which is caused by extraordinary circumstances (war, currency devaluation, etc.).

Discretionary or occasional adjustment can also prepare and facilitate the introduction of permanent or other more sophisticated adjustments (e.g. global adjustment). Discretionary adjustment has even been used when permanent adjustment measures have shown themselves insufficient to correct accurately the distorting effects

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22. *Ajustes del Impuesto sobre las Utilidades de las Empresas Financiamiento del Desarrollo* (O.A.S., Washington, 1977), at 5. There are, however, some exceptions, e.g. the Uruguayan law has permitted the use of the LIFO method since 1945 and the Mexican Income Tax Law accepts any of the following methods: identified cost, FIFO, LIFO and retail method.

of a high inflation.[23] Finally, in countries, where taxes on extraordinary or excessive profits are levied, partial adjustment can also be aimed at correcting the capital of enterprises in order to calculate the pertinent tax.

Discretionary or occasional adjustment is normally the first method used by countries affected by inflation. This approach is based on the assumption that inflation is a temporary phenomenon and that in order to neutralize its effects on taxation it is enough to take measures which are applicable only once.

The discretionary or occasional adjustment was used by European countries after the war and also in Latin American countries affected by inflation. Nevertheless, as high inflation became permanent in some Latin American countries, adjustment measures became permanent as well.

Discretionary or occasional adjustments cannot neutralize the distorting effects produced by a high and permanent inflation, which has been the case of several Latin American countries. Moreover the temporary nature of the method, and particularly the fact that sometimes it assumes a voluntary nature, makes it difficult to administer and control. Furthermore, in order to implement discretionary adjustments, special assessments are necessary, special inventories must be prepared (sometimes on dates other than closing dates), and a special tax is in some instances levied.

Where revaluation of merchandise and raw materials is allowed, auditing and controlling problems can be increased by the lack of auditing resources to control all taxpayers. The auditing and control problems are greater for inventory adjustments, where the replacement cost is normally used, than for fixed assets, which are corrected in conformity with fixed indexes based on industrial prices, wholesale prices, consumer prices, cost of living, etc.

Perhaps the principal reason why a special tax on revaluation of inventories is sometimes levied is the need to counteract the trend of taxpayers to unduly overvalue their inventories in order to reduce taxes.

From another point of view, discretionary adjustments, being made on a one-time basis or from time to time, can worsen the neutrality problem arising from inflation because of their partial nature. Being calculated on a certain date, they can favor some taxpayers to a greater extent than others. In fact, those taxpayers who have more assets on the revaluation date do not pay income tax on the appreciation and are better off than those who sold their assets before the revaluation and must compute the receipts from the sale in calculating their taxable profits.

All this means that partial adjustment of a discretionary nature can be discriminatory in a double sense: (i) their partial nature makes them more favorable to those who have more assets to be revalued; and (ii) the fact that they are applicable only once, at a fixed date, makes them more favorable to those taxpayers who have larger stocks on that date as compared to those who have sold inventories before that date.

D. Permanent partial adjustment

Partial adjustment of a permanent or automatic nature enables taxpayers to revalue regularly certain assets in order to distill profits from the distorting effects produced by inflation on the value of eligible assets.

If it can be assumed that inflation is a permanent phenomenon, then it is convenient to introduce permanent mechanisms to solve not only current distortions in values but also correct future discrepancies as they arise.

Experience shows that when high inflation has become a chronic problem, Latin American countries have finally replaced occasional or discretionary adjustments by permanent mechanisms. This trend has been encouraged by problems arising from occasional or discretionary adjustments, such as administration and control problems, inequalities arising from occasional adjustment, etc. In some cases, the revaluation of fixed assets has been compulsory. In other instances, taxpayers have had the opportunity to choose to have their fixed assets revalued or not.

When faced with high inflation of a permanent nature, Latin American countries have enacted provisions for the permanent and periodical adjustment of the value of certain items, especially fixed assets. As a result of the adjustment of the value of fixed assets, depreciation allowances have been corrected and the income tax has been reduced accordingly. Moreover, where net worth or capital taxes exist the updated value of fixed assets has been taken into account in calculating these taxes.

Under the permanent adjustment of fixed assets, both the book value of assets and the relevant depreciation allowances are normally increased (Argentina, Bolivia and Uruguay). There are, however, instances where depreciation allowances are adjusted but the value of fixed assets is not increased (Ecuador). Finally, taxpayers may be allowed to revalue assets only in order to compute taxes on gains derived from the disposal of assets, on extraordinary or excessive profits, and on net worth or capital (Brazil up to 1964, and Colombia).[24]

The tax law usually provides for an index under which the value of fixed assets is corrected. In Argentina, capital assets are updated according to wholesale prices for industrial products, while in Uruguay the tax authorities are empowered to establish annual indexes based on current prices of fixed assets. The tax law can also provide that the value of fixed assets be increased up to replacement cost (Ecuador).[25] Some countries, e.g. Bolivia and Peru, demand the payment of a special tax on the increase, such tax being more frequent in case of partial adjustments of an occasional nature.

The partial adjustment of a permanent nature limited to fixed assets is easier to administer as compared to re-

23. A good example of this feature is found in Chilean legislation and specifically in Law 13,305 of 1959, Decree-Law 110 of 1973 and Decree-Law 824 of 1974, all of which were enacted while permanent adjustments were in force. For further information, see Section VII.D below.

24. *Ajustes del Impuesto sobre las Utilidades...*, at 12. In Colombia, this rule was in force up to 1979.

25. Id., at 12.

valuation of inventories. Such a partial adjustment, however, discriminates in favor of enterprises the capital of which is concentrated on fixed assets, and against industrial enterprises with higher use of working power, commercial enterprises where inventories are more important, and financial enterprises.

E. Accelerated depreciation

An alternative to revaluation of fixed assets of a permanent nature is found in accelerated depreciation which has been used in some developed countries (e.g. Sweden and Great Britain) where a depreciation allowance of 100 percent was established for plant and machinery.[26]

Accelerated depreciation, however, does not eliminate the distorting effects caused by inflation on profits. By anticipating the timing of depreciation the effects caused by inflation on profits are alleviated because the tax burden is reduced during the first years of the useful life of assets but can be increased during subsequent years.

There is also a difference between revaluation of fixed assets and accelerated depreciation in the sense that the former is more favorable to old enterprises owning the oldest assets while the latter is more favorable to new enterprises or to enterprises the investments of which are expanding.

In this way, accelerated depreciation favors capital investment because it promotes the use of more capital and less labor. This feature is increased if the revaluation is limited to fixed assets.

Accelerated depreciation has been used in Latin America as an incentive for investment but the distorting effects of inflation have been corrected, rather, by specific adjustment measures.

VII. PARTIAL ADJUSTMENT IN A NUMBER OF LATIN AMERICAN COUNTRIES

Several Latin American countries introduced partial adjustment of an occasional nature. Some Latin American countries have also used or are using partial adjustment of a permanent nature (Brazil and Chile in the past; Argentina and Uruguay currently).

Partial adjustment of a permanent nature has normally covered only fixed assets. On the other hand, revaluation of inventories has normally been granted on an occasional basis.

Uruguay is the only country in Latin America where a partial adjustment of a permanent nature has been applied which not only covers capital assets but also corrects the book value of inventories at the beginning of the period. This adjustment, however, is limited to a certain percentage of taxable income.

A. Argentina

The first adjustment measures enacted in Argentina referred to depreciation allowances on fixed assets, calculated by means of supplementary rates provided in the law.

In 1943 taxpayers were allowed by Decree-Law 18,229 to register an additional deduction representing 20 percent of the normal depreciation in order to constitute a fund for the replacement of industrial, commercial and industrial fixed assets.

Law 14,060 instituted a new and more liberal system of extraordinary depreciation allowances the percentages of which varied according to the year of origin of the relevant asset in order to take account of the different degrees of inflation affecting their values. Coefficients were updated and the coverage of the system extended by Law 14,343, Decree-Law 4610/58 and Law 15,273.

A revaluation referring only to livestock was permitted by Law 14,421 of 1954.

Law 15,272 of February 15, 1960 allowed a general updating of real property (unless specifically excluded) and depreciable fixed assets under maximum coefficients provided by the law and varying in accordance with the acquisition date of the asset. The updating also covered cattle raising enterprises for which some special rules were provided. The written up values, except for land, were depreciable at a 10 percent annual rate. The total written up value was exempt from ordinary taxation but was subject to a single tax computed on half the written up value at progressive rates ranging from 3 to 10 percent. The appreciation resulting from the correction could only be used to increase the capital or to offset losses.

Law 17,335 of 1967 allowed another general revaluation of assets and breeding cattle, the coverage of which was similar to that of year 1960. Depreciation allowances on the written up values were admitted in addition to normal depreciation based on a useful life of 25 years for depreciable real property and 10 years for other assets. A tax similar to that of 1960 was applied on the written up value.

Since 1972, automatic annual revaluation of assets and correlative adjustments of depreciation have been allowed in accordance with official indexes. Law 19,409 of 1972 introduced a system of permanent automatic correction of the value of fixed assets and depreciation allowances which since 1974 is governed by Law 20,628. The residual value of movable depreciable assets and of real property is adjusted under indexes established by the tax administration which reflect the variation of the general non-agricultural wholesale price index provided by the National Institute of Statistics and Census. The relevant table includes average quarterly calendar values for the four immediately preceding years and average annual values for the remaining periods, taking as a basis the average prices of the last calendar quarter.

The annual depreciation allowance of fixed assets is adjusted by applying to the ordinary depreciation the updating index pertaining to the date of acquisition or construction as indicated in the table prepared for the quarter ending at the closing of the taxable period.

26. *Cahiers de droit fiscal international,* Volume LXIIa (1977), at 485, 496.

Depreciation allowances on the cost of buildings and other construction are adjusted under the same procedure and indexes.

B. Bolivia

Article 46 of the Company Income Tax Law[27] provides that for the purpose of determining depreciation deductions the Executive Power may authorize the revaluation of assets if fluctuations in international exchange rates, general prices, or prices of particular fixed assets exceed 15 percent over any period of time. Fluctuations are determined on the basis of prices in the previous tax year, the first of which is that ending on December 31, 1975. Depreciation allowances are calculated on the restated values of assets.

While revaluations are generally exempt from income taxation, the Executive Power may authorize a special tax of up to 5 percent of the increase in book value resulting from the revaluation.

According to the previously mentioned rules, Supreme Decree 14,460 of March 25, 1977 provided that companies in general were obliged to revalue their fixed assets to December 31, 1976. The value of these assets was to be adjusted on the basis of a multiplication factor provided by the Law, according to their date of inclusion in the corporate assets, and a single tax of 5 percent was applicable to the increase in value resulting from the revaluation, which tax was payable at one time or in installments.

The capital increase derived from the revaluation is not subject to any other national or municipal charge, and shareholders benefiting from a distribution originating from the revaluation are not affected as concerns their personal income tax.

C. Brazil

Before 1958, revaluations of fixed, depreciable assets were generally taxable as part of a legal entity's operational income. However, as an incentive to revalue fixed assets in accordance with the reduced purchasing power of the currency, temporary tax benefits were granted in 1944, 1951 and 1956 to taxpayers who adjusted the values of their fixed assets within prescribed limits.

Law 3,470 of November 28, 1958 introduced the monetary restatement of values of fixed assets for the purposes of assessing the tax on excessive profits. A permanent distinction was made between voluntary, unlimited revaluations of fixed assets, and monetary restatements, i.e. "monetary corrections" of the original acquisition cost of fixed assets in accordance with official indexes based on the actual currency inflation rate that were issued by the Ministry for Economic Planning. From 1958 to 1964, monetary restatement of the book values of fixed assets could be voluntarily made every two years. The law prescribed that the net increment derived from the monetary restatements of fixed assets, after being offset against exchange losses or other monetary corrections (afterwards restricted to those on loans to finance, or directly related to, fixed assets), was subject to a 10 percent income tax and the resulting surplus had to be applied to increase capital. This tax was in effect a tax on inflation (or on capital). For income tax purposes, however, depreciation allowances were still to be calculated on the old values (i.e. without taking the restatement into account).

As from 1964 (Law 4,357 of July 16), the restatement became compulsory for legal entities (except for those specifically exempt) and for subsidiaries, branches, agencies and representatives of foreign companies operating in Brazil; furthermore, depreciation on monetary restatements of fixed assets was permitted. The original acquisition cost of fixed assets was restated in accordance with official indexes reflecting the variation in the purchasing power of the Brazilian currency between December of the previous year and the annual average of each of the preceding years. From the restated value thus obtained, the original cost and monetary restatements of preceding years were deducted in order to arrive at the increment of the year. The net adjustment was subject to a 5 percent tax which was abolished in 1966. The taxpayer could choose, instead of paying the tax, to have an amount equal to 10 percent of the net adjustment invested in Readjustable Bonds of the National Treasury for five years.

Up to 1973, the annual increment of fixed assets resulting from the restatement of values was registered separately and treated as if it were a "new investment" with the same useful life of the relevant original asset (i.e. as expressed in the number of years). Depreciation allowances of these "new investments" were calculated separately taking into account a useful life starting on the date on which the "new investment" was registered and thus going beyond the end of the useful life of the original asset. This provision was aimed at avoiding a loss of revenue but involved serious registration and control complexities.

On December 31, 1973 a new procedure to account for the monetary restatement of accumulated depreciation was introduced by Decree-Law 1,302 with a view to computing depreciation of both the original cost and its monetary restatement at the same rate and at the same time. Under this new procedure the annual increment derived from the restatement of the value of assets was debited to fixed assets and credited to a capital reserve if no depreciation on original cost had been accounted for. If depreciation had been calculated and recorded, an amount sufficient to equalize, on a percentage basis, depreciation of original cost and depreciation of its monetary restatements was recorded and then the remaining balance was credited to a reserve for future capital increase. Such a capital reserve could, for tax purposes, be utilized to offset accumulated deficits. This procedure was introduced with a view to computing depreciation of both original cost and its monetary restatement at the same rate and at the same time, so that at the end of the service life of the related fixed asset it would be fully depreciated.

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27. Impuesto sobre la renta de Empresas: Decree-Law No. 11,154 of October 26, 1973, as amended by Decree-Law No. 12,853 of September 12, 1975.

D. Chile

Chile introduced several acts establishing partial adjustments which were sometimes of a temporary nature and sometimes permanent.

An early reference to readjustments was made in Law 7,144 of January 5, 1942, which governed the tax on excessive profits. This law specified that revaluation of machinery, installations and movable and immovable property could be accepted by the tax administration provided the revaluation was justified and the income tax was paid.

Law 7,747 of December 24, 1943 subsequently established that revaluation of immovable property made by the tax administration under the Income Tax Law and the Immovable Property Tax Law should be considered in calculating the excessive profits tax which was then in force without paying the Third Category Income Tax.

Law 9,040 of September 22, 1948 provided that taxpayers included in the Third and Fourth Income Categories[28] could revalue assets appearing in their balance sheets prepared after July 1, 1947. Raw materials, merchandise, minerals and other values or goods were excluded from the revaluation if gains derived from the sale of such values or goods were subject to tax under the Third or Fourth Categories. The amount of the revaluation was subject to the approval of the tax administration. Moreover a single tax was levied on such revaluation at 4 or 6 percent depending on the date on which it was paid (i.e. December 15, 1948 or December 31, 1949).

Corporations were permitted by the same Law 9,040 to increase their paid-in capital by capitalizing reserves or funds, even those derived from revaluations mentioned above. The capitalization was subject to a special tax at the rate of 3 or 5 percent depending on the date on which it was paid (i.e. December 15, 1948 or December 31, 1949). The capitalization was free from personal taxation provided it was made by increasing the par value of shares.

The revaluations provided by Law 9,040 were only temporary. Taxpayers could, however, take advantage of them either once (in 1948 or 1949) or twice (in 1948 and 1949).

Important measures were taken by Law 11,575 of August 14, 1954, which provided that taxpayers included in the Third and Fourth Categories of the Income Tax Law could revalue, every year, tangible assets appearing in their balance sheets. Raw materials, merchandise, minerals and similar goods or values were excluded from the revaluation if gains derived from the sale of such values or goods were subject to tax under the Third or Fourth Categories of the Income Tax. The amount of the revaluation was subject to the approval of the tax administration. Moreover a single tax of 4 percent was levied on such revaluation, as a consequence of which the owner's equity (capital propio) was increased in the same amount.

Law 11,575 also amended the Income Tax Law introducing a permanent provision under which depreciation allowances were calculated taking into account replacement costs. In order to avoid any sharp loss of revenue, depreciation allowances were limited to 40 percent of the net profits of the enterprise. Moreover if accumulated depreciation of an asset exceeded its book value, excess was subject to a single 6 percent tax, placed into a reserve fund and used for replacement of assets.

Law 12,041 of June 26, 1956 provided that Chilean shipping companies were entitled to revalue boats and other floating assets every year up to their replacement costs. This revaluation was exempt from the 4 percent tax established by Law 11,575 and was recently revoked.

Law 12,084 of August 18, 1956 provided that taxpayers included in the Third and Fourth Categories of the Income Tax Law could revalue assets not covered by Law 11,575, namely, inventories. This revaluation could be made only once and was subject to the 4 percent tax and other rules included in Law 11,575.

Law 13,305 of April 6, 1959 revoked the revaluation of fixed assets governed by Law 11,575 and also the provisons for the computation of depreciation allowances, and introduced a global adjustment (this method is discussed in Section VIII. E below).

Furthermore, Law 13,305 provided that taxpayers included in Categories Three and Four of the Income Tax Law could revalue assets not covered by Law 11,575 (i.e. inventories) up to their market cost or price. The revaluation could be made only once and was subject to a 6 percent tax.

In order to avoid a major loss of revenue for the treasury, Law 13,305 provided that taxpayers taking advantage of the revaluation would pay on income arising during the period in which the revaluation was made a tax at least equal to that paid on income derived during the preceding period.

Decree-Law 110 published in the Official Journal of November 2, 1973 established a new partial revaluation. It is worthwhile to point out that this new partial revaluation was enacted while the global adjustment had been in force for several years and was still in force.

Under Decree-Law 110 taxpayers of the First Category of the Income Tax[29] could revalue, only once, tangible fixed assets and stock in trade. Foreign currency and gold coins were excluded from the revaluation. Industrial enterprises could revalue inventories only where they consisted of raw materials as such or raw materials incorporated in products in production or in finished products.

Under Decree-Law 110, revaluation of fixed assets was limited to replacement cost and was to be made taking into account the condition of the assets and their possible useful life. Stock-in-trade could be revalued up to the average replacement cost on the date on which Decree-Law 110 was published. The aggregate value of

28. Taxpayers deriving income from trade, industry, construction, mining and other similar activities.

29. Previously Third and Fourth Categories. Law 15,564 of February 14, 1964 (Article 5) reshuffled the Categories; the change was maintained in the Income Tax Law (Decree-Law 824 of December 31, 1974).

inventories could not be increased above five times the acquisition cost of such inventories. A single tax of 5 percent for fixed assets and 10 percent for inventories was paid on the revaluation.

Decree-Law 824 of December 31, 1974 revoked the global adjustment established by Law 13,305 (discussed in Section VIII. E. below) and introduced an integral adjustment (discussed in Section IX. B. below).

Moreover, Decree-Law 824 provided that taxpayers of the First Category of the Income Tax Law, who were subject to the global adjustment rules then in force, could revalue, only once, assets and liabilities specified by the law.

Tangible assets forming part of fixed assets were revalued in accordance with their replacement cost taking into account their condition and useful life computed from the same date. Fixed assets revalued under Decree-Law 110 were excluded from the benefit of the new revaluation. The restated value was taken into account in calculating subsequent depreciation allowances.

Inventories were revalued according to their replacement cost under rules similar to those included in the integral adjustment discussed in Section IX. B. below. Foreign currency and gold coins were adjusted to their quotation in the market. Shares were adjusted to their quotation in the stock exchange. The law provided also for the revaluation of intangible temporary assets, including deferred charges, debt claims in foreign currency or subject to adjustment for inflation (e.g. linked to a price index), contributions or rights in companies, and debts and liabilities in foreign currency or adjustable for inflation.

The readjustment was subject to a single tax at the following rates: 10 percent for tangible fixed assets other than real property, 5 percent for real property, 35 percent for inventories, foreign currency and gold coins, 15 percent for deferred charges, and 10 percent for nominal assets (debts, etc.).

E. Colombia

Law 54 of December 23, 1977 introduced several rules which took inflation into account, some of which provided the following:

(i) The cost of real property and shares, if registered at the end of taxable year 1977, could be increased under special rules which offered several alternatives, the most significant of which considered: the cadastral value of real property; the value of real property as assessed by the taxpayer; and the price of shares in the stock exchange based on that of the last transfer prior to July 1, 1977.

(ii) As from the taxable year 1978, the cost of personal and real property representing fixed assets could be annually argumented by 60 percent of the increase in the consumer price index for employees as registered between September 1 of the year preceding the taxable year and September 1 of the taxable year. (For the taxable year 1977 the augmentation in the cost of personal property was established at 14 percent.)

It is necessary to consider that all the rules mentioned above had limited consequences in that they only affected the calculation of:

(i) capital gains derived from the transfer of fixed assets held by the taxpayer for a least two years;
(ii) the presumed income (8 percent of net worth);
(iii) the taxable net worth; and
(iv) the value of real estate.

These rules had no effect on the calculation of amortization, depreciation allowances, losses of goods, or losses resulting from the transfer of assets, all of which were calculated on the basis of historical cost. As to shares, the rules mentioned above applied only to the calculation of capital gains.

Law 20 of April 16, 1979 established new rules which take inflation into account and replace those of Law 54. The new law includes the following provisions:

(i) The cost of personal and real property representing fixed assets can be annually augmented by the full increase in the "consumer" price index for employees, as registered between September 1 of the year preceding the taxable year and September 1 of the taxable year. The possibility to restate the value of eligible assets must be exercised during the pertinent year and cannot be deferred to subsequent years. If the taxpayer does not take advantage of this right in due time, such right is lost.

(ii) Amounts received as a consequence of the adjustment of debt-claims for inflation are exempt from income tax for that part which does not exceed 8 percentage points per year; taxpayers are subject to capital gains tax on the excess.

F. Peru

Decree-Law 21,694 of November 16, 1976 introduced an adjustment system covering fixed assets and depreciation allowances.

Taxpayers whose income is classified under the third category (income from commerce, industry and similar income) are required to revalue periodically their fixed assets and respective depreciation in accordance with the price index of new investments in similar assets and to pay a tax on the net appreciation resulting from said revaluation.

Exemption from the tax is granted to: companies which are exempt from income tax and regulated public service companies that provide telephone, water, electricity and transportation services.

Revaluations governed by Decree-Law 21,694 are implemented by means of Supreme Decrees as follows:

(i) *Supreme Decree 171-77-EF of December 20, 1977, as amended by Supreme Decree 20-78-EF of March 14, 1978.* This Supreme Decree establishes the revaluation of fixed assets in existence on December 31, 1977 provided they were acquired or constructed not later than December 31, 1976. The revaluation is made in accordance with the price index of new investments in similar assets and a tax of 4 percent is paid on the net appreciation resulting from the revaluation. The rate is 2 percent for agriculture, cattle raising and forestry enterprises.

The revaluation is not taken into account in calculating the income tax and the net worth tax for the 1977 taxable period. However as from January 1, 1978 depreciation allowances are calculated on values resulting after revaluation made under Supreme Decree 171;

(ii) *Supreme Decree 175-78-EF of December 12, 1978 as amended by Supreme Decree 067-79-EF of May 8, 1979.* This Supreme Decree establishes the revaluation of fixed assets in existence on December 31, 1978 provided they were acquired or constructed not later than December 31, 1977. The revaluation is made in accordance with the price index of new investments in similar assets and a tax of 10 percent is paid on the net appreciation resulting from the revaluation. The rate is 3 percent for agriculture, cattle raising and forestry enterprises.
The revaluation is not taken into account in calculating the income tax and the net worth tax for the 1978 taxable period. However, as from January 1, 1979 depreciation allowances are calculated on values resulting after revaluation made under Supreme Decree 175.

(iii) *Supreme Decree 181-79-EF of December 27, 1979.* This Supreme Decree establishes the revaluation of fixed assets in existence on December 31, 1979, provided they were acquired not later than December 31, 1978, as well as the revaluation of accumulated depreciation of these assets, as registered in accountancy records on December 31, 1979. The revaluation of land is made in accordance with values included in official tariffs approved by the government. The revaluation of other fixed assets is made in accordance with percentages provided in the same Supreme Decree, as follows: for construction and for fixed and permanent installations, 80 percent; for machinery and equipment and for other fixed assets, 74 percent. The net appreciation resulting from the revaluation (i.e. the increase in the value of assets minus the increase in the amount of accumulated depreciation) is credited to a special account (Excedente de Revaluación). A tax of 5 percent is levied on this net appreciation. The rate of this tax is 2 percent for real estate enterprises, hotels and forestry enterprises and 1 percent for agriculture and cattle raising enterprises.[30]
The revaluation is not taken into account in calculating the income tax and the net worth tax for the 1979 taxable period. However, as from January 1, 1980 depreciation allowances are calculated on values resulting after the revaluation made under Supreme Decree 181-79. Likewise, the net appreciation resulting from the revaluation is included in the taxable amount in calculating the net worth tax for the taxable period 1980.

G. Uruguay

Uruguay has taken adjustment measures regarding both fixed assets and inventories.

In 1955 an optional revaluation of fixed assets was permitted. Later in 1961 this system became compulsory and applicable every two years in accordance with coefficients determined by the Government on the basis of the cost of living index.

As from 1974 the revaluation of fixed assets and their depreciation is updated annually. The law establishes that movables and real estate (of the fixed assets) must be revalued every year on the basis of coefficients to be set up by the Executive considering variations occurring in replacement costs. In practice, the Executive has been utilizing coefficients emerging from the general index of prices (index of inflation or of cost of living). The resulting greater value of such revaluations is not considered taxable income. In spite of this, deductible depreciations may be computed on revalued amounts.

Law No. 13,420 dated December 2, 1965 established that the Executive will fix the revaluation coefficients for fixed assets every year in order to keep up with the variations in the replacement cost. Maximum and minimum coefficients will be fixed. It has also been provided that a fixed asset's revaluation should be taken into consideration for all fiscal purposes.

Coefficients were issued annually for fiscal years beginning in January of 1975 through 1980. The most recent coefficients are discussed below.

Coefficients were issued in February 1979 applicable to fiscal years beginning on or January 1, 1979. Minimum and maximum percentages range between 3,807.8 and 4,653.0 for assets purchased in 1958 or earlier to 1.1 and 1.3 for 1978 purchases. With respect to leased real estate the coefficients are 50 percent of the above rates unless for real estate purchased in 1977 or 1978 for which a single coefficient of 1 is provided. For real estate, however, a value equal to 15 annual rents is taken provided it is not above the value resulting from ordinary coefficients mentioned above nor below the value resulting under the special rules provided for leased real estate.

Coefficients were most recently issued in March 1980 applicable to fiscal years beginning on or after January 1, 1980. Minimum and maximum percentages range from 5,000.2 and 6,111.3 for assets purchased in 1959 or earlier to 1.2 and 1.4 for 1979 purchases.

In 1967 the law gave facilities to the Executive Power to authorize inventory revaluations and to grant full or partial exemptions for the revaluation increment under the condition that this increment be appropriated to a reserve that cannot be distributed, but can only be capitalized. So far these inventory revaluation increments, based on coefficients set by the Government, have been considered as totally exempt profits.

According to the above rules, Decree 175 of April 5, 1978, published in the Official Journal of April 12, 1978, allowed a deduction from gross income in order to calculate net taxable income derived from tax periods beginning during the 1977 calendar year. The deduction represents 15 percent of the fiscal value of inventory (merchandise, raw material and products in process) at the beginning of the tax period.

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30. A special of 0.5 percent is provided for houses belonging to real estate enterprises when the rent of such houses is frozen.

The amount of the deduction cannot exceed 10 percent of the fiscal value of the above goods at the end of the tax period, nor the net taxable income as calculated before taking this deduction and the deduction of income which is exempt under Articles 17 and 18[31] of the Income Tax Law (several items). Any sum which exceeds one of the limits just discussed cannot be carried forward. The deduction must be used to establish a reserve fund for maintaining the working capital. This reserve fund can only be used for capitalization.

Subsequently, Decree No. 748 published in the Official Journal of January 12, 1979 allowed a deduction from gross income in order to calculate net taxable income derived from tax periods beginning during the 1978 calendar year. The deduction represents 15 percent of the fiscal value of inventory at the beginning of the tax period.

The amount of the deduction cannot exceed 10 percent of the fiscal value of the above goods at the end of the tax period, nor the net taxable income as calculated before taking this deduction and the deduction of income which is exempt under Articles 17 and 18 of the Income Tax Law (several items). Any sum which is in excess of one of the limits just discussed cannot be carried forward. The deduction must be used to establish a reserve fund for maintaining the working capital. This reserve fund can only be used for capitalization.

Similarly, Decree 73/980 of February 6, 1980 published in the Official Journal of February 21, 1980 allows a deduction from gross income in order to calculate the net taxable income derived from tax periods beginning during the 1979 calendar year. The deduction represents 25 percent of the fiscal value of stocks (merchandise, raw material and products in process) at the beginning of the tax period.

The amount of deduction cannot exceed 15 percent of the fiscal value of the above goods at the end of the tax period nor the net taxable income as calculated before taking this deduction and the deduction of income which is exempt under Articles 23 and 24 of the Income Tax Law. Any sum which is in excess of one of the limits just discussed cannot be carried forward.

The deduction must be used to establish a reserve fund for maintaining the working capital. This reserve fund can only be used for capitalization.

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31. Articles 23 and 24 in the current draft.

[Continued in next issue]

Recent Developments in China's Tax System

By Y.C. Jao *

The purpose of this article is to report on recent developments — specifically the enactment of two tax laws on joint ventures and personal income — in the People's Republic of China, and to assess their economic significance. In order to appreciate fully the importance of these developments, some discussion of China's existing tax system and the economic background for the introduction of the new taxes is necessary.

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1. Agricultural tax
2. Consolidated industrial and commercial tax
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I. CHINA'S TAX SYSTEM

The last tax reform in China took place in 1958-59, when a number of simplifications and rationalizations of the tax structure were carried out. [1] As a result, the tax system since then has comprised the following major categories:

1. *Agricultural tax* which is collected in kind, from crops of all kinds, but mainly food grains, and assessed on a hypothetical normal yield of each crop. The 1958 regulations fixed the tax rates for each province, ranging from 13 percent to 19 percent. Exemptions and reductions were allowed for newly opened land, and disaster or distressed areas.

2. *Consolidated industrial and commercial tax* which combined and superseded four previous taxes, namely, commodity circulation tax, business tax, goods tax and stamp duty. The tax rates, which are levied on total sales, vary according to the commodities concerned, from 1.5 percent on unbleached cotton cloth to 69 percent on top grade cigarettes. The tax is payable by all enterprises in state, collective, joint state-private, and private ownership, but exemption is given to state banks, insurance companies, agricultural machinery stations, medical and health institutions, and scientific research institutes. It is not applicable, however, to intermediate products made by an industrial enterprise and used for its own production purposes, except in the case of cotton yarn, leather and hides, wines and spirits.

3. *Industrial and commercial income tax*. In the early days of the People's Republic, three types of income tax were provided in the tax regulations: industrial and commercial income tax, income tax on interest from bank deposits, and income tax on salaries and wages. The tax on bank interest income was suspended from January 1, 1959, while the tax on salaries and wages was suspended from June 1950 before it was even enforced. Thus only the first type, industrial and commercial income tax, has been retained. It is payable by non-state enterprises, both private and collective, on their net profits, but not by state-owned enterprises, since the latter are obliged to transmit all their profits to the State. The tax provides for a progressive scale with 21 platforms, the marginal rate varying from 5.75 to 34.5 percent. The scope of the tax has diminished drastically, however, since the socialisation of the private sector in 1956-58.

* Reader in Economics, University of Hong Kong.

1. For a detailed account of China's tax system in the 1950s and 1960s, see A. Donnithorne, *China's Economic System* (London: Allen and Unwin, 1967), Chapter 14; Richard Diao, *The Taxation System of Communist China* (in Chinese) (Hong Kong: Union Institute, 1969), Chapters 3-10.

4. *Customs duties.* The rates on dutiable imported goods range from 5 to 400 percent. There are special regulations governing dutiable personal goods brought in by visitors or sent by mail, which are frequently changed on an ad hoc basis. Export duties were abolished as from 1959.

5. *Salt tax*, like the agricultural tax, was one of the major sources of revenue before the change of regimes in 1949, and has been retained as a distinct category of tax by the Communist government for historical reasons. It is levied in the form of a specific tax per unit weight of salt for edible purposes, the rates varying according to locality. Salt for industrial uses is tax-exempt, but salt used in primary production is taxed at 30 to 40 percent of the rate on edible salt.

6. *Local taxes and surtaxes.* According to the 1958 tax reform regulations, local taxes were to include stamp duty, interest tax, slaughter tax, cattle transactions tax, urban real estate tax, entertainment tax, and licence fees for vehicles and boats. However, as stamp duty was merged into the consolidated industrial and commercial tax, and interest tax was suspended from 1959, only the five latter taxes now remain as taxes to be collected by local authorities. Local surtaxes are a form of extra-budgetary funds which local governmental authorities may add on to the principal national taxes such as industrial and commercial tax, agricultural tax, etc. The surtax rates again vary from one locality to another, but in general they range between 15 and 30 percent of the principal taxes.

Until very recently, the main features of the 1958-59 tax reforms have remained basically unchanged. However, little quantitative information on the relative importance of the various taxes has been available since 1959, as neither the annual budgets nor the final accounts provide for any breakdown of the tax revenue.

II. ECONOMIC BACKGROUND

As is well-known, China is in the midst of a huge modernization programme which hopefully will catapult China into the ranks of the industrially advanced nations by the end of this century. Although the modernization programme was formally announced in 1975, it never got off the ground because of fierce opposition and sabotage from the extremist faction of the Communist Party. It was not until the death of Mao and the downfall of the Maoist "Gang of Four" in 1976 that the modernization drive was given a new lease of life, and an extremely ambitious ten-year (1976-1985) economic plan was unveiled in 1978. The plan in its original form clearly under-estimated the damage to the economy after years of disruptions under the Maoist era, particularly during the disastrous periods of the Great Leap Forward (1958-61) and Cultural Revolution (1966-69). The ten-year plan was therefore drastically scaled down in 1979 and modified into a three-year plan (1979-81) whose objective was to consolidate and readjust the national economy.

This more pragmatic and subdued approach to modernization has been accompanied by a fundamental re-orientation in economic and financial policies. In the area of macroeconomic policy, there has been a shift of emphasis from heavy industry to light industry and agriculture, and within agriculture itself, a shift from food-grain to cash crops and livestock, as well as from mechanization to modern inputs (like seeds and fertilizers), and modern methods of farm management. The need to raise the standard of living of the population, particularly the peasantry, and to provide material incentives in order to stimulate productivity, has been openly acknowledged. A greater role is now being given to the price mechanism for allocating resources and regulating demand and supply, and more powers are also being granted to state-owned enterprises for making autonomous decisions. Recognizing that the importation of foreign equipment and technology must somehow be financed, top priority is being accorded to the exports of light industrial goods, and a number of special export-processing zones have been established, especially in the southern coastal provinces of Guangdong and Fujian. *

In the sphere of financial policy, which is of more direct relevance to our discussion, the change has been no less significant. Prior to 1976, the official attitude towards finance in general, and foreign credit and investment in particular, was highly negative. The Sino-Soviet split in the early 1960s, during which China was forced to repay its debt to the Soviet Union ahead of schedule, had undoubtedly also coloured the Chinese view, as epitomized in the simple but forthright official guideline: "no foreign loans, no foreign investment, no foreign aid". Soon after the repayment of Soviet loans, domestic loans in the form of national bonds floated during 1950-58 were redeemed on schedule. China therefore rather prided itself on the fact that, by 1968, it had become "a socialist country with no domestic or foreign debt".

To achieve the declared goal of modernization of "agriculture, industry, defence, and science and technology" by the end of the century, massive imports of plants and technology from abroad would be necessary. China's new pragmatic leaders soon realized that the country's export capacity was limited, and exclusive reliance on export drive simply could not generate the foreign exchange required. It follows that alternative sources of finance would have to be tapped. From 1977 onwards, the official policy towards foreign credit and investment began to change perceptibly, and, by the end of 1978, it had softened to the extent that all forms of international credit, including government-to-government loans, would be considered. Throughout 1979, China received one loan after another from Western governments and the international banking community, and it is officially reported that at the end of 1980 China's outstanding foreign debt amounted to

* *Editor's note:* Also in the Shekou district; See 34 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 171 (April 1980). A translation into English of the Regulations on Special Economic Zones in Guangdong Province was published in 34 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 516 (November 1980).

about US$3.4 billion. [2] In July 1979, the Joint Venture Investment Law was promulgated, marking another milestone in China's changing financial policy. For the first time since the establishment of the People's Republic in 1949, foreign companies and individuals are allowed to own equity interests inside China. The investment code is couched in general terms, the original intention being that supporting regulations concerning taxation, arbitration, labour management and so on would be worked out later. The new income tax on joint ventures represents therefore a sequel to the joint venture investment code itself.

The new tax on joint ventures was also enacted at a time when reforms of the economic system were being carried out or experimented with in all spheres of economic activity. Basically, the reform programme is characterized by greater decentralization and liberalization of the economic decision-making process. In particular, more autonomy is being given to state-owned economic units, a greater role is being assigned to the market mechanism, and permission or even encouragement is being granted to small-scale private enterprises. In the financial sector, even more thought has been given to the enforcement of financial discipline for state-owned enterprises, so that they will henceforth be responsible for their own profits and losses. Under the present tax system, all profits of such units are surrendered to the State, and, by the same token, all their losses are automatically covered by State subsidies or grants. It is obvious that this system, which does not distinguish between taxes and retained profits, hardly provides any incentives for greater efficiency and productivity which is so badly needed for China's modernization and industrialization. The importance of taxation as a means of ensuring fiscal discipline and accountability for state-owned enterprises was recognized many years ago by Chinese economists. [3] However, this line of thought was denounced during the Cultural Revolution as "revisionist" heresy and it was not until very recently that the idea of fiscal discipline has been revived. We will return to this point later.

The personal income tax has been officially justified on the grounds that scientific, technological and managerial staff engaged in the modernization programme, particularly those of foreign origin, have to be paid internationally competitive salaries and wages, which are currently much higher than those of other domestic workers. [4] There are, however, other more fundamental reasons for implementing this tax, which, as noted earlier, was originally provided for in the tax structure but hitherto has never been enforced. Almost at the same time as the tax was announced, it was also disclosed that China had incurred the largest fiscal deficit in 30 years. As shown in the Table below, the realized deficit in 1979 was Rmb 17.06 billion (about US$11.6 billion). [5] Moreover, the Finance Minister conceded that 1980 and 1981 will be deficit years as well, though the deficits are expected to be smaller (Rmb 8 billion in 1980 and Rmb 5 billion in 1981). While the principal cause was said to be the sharp rise in defence spending, the higher state purchase prices for farm products and wages for urban workers were also contributing factors. Thus the personal income tax — and to a lesser extent the tax on joint ventures - may have been introduced, not only as additional sources of revenue, but also as a device for dampening inflationary pressures, which have already become apparent in China during the past year.

China's 1979 Year-end State Accounts and 1980 Draft Budget
(Rmb million)

Items	1979	1980
Revenue	110,330	106,290
Expenditure	127,390	114,290
Deficit	17,060	8,000
Expenditure (breakdown)		
Capital construction	51,450	37,350
Enterprise renovation	7,200	6,980
Circulating capital and bank credit	5,200	3,720
Agriculture	9,010	7,740
Culture, education, health and science	13,210	14,830
National defence	22,270	19,330
Administration	5,690	5,780
Subsidy to under-developed areas	0	500
General reserve fund	n.a.	1,880
Foreign debt service	n.a.	2,170
Others*	13,360	14,010

n.a. = not available
* Including depreciation funds, retained profits, rural construction and relief funds, and agricultural loans.

Source: Finance Minister Wang Bingqian's Budget Speech to the National People's Congress, August 30, 1980.

III. ANALYSIS OF THE NEW TAXES

The English versions of the full texts of the joint venture tax and personal income tax laws, as released by the official New China News Agency, are reproduced as in Appendices A and B.

The main features of the joint venture tax are:

(a) The tax rate on the net profits of joint ventures with Chinese and foreign capital participation is 30 percent, plus a local surtax on the assessed tax, making the effective tax rate 33 percent. [6] Tax rates on joint ventures exploiting petroleum, natural gas and other resources will be stipulated separately (as yet undisclosed).

(b) An additional 10 percent is levied on that part of net profit remitted abroad.

(c) Exemption from tax is provided in the first profit-making year for ventures with a planned life-time of at least 10 years, together with a 50 percent reduction in tax liabilities in the second and third

2. Finance Minister Wang Bingqian's budget speech to the National People's Congress on August 30, 1980.
3. See Shen Yung, "The substance, characteristics and system of socialist public finance" (in Chinese), *Jingji Yanjiu* (Economic Research), June 1965, pp. 12-20.
4. See the exclusive interview with Liu Zhicheng, Director of the General Tax Bureau of the Ministry of Finance, in *China Economic News*, Sept. 22, 1980, pp. 2-3.
5. Rmb is the abbreviation for *Renminbi*, the Chinese currency.
6. 30% + (30 x 10%) = 33%.

years. For joint ventures in farming, forestry or in remote areas, a 15 to 30 percent reduction in income tax for a further period of 10 years is allowed.
(d) Carry-over of losses is allowed up to five years.
(e) A rebate of 40 percent of tax paid on reinvested profits for a period of not less than five years is allowable on application.

This tax on the net income of joint ventures is said to have been the result of careful studies of tax systems in other countries. The effective rate of 33 percent (which will be higher if profits are remitted abroad), while lower than similar tax rates in most industrialized countries, is considerably higher than those in most developing countries, especially low tax areas. It compares unfavourably, for example, with the 17 percent corporation profit tax in Hong King, which is right on China's doorstep. The tax should also be compared with the prevailing rate of 15 percent in the special economic zones inside China, even though it is recognized that these zones specialize in processing goods for export. [7] Given this discrepancy in tax rates, a foreign investor will presumably only prefer joint ventures if there are other offsetting factors (such as ready accessibility to the domestic market).

In terms of other provisions, the tax law, while reasonably consistent with international practices, is not particularly generous if its purpose is to attract foreign investment. Thus tax holiday is limited to one year, compared to five years in most developing countries. There is also no mention of any possibility for accelerated depreciation. Other greay areas include the lack of established rules on the valuation of inventory, and the absence of standard accounting methods. Recalling that the objective of the joint venture law itself is to attract foreign capital and technology in order to facilitate China's modernization, it may be questioned whether the joint venture tax is really conducive to the realization of the declared aim. There are signs that the Chinese Government is aware of the lukewarm response from foreign investors. Thus a leading Chinese economist, Xue Muqiao, who is widely regarded as one of the architects of current economic reforms, recently told a seminar in Hong Kong that the joint venture tax rate of 33 percent would probably be reviewed and lowered in the light of overseas comments. [8]

One possible reason why the joint venture tax was fixed at a relatively high rate may well be that attracting foreign capital and technology is not the only consideration for the Chinese Government, which may be equally concerned with maximizing tax revenue from whatever sources to cope with the rapid growth of public expenditure and the emergent problem of fiscal deficit. Indeed a sound case can be made for designing tax incentives carefully in the less developed countries (LDCs) so as to avoid revenue loss, wasteful competition, and distributional inequity. [9]

The joint venture tax can also be seen as part of a forthcoming reform of the tax structure. [10] As mentioned earlier, state-owned enterprises are now being given more autonomous powers of management and decision-making. It has been reported that by the end of June 1980, about 6,600 establishments contributing some 45 percent of the gross output value of all state-owned industrial enterprises had been given autonomy in such areas as production, pricing, supply and marketing. [11] In return, these enterprises are expected to be financially independent, i.e. inefficient enterprises which have a record of chronic losses can no longer rely on State subsidies indefinitely. Under the present tax system, state-owned enterprises are obliged to transmit their profits to the State, and, by the same token, all their losses are automatically taken care of by budgetary grants or subsidies. It is true that the State may reimburse part of the profits in the form of budgetary grants to enable the efficient and profitable enterprises to expand, but such reimbursements do not necessarily bear any positive relationship to the performance of the enterprises concerned, and are in any case subject to the cumbersome bureaucratic process. It is easy to see that such a fiscal system hardly provides any incentives for initiative, efficiency and productivity. [12] A financial reform programme is therefore being planned in China whereby the present system of State absorption of profits will be gradually replaced by a system of corporate income tax, so that enterprises can retain their own profits after payment of taxes to the State. Similarly, the present system of budgetary grants for fixed and circulating capital will be phased out by bank loans, so that both the interest rate and the amortization of loans can play their proper roles in allocating scarce capital funds.

The personal income tax covers wages, salaries, compensation for services, royalties, interest, dividends, bonuses, rents, but excludes prizes and awards for scientific, technological or cultural achievements, interest on savings deposits, welfare benefits, pensions, relief payments, insurance indemnities, severance or retirement pay, salaries of foreign diplomats, and other tax-free incomes as stipulated in international conventions to which China is a signatory. The new law does not provide for a system of personal or family al-

7. Thus Article 14 of the "Regulations on Special Economic Zones in Guangdong Province" stipulates that "the rate of income tax levied on the enterprises in the special zones is to be 15 percent". The English version of the full text is published in *Economic Reporter*, August 1980, pp. 9-10, and also in 34 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 516 (November 1980). In the industrial zone of Shekou, which is just opposite Hong Kong, corporate income tax was fixed at 10 percent for contracts negotiated before the promulgation of the regulations for special economic zones.
8. Xue's remarks were made during a discussion session after delivering a paper entitled "China's Economy: Retrospect and Prospect" to the Seminar on China's New Economic Development Trends held in Hong Kong, October 8-9, 1980. Xue is currently Advisor to the State Planning Commission and Director of the Economic Research Institute.
9. For a concise discussion, see R.A. Musgrave and P.B. Musgrave, *Public Finance in Theory and Practice* (New York: McGraw-Hill, 1973), pp. 743-747.
10. This was confirmed to me by Xue Muqiao in our recent discussions in Hong Kong.
11. See Liao Jili, "Structural Reform of Economic Management in China", paper presented to the Seminar on China's New Economic Development Trends, Hong Kong, Oct. 8-9, 1980.
12. The lacklustre financial performance of public enterprises, often attributed to their unrestricted access to the government budget, is not peculiar to China, or even centrally planned economies. For a general discussion, see A. Premchand, "Government and public enterprises — the budget link", *Finance and Development*, December 1979, pp. 27-30.

lowances. However, a monthly exemption of 800 yuan is allowed for wages or salaries, while in the case of compensation for personal services a deduction of 800 yuan is allowed for single payments under 4,000 yuan and a flat deduction rate of 20 percent is allowed for single payments in excess of 4,000 yuan.[13] These deductions do not apply to interest, dividends, bonuses or other kinds of income. Wages and salaries are subject to a sliding scale of progressive rates ranging from 5 to 45 percent, but other forms of income are taxed at a flat rate of 20 percent. The personal income tax is to be paid by eligible individuals residing in China, but whereas residents for less than a year are required to pay tax only on what they earn inside China, residents for a year or more have to pay tax on their world-wide income.

The general reaction to this new tax is that it seems to be aimed primarily at foreigners, since the present average income of most Chinese is so low that the flat monthly allowance of 800 yuan a month (about US$6,530 a year) virtually excludes all the working Chinese population from the tax. Foreign companies are also worried about the stipulation that their employees resident in China for more than a year will have to pay income tax on a global basis. Again the question is being asked whether the new law is conducive to China's modernization if foreign technologists, managers and experts are discourgaged by the potentially heavy burden.

The answer is again that the Chinese Government may have some pressing fiscal considerations in mind. Although it is true that at present the impact of the tax is likely to fall mainly on foreigners, the tax may well have been designed in anticipation of the day when more and more Chinese will be brought within the tax net. Even now, former capitalists are receiving interest and dividends on their financial assets — the payments of which were suspended during the Cultural Revolution — and intellectuals like writers, inventors, artists, etc., who are now given greater freedom in their activities, may also be receiving sizeable royalties and fees. More important, as indicated earlier, China is entering a development phase where the growth of public expenditure is outstripping that of public revenue, and it makes sense to explore all possible sources of revenue to finance the modernization process. Apart from balancing the budget, another thorny problem looms on the horizon. For the first time in 20 years, the Chinese Government has openly admitted that inflation not only exists, but appears to be accelerating. The official inflation rate in 1979 was reported to be 5.8 percent.[14] Even this

13. Yuan is the Chinese currency *unit*, as opposed to Renminbi, which denotes the Chinese *currency* (see note 5 supra).
14. This figure was disclosed by the Deputy Director of the State Planning Commission to the National People's Congress held in Peking, September 1980. At the Congress many provincial and

figure probably under-states the true extent of inflation: as is well-known to students of Communist-ruled economies, there is a great deal of "suppressed inflation" which manifests itself principally in the form of shortages and queues. The newly introduced personal income tax may therefore serve also as a demand-reducing and inflation-dampening device. Significantly, the pre-Cultural Revolution concept of "Comprehensive balance" — roughly the equivalent of "general equilibrium" or absence of excess demand in Western terminology — has been revived in theoretical discussions on economic policy in China. 15

IV. CONCLUDING REMARKS

For the first time in 22 years, the enactment of two important tax laws has ushered in a new era of development for China's tax system. These changes took place at a time when China's economy was going through a difficult period of readjustment after years of disruptions and mismanagement. The newly introduced joint venture tax and personal income tax can be seen as an integral part of a comprehensive economic and financial reform programme which provides the institutional basis for China's modernization drive. One very likely development in the near future is the enactment of a domestic corporate profit tax law which hopefully will enforce fiscal discipline for and increase operational efficiency of all public enterprises. Over the longer run, the rationalization of other taxes (such as the agricultural tax, which is at present assessed on a hypothetical yield and is collected in kind) may also be necessary if China's tax system is to carry out properly its fiscal and developmental functions.

local delegates had complained about sharp rises in the prices of commodities, especially food.

15. See Tuan Yun, "On Certain Problems in Fiscal, Credit and Material Balances" (in Chinese), *Hongqi* (Red Flag), No. 17, 1980. pp. 12-18 and p. 24.

APPENDIX A – INCOME TAX LAW CONCERNING JOINT VENTURES

(Adopted at the third session of the Fifth National People's Congress on September 10, promulgated by an order of Ye Jianying, Chairman of the NPC standing committee, the same day.)

THE INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA CONCERNING JOINT VENTURES WITH CHINESE AND FOREIGN INVESTMENT

Article 1. Income tax shall be levied in accordance with this law on the income derived from production, business and other sources by any joint venture with Chinese and foreign investment (hereinafter called joint venture for short) in the People's Republic of China.

Income tax on the income derived from production, business and other sources by branches within or outside the territory of China of such joint ventures shall be paid by their head office.

Article 2. The taxable income of a joint venture shall be the net income in a tax year after deduction of costs, expenses and losses in that year.

Article 3. The income tax rate on joint ventures shall be 30 percent. In addition, a local surtax of 10 percent of the assessed income tax shall be levied.

The income tax rates on joint ventures exploiting petroleum, natural gas and other resources shall be stipulated separately.

Article 4. In the case of a foreign participant in a joint venture remitting its share of profit from China, an income tax of 10 percent shall be levied on the remitted amount.

Article 5. A newly established joint venture scheduled to operate for a period of 10 years or more may, upon approval by the tax authorities of an application filed by the enterprise, be exempted from income tax in the first profit-making year and allowed a 50 percent reduction in the second and third years.

With the approval of the Ministry of Finance of the People's Republic of China, joint ventures engaged in such low-profit operations as farming and forestry or located in remote, economically underdeveloped outlying areas may be allowed a 15 to 30 percent reduction in income tax for a period of 10 years following the expiration of the term for exemptions and reductions mentioned in the preceding paragraph.

Article 6. A participant in a joint venture which reinvests its share of profit in China for a period of not less than five years may, upon approval by the tax authorities of an application filed by the said participant, obtain a refund of 40 percent of the income tax paid on the reinvested amount. A participant which withdraws its reinvested funds within five years shall pay back the tax amount refunded.

Article 7. Losses incurred by a joint venture in a tax year may be carried over to the next tax year and made up with a matching amount drawn from that year's income. Should the income in the subsequent tax year be insufficient to make up for the said losses, the balance may be made up with further deductions against income year by year over a period not exceeding five years.

Article 8. Income tax on joint ventures shall be levied on an annual basis and paid in quarterly instalments. Such provisional payment shall be made within 15 days after the end of each quarter. The final settlement shall be made within three months of the end of a tax year. Excess payments shall be refunded by the tax authorities or deficiencies made good by the taxpayer.

Article 9. Joint ventures shall file their provisional income tax returns with the local tax authority within the period prescribed for provisional payments. The taxpayer shall file its final annual income tax return together with its final accounts within three months of the end of the tax year.

Article 10. Income tax levied on joint ventures shall be computed in terms of renminbi (Rmb). Income in foreign currency shall be assessed according to the exchange rate quoted by the State General Administration of Exchange Control of the People's Republic of China and shall be taxed in renminbi.

Article 11. When joint ventures go into operation or when they change the nature of their business, change their address, close down, and make changes in or transfer registered capital, such joint ventures shall register with the General Administrative Bureau for Industry and Commerce of the People's Republic of China, and, within 30 days of such registration, present the relevant certificates to the local tax authority for registration.

Article 12. The tax authorities have the right to investigate the financial affairs, account books and tax situation of any joint venture. Such joint venture must make reports according to the facts and provide all relevant information and shall not refuse to cooperate or conceal the facts.

Article 13. A joint venture must pay its tax within the prescribed time limit. In cases of failure to pay within the prescribed time limit, the appropriate tax authority, in addition to setting a new time limit for tax payment, shall surcharge overdue tax for every day in arrears, starting from the first day of default.

Article 14. The tax authorities may, acting at their discretion, impose a penalty on any joint venture which has violated the provisions of Articles 9, 11 and 12 of this Law.
In dealing with any joint venture which has evaded or refused to pay tax, the tax authorities may, in addition to pursuing the tax, impose a penalty of not more than five times the amount of tax unpaid or not paid, according to the seriousness of the offence. Cases of gross violation shall be handled by the local People's Courts according to Law.

Article 15. In cases of disputes with tax authorities about tax payment, joint ventures must pay tax according to the relevant regulations first before applying to higher tax authorities for reconsideration. If they do not accept the decisions made after such reconsideration, they can bring the matter before the local People's Courts.

Article 16. Income tax paid by a joint venture or its branch in other countries may be credited against the assessed income tax of the head office as foreign tax credit.
Where agreements on avoidance of double taxation have been concluded between the government of the People's Republic of China and the government of another country, income tax credits shall be handled in accordance with the provisions of the related agreements.

Article 17. Detailed rules and regulations for the implementation of this Law shall be formulated by the Ministry of Finance of the People's Republic of China.

Article 18. This Law shall come into force from the date of promulgation.

APPENDIX B – INDIVIDUAL INCOME TAX LAW

(Adopted at the third session of the Fifth National People's Congress on September 10, promulgated by an order of Ye Jianying, Chairman of the NPC standing committee, the same day.)

INDIVIDUAL INCOME TAX LAW OF THE PEOPLE'S REPUBLIC OF CHINA

Article 1. An individual income tax shall be levied in accordance with the provisions of this law on the incomes gained within or outside China by any individual residing for one year or more in the People's Republic of China.
For individuals not residing in the People's Republic of China or individuals residing in China less than one year, individual income tax shall be levied only on that income gained within China.

Article 2. Individual income tax shall be levied on the following categories of income:
(1) Wages and salaries;
(2) Compensation for personal services;
(3) Royalties;
(4) Interest, dividends and bonuses;
(5) Income from lease of property; and
(6) Other kinds of income specified as taxable by the Ministry of Finance of the People's Republic of China.

Article 3. Individual income tax rates:
(1) Income from wages and salaries in excess of specific amounts shall be taxed at progressive rates ranging from 5 to 45 percent (see appended tax rate table).
(2) Income from compensation for personal services, royalties, interest, dividends, bonuses and lease of property, and other kinds of income shall be taxed at a flat rate of 20 percent.

Article 4. The following categories of income shall be exempted from individual income tax:
(1) Prizes and awards for scientific, technological or cultural achievements;
(2) Interest on savings deposits in the state banks and credit co-operatives of the People's Republic of China;
(3) Welfare benefits, survivors' pensions and relief payments;
(4) Insurance indemnities;
(5) Military severance pay, decommision or demobilization pay for cadres and fighters of the armed forces;
(6) Severance pay or retirement pay for cadres, staff members and workers;
(7) Salaries of diplomatic officials of foreign embassies and consulates in China;
(8) Tax-free incomes as stipulated in international conventions to which China is a party or as stipulated in agreements China has signed;
(9) Incomes approved as tax-free by the Ministry of Finance of the People's Republic of China.

Article 10. A commission of 1 percent of the tax amount withheld shall be paid to the withholding agents.

Article 11. A withholding agent or a taxpayer filing personal returns must pay the tax due within the prescribed time limits.
In cases of failure to pay within the prescribed time limits, the appropriate tax authority, in addition to setting a new time limit for tax payments, shall surcharge overdue payment at one half of 1 percent of the overdue tax for every day in arrears, starting from the first day of default.

Article 12. The tax authorities may, acting at their discretion, impose a penalty on a withholding agent or on a taxpayer filing personal returns who has violated the provisions of Article 9 of this law.
In dealing with those who have concealed income or evaded or refused to pay tax, the tax authorities may, in addition to pursuing the tax, impose a penalty not more than five times the amount of tax underpaid or not paid, according to the seriousness of the offence. Cases of gross violation shall be handled by the local people's courts according to the law.

Article 13. In case of disputes with the tax authorities over the payment of taxes, the withholding agent or taxpayer filing personal returns must pay taxes according to the relevant regulations first before applying to higher tax authorities for reconsideration. If they do not accept the decisions made after such reconsideration, they can bring the matter before the local people's courts.

Article 14. Detailed rules and regulations for the implementation of this law shall be formulated by the Ministry of Finance of the People's Republic of China.

Article 15. This law shall come into force from the date of promulgation.

Article 5. The amount of taxable income shall be computed as follows:
(1) For income from wages or salaries, a monthly deduction of 800 yuan shall be allowed; that part in excess of 800 yuan shall be taxed;
(2) For income from compensation for personal services, royalties or lease of property, a deduction of 800 yuan shall be allowed for expenses if the amount in a single payment is less than 4,000 yuan; for single payments in excess of 4,000 yuan a deduction of 20 percent shall be allowed. The balance remaining after deduction shall be taxed;
(3) Interest, dividends, bonuses or other kinds of income shall be taxed on the full amount received in each payment.

Article 6. For individual income tax, the income earner shall be the party responsible for paying the tax and the paying unit shall be the withholding agent. Taxpayers not covered by withholding are required personally to file declarations of their income and pay tax themselves.

Article 7. Taxes withheld each month by a withholding agent and those to be paid each month by taxpayers filing personal returns shall be turned in to the State Treasury and the tax return submitted to the tax authority within the first seven days of the following month.
Any taxpayer who earns income outside China shall pay the tax due to the State Treasury and submit a tax return to the tax authority within 30 days of the end of each year.

Article 8. All incomes shall be computed in terms of renminbi (Rmb). Income in foreign currency shall be assessed according to the exchange rate quoted by the State General Administration of Foreign Exchange Control of the People's Republic of China, and shall be taxed in renminbi.

Article 9. The tax authorities have the right to conduct investigations concerning the payment of tax. Withholding agents and taxpayers filing personal returns must report according to the facts and provide all relevant information and shall not refuse or conceal the facts.

Individual Income Tax Rates
(applicable to wages and salaries)

Grade	Range of income	Tax rate (%)
1	Monthly income of 800 yuan and less	exempt
2	That part of monthly income from 801 yuan to 1,500 yuan	5
3	That part of monthly income from 1,501 yuan to 3,000 yuan	10
4	That part of monthly income from 3,001 yuan to 6,000 yuan	20
5	That part of monthly income from 6,001 yuan to 9,000 yuan	30
6	That part of monthly income from 9,001 to 12,000 yuan	40
7	That part of monthly income above 12,000 yuan	45

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35th Annual Congress of I.F.A.: I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

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KENYA'S 1980 BUDGET

by Lawrence A. Rupley and Brendan P. Finucane *

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The 1980 Kenya Government Budget as presented in the Budget Speech by Vice-President and Minister for Finance Kibaki on June 19, 1980, is directed toward three major concerns:
first is the need for revenue to finance government activities;
second is the balance of payments constraint on the Kenyan economy;
and *third* is the desire to modify the industrial structure in the direction of increased export production and greater efficiency. This article discusses these three concerns.

I. THE NEED FOR GOVERNMENT REVENUE

Revenue is needed to finance any government's expenditure, and that expenditure is necessary for most government programs. In less developed countries (LDCs) in particular, revenue is often as vital a consideration as are the economic effects of taxation such as the effects on consumption, saving, and investment; or the equity implications of the tax system; or the effects of the tax system on economic stabilization and growth. There are frequently conflicts between these various considerations or goals that governments attempt to pursue.

Table 1 contains Kenya central government revenue data for several recent years. [1] The results of the government's decision several years ago to rely heavily on indirect rather than direct taxes is apparent in that table. The amount of revenue derived from import duties, the manufacturers' sales tax, and excise duties in 1979-80 amounted to 59 percent of recurrent revenue; that proportion is up from 50 percent in 1976-77. Over the same span, revenue from personal and company income taxation and export duties decreased from 36 percent to 29 percent of recurrent revenue collected. The basic sales tax rate is 15 percent — raised from 10 percent one year ago — but a number of intermediate manufactured goods are exempt and a number of items are taxed at rates other than 15 percent, so that the sales tax rather resembles a set of excises. The excise system itself covers only tobacco products, alcoholic beverages, and sugar. The rates of import duty range from zero to 200 percent.

Table 2 contains data for recurrent expenditure, while Table 3 shows total development (capital) expenditure. The major items of recurrent expenditure are education and defense, accounting for a combined total of nearly 40 percent of such expenditure in 1979-80. The major capital expenditure items are works, water development, power and communications, and agriculture. It is notable that the 1980-81 estimated capital expenditure total is scarcely higher than in the previous year, and represents a decline in real terms. Total budgeted recurrent expenditure for 1980-81 is increased by 10 percent over the previous year. This may reflect a deliberate decision to prevent an expenditure decline in real terms, but may also reflect the fact that it is harder to cut back on recurrent expenditure than on capital projects. The incomplete data for 1980-81 in Tables 1, 2 and 3 is a result of the government reorganization of Ministries announced shortly after the Budget, and the consequent re-printing of the Budget *Estimates*. [2]

The use of indirect taxation is intended to bring about a number of effects; the effects actually caused may or may not always be the intended ones. Let us examine six intentions and/or effects of indirect taxes.

(1) Selective indirect taxation such as excise or import duties rather than a *general* sales tax can bring about a change in the *composition* of items consumed. This is the intention of the 1980 Budget's increases in import duty on furniture (from 50 to 100 percent), shampoos (from 50 to 75 percent), glassware (from 30 or 40 to 50 percent), and large petrol-powered cars (up by one-third to one-half the original rate of duty). [3]

(2) A *general* indirect tax discourages all consumption in favor of saving, or all imports in favor of domestically-produced items. In the case of the 1980 Budget's "10 percent add-on" import duty, the effect may be even

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1. KSh20 = K£ 1. On August 28, 1980, KSh7.35 = US$ 1 and KSh17.62 = £ 1 sterling.

2. The major changes include the division of the Ministry of Agriculture into 1) Agriculture and 2) Livestock Development; the division of the Ministry of Education into 1) Higher Education and 2) Basic Education; and the division of the Ministry of Commerce and Industry into 1) Commerce and 2) Industry. A new Ministry of Energy was created, as was a Ministry of Home and Constitutional Affairs, while the Finance section of the Ministry of Economic Development and Finance was placed within the Office of the Vice-President.

3. See Table 5. Some other import duty increases entailed some element of import protection.

TABLE 1
Kenya government recurrent revenue
(K£ million)

	1965-66 Actual	1976-77 Actual	1977-78 Actual	1978-79 Revised Estimate	1979-80 Estimate	1980-81 Estimate
Total recurrent revenue	60.4	295.3	449.3	472.5	520.7	674.0[a]
Some details of total above:						
Import duty	17.2	52.9	104.2	100.9	100.0	n.a.
Excise duty	7.5[b]	28.2	38.5	50.7	60.0	n.a.
Sales tax on local manufactures	d	30.5	46.0	55.0	80.0	n.a.
Sales tax on imported manufactures	d	35.0	46.8	54.9	65.0	n.a.
PAYE income tax	15.9	30.1	35.8	38.0	42.0	n.a.
Other income tax[c]	15.9	77.4	106.6	112.0	106.0	n.a.
Export duty	0.7	d	8.3	4.0	3.0	n.a.
Other taxes	0.7	5.6	6.8	6.9	8.2	n.a.
of which: Hotel accommodation tax	d	1.4	1.8	1.7	2.5	n.a.
Stamp duty	0.7	2.5	3.1	3.3	3.3	n.a.
Traffic revenue	0.8	3.8	4.2	4.8	7.2	n.a.
Investment revenue	n.a.	7.5	14.7	16.5	17.5	n.a.
Loan interest receipts	n.a.	6.2	9.4	9.4	8.8	n.a.
Tourist and wildlife revenue	n.a.	1.8	0.8	1.1	1.2	n.a.

Source: *Statistical Abstract 1967; Estimates of Revenue* 1978-79 and 1979-80; 1980 Budget Speech.
a) Gross revenue, including local Appropriations-in-Aid.
b) Includes petrol and diesel tax.
c) Includes individual and company income tax.
d) Item does not appear in source document.
n.a. indicates not available.

TABLE 2
Kenya government recurrent expenditure
(K£ million)

	1965-66 Actual	1978-79 Estimate	1979-80 Estimate	1980-81 Estimate
Total recurrent expenditure	63.3	485.9	502.1	551.0
Some detailed heads of above:				
Ministry of Education	5.9	97.8	113.2	n.a.
Ministry of Defense	3.9	99.2	74.9	n.a.
Office of the President	n.a.	35.2	36.1	n.a.
Ministry of Health	3.6	30.9	33.1	n.a.
Ministry of Agriculture	6.5	21.7	23.6	n.a.

Source: *Estimates of recurrent expenditure, 1979-80,* 1980 Budget Speech, *Statistical Abstract 1967.*
n.a. indicates data not available. For 1980-81 the unavailability is the result of the reorganization of Ministries within the Kenya Government and the consequent reprinting of the *Estimates.*

TABLE 3
Kenya government development expenditure
(K£ million)

	1965-66 Actual	1978-79 Gross revised estimate	1979-80 Gross estimate	1980-81 Gross estimate
Total Development Expenditure[a]	14.3	268.2	243.0	244.0

Source: As for Table 2.
a Major items of development expenditure were Ministries of Works, Water Development, Power and Communication, Agriculture.

larger than expected. This "10 percent add-on" is basically a device to raise the effective rate of *all* import duties. However, instead of being a 10 percent surcharge on all existing rates of duty (i.e. 10 percent of the tax liability), it is such a surcharge only where the base import duty is levied on a specific (per unit of quantity) basis. In the more common case where the import duty is levied as a percentage of the value of the import — ad valorem — the new measure is stated as a 10 percent *increase in the rate of tax*. In the latter case, the "10 percent add-on" has the effect of raising the total rate of import duty by the largest percentage where the initial base rate was the lowest. For example, an initial rate of 100 percent is raised by only 10 percent, but an initial rate of 10 percent is doubled. Such a system will presumably raise more revenue and cause a larger decrease in imports than would a lower rate of duty. However, it is not clear whether such effects are intentional inasmuch as many of the items taxed at the lower initial rates are capital goods and manufacturing and construction inputs such as electric motors, boilers and machinery, tools and implements, and metal rods/shapes used in construction and fabrication. This seems to be inconsistent with the desired expansion of manufactured exports mentioned elsewhere in the Budget.

(3) In addition to any other factors, heavy reliance on indirect taxation may cause some increase in the price level when such taxes are imposed or raised. Such an inflationary effect occurs when the prices of goods are driven up by the tax wedge. If prices are rigid downward, the accompanying fall in aggregate demand as the tax is imposed may not lead to decreases in pre-tax prices of goods. If, of course, the government spends the revenue immediately, aggregate demand may not even fall. The Budget Speech estimates that an addi-

tional K£ 74 million of revenue will result from increased rates of import duty, K£ 3.65 million from higher excises on tobacco, K£ 22 million from additional sales tax, and K£ 4 million from the telecommunications excise tax. Thus, there is a significant increase in the total amount of indirect consumption taxes as a result of the 1980 Budget.[4] An increase in the price level as a result of the use of indirect taxation illustrates the conflict that can arise between a government's goals of raising revenue, encouraging economic expansion, and stabilizing the price level.

(4) A major weakness of indirect consumption taxation is that the incidence of such taxation — the effect on income distribution in the society — is quite uncertain and is difficult to ascertain accurately. Such uncertainty makes it difficult to predict the effects as to the equity of the tax system and the economic adjustments caused by the taxes. Insofar as equity is concerned, it is difficult to relate such indirect taxes to the individual's ability to pay tax since the incidence depends on the taxpayer's consumption pattern and the extent of forward shifting depends upon the elasticity of supply and demand for the taxed goods. Although it might once have been so, it is no longer true that all manufactured goods or even all imports are luxury goods (e.g. Hong Kong ready-made clothing). Therefore, import duties do not automatically tax luxury goods, and the incidence is not automatically borne by high-income consumers. The economic effects of indirect taxes also depend on the pattern of incidence, and prediction is very difficult where that incidence is unknown. As an example, is it high or low-income individuals in Kenya who will pay the newly-introduced 15 percent telecommunications excise tax? In the case of residential telephones, the tax will generally be paid by high-income consumers who have telephones in their homes. However, this tax is also levied on business telephones; it will presumably be passed on as one of the costs of doing business by firms to their customers. The buyers of the output of firms will in many cases be both high and low-income persons. Therefore, the effects on the distribution of income cannot be determined in advance.

(5) In a country like Kenya there is an ever-expanding demand for public-sector goods and services such as schools, medical care, roads, water supplies, etc. In light of the relatively limited range of taxes available — and the absence of "painless" revenues from oil or copper or diamonds — it is necessary for low-income persons to pay some taxes as well as high-income persons.[5] Given the Kenyan government's reliance on indirect taxes to raise revenue, the 1980 Budget increases in the rates of indirect taxation can be expected to cause some increases in the prices of goods for low-income persons, particularly since there is relatively sparing use of direct taxation on this group. Of course, to fully assess the effect on low-income households and the equity implications, one should take into account the incidence of both taxes and government expenditure. In Kenya as in many other places, such studies are in short supply.

(6) There is a need to secure a higher degree of taxpaying compliance among higher-income self-employed individuals in Kenya.[6] A significant advantage of indirect consumption taxation, however, is that even if some persons evade the payment of income tax, they still pay *some* taxes. To the extent that such persons are ignorant of the amount of indirect taxes that they pay, they may not even resent being taxpayers. The administration of such taxes is accordingly relatively easy. More generally, this point provides a strong argument for a tax system that contains numerous types of taxes: on income, consumption, wealth. It will then be less likely that evasion of one type of tax means that an individual pays no tax at all.

II. BALANCE OF PAYMENTS CONSIDERATIONS

The second major concern of the 1980 Budget Speech is the balance of payments constraint on the Kenyan economy. Announcement was made early in 1980 of the relaxation of the advance import deposit scheme on most items that had been introduced a year earlier. However, the 1980 Budget contains a number of restrictive measures. A major restrictive element is the "10 percent add-on" increase in import duties. This is, in effect, a one-sided devaluation in that it serves to make all dutiable imports more expensive. Inasmuch as this measure does not reduce the prices of Kenya's exports in foreign markets, it cannot be expected to stimulate exports. It may, in fact, dampen export incentives by raising the cost of imported inputs.[7]

Central to any discussion of Kenyan balance of payments is the extremely large value of petroleum imports in recent years. The recent Sessional Paper[8] (No. 4) is quite candid on this matter, and the numbers are indeed cause for concern. Whereas gross petroleum imports in 1973 amounted to 10 percent of total foreign exchange earnings, such imports amounted to 24 percent of such earnings in 1979. Stated alternatively, gross petroleum imports amounted to 60 percent of total coffee exports in 1973 but had risen to 120 percent in 1979. Although more than half of Kenya's petroleum imports are re-exported, net imports for 1979 amounted to 11 percent of total foreign exchange earnings and 57 percent of

4. These increases amount to about 5 percent of GDP.
5. This should not be interpreted as an argument that *only* low-income persons should pay tax. In most countries there is acceptance of the notion that one should pay taxes in accordance with one's ability to pay, and that high-income persons should pay a greater proportion of income in tax than should low-income persons. Tax systems do not always bring about this result, but the notion is widely accepted in 1980.
6. The need for higher effective levels of direct taxation on the self-employed is suggested by G.K. Ikiara in "A Look At Kenya's Budget Proposals", *The Weekly Review* (Nairobi), June 27, 1980, pp. 27-29.
If direct income taxation of farmers is introduced, care should be taken that marketing board pricing policies are changed so that farmers do not continue to bear significantly heavier tax burdens than do urban dwellers.
7. Another sort of restriction is the ban on the re-export from Kenya of pharmaceuticals and motor spare parts.
8. Kenya, Sessional Paper No. 4 of 1980 on Economic Prospects and Policies, Nairobi: Government Printer, May, 1980.

TABLE 4

Petroleum motor fuel prices and taxation — Kenya

	Retail price prior to June 20, 1980 (Sh/litre)	Sales tax prior to June 20, 1980 (Sh/litre)	Sales tax June 20, 1980 (Sh/litre)	Retail price June 20, 1980 (Sh/litre)	Import Duty (Sh/litre)	At June 20, 1980 Sales tax as percent of retail price (%)	Import duty as percent of rerail price (%)
Premium petrol	4.82	1.05	1.547	5.35	.60	28.92	11.21
Regular petrol	4.30	.905	1.272	4.70	.60	27.06	12.77
Diesel fuel	3.05	.20	.347	3.13	.40	11.09	12.78

Source: Kenya, The Finance Bills 1979 and 1980, The Customs and Excise Bill 1978.

total coffee export earnings.[9] There is good reason for official concern with respect to the volume of petroleum imports; the proportion of *net* export earnings taken up by *net* petroleum imports now exceeds the proportion for gross petroleum imports only six years ago. In addition, the proportion of petroleum imports retained in Kenya has increased from less than one-third in 1976 to nearly half (47.4 percent) in 1979. Petroleum consumption has increased at an annual average rate of 5 percent since 1974.[10] Given such trends, the situation is likely to become more serious rather than less so.

The 1980 Budget provides a strong push toward conversion to diesel vehicles via its continued taxation and pricing policy for diesel fuel versus petrol. As shown in Table 4, the price of premium petrol was raised from 4.82 shillings per litre to 5.35, regular petrol from 4.30 to 4.70, and diesel fuel was raised from 3.05 to only 3.13. Nearly all the price increase was accounted for by the increased sales tax on motor fuels. After the Budget, sales and import duties made up nearly two-fifths of the price of petrol, but not quite one-quarter of the lower price of diesel fuel. The other major element of the Budget that intends to encourage dieselization is the higher rate of import duty introduced on petrol-powered buses and private cars of engine size greater than 1750 cc. Whereas the rates on diesel-powered vehicles remain at 75, 100 and 150 percent on progressively larger engine sizes, the rates on petrol-powered vehicles are increased to 100, 150, and 200 percent, respectively.[11]

Although the shift to diesel fuel can only be regarded as an interim measure, it makes very good sense due to the fact that the mileage per litre of diesel fuel is some 40 percent greater than for petrol. The combination of better mileage and lower price per litre means that the operating cost per kilometre of a diesel-fueled vehicle in Kenya is only half that of a comparable petrol-fueled one.[12]

In the longer run, attention must be given in the strongest terms to the development of alternative non-petroleum energy sources. The prospects for such alternatives are considerably better than average in Kenya, with possibilities for hydropower, geothermal energy, solar and wind energy. These are not always perfect substitutes for petroleum fuels for transport use, but concerted attention needs to be directed to such alternatives wherever they can be employed. In that regard, the budget is silent.

The importance of petroleum imports and measures to curb them via higher prices will have a number of effects. Transport costs of goods can be expected to rise somewhat and ultimately passed on to consumers. Diesel-powered railway transport should receive a boost in comparison to road transport. There is pressure in the Budget toward greater dieselization of passenger transport (large buses and large cars) and toward smaller, more fuel-efficient cars. Expanded public transport may be necessary and wise to help economize on petroleum use. The mostly lower-income *matatu*[13] passengers were affected within hours after the Budget Speech by increased fares attributed to the increased cost of petrol; however, small trucks and small buses which are converted into *matatu* vehicles are not affected by the higher differential rates of import duty for petrol-fueled vehicles. Therefore, fares should rise by less than they otherwise would. The operating costs of mechanized agricultural equipment will be increased by the higher prices of refined petroleum products. Such increases raise questions with regard to the wisdom of increased mechanization, particularly since the foreign-exchange cost of petroleum-based fertilizers is likely to continue to rise.

9. Kenya, *Economic Survey 1980*, Nairobi: Central Bureau of Statistics, 1980.
10. Kenya, Sessional Paper No. 4 of 1980.
11. Plus the 10 percent add-on import duty. The rate of sales tax remains at 25 percent.
12. The price per litre of regular petrol (Sh. 4.70) divided by the price of diesel fuel (Sh. 3.13) means that one can purchase 1.5 times as much diesel fuel per shilling. When the price differential (1.5) is multiplied by the fuel efficiency differential in favor of diesel (1.4), by product is 2.10. Thus, the expenditure differential per kilometre (2.10) means that one can drive 110 percent further per shilling by using diesel fuel rather than petrol.
13. *Matatus* are vehicles for the transport of passengers. They result from the modification of small pick-up trucks or mini-buses for intensive passenger transport, and are the Kenyan equivalent of the mammy wagon. Fourteen passengers is not an exceptionally crowded load.

III. STRUCTURAL CONSIDERATION

A. Background

The policy measures contained in the new budget constitute a potentially very significant step toward the implementation of a fundamentally changed, and long awaited, development strategy within Kenya. If the Budget becomes fully operational and, more importantly, if the proposed subsequent actions are taken, then the Kenyan economy will experience an increasing degree of openness to the competitive forces of international markets. The rationale for a gradual reduction of the protectionist devices which have thus far largely sheltered local producers has been discussed for several years. Before examining several of the budget measures in detail, a brief review of the movement toward the adoption of this new strategy may be of interest.

More than two years ago, Mr. Kibaki delivered to a National Leaders Conference a major policy speech which focussed on the dramatically altered economic realities facing Kenya in the second half of the 1970s.[14] In essence, Kenya was portrayed as having achieved some success via an import-substitution (IS) approach to development, but that export promotion (EP) and greater efficiency in the utilization of domestic inputs by local producers would be the key to sustained future growth. He stressed that Kenya was confronted with the need to switch from the earlier set of "soft" options to a different array of harsher options.

The "hard options" theme re-appeared in the current Development Plan as a major issue. Ironically, it is the good performance of the IS measures in the past which has restricted their potential future efficacy. By protecting and subsidizing the local production of consumer goods, many new industries have been established in Kenya, and this has helped provide employment and training. However, whereas final consumption goods were 29.2 percent of total imports in 1964, by 1977 they constituted only 14 percent of total imports. Clearly, further compression of imported consumer goods would be achievable only at a more modest pace. Hence, the inevitable waning of the IS thrust.

What perhaps cannot be overemphasized is the crucial nature of Kenya's switch to her new development orientation and the inherent transitional difficulties. Past growth has been obtained within a protected environment and has nurtured industries which are accustomed and adapted to such a "hot house" arrangement. The transitional dilemma is the question of how to remove the protective shield without causing undue economic harm and disruption in the process.

In May 1980, the government announced its intention to revise industrial policy in order to encourage exports. Past protection levels were judged to have resulted both in inflated prices for locally manufactured goods for Kenyan consumers and in the inability of such goods to be price-competitive in world markets. Explicit reference was made by the government to the slack management encouraged by past policies. Several policy changes — most of which were subsequently included in the June 1980 Budget Speech — were discussed and were scheduled to be implemented "as soon as practicable".[15] Some observers questioned the likelihood of quick action on these items. However, it appears that the sceptics may be proved wrong as numerous changes became effective "with immediate effect" on Budget Day.[16]

B. Major policy changes

The most important provisions of the Budget vis-à-vis Kenya's economic structure are:

(1) replacement of quantitative trade restrictions by tariffs;
(2) strengthening of the export promotion scheme; and
(3) continuation of the import licensing system and foreign exchange quotas.

Clearly, not all of these changes will increase the degree of openness and competitiveness of local production; some act to preserve the previous protection levels while changing the instruments of protection.

Local manufacturers are now restricted from obtaining either total bans on competing imported items or "Letters of No Objection". This is actually the second step toward the withdrawal of such protectionist devices. In May 1980, the government prohibited the issuance of any *new* "Letters". These letters or certificates permitted the importation of goods only after a statement by the relevant local producer that he could not supply the same or a comparable item. However, the government is sensitive to the fact that the end of its protective trade regime should not be introduced too abruptly; therefore the quantitative restrictions were supplanted by tariffs immediately and anti-dumping devices are to be bolstered shortly.

The 1980 customs duty changes affect a long detailed list of items and their respective rates which are given

TABLE 5

Amendments of rates of import duty

Commodity	Rate of duty prior to June 20, 1980 (percent)	Rate of duty June 20, 1980 (percent)
Shampoos	50	75
Wood and wooden products	30	50
Furniture	50	100
Paper and paperboard	20	50
Yarns	30	50
Synthetic fibres	30	100
Porcelain and glassware	30–40	50

Source: Kenya, The Finance Bill, 1980, Second Schedule, and Budget Speech.

14. The Conference was held in January, 1978, in Nairobi. *Kenya Newsletter*, July, 1978.
15. Kenya, Sessional Paper No. 4 of 1980.
16. In retrospect one may speculate that the government used Sessional Paper No. 4 as a trial balloon, i.e. as a means of testing public opinion on planned policy alternatives.

in Schedule II of the 1980 Finance Bill. Some of the more significant revisions are listed in Table 5. The Budget Speech mentioned several factors that influenced the determination of these new rates. In some cases, e.g. artificial yarns and synthetic fibers, Kenyan producers are capable of supplying these goods in sufficient quantity and acceptable quality. For some other goods, e.g. imported furniture and glassware, Mr. Kibaki referred to the persistent inclination to import these items by people with "misdirected values". Such people should, in his view, pay higher prices in order to continue their purchasing habits.

Past efforts to stimulate exports of non-traditional items, i.e. goods other than coffee, tea and other agricultural products, have not proved to be potent enough. Under the Local Manufacturers Export Compensation Act of 1975, exporters could claim reimbursement of 10 percent of the f.o.b. value of the goods exported. This rate of compensation has been raised in the 1980 Budget to 20 percent, subject to the requirement of 30 percent local input content in the product. According to Mr. Kibaki, a major drawback of the earlier compensation system was the administrative arrangements whereby the Customs Department had to approve all applications. The Central Bank of Kenya will now pay exporters their 20 percent rebate as soon as the exporter's bank acknowledges receipt of the foreign exchange as stated in the export documents. This re-organization should speed the compensation process and, together with the higher reimbursement rate, induce greater efforts and results on the part of Kenyan exporters.

Last, the Budget provides for the continued use by the government of import licenses and foreign exchange quotas as means of regulating both the structure and level of imports. While these appear to contradict the pronounced intentions for openness, their immediate removal would probably cause an import surge and result in severe balance of payments problems.

C. Structural impacts

The immediate product of these Budget Speech provisions has been criticism from the Kenyan business community on two issues. First, Kenyan manufacturers have noted that the export incentive measures are offset by the new higher duties on imported inputs and the sales tax on manufactured inputs regardless of origin. Previously, Kenyan manufacturers had been permitted a refund of the 15 percent sales tax paid on materials used in the manufacturing process. The repeal of this refund automatically increases producers' material costs by 15 percent. Coupled with the 10 percent additional duty applicable to all dutiable imports, these measures could easily negate the anticipated export incentive of the 20 percent export compensation rate.[17] Second, some Kenyan importers have been told that their import license applications cannot be processed until "the appropriate mechanism has been worked out and made public".[18] This indicates that the government is experiencing some difficulty in implementing the new measures. In both cases, productive activity stands to suffer due to the anomalies and the uncertainty. Discussions are taking place between the government and leaders of the business community in an effort to resolve some of the differences.

However, it is inevitable that the switch in protection instruments and the eventual reduction in levels of protection — and the openness to competition that results — will cause casualties among some firms in Kenya, particularly those with slack management. The current measures are only an initial movement toward a reduction of the degree of protection. Under the new tariff system the government can, and has stated that it intends to, proceed to "standardize and reduce the levels of protection".[19] These new instruments of the 1980 Budget have been purposely designed as intermediate measures "in a way that minimizes disruption and dislocation for existing firms".[20] What remains to be seen is how swiftly the government will be able to progress toward greater openness and efficiency.

IV. CONCUSION

The 1980 Kenya government budget introduces a number of measures intended to bring about major shifts in the structure of the Kenyan economy. However, a number of unanticipated side effects have emerged as a result of some of the changes in taxation and in the export compensation scheme. This is not surprising in the course of the attempt to bring about such a re-structuring of the economy, particularly when, simultaneously, there is the need to deal with severe constraints on the balance of payments and government revenue.

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17. *Sunday Nation*, August 17, 1980, and *The Standard*, July 30, 1980.
18. *The Standard*, August 14, 1980.
19. Kenya, Sessional Paper No. 4 of 1980.
20. Ibid.

KENYA: BUDGET 1980-81

Extract from the Budget Speech pronounced on June 19, 1980 by the Hon. Mwai Kibaki, Vice-President and Minister for Finance.

A detailed discussion of the Kenyan tax system appears in the Bureau's publications:
AFRICAN TAX SYSTEMS/SYSTEMES FISCAUX AFRICAINS

NEW TAXATION PROPOSALS

In review of the expected developments in the economy next year, I have warned of the great difficulties that we shall experience in financing Government expenditure and the bulk of this expenditure will have to be financed from our own resources. I have also drawn the attention of hon. Members to the long-term structural reforms which will be necessary to put our economy on the right path for future growth.

Mr. Speaker, the remaining part of my Speech will therefore be concerned with how I propose to close the gap of K£124 million in Government spending, while at the same time pursuing the policy initiatives I have already mentioned. The Finance Bill published today also contains amendments aimed at both streamlining several existing fiscal measures and removing existing anomalies, in addition to increasing the rate of collection of revenue. As usual, I would ask that the rest of my Speech shall be regarded as being Notice of a Motion to be moved before the Committee of Ways and Means.

CUSTOMS AND EXCISE

Many of the changes proposed today deal with Customs and Excise. Before drawing the attention of the House to the most important of these changes, let me first deal with a few technical and procedural matters. The Finance Bill includes amendments to the Customs and Excise Act intended to rectify previous typographical errors and omissions. It also includes amendments to the Customs Tariff arising out of the decisions of the International Customs Co-operation Council primarily intended to streamline and harmonize tariff numbers and descriptions.

Mr. Speaker, the Customs Act provides that for a number of offences, only a sentence of imprisonment may be imposed without the option of a fine. The severity of this provision is intended to deter offenders from taking calculated financial risks on the basis of inadequate fines. However, these provisions make it difficult for the Commissioner of Customs to deal with petty offenders, particularly in dealing with technical infringements where the courts feel that it would be too harsh to impose a custodial sentence. It is therefore proposed to amend the relevant sections in order to provide alternative but stiff and prohibitive fines. The fines range between fifty thousand and one hundred thousand shillings and would, of course, be in addition to any other penalties including forfeiture of the goods in question.

The Act is further amended to provide more clear definition of items which may qualify for importation free of duty as personal effects on "bona fide" change of residence, in particular to exclude luxury items and equipment which may be used for trade.

As hon. Members are aware, Kenya was one of the first countries to prohibit trade with Rhodesia when the latter declared Unilateral Independence from Britain in 1965. With the attainment of independence by Zimbabwe in April this year, it is now necessary to amend the Act in order to remove these prohibitions and restrictions.

Currently, diplomats accredited to Kenya and certain organizations are allowed to purchase manufactured goods free of duty from any supplier who is then allowed to claim refund from the Customs and Excise Department. It has become increasingly difficult for the Department to monitor and control the various suppliers involved and revenue has been lost in this way. Consequently, the Act is being amended to provide that duty on all goods other than petrol can only be remitted if the goods are acquired from a manufacturer.

I would now like to turn to those amendments which have direct revenue implications.

I have previously referred to the system of industrial protection under which local manufacturers have been allowed to influence Government decisions on the licensing of imports through Letters of No Objection and demands for total bans on competing items.

For the reasons stated earlier, I propose that these privileges should be removed with immediate effect. In order, however, to ensure that adequate and more equitable protection is enjoyed by all the manufacturers who have enjoyed these facilities, I propose to raise the customs duty on all the items concerned to the level which, I believe, will provide such protection.

This measure, which will come into effect at midnight tonight, involves a large list of items and different rates of duty all of which are listed in Schedule II of the Finance Bill. The imposition will result in the high premiums now enjoyed by importers being transferred to the Exchequer. However, to ensure that this liberalization of trade does not result in undesirable practices such as dumping of cheap goods in our market, and unnecessary over-importation, the items will still be subject to import licensing and normal allocation of foreign exchange quotas. In addition, new rules will soon be published containing various anti-dumping measures including possibly, setting up of minimum import and export prices as well as anti-dumping duties.

Hon. Members are aware of the wide range of products that are now manufactured by our industries. Notwithstanding my earlier general comments on efficiency of local industries, some of these goods are of reasonably high standard and compare well with imported equivalent items. In spite of this, many of us continue to despise these products and to prefer imported substitutes. It is my view that people with such misdirected values should expect to pay more for these imports. Therefore, duty on imported soaps, washing preparations and shampoo which presently range between 30 percent and 50 percent will be increased to between 50 percent and 75 percent.

Although Kenyan wood is of very high quality and our furniture is exported to many other countries, there are some people who will not accept locally made furniture in their homes and continue to insist on imported furniture. In order to discourage such extravagant tendencies, the duty on imported wood and wooden articles will rise from 30 percent to 50 percent, while duty on importe furniture, brooms and brushes will rise from the current range of between 33 1/3 percent and 50 percent to between 50 percent and 100 percent. Similarly, paper and paperboard which in the past attracted duty at the rate of 20 percent will now be subject to duty at 50 percent.

As regards textiles, hon. Members will be aware of our consistent past efforts to discourage importation of items which compete unfairly with domestically produced items. Our industries are now able to produce not only very satisfactory fabrics but also artificial fibres of reasonable quality. I therefore propose to raise duty on artificial yarns and other man-made fibres from the present range of between 30 percent and 40 percent to 50 percent. By the same token, imported sanitary towels which currently attract duty at the rate of between 10 percent and 30 percent will now be subject to duty at between 50 percent and 100 percent.

There are other items including ceramic products, glass and glassware and jewellery of all types which will have their duties raised from the present level of between 30 percent and 50 percent to between 50 percent and 100 percent.

The Government has, on various occasions, urged Kenyans to reduce consumption of petroleum products in view of constantly rising fuel prices. In spite of these appeals, companies and individuals continue to import saloon cars and paratransit vehicles propelled by high octane petrol. In order to discourage this practice, I propose to increase duty on all petrol propelled motor vehicles with an engine capacity exceeding 1,750 c.c. by between 25 percent and 50 percent.

In the context of the anticipated increase in expenditure and the slower growth of ordinary revenue, it is necessary to seek additional revenue from new taxation measures. This is particularly necessary in view of the short-term problems of financing the high expenditure on food importation as well as strengthening of export incentives. To assist in this I propose to increase taxation of imports in general. This is mainly to boost receipts and meet export compensation claims which I shall deal with later. Consequently, all dutiable goods will carry an additional 10 percent duty over and above their present or amended duties. It is my hope that improved economic performance will enable us to review this imposition in the coming financial year.

I estimate that these measures, which take effect as from midnight tonight, will provide the Exchequer with additional revenue amounting to K£74 million.

Finally under the Customs and Excise Act, I propose to impose a ban on the re-exportation of two items, namely pharmaceuticals and motor spare parts. For some time now, Kenya has been losing precious foreign exchange through the importation and subsequent re-exportation of these items under circumstances where we do not obtain full reimbursement for our foreign exchange costs. The practice has also tended to encourage irregular trade including smuggling. For similar reasons, I also propose to place a total ban on the exportation of hides and skins. The latter should have the further advantage of encouraging the rapid expansion of our leather industry which has lacked incentives and tended to lag behind.

EXCISE

Although local production of tobacco has been increasing considerably in recent years, we still have to import substantial quantities of cured tobacco. It is my view that smokers should continue paying a little more for this privilege. I propose, therefore, to make a change in the excise tariff on tobacco. The rates of excise duty on cigarettes and tobacco will remain unchanged but the levels at which current rates of duty become effective will be raised by 9 percent. Allowing a small increase to the manufacturer, this measure will raise the price of some popular brands of cigarettes such as Sportsman by 30 cents per packet, Nyota by 25 cents per packet and Rex by 50 cents per packet. There will be no increase in the prices of the more popular brands of Embassy and Ten Cent. This measure on excise duty will bring an additional K£3.65 million in revenue.

EXPORT COMPENSATION SCHEME

As part of the restructuring programme and export promotion theme of today's measures, it is necessary to re-examine the operations of the Local Manufacturers Export Compensation Act of 1975. Under the Act, local manufacturers who export their products are entitled to claim a refund of 10 percent of the f.o.b. value of the goods declared for export, provided their exports meet the requirements of 30 percent local content.

Although the Scheme has been in operation for five years, its success has been limited and only a few manufacturers have made use of it. Last year, payments under the Scheme amounted to about £6 million. We believe this has been the result of a somewhat low level of the applicable rate as well as the lengthy and involved operational procedures. Delays in payment have been quite long and uncertainty has also been created by rejection of applications on mere technicalities.

I am, therefore, proposing changes in the Scheme which should, I believe, overcome these problems. First, I intend to change the administrative arrangements so that payment will be made by the Central Bank of Kenya, as agent of the Government, rather than by the Customs Department. Payment will now be made as soon as the exporter's bank confirms to the Central Bank of Kenya the reciept of the full foreign exchange value of the goods exported as stated in the Customs Department CD 3. This system will be quicker and will give the exporter more certainty, without risking loss of revenue on fraudulent claims. Second, I propose that the Scheme should not be restrictive but should be open to all manufactured items of export provided they fulfil the requirement of 30 percent local content. Thus, the Scheme would now cover items of non-traditional exports, excluding horticultural and other agricultural products. Major export commodities like coffee, tea, pyrethrum, sugar, sisal as well as petroleum products and soda ash would not be eligible. All products which carry no import duty would not qualify. Exceptions to this would be fertilizers, pharmaceuticals, agricultural plant and equipment and educational supplies which will continue to enjoy export compensation facilities. Third, I propose to raise the rate of compensation from 10 percent to 20 percent.

This last measure will result in a major revenue concession and a loss of the Exchequer which, in the first year, is estimated to be about K£24 million. I hope and trust that our exporters will now make more use of this very generous offer of incentive and support from the Government.

INCOME TAX ACT

The rates of income tax in this country are reasonable for a developing country and I do not propose any change. I do, however, propose to raise the rates of withholding tax paid by non-residents. The rates of withholding tax on management fees, royalties and fees paid to foreign artists will be increased from 20 percent to 30 percent. The rates of tax on rents will be increased from 30 percent to 40 percent, that on dividends from 15 percent to 20 percent and that on interest from 12.5 percent to 20 percent.

These changes will bring an additional K£3 million in revenue.

On a procedural matter, Mr. Speaker, I propose to amend the Local Committee Rules to provide that an appeal to the Local Committee will only be heard if the appellant has submitted a Return of Income and Accounts to the Department. This will eliminate frivolous appeals and other appeals designed by taxpayers and their professional advisers as tactics to delay payment of tax which is due.

SALES TAX

I would now like to turn to Sales Tax. The House will recall that I raised the general rate of sales tax from 10 percent to 15 percent last year. It will also be recalled that the Government has committed itself to continuously relying more on indirect taxation as a major source of development finance. In view of this policy objective, I must express my serious concern that effectiveness of the Act continues to be frustrated by deliberate and widespread evasion and open disregard through inadequate and at times false documentation by both manufacturers and distributors.

Firstly, section 22(1)(b) of the Act requires the Commissioner to refund tax paid on goods to a manufacturer after he is satisfied that such goods have been subsequently used as raw materials in the process of his manufacturing. The provision has been grossly misused by manufacturers with integrated production systems, thus becoming the largest single avenue for loss of revenue. The number of claims under this section has increased three-fold in the last four years and the sales tax staff have been occupied almost fulltime checking and approving claims instead of tracking down tax defaulters. I therefore propose to repeal this section of the Act. The effect of this is that there will be a slight increase in the prices of final manufactured items but this should not exceed 3 percent on our calculation. Manufacturers will be required to submit any proposed price revisions to the Price Controller before introducing them. In view of existing arrangements between the Government and a few basic industries, I propose to exempt them from payment of sales tax on their imported raw materials. These are the motor vehicle assembly plants and Kenya Wine Agencies Limited. Considering that refund amounting to approximately £10 million are made by the Commissioner of Sales Tax under this provision every year, I estimate that the Exchequer will now benefit to this extent, in addition to all the other gains to be achieved by intensified tax collection.

While still on the subject of sales tax, I would like to take this opportunity to warn hoteliers who have found it expedient to exploit consumers of wines and spirits. Hon. Members will recall that the Government decontrolled the prices of wines and spirits last year. Since then, some hotels have exploited customers by charging anything up to Sh. 250 for a bottle of wine which costs less than Sh. 100 in the shops. This is obviously unscrupulous and hoteliers must act responsibly on this matter otherwise the Government will be forced to take corrective action.

Secondly, it has come to light that some manufacturers have found it convenient to refuse to pay tax because the Commissioner has no powers to issue a distress order as is the case with the Commissioners for Customs and Income Tax. I, therefore, propose to amend the law to provide the Sales Tax Commissioner with these powers.

Thirdly, although the law requires the manufacturer to issue invoices on goods sold on credit, it does not specify when such invoices should be issued to the buyer. This has been exploited by some unscrupulous manufacturers who have sold goods and have no records of how much their customers owe them in the form of tax. I propose to seal this loop-hole by requiring all registered manufacturers to issue invoices immediately on delivery of the goods.

Fourthly, I would now like to turn to specific amendments which have revenue implications. I propse to raise the rate of sales tax on beer by 50 cents per litre. This will raise the price of Tusker/White Cap by 25 cents per bottle with *pro-rata* increases in other brands. There will be no increased revenue to Kenya Breweries on these products. However, consumers of stouts will pay an additional 10 cents per bottle of Guinness to enable Breweries to recover some of the increased costs arising out of imported matured brew. Although we have had to increase the price of beer substantially in the last few years, it still remains reasonably low in comparison with prices elsewhere for beers of lower quality. I do not propose to increase tax on non-malt beers at this stage.

Mr. Speaker, I regret that I must now come back to the motorists. As I have already pointed out, there is urgent need for Kenyans to reduce the amount of petroleum products they consume. Hon. Members will recall that I had to increase the price of petrol early this year in order to enable the oil industry to recover the increased crude oil prices and ensure that we had adequate supplies of this important commodity. Since then, the prices of crude oil imported by Kenya have increased by another US$2 per barrel and further increases are imminent. I am afraid that these additional costs, which are obviously beyond our control, will have to be passed on to the consumer. In addition, I propose to maintain the tax/price ratio which prevailed before the last price increase. I, therefore, propose to increase the price of Premium motor spirit by 53 cents per litre, Regular motor spirit by 40 cents per litre and Diesel by 18 cents per litre. These increases will take effect from midnight tonight. All efforts will continue to be made to protect industrial and agricultural users of industrial diesel oil and the consumers of illuminating kerosene, although minor increases are inevitable.

At this juncture, I am sure that the House and the country will wish me to express our deep appreciation and gratitude to our beloved President for his constant efforts to seek, personally, a cheaper source of crude petroleum for our country. I believe that as his efforts bear fruit, we shall be able to maintain reasonable stability in our petroleum energy prices.

Finally, on sales tax, Mr. Speaker, I would like to draw the attention of building contractors who manufacture materials for construction of buildings on site that, for all intents and purposes, they are manufacturers under the Sales Tax Act. Therefore, if a contractor manufactures materials worth more than Sh. 200,000 in one year, such materials are liable to tax. Such contractors should therefore register themselves with the Commissioner as required by law.

Taken together, the measures I have announced on sales tax will bring the Exchequer an additional K£22 million in revenue.

HOTEL ACCOMMODATION TAX

Last year, I increased the rate of hotel accommodation tax from 10 percent to 15 percent. I do not intend to increase the rate of tax this year. I am, however, not entirely satisfied with the effectiveness of this tax and I propose the following amendments intended to close loop-holes now used for tax evasion.

Firstly, the law allows tour agents to retain tax for a considerable period before paying it to the hotels although the agents receive payment for accommodation from tourists in advance. This delay in payment of tax is tantamount to giving interest-free loans to tour operators. I, therefore, propose to amend the law to provide that the tax shall be payable not later than 30 days after the hirer vacates the hotels rather than at the time the hotel receives payment from tour operators. This provision will become effective as from 1st October, 1980. The onus will, therefore, be on the hotelier to ensure that tax is paid promptly on the departure of the hirer. Tax payable shall therefore not wait for the reconciliation of accounts between the hotelier and the tour operators. By the same token, I propose to amend the Hotel Accommodation Tax (Accounts) Regulations to require managers of hotels to keep daily/monthly records of tax "chargeable" in lieu of tax received.

Secondly, section 1(2)(b) of the Act exempts members' clubs from payment of hotel accommodation tax on the grounds that such clubs are operated purely for for the benefit of members and not for commercial purposes. Inspection of these clubs, however, has revealed that there are very many clubs which provide accommodation to non-members who pay commercial rates. This exemption is, therefore, being abused by some unscrupulous hoteliers who have acquired licences under the disguise of members' clubs. I therefore propose to withdraw this exemption with immediate effect. Similarly, in view of the high administrative costs incurred on collecting tax from small market hotels scattered throughout rural areas, I propose to exempt hotels with less than 10 beds from tax.

I expect only minor increases in revenue from these changes.

ESTATE DUTY

On a different subject, hon. Members may be aware that currently, estate duty becomes chargeable if the estate of the deceased exceeds K£5,000. The Act has not been amended since its enactment. As hon. Members are also aware, the prices of properties have risen exorbitantly recently and a deceased person who leaves behind only a small house now has his estate chargeable to duty because its value exceeds K£5,000. I, therefore, propose to raise the level at which estate duty becomes chargeable from K£5,000 to K£25,000. The effect of this will be that estate duty will not apply to the majority of rural and urban people who own only a small dwelling house or a family smallholding. Thus, a widow who is left with one house in say, Buru Buru, will not have to sell it to pay duty.

This amendment will cost the Exchequer about K£250,000.

TELECOMMUNICATIONS TAX

Mr. Speaker, telecommunication services absorb large amounts of capital and foreign exchange but they are only readily available to the high income groups. There is, therefore, no sound reason why these services should not be taxed like other goods — e.g. electricity. Judging by the long waiting lists for connexions, it is obvious that this is a very high demand item, the value of which the few privileged users do not always appear to appreciate. I, therefore, propose to introduce a new tax on telecommunication services to be called telecommunications tax. The tax shall be equal to 15 percent of charges on telephone bills, telegraphs and telexes and shall be collected by Kenya Posts and Telecommunications Corporation on behalf of the Exchequer. In order to allow the Corporation time to prepare for its collection, the tax shall become effective on 1st August, 1980. All telephone subscribers will have their August bills increased by the tax element. To protect the ordinary mwananchi who only uses these services when necessary, no tax shall be paid by users of call boxes. This tax brings an additional K£4 million in revenue.

Before concluding my Speech, Mr. Speaker, I wish to touch on a few additional non-revenue matters which are central to the continued sound management of the economy and to realization of the goals set out in this Financial Statement.

BANKS AND FINANCIAL INSTITUTIONS

Mr. Speaker, in our efforts to promote savings, investment and the use of credit, we have encouraged the growth of banking institutions and non-bank intermediaries operating within fairly broad and generous guidelines issued from time to time by the Central Bank of Kenya under the Banking Act. This, together with a system of low interest rates, has enabled us to maintain considerable financial and monetary stability at times of increased pressures from external forces. In the current situation, however, our system needs to be flexible to cope with ever-changing economic conditions.

Mr. Speaker, the value of money has depreciated considerably since the Banking Act was enacted in 1968. Notwithstanding this depreciation, the law still requires locally incorporated banks to be licensed if their paid-up capital is at least Sh. 2 million. If we are to protect the interests of depositors, the banks must be required to have a higher paid-up capital than is now prescribed in law. I, therefore, propose to amend the law to provide that no locally incorporated bank shall be licensed to conduct business if its paid-up capital is less than K.Sh. 10 million. In the case of foreign incorporated banks, the law requires their paid-up capital to be not less than Sh. 10 million. I propose to amend the Act to provide that foreign incorporated banks shall not be licensed if their paid-up capital is less than Sh. 50 million. In addition, foreign incorporated banks will now be required to keep within Kenya an assigned capital of not less than Sh. 10 million as opposed to the present Sh. 2 million.

Similarly, financial institutions incorporated locally shall now be required to increase their minimum paid-up capital from Sh. 500,000 to Sh. 1 million; while those incorporated outside Kenya shall increase their minimum paid-up capital from Sh. 2.5 million to Sh. 5 million and their assigned capital from Sh. 500,000 to Sh. 1 million.

As hon. Members are aware, the Banking Act requires financial institutions not to advance unsecured credits of more than Sh. 10,000 to their officers or members of their immediate family. It has come to my notice that some financial institutions take public deposits only to use them to finance their sister companies — thereby depriving the public the credit they are entitled to. I propose to close this loophole by amending the Act to provide that no financial institution shall be allowed to lend to any company in which the financial institution has an equity interest (directly or indirectly) exceeding 25 percent of the share capital.

As regards savings and credit, it must be recognized that a system of low interest rates has its disadvantages, the most significant being that savings are discouraged while excessive demand for credit is encouraged. In addition, capital intensive projects are encouraged in preference to use of labour while foreign investors also prefer to borrow cheap local finance instead of bringing in their own capital. For this reason, it is necessary to introduce a gradual adjustment of deposit and lending rates in order to reduce these undesirable anomalies. With immediate effect, therefore, commercial banks are being instructed to raise the interest rates on savings deposits from 5 percent to 6 percent. Their maximum lending rate will be allowed to rise from the present level of 10 percent to 11 percent.

Non-bank financial institutions have, in the past, operated without any specific guidelines as to their maximum lending rates. As a result, they have been able to play the market for deposits at the expense of commercial banks while also making higher profits. I consider that their operations would still be very profitable if their lending rates are fixed at 3 percentage points above the commercial bank rates. With immediate effect, therefore, the maximum lending rate chargeable by such institutions which are subject to Central Bank regulations will be limited to 14 percent.

I am concerned that the higher lending rates should not inhibit agricultural credit by virtue of financial institutions preferring to lend for easier and cheaper operations. Although the new higher lending rates will apply equally to agriculture, certain steps will be taken to ensure adequate availability or credit to this sector. Firstly, commercial banks will be required to achieve the existing requirement of 17 percent agricultural lending not later than 30th June, 1981; this requirement has been in existence now for well over four years and yet has not been fulfilled by the majority of the banks. Secondly, the Central Bank will soon introduce and announce corresponding quotas for lending to agriculture by non-bank financial institutions which have so far not taken any interest in agricultural credit. Thirdly, the Central Bank is examining the most effective way of giving favourable treatment to commercial banks' agricultural loan portfolios to provide adquate liquidity and profitability.

In this context, I wish to draw the attention of hon. Members to the Money-lenders Act (Cap. 528). Under this piece of outdated legislation, individuals may be licensed to lend money subject to a maximum rate of interest of 48 percent. While there may be people in our society who wish to borrow at these extortionate rates for their own reasons, I am also aware of the many evil practices now being carried out by these money-lenders including the taking of deposits and dealing in foreign exchange illegally. While it is necessary to examine this law more carefully to establish whether it is still relevant to our present-day circumstances, I am proposing amendments to that Act to reduce the maximum rate of interest to 24 percent p.a. and to make it clear that it is illegal for money-lenders to take deposits and to deal in foreign exchange. Other amendments will be submitted to the House in due course.

Finally in this area of financial policy, I wish to mention the level of support which the Treasury expects from non-bank financial institutions. So far, the instituions have reaped the benefits of our sound financial system without finding it necessary to invest in Government short-term paper. The Central Bank is therefore being requested to devise an acceptable system which will enable these institutions to invest at least 50 percent of their minimum liquidity ratio requirements in Treasury Bills during the coming financial year.

I would now like to turn to those amendments which have revenue implications.

Last year, I increased licence fees payable by banks to Sh. 10,000 for headquarters and an additional Sh. 2,000 for each branch of a bank in a municipality. After further consideration of this matter, I have come to the conclusion that there are cases where banking business is more lucrative in towns and in municipalities. Further, considering that I have raised the level of interest that these banks may now charge, I see no reason wy the Exchequer should not share in the increased profits which will accrue to the banks. I therefore propose to increase annual licence fees to Sh. 50,000 for headquarters; Sh. 25,000 for each branch in a municipality; Sh. 10,000 for each branch in a town council area and Sh. 5,000 for each branch in an urban council area. No fees will be paid in respect of branches in market centres.

With regard to financial institutions, the new fees shall be Sh. 30,000 for the headquarters plus an additional Sh. 15,000 for each additional branch.

This measure will benefit the Exchequer by an additional K£160,000.

Taken as a whole, the new taxation measures introduced today will bring a net addition to revenue of £83 million. I shall, therefore, still be left with a residual deficit of some £41 million to finance from short-term borrowing. Although this level of deficit financing is much higher than I would have wished to see, and will obviously be inflationary, it is my belief that the higher level of Government spending is necessary to effect economic recovery and that the results of such economic growth will yield higher revenues than now forecast.

In effect, Mr. Speaker, my proposals today are aimed at responding to the short-term challenges facing our country while at the same time creating the framework within which, in the medium term, we can return to the path of accelerated economic growth outlined in our current Development Plan. In short, the main objective of my proposals is to make first steps towards the major long-term restructuring programmes indicated in the Development Plan and the Sessional Paper now before the House. The measures are aimed at making maximum foreign earnings and savings, containing inflation while creating financial stability, stimulating further growth of the industrial sector and maintaining the principles of sound international credit standing and management.

In recognize that the additional revenue measures represent an increased burden on our tax-payer, but I am sure hon. Members will agree that this is inescapable in view of the problems facing our country. Indeed, the ability and willingness to carry one's own fiscal burdens is the true meaning of independence and self-reliance.

Mr. Speaker, our President has told us many times that the obligation to pay taxes is the duty of every Kenyan who is loyal and dedicated to his country. I believe that all Kenyans will heed this advice and demonstrate in action that they are true followers of "Nyayo".

Mr. Speaker, I beg to move.

Pakistan's Budget for 1980-81 in Perspective – Important Fiscal Measures

by N.M. Qureshi

N.M. Qureshi
Chairman of the Central Board of Revenue and ex-officio Secretary to the Government of Pakistan.

INTRODUCTION

The formulation of fiscal budgetary measures is always a difficult task for a developing country because of the increasing requirement of finances for development programmes in the public sector on the one hand and the conflicting compulsions of tax incentives for economic development in the private sector on the other. Therefore, unlike that of a household, the national budget document is not merely a statement of cold statistics; it underlines the whole philosophy of economic measures designed to promote certain well considered economic and social objectives consistent with the hopes and aspirations of the people.

The fundamental philosophy of the economic policies of the present Government has always been to correct the course of the economy, to improve and consolidate the finances of the country and to build its physical production base on an even keel to achieve its objective of preparing the country politically for a well-functioning Islamic democratic system. Needless to say, these objectives cannot be achieved in a single day; it requires dedicated effort, sacrifice, cooperation of the people and long term planning.

The rationale behind the proposed budgetary tax measures has been to provide adequate protection to the local industry and to encourage gradual import substitution without any inconvenience to the consumer, to provide incentives to the desired industrial sectors of the economy, e.g. local capital goods industry, small industrial companies and sick industries so as to improve their financial health and profitability, to encourage industrialisation in the backward areas, to give a necessary fillip to other essential sectors of the economy, i.e. poultry and dairy farming, agricultural machinery, etc., to boost up exports, to maximise foreign exchange earnings, to improve the investment climate with a view to promoting capital formation in the country, to stimulate production and productivity and to provide incentives to professionals. The new tax measures also aim at bringing about rationalisation of procedures, removal of fiscal anomalies and plugging of loopholes.

In precise terms, the fiscal measures adopted in Pakistan's national budget for the fiscal year 1980-81 highlight the following broad policy objectives:

(i) accelerating the growth of the industrial sector with particular emphasis on less developed areas;

(ii) development of agriculture;

(iii) inducing greater savings and investment;

(iv) encouraging exports of goods and services;

(v) attracting foreign capital and technology.

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I. INCENTIVES FOR THE INDUSTRIAL SECTOR

Like most other developing countries, Pakistan is anxious to step up the pace of industrialisation. Apart from such tax concessions as a tax credit for installation of machinery for balancing,[1] modernisation and replacement, a tax credit to companies for investment in other companies set up in specified less developed areas, a tax credit for investment in shares and debentures of the Equity Participation Fund, liberal initial depreciation on industrial buildings and machinery, a continuing concessional rate of tax on intercorporate dividends, some further incentives have been provided this year.

As a result of certain adverse economic factors in the past, some industries (e.g. textile mills) have suffered serious setbacks and are still under great financial strain. In order to revitalise such sick industries, losses of wholly owned subsidiary companies have been allowed to be set off against the profits of parent companies if the parent companies are listed on the stock exchange and these companies prepare plans which are approved by specified financial institutions for reviving the sick subsidiaries.

For development of export-oriented industries, an Export Processing Zone has been established at Karachi. Industries set up in the Zone have been provided with the following tax concessions:

(i) income of the industrial undertaking and of its foreign employees will be exempt for five years, which period is extendable in the light of the performance of the industry;

(ii) after the expiry of five years, a concessional rate of tax at 25 percent of the normal tax rates will be charged for the next five years;

(iii) capital gains on the sale of assets and shares will be exempt from tax.

The rebate in super tax to small and medium-sized companies which was to expire on 30 June 1980 has been extended for a further period of three years with the prime object of helping such companies to build up capital.

Exemption from customs duties on imported machinery for balancing, modernisation and replacement for the tanning, cutlery, surgical goods, leather garments and glove industries has also been granted this year with a view to making the products of these industries competitive in the export market. This exemption will apply only to such machinery as is not manufactured in Pakistan.

For the economic uplift of less developed areas, encouragement to establishment of industries in such areas has been a major policy consideration. A tax holiday for five years is available to industries set up in certain economically backward areas. Experience from the past has, however, indicated that this form of tax holiday has not been of much help because of the lack of the necessary infrastructure, which could not be provided in far-flung areas on account of limited resources. Keeping this factor in view, a new and more practical approach has been adopted this year by including approved industrial estates established in specified less developed areas in the tax holiday scheme. Industries set up in these industrial estates during the period from June 1980 to June 1983 will enjoy exemption from tax for a period of five years from the date of commencement of commerical production. In addition, machinery imported for installation in the industries set up in these industrial estates has been exempted from payment of customs duty. Since it would be financially possible to provide essential services like supply of water, electricity, means of communication and transport to the limited area of the industrial estates, it is hoped that the tax holiday will prove to be an effective instrument in attracting industries to these areas.

Besides a tax holiday, industries set up in certain specified areas are allowed partial tax exemption on their profits up to 10 percent of the capital employed. This exemption, which was to expire on 30 June 1980, has now be extended up to 30 June 1983.

II. CONCESSIONS TO AGRICULTURE

In view of the fact that Pakistan is predominantly an agricultural country and that development of this sector is of paramount importance for the over-all economy of the country, the Government attaches a very high priority to sustained growth in agriculture. With this end in view, tax incentives, as well as other measures, are being widely used to achieve the desired objective. Agricultural income is already exempt from tax. Exemption on income from poultry farming, fishing, cattle and sheep breeding and dairy farming, which was available up to June 1980, has been extended for three more years in order to develop these industries.

As the use of modern and sophisticated farm implements and machinery is very important for an economical increase in production, income from the domestic manufacture of such implements and machinery which enjoyed exemption up to 30 June 1980 will now be eligible from exemption up to 30 June 1983. Income from renting out of agricultural machinery or from

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1. The term "balancing" (of machinery) means installation of additional machines in an industrial unit for the purposes of achieving optimum efficiency of the various inter-related components of that unit. For instance, in the textile industry, if an industrial undertaking has both yarn-producing and weaving facilities, 25,000 spindles "balance" with 500 looms. Therefore, if such an undertaking does not have the spindles and looms in the appropriate proportion, either the spindles or the looms would be working below capacity resulting in less than optimum efficiency. Installation of additional looms or spindles, as the case may be, to bring about the right proportion between the two would mean "balancing" of the existing machinery. Similar standards can be found for the ideal capacity of machines involved in intermediate stages of production from raw material to the end product.

providing pest control services has likewise been exempted from tax up to June 1983.

III. INCENTIVES TO PROMOTE INVESTMENT

A low rate of capital formation is a problem peculiar to developing countries and Pakistan is no exception. Fiscal incentives have, therefore, been provided to encourage savings and investment. The tax rebate on investment in Government saving schemes or in shares of approved industrial undertakings has been liberalised. Hitherto the limit of such investments was 30 percent of total income subject to a maximum of 35,000 Rs. This limit has been raised this year to one third of total income (i.e. 33 1/3 percent) up to a maximum of 40,000 Rs.

In order to encourage diversion of savings into the corporate sector and to give a boost to the stock market, exemption from the tax on capital gains which was to expire on 30 June 1980 has been extended for three more years. Companies are liable to pay surcharge at the rate of 10 percent of the tax payable on distributed profits. This levy was introduced a few years ago in order to encourage building up of corporate capital. However, as reasonable distribution of dividends is also necessary for attracting savings into the corporate sector, a more rational approach has been adopted this year with a view to maintaining a balance between retained earnings and dividends. Now, a company whose free reserves are less than 150 percent of its paid-up capital gets a rebate in surcharge in the ratio of retained income to the after-tax profits.

Tax concessions allowed to industries set up in the Export Processing Zone are expected to attract foreign investment as well.

IV. INCENTIVES TO ENCOURAGE FOREIGN EXCHANGE EARNINGS

Although Pakistan's exports chiefly consist of primary products, export of finished goods and services contributes significantly towards foreign exchange earnings. In view of the international trend in prices, which tend to be in favour of finished goods, it is imperative to increase the export of manufactured products and, to the extent possible, of services. To attain this objective, domestic construction companies have been given exemption from super tax on their income from construction contracts executed abroad when such income is repatriated to Pakistan. Similarly, non-company professionals earning income from technical and consultancy services rendered abroad have been allowed a rebate of 30 percent on the tax payable on such income when repatriated to Pakistan. Income of a company from provision of technical and consultancy services abroad is already exempt from tax.

As for export of goods manufactured in Pakistan, income from export already gets a rebate of 55 percent on the tax payable on such income. Mention has already been made of tax concessions allowed this year to industries set up in the Export Processing Zone at Karachi which would, hopefully, increase the production of exportable goods and thus earn valuable foreign exchange for the country.

V. INCENTIVES FOR NON-RESIDENTS

While the development of industry in the country based on indigenous resources remains the cornerstone of Pakistan's economic strategy, there is a strong case for import of foreign capital and advanced technology to accelerate the pace of industrialisation in a highly competitive world.

Tax holidays for a specified period to industries set up in certain areas offer an attractive incentive for foreign investment as well. Highly liberal tax concessions granted to industries in the Export Processing Zone are primarily designed to attract foreign investors.

Reduction in the rates of customs duty on machinery imported under the Non-repatriable Investment Scheme announced this year is another step towards providing an opportunity to non-residents for investment in the country.

The salary of foreign technicians working for an industrial undertaking in Pakistan is already exempt for a period of three years subject to approval of contract of service.

Perhaps the greatest advantage to non-residents lies in the area of treaties for avoidance of double taxation. Pakistan's treaties with most of the developed countries offer liberal tax concessions, particularly for dividends, interest and royalties. Since the flow of investment is invariably from developed to developing countries, the treaties which Pakistan has concluded with the developed countries include favorable terms to these countries in order to attract foreign investment to Pakistan.

Pakistan: BUDGET 1980 ~ 81

Extract from the Budget Speech pronounced on June 26, 1980 by Mr. Ghulam Ishaq Khan, Finance Minister

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

I. INCOME TAX

16. **Collection of income tax.** I now move to the taxation area. Government has made all-out efforts during the current year to make the system of collection of Income Tax Revenues simpler, more pragmatic and more balanced.

17. **Self-assessment scheme.** Under the self-assessment scheme more than 95 percent of the returns of income have been accepted. Even in the case of the returns set-apart for detailed scrutiny assessments were mostly made on agreed basis. The other bright aspects of the scheme are that a record number of 55,000 tax payers for the first time filed returns of income voluntarily and about 80 percent assesses filed returns of income in time against an average of 50 percent in the past. Due to Department's efforts to bring more taxpayers on tax registers the number of taxpayers has gone up from about 5,000,000 at the end of last year to about 7,000,000 now.

18. The results of all these efforts are manifest from the amount of tax collection. Against last year's collection of about Rs. 334 crores, the expected collection this year is over Rs. 500 crores. This increase of over 50 percent in the income tax revenues can be attributed only to better performance of the Department for which the Central Board of Revenue and officers and staff of the Income Tax Department deserve to be congratulated.

19. **Salient features of tax proposals.** I now come to the salient features of the tax proposals for the next financial year.

(i) The scope of the liberal self-assessment scheme, as introduced last year, is being further enlarged to bring companies as well into its ambit.

(ii) Another feature of this year's scheme is that if an assessee's declared income for the year 1980-81 is more by at least 20 percent as compared to the highest assessed income of the three preceding years, his case will not be selected for scrutiny. Further if a company furnishes a certificate from a Chartered Accountant as to the correctness of the account version on the lines prescribed by Central Board of Revenue such case will also not be selected for scrutiny. These concessions will, however, not be available in cases falling in any of these categories if the department possesses a positive proof of concealment of income.

20. **Association of experts/professionals, etc. with assessment of selected cases.** In order to restore the confidence of the public, it has been decided that wherever considered proper, experts/professionals or representatives of Trade bodies will be associated with the assessment of cases selected for scrutiny. Where the Department differs with the opinion of such experts/representatives, the assessment order will mention the opinion rendered and the reason for differing with it. Since the assessment orders are appealable both the points of view will be before the appellate authorities.

21. **Appeal against assessment under self-assessment scheme — Time-limit for re-opening such cases.** Hitherto the assessee had no right of appeal against an assessment made under the self-assessment scheme, though the Income Tax Officer could make certain adjustments in the declared income. Now the taxpayer has been provided with such a right. Further there was no time-limit for re-opening a case completed under self-assessment scheme. A time-limit of 10 years for re-opening such cases has now been fixed.

22. The success of the self-assessment scheme depends on two factors. Firstly that the assessees declare correct particulars of income and secondly that the Department accepts such returns under declared policy. If any one of these conditions is not fulfilled, the success of the scheme will be jeopardised. Since the Government is determined to make the scheme a success, such arrangements have to be made as to identify the tax-evadors and to recover from them not only the evaded taxes but also to punish them for having committed this offence. Evasion of taxes is a far graver offence than ordinary theft because it tantamounts to depriving the society of its rightful share. In these circumstances, it is the legal and moral obligation of the Government to deal with such unpatriotic elements effectively. It has, therefore, been decided that whereas the interests of honest taxpayers will be adequately protected, an organised campaign against tax evasion would be launched. The Income Tax Department and its affiliate agencies has been instructed to spare no efforts in this behalf. In view of the tendency of large-scale evasion of taxes, it is expected that the Department should be able to collect rupees fifty (50) crore through this campaign. I would, therefore, urge upon the taxpayers to fully avail of the the Self-assessment Scheme by declaring honestly the true particulars of their income. In this way, they will be serving the nation and will also be saving themselves of any unnecessary inconvenience.

23. **Steps to encourage industrial development.** Some important steps taken to encourage industrial development in the country are as follows:

(i) As you know an export free zone has been established at Karachi for setting up export oriented industries. Such industries will be entitled to the following concessions:
   - (a) Income of the enterprise and of the foreign employees will be exempt from tax for five years which period is extendable by the Federal Government in the light of the performance of the enterprise.
   - (b) After the expiry of full tax-holiday period, a concessional rate of tax at ¼ th of the prevalent tax rates shall be charged for next five years.
   - (c) Capital gains on sale of assets and shares will be exempt from tax.

(ii) In order to revive sick industries it has been decided to allow set off of current year's losses of a wholly owned subsidiary company against current year's income of a listed holding company. The concession of set off of losses will be available for 3 years and will be subject to the condition that the holding company gives a scheme of revival of the sick mill duly approved by financial institutions namely: PICIC, IDBP, NDFC or Bankers Equity and submits a yearly progress report to such financial institution to show that steps for rehabilitation of the sick industry are being taken as planned.

(iii) Initial depreciation allowance to industrial machinery and building which is expiring on 30 June, 1980 has been extended to 30 June, 1983.

(iv) A relief of 5 percent in super-tax admissable to small industrial companies which is expiring on 30 June 1980 has been extended up to 30 June, 1983. Further this relief which was hitherto available to companies owning assets of the value of Rupees thirty (30) lakhs will now be admissible to companies owning assets up to the value of Rupees fifty (50) lakhs.

24. Steps for development of backward areas. Steps that are being taken for development of backward areas are as follows:

(i) Presently all industries owned by companies and set up to 30 June 1983 in the Province of Baluchistan, or in D.I. Khan and Malakand Divisions and District of Mansehra and Kohistan of Hazara Division of N.W.F.P. enjoy a tax-holiday for a period of 5 years from the date of commencement of commercial production. This tax-holiday is being extended to industries set up in industrial estates approved by Central Board of Revenue and located in N.W.F.P., the districts of D.G. Khan and Minwali and Tehsil Khushab in the Punjab and District of Dadu excluding Kotri, districts of Jacobabad and Shikarpur in Sind.

(ii) The existing law provides for partial exemption of income of an industrial undertaking set up between 1st July, 1975 and 30th June 1983 in underdeveloped areas. The exemption is available from the year of commencement of commercial production up to 30th June, 1983. The existing provisions allowed exemption for less than 5 years to industries set up after 1978. To make this exemption more effective it has now been made available to industires set up up to 30 June 1983, for a minimum period of 5 years.

25. Incentives to other essential sectors. Tax incentives being provided to other essential sectors are as under:

(i) Exemption of income from poultry farming, dairy farming, fish catching and cattle and sheep breeding which is expiring on 30 June 1980, has been extended up to 30 June, 1983.

(ii) Income derived during 1 July 1980 and 30 June 1983 from "poultry processing" has also been exempted from tax.

(iii) Income derived from renting out of agricultural or pest control machinery was exempt from tax up to 30 June 1980. This exemption has now been extended to business set up up to 30 June, 1983.

(iv) Income from local manufacture of agricultural implements was exempt from income tax up to 30 June, 1980. This exemption has now been extended till 30 June 1983.

(v) Following exemption for a period of 5 years was available to houses or flats constructed up to 30 June 1980:

(a) Where the annual letting value is up to Rs. 12,000/- — The whole of such income.

(b) Where annual letting value exceeds Rs. 12,000/- — Rs. 6,000/-

This exemption has now been extended to houses and flats constructed up to 30 June 1983.

(vi) Depreciation allowance on building comprising residential quarter for industrial labour is presently allowed @ 5 percent of the written down value. This allowance has been increased to 10 percent.

26. Repatriation of foreign earnings. In order to encourage repatriation of foreign earnings the following further incentives are being provided:

(i) A Pakistani construction company earning income from construction contracts abroad, shall on repatriation of profits to Pakistan be entitled to a rebate equal to the amount of supertax payable on such income. The present rate of super-tax is 25 percent of the total income.

(ii) Non-company resident professionals earning income from consultancy services abroad shall on repatriation of such income be entitled to a rebate equal to 30 percent of the tax payable on such income.

27. Steps to promote savings and investments. Following steps are being taken to promote savings and investments:

(i) Exemption on capital gains which expires on 30th June 1980 has been extended up to 30th June 1983.

(ii) Personal investment allowance is at present admissible at 30 percent of the total income subject to a maximum of Rs. 35,000/-. These limits have been raised to $33^1/3$ percent and Rs. 40,000/- respectively.

(iii) At present companies are liable to a surcharge at 10 percent of the income tax and super tax. A rebate is admissible in respect of the profits retained. To make this concession more effective the rate of rebate is being enhanced. Now the rebate shall bear the same ratio with the surcharge as the retained profits bears to the after-tax profits. In order to ensure that the companies do not go on creating unlimited reserves at the cost of share holder's dividends, it has been provided that the rebate will be admissible only to such companies whose free reserves do not exceed 150 percent of the paid up capital.

28. Relief to taxpayers. Steps which are being taken to provide relief to taxpayers and to remove their difficulties are as under:

(i) In order to discourage the grant of unreasonably high perquisites to employees, perquisites in excess of 30 percent of the salary are disallowed as expenditure in the hands of the employer. This percentage was fixed in 1972. Due to rising prices, employers are forced to allow more perquisites which has rendered this limit un-realistic. It has, therefore, been raised to 50 percent of the salary of the employee.

(ii) Exemption limit in respect of income of non-professional writers and artists derived from literary or artistic work has been raised from Rs. 5,000 per annum to Rs. 15,000. The exemption will be over and above the normal tax exemption limit of Rs. 12,000.

(iii) Law is being amended to provide that where investment made by a minor child in a firm in which neither of his parents is a partner is from the money gifted to him on which gift tax has been paid then his share income will not be clubbed with his parent's income.

(iv) Hitherto, no income tax authority had powers to extend the time for filing of income tax returns, Income tax Officer has now been authorised to extend the time up to 15 days on his own and for additional period with the approval of the Inspecting Assistant Commissioner.

(v) Inspecting Assistant Commissioner is being given powers to stay the tax demand or allow it to be paid in instalments in suitable cases.

(vi) In respect of income from house property, repairs allowance has been raised from $16^2/3$ percent to 20 percent.

(vii) Depreciation is admissible only if the plant and machinery has been used for two consecutive months during the income year. This allowance shall now be available in full even if the assets have been used for one day.

(viii) In case of a recognised providend fund, the exemption limit on the rate of profit on the credit balance in the account of an employee is presently 12 percent per annum which was fixed in 1975. Since the return on other investments has increased, this limit is, therefore, being raised from 12 percent to 14 percent.

29. Additional relief to doctors, lawyers, etc. Professionals such as doctors, lawyers, chartered accountants etc. who are not entitled to any pension etc. on retirement are being provided an additional relief. A sum equal to 5 percent of the income subject to a maximum of Rs. 10,000 per annum invested by them in an annuity scheme the main object of which is to provide life annuity to the assessee commencing after the age of 60 but before the age of 70, shall qualify as investment allowance in addition to the present investment allowance.

30. Simplification of the provisions of law. In order to simplify some of the provisions of law and to make them more effective, the following steps are being taken:

(i) A permanent National Tax Number shall be alloted to every taxpayer which will enable the Department to keep a better record of taxpayers. It will also help in collecting and collating the information relating to an assessee business activities and in computerization of this information to preclude evasion.

(ii) In order to improve tax collection and to make the system of deduction/collection of tax at source more effective, he provisions of withholding tax on contracts, supplies and imports have been made applicable to limited companies.

(iii) Advance tax collection on passenger vehicles was introduced last year but the measure was not made effective. This advance payment of tax shall now be effective from 1st July, 1980 and shall be collected from every vehicle with registered seating capacity of 20 or more at 15 percent per annum in case of vehicles plying on routes within a city and at 20 percent per annum from others. No tax shall be collected from vehicles of models older than 10 years.

(iv) At present foreign shipping and air enterprises are taxed on net-income basis computed on the basis of their world income. This is a complicated method. Tax shall now be charged as percentage of gross Pakistan billings. The rate of tax in respect of air enterprises shall be 3 percent of gross billings and in respect of shipping enterprises 8 percent of the gross billings.

(v) In respect of income from property, pugree or non-adjustable advances is not liable to tax under the present law. Provision is being made to tax such advance or pugree by spreading the amount over 10 years so as to treat 10 percent of the amount as rent received in each of these years. This provision will also apply to cases where any such pugree, or advance was received at any time during the last 10 years. In such cases 10 percent of the advance shall be treated as rent received for all the years which have not expired.

31. Surcharge on jewellers, date for filing return and other measures. In the end, I shall briefly mention some other proposals:

(i) At present jewellers are subjected to a surcharge of 6 percent on their income. This is being raised to 10 percent.

(ii) The last date for filing of returns in non-company cases whose income years end after 31st December is being changed to 1st of November.

(iii) Under the present law, the Inspecting Assistant Commissioner and Commissioner of Income-tax are associated in certain assessments. Appeals against such assessment are presently filed with the Appellate Assistant Commissioner. It has been decided that appeals against important assessments shall be heard by the Commissioner Appeals.

(iv) In order to make the working of the Department more effective Regional Commissioners are being appointed.

(v) Any profit paid to any Mudarba or on a Participation Term Certificate created under the Islamic Mudarba law has been made deductible business expense.

32. These were some of the most important amendments, hence these have been mentioned in some detail. Apart from these, a few other provisions of law have been slightly amended. Besides this the amendment brought about during the current financial year in the Ordinance through notifications issued under Section 167 which were effective only for one year have been made part of the law.

33. Prospective tax proposals. The prospective enforcement of tax proposals is generally more convenient to the taxpayers as it enables them to deal with their tax and other business matters in a better way. Keeping this aspect in view it has been decided that barring two proposals the rest of the revenue relief proposals will be prospective. The proposals which will not be prospective are the ones relating to taxation of pugree or unadjustable advance and the taxation of air and shipping companies. On account of these two proposals there will be a revenue gain of Rs. 5.5 crores. As against this the revenue loss on account of tax relief on Wealth Tax and Zakat payment will be Rs. 11.5 crores. There will thus be a net loss of Rs. 6 crores which will be made good through better tax collections. The revenue loss on the concessions announced having prospective effect will be Rs. 19.94 crores which will be reflected in the budget for the year 1981-82.

II. WEALTH TAX

34. Levy of Wealth Tax to continue on immovable property and certain assets. Wealth tax is the only other direct tax in the country besides income tax. This levy has not only a redistributive impact on account of its incidence on the comparatively richer class but it is effective also for removing allocative distortion in the economy. Over the last one year this instrument has been successfully used to slow down the rampant trend towards heavy investment in urban immovable property. With the introduction of Zakat in the country, wealth tax is now no more leviable on such wealth as is subject to compulsory deduction of zakat under the Zakat and Ushr Ordinance. However, it would continue to be leviable on the value of immovable property and such other assets as are not subject to compulsory deduction of Zakat. In order to ensure effective administration of this tax the rates of penalties for various defaults under the law have been enhanced and brought in line with the penalties provided in the income tax Ordinance, 1979.

III. CUSTOMS DUTY/SALES TAX

35. Industries in under-developed areas. On the Customs side the main emphasis during the present budget is on the encouragement of the local industry with special references to under-developed areas and export oriented sectors. As regards encouragement of industries in under-developed areas, Government has already exempted from duty machinery imported for installation in Baluchistan and Azad Kashmir. In future this exemption will also be available on the machinery for units located in the industrial estates in the whole Frontier province, Districts of Dera Ghazi Khan, Mianwali and Tehsil Khushab of the Punjab province, and districts of Shikarpur, Jackababad and Dadu excluding Kotri, in the province of Sind. In addition to this, industrial estates located in other areas of the country excluding the 13 notified developed areas will be chargeable to 10 percent rate of duty.

36. Ship breaking. Ship breaking is an important industry of under-developed province of Baluchistan. In order to give further boost to this industry the duty on ships for scrapping is being reduced from 50 percent to 30 percent and the sales tax of 8 percent is being abolished. In net terms the incidence of taxes on the raw materials of this industry is being reduced by more than half.

37. Ready-made garments, etc. Government, in the budget of 1978-79, allowed exemption on machinery for ready-made garments, towels and hosiery industry. In order to encourage the modernization of textile industry, necessary machinery for its BMR was also exempted from duty. These exemptions were allowed to make the products of these industries competitive in the export market. Keeping the same considerations in mind it has been decided to give exemption to machinery for BMR of the tanning, cutlery, surgical goods, sports goods and leather garments and gloves industry also. In order to ensure that this exemption does not adversely affect the locally manufactured machinery, the exemption is being restricted only to that machinery which is not manufactured locally. For the same reasons while on the one hand the automatic cone-winders, which are a substitute for locally manufactured cone winders are being excluded from the concession to the textile industry, on the other hand, the scope of the exemption is being extended to looms of 72 inches width and above as well as shuttle-less looms as those are not manufactured locally and are a genuine requirement of the industry. Duty on

hosiery needles is also being reduced from 40 to 20 percent.

38. **Investment by overseas Pakistanis.** In order to provide overseas Pakistanis with better opportunities of investment in the country, the duty on machinery under NRI Scheme is being reduced from 40 to 30 percent. In the areas of 20 percent duty NRI Scheme will now attract 15 percent duty and in industrial estates eligible for 10 percent duty it will be 7½ percent only. The areas eligible for total exemption are obviously free from duty. It is expected that overseas Pakistanis will make effective use of these concessions and contribute to the development of the country.

39. **Capital goods.** During the last budget capital goods and allied industries were given the concession of 30 percent rate of duty on their raw materials. They are, however required to give a bank guarantee for the balance amount of duty and taxes till the production of consumption certificate for these raw materials. In order to reduce their financial burden on account of these bank guarantees the condition of bank guarantee is being substituted by the condition of insurance guarantee.

40. **Metalic Ores.** Metalic Ores are chargeable to 25 percent import duty at present. Previously there were no industries in the country which could use ores. Now that heavy industries requiring such ores as raw materials are being established, ores are being exempted from duty as an incentive for these industries.

41. **Polyester fibre plant.** One polyester fibre plant will go into production next year. Another unit is likely to go into production by 1982. In order to make the locally manufactured polyester fibre competitive with the imported fibre, the raw materials for its local manufacture are being exempted from duty. Further the duty on the imported polyester and other fibres is being enhanced from Rs. 11.00 to Rs. 15.00 per kg. In order to ensure that this increase in duty on fibre does not adversely affect the local spinning units *vis-a-vis* the imported yarns the duty on synthetic yarn is being increased by Rs. 10 per kg.

42. **Calcium carbide, etc.** There is sufficient capacity for the manufacture of calcium carbides, PVC resins and polyethelene granules in the country. These units are not in a position to compete with the imported products in view of economies of scale. As a result, a number of units set up with huge amounts of foreign exchange are lying idle. In order to effectively utilise the production capacity of these industries the duty on calcium carbide is being increased from 40 to 70 percent and on PVC resins, polyethelene granules and other primary plastic materials from Rs. 7.50 per kg. to Rs. 11.00 per kg.

43. **Baby milk.** Baby milk food at present is free of all incidence of taxes. The local manufacturers of baby milk food import their requirements of raw materials from abroad and have to pay taxes. In order to provide proper protection to the local manufacturers of baby milk food they are being allowed repayment of duty and sales tax paid on their inputs i.e. sales tax on imported milk and customs duty and sales tax on aluminium foils.

44. **Imported printing ink food.** Imported printing ink is chargeable to 40 percent duty. The locally manufactured printing ink cannot compete with the imported ink as the incidence of taxes on its raw materials is more than 40 percent. In view of this, it has been decided that the local industry be allowed repayment of duty in excess of 40 percent on its raw materials.

45. **Napthalene balls.** Napthalene balls manufacturers are being allowed exemption on their raw materials i.e. crude napthalene.

46. In order to encourage better utilisation of molasses in the country duty on the export of molasses is being increassed from 20 to 25 percent. Similarly in order to encourage the export of finished leather and leather goods which have a higher added value, the duty on wet blue leather is being increased from 20 to 25 percent.

47. **Buses and trucks in C.K.D. form.** In addition to the above measures for encouragement of industry, Government has taken steps to improve transportation facilities in the country. In order to improve transport facilities further the duty on buses and trucks in C.K.D. form is being reduced from 40 to 30 percent. This reduction will also provide better opportunities of investment to overseas Pakistanis and promote the proper utilisation of the local capacity. In order to encourage progressive assembly of vehicles in the country, duty on the raw materials for the local manufacture of autoparts is also being reduced from 40 to 30 percent.

48. **Microfilming equipments.** Microfilming equipment is an important development of modern times for preserving and exhibiting the ever increasing store of knowledge. For promoting its use for educational purposes the duty on this item is being reduced to 40 percent and sales tax from 20 to 10 percent.

49. **Graphic art films.** The concessional rate of 40 percent duty on graphic art films and plates is currently available only to industrial consumers. As these films and plates are extensively used in printing industry, this concession is now being made available to all importers.

50. **Artificial parts of human body.** During the budget of 1978, Government exempted the raw materials required for the manufacture of artificial parts of human body by Fouji Foundation workshop from duty. This exemption on raw materials is now being extended to all orthopaedic workshops.

51. Continuous efforts are being made to streamline the working of the Customs Department. Keeping in view this objective in mind Pakistan Customs Tariff has been revised in line with the latest international customs nomenclature and all notifications and orders regarding customs duties are being consolidated. The most important step in this direction is the opening of Customs Treasuries at important inland customs stations. These treasuries will start functioning with effect from 1 July, 1980. This will eleminate the long outstanding complaints of the exporters regarding delays in the payment of export rebates. As a further incentive to the exporters the rates of rebate on 87 items have already been standardised. The rebate rates on electric fans, artificial yarn and other products of artificial silk, bleached ready-made garments, bleached hosiery and leather footballs have now been revised and linked with F.O.B. value.

IV. CENTRAL EXCISE DUTY

52. In view of the harmful effects of tobacco-smoking on health, the President has recently promulgated an Ordinance aimed at discouraging the consumption of tobacco. The Ordinance, inter alia, requires an obligatory printing of appropriate warning on all cigarette packets. In furtherance of the aims of the said Ordinance, it has been decided to enhance the rates of Central Excise Duty on all cigarettes. Care has, however, been taken to ensure that the consequential tax burden on manufacturers as well as consumers does not exceed a certain limit. With this end in view, the recent 7½ percent enhancement in the price of leaf tobacco has been off-set by making a corresponding reduction in the rate of Central Excise duty applicable to the unmanufactured tobacco. Now the un-manufactured tobacco will be charged to central excise duty at 1.70 per kg. instead of Rs. 2.25 per kg. As regards cigarettes, the prevailing rate of central excise duty consists of two slab structure which is linked with the retail prices. If the retail price of cigarettes is less than fifty-two paisas per ten cigarettes, the rate of central excise duty is Rs. 8/- per one thousand cigarettes plus 50 percent of the retail price in excess of Rs. 20/-. If the retail price of cigarettes is fifty-two paisas or more, the rate of central excise duty is Rs. 15/- per one thousand cigarettes plus 70 percent of the retail price in excess of Rs. 30/-. The enhanced rate of duty will be as follows. If the retail price of cigarettes is upto sixty paisas per ten cigarettes, the excise duty will be Rs. 8/- per one thousand cigarettes, plus 52 percent of the retail price in excess of Rs. 20/-. In case the retail price is

more than sixty paisas per ten cigarettes the rate of central excise duty will be Rs. 15/- plus 72 percent of the retail price in excess of Rs. 30/-.

53. Central Excise duty on matches is being collected through a system of banderolling whose cost has been escalating from year to year. Accordingly the cost of collection has also been rising and has now reached un-economical proportions. It has therefore been decided to do away with the banderolling system. The existing rate of central excise duty has been converted into percentage incidence and the same has been linked with the retail price.

54. Services rendered by hotels and the daily room rent of any room or apartment of which is upto Rs. 25/- are presently exempt from central excise duty. In 1970-71 when this exemption limit was fixed it could be justifiably presumed that guests available of the services rendered by hotels where the daily room rent was more than Rs. 25/-, were in a position to pay the central excise duty. Due to inflationary pressures, however, the said presumption has ceased to be valid and the raising of exemption limit seems called for. It has, therefore, been decided that services rendered by hotels the daily room rent of any room or apartment of which is upto Rs. 50/- will now be exempt from central excise duty. The exemption relating to restaurants has also been reviewed. It has been decided to withdraw the benefit of exemption from such restaurants as are situated within the building, premises or precincts of duty paying hotels and whose liability to pay or not to pay duty is determined independently because of their being distinct legal persons. It is pertinent to mention here that such restaurants provide services to the guests residing in the duty-paying hotel who can afford to bear the incidence of central excise duty.

55. Paper which is used as a raw material for the manufacture of corrugated paper and corrugated board is presently exempt from the levy of central excise duty if it is brought under bond to such factories. A large number of small scale manufacturers cannot avail of this exemption as they cannot arrange supplies from paper mills under bond and are forced to purchase duty paid paper from the market. They, thus pay central excise duty twice and consequently cannot compete with the big manufacturers who manufacture both the raw materials and the finished products. It has also come to Goverment's notice that big manufacturers are usually reluctant or unable to supply the materials to the smaller manufacturers under bond. In view of these circumstances it has been decided to unconditionally exempt corrugated paper and corrugated board from payment of central excise duty.

56. Metal containers are presently liable to central excise duty as well as sales tax. Containers which are made of 75 percent chipboard and 25 percent metal are also considered metal containers for the purposes of levy of central excise duty. Since such containers are manufactured predominantly from indigenous chipboard, it is felt that such containers deserve preferential treatment. Besides, containers are usually made from metals or plastics and in both cases foreign exchange is spent on their imports. Taking these facts into consideration, it has been decided that the aforementioned containers which are popularly known as combi-cans, should be exempted from central excise duty.

57. Wires and cables are presently chargeable to central excise duty as well as sales tax. There are numerous small scale manufacturers who braid the duty-paid wire and the cable for different industrial purposes. Technically braiding is a process of manufacture as envisaged under the central excise law and the braided wires and cables are liable to central excise duty once again. However, since braiding is being done on cottage industry basis, it has been decided to exempt the braided wires and cables from excise duty.

V. SALES TAX

58. The fiscal and economic objectives outlined earlier have been kept in view in the measures relating to Sales Tax also. In this connection, the following measures are proposed to be taken in order to protect and promote local industry:

(i) **Artificial leather/rexine.** At present artificial leather/rexine manufactured locally, is subject to sales tax at 20 percent whereas similar imported artificial leather/rexine is subject to 10 percent sales tax. The imbalance in the incidence of tax has adversely affected the local industry resulting in the closure of a number of units. To reactivate this industry it has been decided to increase sales tax on imported artificial leather/rexine from 10 to 25 percent. At the same time sales on locally manufactured artificial leather/rexine has been reduced from 20 to 10 percent.

(ii) **Bus and truck-engines and chasses.** At present bus and truck engines and chasses imported in CKD condition by the approved assemblers are free from sales tax. However, tax is leviable at 20 percent on locally manufactured components of bus and truck engines and chasses. To encourage substitution of imported components of such engines and chasses by locally manufactured products, it has been decided to exempt the locally manufactured bus and truck engines and chasses components, other than tyres and tubes, supplied as original components/equipment to such assemblers of buses and trucks as are approved by the C.B.R.

(iii) **Steel wires.** Locally manufactured steel wires of various specifications are subject to sales tax at 20 percent whereas this tax is leviable on imported steel wires at 10 percent which makes the local wire industry uncompetitive. It has therefore been decided that the rate of sales on imported wires be raised from 10 to 20 percent and the locally manufactured steel wires be totally exempted.

(iv) **Imported re-engining kits.** Re-engining kits imported by Pakistan Railways for the purposes of re-engining/overhauling its fleet of locomotives, are subject to 10 percent sales tax. Since no sales tax is leviable on locomotives it has been decided to exempt re-engining kits as well from this levy.

(v) **Desert coolers.** Desert coolers are at present subject to sales tax at the enhanced rate of 25 percent. In order to promote this industry, it has been decided to withdraw sales tax from desert coolers. It is expected that manufacturers would respond with a corresponding reduction in the prices of desert coolers and improvement in the quality of their products.

(vi) **Typewriters.** The Telephone Industries of Pakistan is manufacturing portable and standard typewriters locally. The unit has sufficient capacity to meet the local demand. It is already exporting its products to 22 countries. The locally produced typewriters are, however, not competitive price-wise in the local market. It has therefore been decided to raise the rate of sales tax on imported typewriters, other than electric typewriters, from 10 to 30 percent. At the same time exemption has been granted to the locally manufactured typewriters from sales tax of 20 percent.

(vii) **Motor cars.** At present sales tax at 20 percent is leviable on imported motor cars. Keeping in view the prevailing market prices of motor cars in the country the rate of sales tax has been raised to 30 percent.

59. **Deficit financing.** As mentioned earlier, the budgetary gap after accounting for the balance of payments support and the relief given to the Government servants comes to Rs. 603 cores. The measures which I have outlined above would yield an additional resource of Rs. 253 cores. This would still leave a gap of Rs. 350 cores. It is proposed to cover the gap by resort to deficit financing. The magnitude of the anticipated deficit financing is within the safe limits of monetary expansion. Its dimensions have been determined after a detailed and careful analysis of all the relevant factors germane in this regard. Keeping in view the planned increase in

domestic output, the comfortable supply position of foodgrains and other basic comsumer goods and the expected pace of monetization of the economy, it can be confidently stated that the proposed dimensions of defict financing would not have any autonomous inflationary implications. As a percentage of Gross National Product (GNP), the amount proposed for deficit financing in the next fiscal year would be 1.3 percent as compared to 1.6 percent on this account in the current fiscal year and 3.9 percent in 1977-78.

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By Jean-Marc River. Neuchâtel, Editions Ides et Calendes, 1980. 507 pp.
Manual explaining Swiss tax law, in particular taxes on income and net worth, both for corporations and individuals. Tax principals of federal and cantonal taxes and the desire for harmonization is considered. References to tax cases are taken into account, administrative regulations are appended. A detailed list on tax books is included. (B. 102.799)

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SIMON'S TAXES

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By David Harrington. Croydon, Tolley Publishing Company, Ltd., 1980. 150 pp., £ 5.
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DIRECT INVESTMENT AND DEVELOPMENT IN THE U.S.

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Revised and updated edition of guide which describes both the development programs and the legal constraints on new investment in the U.S.A. It compiles information on federal and state laws, incentive programs and statistics. (B. 102.812)

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Chicago, Commerce Clearing House, Inc., 1980.
Volume I of 1981 Federal Tax Guide in loose-leaf, entirely devoted to explanation and new developments of the federal income tax. The other three volumes constitute the regular edition of the Guide series and contain official texts of income, estate, gift, and withholding tax regulations.
The material is updated weekly. (B. 102.929)

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THE GIFT TAX

By Frederick J. Gerhart. Published by Practising Law Institute, 810 Seventh Avenue, New York, N.Y. 10019. 1980. 215 pp., $ 30.
The major legislative changes wrought by the Tax Reform Act of 1976 and the Revenue Act of 1978, together with the numerous developments in case law and rulings, have been included in this revised edition of the gift tax. (B. 102.784)

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"Final" and "proposed" under Internal Revenue Code. Three volumes. Chicago, Commerce Clearing House, Inc., 1980.
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Washington, Government Printer, 1980. 619 pp.
Consolidation of all official rulings, decisions, executive orders, tax treaties and other items of a permanent nature published in the weekly Bulletins in the second half of 1979. (B. 102.833)

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Tax and business considerations. New York, Main Hurdman & Cranstoun, 1980. 76 pp.
Introductory booklet describing investment and taxation regulations in the U.S. for foreign companies. (B. 102.928)

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By Robert K. Lifton. New York, Law & Business, Inc./Harcourt Brace Jovanovich, Publishers, 1979. 693 pp.
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April 1, 1979, to September 30, 1979. Volume 72, 1979. Washington, Government Printer, 1979. 1282 pp.
Bound volume containing U.S. Tax Court decisions. (B. 102.786)

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Chicago, Commerce Clearing House, Inc., 1980. 250 pp., $ 6. (B. 102.798)

TAX SHELTERS

Second edition. (Formerly "Tax shelters after tax reform"). Edited by Ruth G. Schapiro. Published by Practising Law Institute, 810 Seventh Avenue, New York, N.Y. 10019. 1980. 425 pp., $ 40.
Revised updated manual examining tax shelters in such fields as real estate, farming, oil and gas, partnerships, minimum and maximum tax on personal services, and motion pictures. (B. 102.837)

UNITED STATES TAXATION AND DEVELOPING COUNTRIES

Edited by Robert Hellawell. New York, Columbia University Press, 1980. 442 pp., $ 37.50.
Studies on United States tax policy as it relates to investment and other operations of multinational corporations in developing countries. Contents include: "Provisions in tax laws of developed countries bearing upon private direct investment in developing countries" by Robert Anthoine; "Creditability of foreign taxes" by Harvey P. Dale; "Effects of U.S. tax laws on the tax systems of developing countries" by Carl S. Shoup; "U.S. tax treaties with developing countries" by Robert J. Patrick Jr. (B. 102.845)

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Unternehmenskauf, Gründung von Tochtergesellschaften und Betriebstätten, Gewinnermittlung in den USA. By Hildegard Dreissig. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1980. 348 pp., 46 DM.
Study on the various possibilities of acquisition of businesses, the establishment of a subsidiary and a permanent establishment in the U.S.A. as well as the determination of taxable profit under U.S. federal income tax law with comparative reference to German tax law and the double taxation treaty between the U.S.A. and the German Federal Republic. (B. 102.970)

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Adjustment of Profits for Inflation

PART II

by Pedro Massone P. *

VIII. GLOBAL ADJUSTMENT OR THE INTERMEDIARY SYSTEM

In order to overcome the shortcomings of partial adjustments and at the same time avoid the complexities which are inherent to an integral or complete method, certain countries have used or are using a global adjustment or intermediary system.

The global adjustment covers a greater number of items as compared with those covered by partial adjustments but it does not adjust all the items appearing in a balance sheet in a complete and detailed manner as is the case when an integral or complete method is used.

The scope of the global system is limited to the adjustment of net worth or to the adjustment of the working capital. The method assumes that income should reflect the real differences in net worth or in the working capital, as the case may be, between the beginning and the end of the taxable period. In order to make the relevant correction the following items must be adjusted to their value at the end of the period:

(i) net worth (or working capital) at the beginning of the period;
(ii) net worth (or working capital) at the end of the period; and
(iii) changes in net worth which occurred during the period and are not derived from results (profits and losses).

Moreover, the increase in the value of net worth resulting from the global adjustment is excluded from profits and is thus exempt from income taxation.

The global system waives the higher degree of accuracy that could be achieved by an integral or complete method in order to gain simplicity and facilitate implementation. The results of the global method are therefore less accurate than those of a complete method but they are obtained with fewer complexities.

There are two main systems of global or intermediary adjustment, namely:
(i) adjustment of net worth accounts, as corrected by depreciation allowances of fixed assets; and
(ii) adjustment of working capital.

A. The adjustment of net worth

The adjustment of net worth (capital propio) covers net worth accounts (i.e. capital, reserves and results) and allows for the deduction from taxable income of an amount equal to the increase in net worth derived from the adjustment. Fixed assets and inventories are, in principle, not corrected under this method, which involves a great simplification.

The fact that fixed assets and inventories are excluded from the adjustment produces the effect that annual results will not be equal to actual profits because very important elements are not corrected. Nevertheless the aggregate profits of successive periods will tend to be, in the long run, equal to real profits as calculated under a complete adjustment method.[32]

Although under this method (adjustment of net worth) a deduction from taxable income is normally allowed in an amount equal to the adjustment of net worth for inflation, it is also possible (e.g. Chile under the system in force up to 1974) that the amount of the adjustment must be allocated or used to revalue fixed assets, increasing in this way subsequent depreciation allowances. If under this approach the adjustment of net worth is higher than the correction of fixed assets, then the difference can be deducted directly from taxable income (in Chile this deduction could be made up to a certain percentage of taxable income). However, the correction of fixed assets is limited by the amount of the adjustment of net worth. This means that if the adjusted net worth is less than the adjusted value of fixed assets a deficit will result and the amount to be allocated to the revaluation of fixed assets will be less than the amount necessary to keep pace with price increases.

B. The adjustment of the working capital

The adjustment of the working capital is a simplification of the "adjustment of net worth" method. This method assumes that capital assets are the oldest items of the enterprise and that depreciation allowances calculated on them must be updated year by year. Thus, every year depreciation allowances of fixed assets are updated under coefficients reflecting the change in prices from the acquisition date up to the end of the period being adjusted.

In addition to the adjustment of the depreciation allowance, a global deduction is allowed every year which is related to non-fixed assets (e.g. inventories) and liabilities. Thus the addition of non-fixed assets and liabilities is adjusted in accordance with the increase in prices which has occurred during the year.

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* Professor of Tax Law, Valparaiso.

32. Macón, Jorge, "Nivel de Precios y Equidad en el Impuesto sobre Ingresos Netos", mimeographed Ph.D. thesis, Buenos Aires, 1971.

ADDITIONAL INFORMATION ON COLOMBIA
(see the January 1980 issue of the Bulletin under E. Colombia at p. 13)

Under Decree No. 2,595 of October 26, 1979, which contains regulations to Law 20, the adjustment of the cost of fixed assets is calculated on the value as registered on the last day of the year or period preceding that which is being adjusted, as augmented by previous adjustments. For property acquired during the period which is being adjusted, the adjustment is calculated on the acquisition cost. The cost subject to adjustment is increased with the value of improvements introduced during the year and reduced by depreciation allowances.

The cost of property acquired or transferred during the year is adjusted proportionally to the holding period. Likewise if the tax return covers only part of the year, the adjustment is calculated on a proportional basis.

For immovable property included in fixed assets, the value resulting from the adjustment cannot be below the cadastral value. Rights and shares in limited liability companies are not adjusted separately; their adjustment is the result of the adjustment of the company's assets.

It is necessary to consider that all the rules mentioned above have limited consequences in that they only affect the calculation of:

(i) capital gains derived from the transfer of fixed assets, held by the taxpayer for at least two years;
(ii) the presumed income (8 percent of the net worth);
(iii) the taxable net worth; and
(iv) the value of estates.

These rules have no effect in the calculation of amortization, depreciation allowances, losses of goods or losses resulting from the transfer of assets, all of which are calculated on the basis of historical costs. As to shares, the rules mentioned above apply only in the calculation of capital gains arising from their transfer.

If the sum mentioned above is positive because non-fixed assets exceed liabilities, the amount of the adjustment is deductible from taxable profits. If, on the contrary, the balance of the above sum is negative because liabilities exceed non-fixed assets then the amount of the adjustment is added to taxable profits.

Under the adjustment of the working capital it is not necessary to update all the items of the balance sheet as is the case with the integral method, nor is it necessary to regulate in detail the valuation methods, because normal methods used for tax purposes can be adopted.

The adjustment of the working capital is less advanced as compared with the adjustment of net worth. It has, however, the advantage of simplicity and easy operation, which features can compensate for the lack of accuracy of its results as compared with those of more sophisticated methods.

Due to the complexities of integral adjustments some countries have preferred global or intermediary adjustments which, although they have a wider scope than partial adjustments, do not adjust balance sheet accounts in detail as is the case with the integral method.

Some countries first used partial adjustments of a permanent nature and then shifted to a global or intermediary system (Argentina, Brazil, Chile and Uruguay). Those countries which introduced the global system earlier (Chile and Brazil), after several years of experience, introduced a complete adjustment system.

C. Argentina

Law 21,894 of October 27, 1978 amended the Argentine income tax law and introduced the adjustment of taxable profits for inflation. This adjustment is applicable to fiscal periods concluded on or after January 1, 1978. Taxpayers could choose to have the new method applied only to fiscal periods concluded on or after January 1, 1979.

In the message attached to Law 21,894 the adjustment is described as permanent, global, general and compulsory. Nevertheless the scope of the adjustment has some limits as will appear in the following paragraphs. The same message states that in periods of inflation the income tax must not be levied on nominal profits that do not reflect a real increase in equity, if the value has remained equal or has even diminished. The message also explains that although the global method is not as accurate as an integral method the first was chosen because its operation is easier for both the taxpayers and the tax administration.

The global adjustment is applicable to income derived by those taxpayers specified by the law, namely: corporations, limited liability companies, partnerships limited by shares and limited partnerships established in Argentina; civil associations and foundations established in Argentina; companies belonging wholly or partially to the government; permanent establishments belonging to any entities, companies or enterprises established abroad or to non-resident individuals; and any other company established in Argentina or proprietorships located in that country.

The Argentine adjustment is also applicable to: taxpayers who carry out land subdivisions with urbanization (building) purposes; taxpayers who sell real property under a condominium system; and professionals who simultaneously with their professional activities carry on commercial or industrial undertakings.

In order to compute the adjustment it is in principle necessary to establish the difference between assets and liabilities at their values at the end of the period preceding that which is being corrected. There are, however, a number of items which are specifically excluded from assets or from liabilities qualifying for this computation.

The difference in value between qualifying assets and liabilities computed under the rules is adjusted in the same ratio as the increase of the wholesale price index between the end of the period preceding that which is being adjusted and the end of the period which is being adjusted.

The assets that are taken into account for the computation of the Argentine adjustment must be inferred indirectly because the law follows the method of listing those assets which must be excluded from total assets for computation purposes. Thus, in order to arrive at qualifying assets it is necessary to deduct from total assets several items, some of which are already protected from the distorting effects of inflation separately or which are devoted to the production of non-taxable or exempt profits. The same approach applies to liabilities.

In order to calculate the adjustment, the following items are excluded from qualifying assets (some of them are adjusted separately under rules enacted before Law 21,894), namely:

(i) real property and personal property subject to depreciation (their cost is adjusted separately upon sale);
(ii) investments in personal property which is not subject to depreciation (i.e. artistic works, yachts and other personal property not producing income);
(iii) intangible assets (i.e. goodwill, trademarks, patents, concession rights, etc.) (their cost is adjusted separately upon sale);
(iv) shares and participations in companies and payments made on account of future contributions of capital;
(v) inventory of goods in the case of forestry exploitations (their cost is adjusted separately upon sale);
(vi) pending contributions to be made by shareholders;
(vii) sums owned by the owner or partner for pending contributions or for transactions concluded under terms which are different from those current in the market for independent parties;
(viii) in case of foreign controlled local enterprises, sums owed by head offices, owners, related companies, related branches, and controlling entities or individuals domiciled abroad for contracts which are not concluded on an arm's length basis;
(ix) establishment, organization and reorganization expenses, as well as development, study and research expenses, as far as they were allowed as a deduction;
(x) non-deductible expenses and advance payments of non-deductible taxes included in assets; and
(xi) investments abroad which produce foreign-source income.

Likewise, for adjustment purposes some items are excluded from liabilities, namely:

(i) provisions or reserves not allowed by the law or which are above the limits allowed by the law;
(ii) advance payments received on account of future capital contributions;
(iii) sums owed to the owner or partner for transactions concluded under terms which are different from those current in the market for independent parties; and
(iv) in case of foreign controlled local enterprises, sums owed to head offices, owners, related companies, related branches, and controlling entities or individuals domiciled abroad for contracts concluded under terms which are different from those current in the market for independent parties.

On the other hand, profits received in advance and profits representing benefits to be received in future periods are included in liabilities.

It is necessary to stress that assets excluded from the global adjustment are not necessarily left unadjusted because some of them are corrected separately under rules enacted before the introduction of the global adjustment.

As a result of the exclusion of specified assets and liabilities the starting point of the Argentine method is what has been called the monetary net worth (capital monetario neto). The term, however, is not precise because it includes not only monetary assets and liabilities but also stock-in-trade. Thus it rather approaches the concept of working capital.

Changes in assets and liabilities which have occurred during the period which is being corrected (e.g. increases of paid-in capital, payment of dividends, purchase of fixed assets, etc.) are not taken into account for adjustment purposes unless they are made to avoid tax.

The amount of the adjustment is deducted from taxable income if assets exceed liabilities (loss caused by inflation) or added if liabilities exceed assets (gain caused by inflation). There are some other items which must be added to taxable income, namely:

(i) interest and other income included in exempt income.[33] Income tax exemptions (whether total or partial), already established or to be established in special laws, regarding documents, bills, bonds and other securities issued by the national, provincial or municipal governments will not benefit taxpayers subject to the global adjustment we are discussing;
(ii) gains derived from the transfer of securities other than shares; and
(iii) any updating or increase in the value of debt claims, securities and foreign currency which has occurred during the period which is being corrected.

The net increase of taxable income that may result from the adjustment made under the foregoing rules can be subject to taxation immediately or spread by the taxpayer over three fiscal periods (including the period which is being adjusted), provided the income increase has previously been used to absorb losses, if any, and provided also distribution of profits is postponed.

D. Brazil

Brazil was the second country in Latin America to

33. See *Corporate Taxation in Latin America* (IBFD, Amsterdam), the chapter on Argentina, Section C.1.01.2.1, items (i), (v), (ix) and (xiii).

introduce a global adjustment for inflation, namely the adjustment of the working capital (manutenção do capital de giro próprio) which was used in addition to the restatement of the values of fixed assets.

Besides the monetary restatement of the book value of fixed assets already in force (see Section VII. C. above), Decree-Law 401 of December 30, 1968 permitted the deduction from taxable income of an amount reflecting the effects of inflation on a company's working capital.

For these purposes the working capital was defined as the capital plus reserves and non-distributed profits, less the net value of fixed assets. The net value of fixed assets is calculated by deducting from their updated values, the updated amount of depreciation deductions. The computation of the working capital is based on the opening balances of the company's financial year.

In order to avoid a loss of revenue the deduction from taxable income of the adjustment of the working capital was first limited to 20 percent of taxable profits, but this limit was revoked at the end of 1973.

Under Decree-Law 1,338 of July 23, 1974 the monetary restatement of the value of fixed assets and the adjustment of the working capital were changed with a view to improving the basis of the calculation and eliminating some distortions. The new rules also moved towards an integration of the various adjustment measures.

In 1974 it was also established that as from 1975 legal entities must include positive differences due to monetary restatements in taxable income while negative differences could still be deducted as expenses.

The statutory official indexes of inflation are applied to the net amounts of their accounts and the result will indicate whether the company had a loss or gain on its working capital. If the amount of net worth is greater than the investment in fixed assets and in shares or capital quotas of other companies, there is a loss, if less, a gain, on inflation. In order to minimize the tax effect on the notional gain on inflation, regulations were issued stating that the gain was to be computed to the extent that, and only if, deductions were made in computing taxable income, relating to exchange losses and/or monetary restatements on loans obtained to finance fixed assets or investments in shares or capital quotas.

The global adjustment in Brazil was revoked by Decree-Law 1,598 which introduced an integral adjustment.

E. Chile

Chile was the first Latin American country to provide for a global adjustment of profits for inflation. In fact, Law 13,305 of April 6, 1959 amended the Income Tax Law then in force (i.e. Law 8,419 of April 10, 1946) and introduced the restatement of net worth for inflation (reajuste o revalorización del capital propio).

The global adjustment, with some minor amendments, was maintained in the subsequent Income Tax Law enacted by Article 5 of Law 15,564 of February 2, 1964 and later fully replaced by an integral method in the revised text of the Income Tax Law enacted by Decree-Law 824 of December 31, 1974.

The Chilean adjustment of net worth (reajuste o revalorización del capital propio) could originally be used on a voluntary basis by taxpayers of Categories Three and Four, that is to say, by taxpayers deriving income from trade, industry, construction, mining and some other similar activities. The method later became compulsory for these taxpayers.

The Chilean adjustment of net worth assumed that inflation produces an erosion of net worth, an appreciation of certain assets and a fictitious increase in nominal income. Accordingly, the global adjustment provided for the restatement of net worth, tangible fixed assets and securities, and possible reduction of the nominal profits arising in the period.

The Chilean adjustment of net worth took into account the change in the purchasing power of the Chilean currency between the month preceding the date of balance sheet closing the period and the same month of the preceding year, such change being measured in accordance with the cost of living index. However, the decrease in the purchasing power of the Chilean currency was subsequently measured in accordance with the consumer price index.

For the purposes of the adjustment, the net worth was equal to assets less liabilities. Nevertheless adjustable net worth did not include profits arising in the period. Moreover, in computing adjustable net worth, intangible, nominal, temporary, and other values which do not represent effective investments were excluded from assets. As from 1964, contributions to companies other than corporations were excluded from assets and updated separately. As from 1969 securities were also excluded from assets in computing adjustable net worth.

Values belonging to owners or shareholders and used in the enterprise were computed in calculating adjustable net worth even if they were not formally part of the capital. For such a computation the original provisions of Law 13,305 required that the aforesaid values be used in the enterprise for more than six months in the relevant period. The new text of the Income Tax Law enacted by Article 5 of Law 15,564 specifically provided that changes in the capital which occurred during the taxable period were to be computed in proportion to that part of the period during which they were used in the enterprise.

The difference between the old value of net worth and its restated value was exempt from any income taxation and was considered as capital for all legal purposes as from the taxable period following the date of the balance sheet. The text of the Income Tax Law enacted by Article 5 of Law 15,564 further specified that the above provision covered both the enterprise itself and its partners or shareholders.

The difference between the old value of net worth and its restated value was successively used for:

(i) the revaluation of tangible fixed assets which was calculated by applying to the net book value at the beginning of the period the index used for the restatement of net worth. The new text of the

Income Tax Law enacted by Article 5 of Law 15,564 further specified that the revaluation of fixed assets was to be computed in proportion to that part of the period during which the asset was held by the enterprise;

(ii) the revaluation of securities in order to adjust their value to their quotation on the stock exchange on the balance sheet date. The new text of the Income Tax Law enacted by Article 5 of Law 15,564 further specified that if there was no quotation on the stock exchange the revaluation of securities was to be calculated under the index used for the restatement of net worth. The revaluation of securities was subsequently eliminated by Law 17,073 of December 31, 1968; and

(iii) the deduction from the profits arising in the period of that part of net worth revaluation which could not be used under the rules discussed above. In order to avoid an excessive loss of revenue for the treasury this deduction was limited to 10 percent of taxable income. This limit was subsequently increased to 20 percent by the new text of the Income Tax enacted by Article 5 of Law 15,564.

The text of the Income Tax Law enacted by Article 5 of Law 15,564 of February 14, 1964 provided that the whole increment of net worth derived from the adjustment was to be capitalized and used to increase the working capital (capital de explotación) of the enterprise. The distribution of such revaluation or its investment for purposes other than those of the enterprise were specifically excluded.

The global adjustment in Chile was revoked by Decree-Law 824 which introduced an integral adjustment, which is discussed in Section IX. B. below.

F. Mexico

A specific provision of the Mexican income tax law states that taxpayers cannot take into account for tax purposes any revaluation of fixed assets or capital.

The Law of December 22, 1978 published in the Official Journal of December 29, 1978 amended the Income Tax Law of December 31, 1964 and established a special deduction from taxable income. For all income tax returns to be filed during 1979 the special deduction was calculated under special rules.

The special deduction is available for enterprises. Development companies (sociedades de fomento), credit institutions, insurance institutions and auxiliary credit organizations are not eligible for this special deduction.

The special deduction is calculated as follows:

(i) the depreciation allowance for goods acquired up to December 31, 1978 is multiplied by the factor established in the Revenue Law enacted every year.[34] The depreciation allowance for goods acquired after December 31, 1978 is multiplied by the relevant factor appearing in a list established in the Revenue Law and taking into account the number of years elapsed from December 31, 1978 to December 31 of the year preceding that in which the income tax return is filed;

(ii) the average of the financial assets (namely documents receivable in national currency under terms of payment that are over a year, including securities and deposits in credit institutions) at the end of each month of the calendar year preceding that in which the tax return must be filed is multiplied by the factor established in the Revenue Law; and

(iii) the average of liabilities at the end of each month of the calendar year preceding that in which the tax return is filed multiplied by the factor established in the Revenue Law.

This special deduction is the result of the calculation described in paragraph (i) plus the result of the calculation described in paragraph (ii) minus the result of the calculation described in paragraph (iii). However, if the result of the calculation described in paragraph (iii) is more than the total amount of the calculations described in paragraphs (i) and (ii), the special deduction will not be available.

The Mexican system is also expected to eventually reduce the income tax burden, and thus to discourage indebtedness.[35]

G. Uruguay

Law 14,948 of November 7, 1979, published in the Official Journal of November 12, 1979, introduced a global adjustment of profits for inflation which is to come into force gradually. As from January 1, 1981 only 30 percent of the adjustment is effective. As from January 1, 1982 only 60 percent of the adjustment is effective. Finally, as from January 1, 1983, the full adjustment is effective.

The Uruguayan adjustment is basically applicable to income derived from the joint utilization of capital and work as applied to regular profitable activities.

In order to calculate the adjustment of profits for inflation, it is necessary to consider the difference between assets and liabilities according to their book value at the beginning of the period.

This difference between assets and liabilities is adjusted in accordance with the percentage of increase in the wholesale price index between the end of the period preceding that which is being adjusted and the end of this period.

In computing the adjustment certain items are excluded from qualifying assets, namely:

(i) assets devoted to the production of non-taxable income;

(ii) fixed assets (fixed assets are, however, revalued under rules discussed at the beginning of Section VII. G. above); and

(iii) investments in other enterprises (shares, however, are included in assets).

If some assets are devoted to the production of non-taxable income, then a proportional part of liabilities is not included for adjustment purposes.

Changes in assets and liabilities which have occurred

34. The factor is established on the basis of price increases.

35. *Comercio Exterior,* Vol. 29, No. 1, January 1979, at 36.

during the period which is being corrected are not taken into account for computation purposes. However, if such changes are made to avoid tax, the tax administration can treat them as if they occurred at the beginning of the period.

If eligible assets exceed liabilities the adjustment is treated as a loss caused by inflation and deducted from taxable income. If liabilities exceed eligible assets, the adjustment is treated as a gain caused by inflation and added to taxable income.

IX. THE INTEGRAL ADJUSTMENT

Under the integral adjustment, also known as price level accounting, taxable profits are calculated taking into account: (i) an adjustment of trade or business results for inflation; and (ii) the computation of results produced by inflation.

Trade or business results represented by the difference between sales and costs are adjusted by means of indexes reflecting changes in the price level between the date of acquisition of goods and services forming part of costs and the date on which income arises.

The results produced by inflation represent transfers of wealth from the enterprise to its debtors and from its creditors to the enterprise, which transfers arise in inflationary periods in connection with claims and debts particularly if they are not linked to price level indexes.

The integral method takes into consideration the two types of results mentioned above in calculating real or adjusted profits. The method changes or corrects financial statements in order to have all items shown or expressed in monetary units representing the same purchasing power. The integral method therefore covers not only the adjustment of fixed assets and inventories but also other items of the balance sheet to keep pace with changes in the acquisition power of currency.

The integral method considers that nominal results arising during inflation and calculated under traditional accounting principles must be converted into real results (i.e. results adjusted for inflation) and that for this purpose it is necessary: (i) to restate costs; and (ii) to include the results produced by inflation in taxable profits.

The integral method assumes that the items of the balance sheet (assets and liabilities) are out of date. However a distinction is made between monetary and non-monetary items. The first group includes monetary assets (cash on hand, deposits in banks, receivables the amount of which is established in contracts) and monetary liabilities (short and long term debts).

During inflation the holder of monetary assets which are not linked to price indexes loses purchasing power while debtors gain through the reduction of the real value of their debts. Inflation hits holders of monetary assets (e.g. creditors of debts not linked to price indexes) even more heavily than owners of other assets because the nominal value of non-monetary assets increases with inflation. The monetary values which are not adjusted are precisely those which produce effects from inflation. If, for instance, there is cash on hand or a one-year loan is granted at the beginning of the period and during this period the general price level increases by 50 percent, then, at the end of the period, the enterprise will suffer a loss equal to 50 percent of that cash or loan. On the other hand, if a one-year debt is incurred at the beginning of the period the enterprise will derive a profit equal to 50 percent. Such results are not taken into account under traditional accounting methods.[36]

Under the integral adjustment, monetary items (assets and liabilities) are not updated and remain unchanged because nominal values and values current at the end of the period are the same. In fact, monetary items consist of cash on hand or the contractual amount of rights to be paid or received which do not need adjustment for tax purposes because at the end of the period their nominal value is equal to their real value.[37]

Although profits or losses produced by inflation derived from monetary items are included the balance sheet, they are also reflected in the results (profits or losses) through the adjustment of non-monetary assets and liabilities. In fact, under the double entry technique, the real transfer of wealth is made through a counter entry in non-monetary assets and liabilities and the sum of adjusted non-monetary items is necessarily equal to monetary items of the balance sheet.

On the other hand, non-monetary items (e.g. fixed assets, inventories, deferred expenses, net worth accounts, results accounts) maintain their intrinsic or real value in inflationary periods but they are registered in accordance with the value that the currency had at the moment of their inclusion into financial records, which value is different from the value of currency at the end of the period. Therefore non-monetary items are expressed in nominal values which do not reflect their real values and must therefore be updated or adjusted to the value of currency at the end of the period.

As shown above, the integral adjustment is aimed at correcting all the distorting effects produced by inflation on financial statements and is not limited to neutralizing those effects distorting replacement costs. With the integral method the corporate income tax is not levied on nominal or fictitious profits but on real

36. *Ajustes del Impuesto sobre las Utilidades...*, at 14. Even measures to adjust debts for inflation can produce profits which are in fact derived from inflation. For instance, in some countries loans and financing can be linked to price indexes. In Argentina, Brazil and Chile the increase in the amount of claims due to their adjustment for inflation under price indexes was not computed in calculating taxable income or was exempted from income taxation. On the other hand, the adjustment of debts (liabilities) for inflation and interest payable by the debtor was deductible for the debtor when calculating his income tax liability.
It was, under these rules (which are no longer in force), very profitable to borrow money and to invest it in adjustable securities because the increase in nominal value of claims was not taxable while the increase of debts and interest payable were deductible in calculating taxable profits. An unreasonable reduction of the income tax liability was in this way allowed. Moreover the system fostered indebtedness and investments in those securities which were linked to price indexes.
37. Provided they are not indexed.

profits which as a consequence of inflation can be higher or lower than nominal profits.

The purpose of having the different items of financial statements expressed in a homogenous currency is not only to provide for the maintenance of the value of tangible assets as is the case with partial adjustments based on replacement costs, but also to restate or adjust resources appearing there in order to take into account changes in the purchasing power of currency and to measure the real value or equity of an enterprise.

This means that the integral adjustment or price level accounting aims at using the monetary unit to make the value of balance items homogenous and to adjust the original value of items to a current and single unit, i.e. the value of the currency at the end of the period.

Under the integral method a taxable profit arises only when there is an increase in the enterprise's net worth as measured in currency of the same purchasing power. Results arising in the taxable period are equal to the difference between net assets at the beginning and at the end of the period, both expressed in currency having the same purchasing power.

The integral adjustment achieves a higher degree of equity as compared to partial adjustment because the first takes into account both losses and gains derived from inflation (as shown above, real profits can be higher than nominal profits) while partial adjustment is aimed only at reducing taxable profits.

The integral adjustment can produce results which are higher or lower than nominal results, increasing or reducing taxable profits, while partial adjustments can only benefit taxpayers by reducing their taxable profits. However, integral adjustment or price-level accounting is more complex than partial adjustments and by being more accurate it can be less favorable to enterprises as a whole.

Moreover, if inventories are valued according to the price level which is current at the end of the period, the adjusted value of inventories can exceed replacement or market values. In this case the value of inventories must be reduced to such replacement or market values, in order to avoid excessive taxation.

A. Brazil

Decree-Law 1,598 of December 22, 1977 introduced new rules governing the adjustment of taxable profits for inflation. As from taxable periods beginning in 1978 the old adjustment of fixed assets and working capital (global adjustment) was replaced by the adjustment of permanent assets and net worth (integral adjustment).

The new system is compulsory for all legal entities domiciled in Brazil, inclusive of firms and individuals who for tax purposes are treated as legal entities (other than exempt persons).

For the above purposes, it is necessary to take into account that all legal entities operating within Brazil are taxable as corporations domiciled in Brazil and are subject to the corporate income tax. This rule includes subsidiaries, branches, agencies and representatives of corporations domiciled abroad. Individuals are also deemed to be legal entities for income tax purposes if they organize their business as a sole proprietorship and in some other circumstances.

Open companies and legal entities, the net worth of which exceeds a certain amount at the beginning of the taxable period (195 million Cruzeiros for 1980), shall use an auxiliary record (razão auxiliar) where the values subject to adjustment are not expressed in Brazilian currency but in the number of Adjustable Bonds of the National Treasury which represents such values. Other taxpayers subject to adjustment for inflation can choose to use the auxiliary record or to correct directly the amount of Cruzeiros appearing in their accounts.

The new Brazilian system takes into account the decrease in the purchasing power of Brazilian currency between the last balance sheet and the balance sheet to be corrected, such decrease being measured in accordance with the variation in the par value of Adjustable Bonds of the National Treasury.

The Brazilian law assumes that inflation produces an appreciation of permanent assets and a loss in the value of net worth. The adjustment for inflation therefore applies to the following items appearing in the balance sheet:

(i) accounts representing permanent assets (ativo permanente), namely, investments having a permanent nature (investimentos), fixed assets (ativo imovilizado) and deferred assets (ativo diferido);
(ii) depreciation, amortization or depletion allowances on permanent assets;
(iii) provisions for probable losses on the disposal of investments;
(iv) immovable property held for sale by enterprises engaged in real estate trade; the adjustment of this property, however, is voluntary for the taxpayer; and
(v) net worth accounts, namely, capital, capital reserves, profit reserves, revaluation reserves, accumulated profits or losses and other reserves.

Changes in adjustable items during the taxable period are taken into account for computing the adjusment (the same approach is followed in Chile but not in Argentina and Uruguay). Moreover, the taxpayer is specifically allowed to adjust balance sheets prepared during the taxable period.

The adjustment for inflation does not apply to inventories other than immovable property held for sale by enterprises engaged in real estate trade. Moreover, technical reserves of insurance companies are not affected by the adjustment and bear no influence on net profits. Finally, profits shown in intermediary balance sheets or in the final balance sheet cannot be adjusted for inflation during the same taxable period in which they arise.

The adjustment for inflation does not specifically cover monetary fluctuations (i.e. adjustments of a taxpayer's credits and liabilities according to the applicable exchange rate or other correction coefficients, whether required by legal or contractual provisions). However, a gain made as a result of monetary fluctuation, whether by adjustment of credits or liabilities or by realization thereof, shall be included in profits. Moreover, any loss resulting from such monetary fluctuation can be deducted from profits.

The difference between the restated value of adjustable items and their book balance is registered in the account where the relevant item is posted. Likewise, increases in the net worth items derived from the adjustment for inflation are registered in a reserve fund which can be used to offset negative balances.

The counter-entries of the adjustments of permanent assets and net worth accounts are registered in a special adjustment account (conta de correção monetaria) which is treated as a profit and loss account. The adjustment of permanent assets is registered as a credit in the special adjustment account and the adjustment of net worth accounts is registered as a debit in the special adjustment account.

If the restatement of net worth accounts exceeds the adjustment of permanent assets, a loss produced by inflation is reflected through a debit balance in the special adjustment account. This debit balance can be deducted in calculating taxable profits.

If, however, the restatement of permanent assets exceeds the adjustment of net worth accounts, a profit derived from inflation is reflected through a credit balance in the special adjustment account. The credit balance of the special adjustment account is computed in calculating the taxable profits but the taxpayer can choose to defer taxation of that part of the credit representing unrealized inflationary profits.

Inflationary profits are equal to the credit balance of the special adjustment account minus the negative balance of monetary fluctuations computed in calculating net profits of the relevant period. If the balance of monetary fluctuations is positive their inflationary profits are equal to the credit balance of the special adjustment account. Monetary fluctuations include adjustments of the taxpayer's credits and liabilities according to the applicable exchange rate or other correction coefficients, whether required by legal or contractual provisions.

Inflationary profits which are realized during the period must be subject to taxation therein and are calculated by applying the percentage that the "aggregate inflationary profits" bear on the value of certain assets (i.e. on permanent assets and inventory of immovable property held for sale by enterprises engaged in real estate trade) to the aggregate of specified items reflecting realization of the aforesaid profits (i.e. the value of assets owned at the beginning of the period and disposed of during the period; depreciation, amortization and depletion allowed as a deduction during the period; and profits and dividends derived from investments received during the period. The "aggregate inflationary profits" include inflationary profits derived from the relevant period and inflationary profits from earlier periods which have not yet been taxed.

The Brazilian system of adjustment of profits for inflation can be considered to be an integral method because it reflects changes in most items of a balance sheet. The system does not cover, however, the value of inventories. The Brazilian system is rather complicated, especially for those enterprises compelled to use the auxiliary record. This complication, however, is an unavoidable price which must be paid in order to reach a more accurate result.

B. Chile

Chile was the first country in Latin America to introduce an integral adjustment method. Decree-Law 824 published in the Official Journal of December 31, 1974 replaced the adjustment of net worth (global adjustment) by the adjustment of assets and liabilities (integral adjustment) for taxable periods ending in 1975 and subsequent years.

The Chilean adjustment is compulsory for enterprises subject to First Category income tax on their actual profits as shown in a balance sheet. This means that the adjustment is applicable to corporations, legal entities and individual enterprises not specifically exempt on their unearned income and business income.

Values or amounts are generally corrected in accordance with changes in the consumer price index during the period covered by the adjustment or, more precisely, between the last day of the second month preceding the date opening the period and the last day of the month preceding the date closing the period. There are, however, some deviations from this rule.

The Chilean system assumes that inflation produces an appreciation of assets, an increase of debts in foreign currency or linked to price indexes, and a loss on the opening value of net worth. The adjustment for inflation covers, therefore, all items appearing in the balance sheet closing the period, inclusive of those entered during the period, and net worth.

The principal items covered by the adjustment are listed by the law, which also specifies the adjustment standards, as follows:

(i) the book value of tangible fixed assets whether in existence at the beginning of the period or acquired during this period is corrected in accordance with changes in the consumer price index during the whole period or during the period the asset was held by the enterprise, as the case may be;

(ii) the amount effectively paid for goodwill, mining property and concessions, production rights, trademarks, patents and usufructs is corrected in accordance with changes in the consumer price index;

(iii) the value of shares in stock corporations is corrected in accordance with changes in the consumer price index. Stock dividends do not change the aggregate value of shares held by the taxpayer in the issuing company; however, enterprises which are not habitually engaged in the transfer of shares, bonds and debentures must exclude the above items from their assets and exclude from their liabilities any loan or financing used for the acquisition of said securities;

(iv) participations in companies are corrected in accordance with changes in the consumer price index but are subsequently adjusted in accordance with the net worth of the company where the participation is held;

(v) the acquisition value or direct cost of tangible property representing stock in trade held by the enterprise on the closing date is restated in accordance with replacement costs;[38]

(vi) the value of foreign currency and gold coins is corrected in accordance with the quoted price on the date closing the period;

(vii) the amount of debt claims in foreign currency or linked to price indexes is corrected in accordance with the quoted price of the foreign currency or in accordance with the relevant index, as the case may be;

(viii) expenses and costs which must be deferred to subsequent periods are corrected in accordance with changes in the consumer price index;

(ix) the amount of debts or obligations in foreign currency or linked to price indexes which are pending on the date closing the period is corrected in accordance with the quoted price of the foreign currency or in accordance with changes in the relevant index, as the case may be;

(x) the amount of goods, rights, debts and obligations the correction of which is not specified by the law must be corrected in the way to be established by the tax administration; and

(xi) the amount of net worth (capital propio) at the beginning of the period is corrected in accordance with changes in the consumer price index during the period. For these purposes the net worth is equal to assets (exclusive of intangible, nominal, temporary, ordinary and similar values which do not represent an effective investment) less liabilities. Assets belonging to the owner or shareholder used for the purposes of the business are included in assets for calculating net worth.

In computing the adjustment, changes in net worth and other items during the taxable period are normally taken into account as from the date on which they occur.

Although the Chilean adjustment is very comprehensive, there are, however, a few items which are not covered. In fact, for adjustment purposes, individuals must exclude from their accounting records goods and debts which do not relate to the production of profits subject to the corporate income tax (First Category Income Tax) or which do not pertain to the enterprise's ordinary business, activities or transactions.

Moreover, enterprises which are not habitually engaged in the transfer of shares, bonds and debentures must exclude the above items from their assets and exclude fron their liabilities any loan or financing used for the acquisition of said securities.

The value of goods, rights, debts and obligations the correction of which is not specifically provided by the law nor specifically excluded by it under the rules just mentioned above must be corrected in the manner established by the tax administration. The comprehensive nature of the Chilean adjustment is well illustrated by this provision as well as by the fact that it is not easy to find instances where this supplementary provision can be applied.

The restatement of the value of different items must be registered in the account where the relevant item is registered. The counter-entries of such adjustments must be posted in a special adjustment account (corrección monetaria) which reflects gains and losses produced by inflation:

(i) the increase in the value of assets is debited to the account where the relevant asset is registered and credited to the special adjustment account on the assumption that such increase in value is a gain;

(ii) the increase in the amount of debts and obligations is credited to the account where the relevant liability is registered and debited to the special adjustment account on the assumption that such increase in the amount of debts and obligations is a loss; and

(iii) the increase in net worth is credited to an account reflecting the adjustment of net worth (revalorización del capital propio) and debited to the special adjustment account on the assumption that it is necessary to protect the owner's capital from the distorting effects of inflation and avoid taxation on nominal increases of same.

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38. Unless the taxpayer can substantiate with documents and other proof that the replacement cost is lower, the replacement cost is established under the following rules:

for goods acquired in Chile:

— if goods similar to those to be corrected were acquired during the second semester of the period, the replacement cost is deemed to be equal to the highest acquisition price of the period;

— if no such acquisition took place during the second semester of the period but during the first semester of this period, the replacement cost is deemed to be equal to the highest acquisition price of the first semester, as corrected in accordance with the changes in the consumer price index during the second semester;

— if no such acquisition took place during the whole period the replacement cost is deemed to be equal to the book value at the end of the preceding period, as corrected in accordance with changes in the consumer price index during the whole period;

for goods acquired abroad

— if goods similar to those to be corrected were imported during the second semester of the period the replacement cost is deemed to be equal to the value of the last importation (i.e.: c.i.f. value plus customs duties and clearance expenses);

— if no such importation took place during the second semester of the period but during the first semester of this period, the replacement cost is deemed to be equal to the value of the last importation as corrected in accordance with variations in the exchange rate of the relevant foreign currency during the second semester;

— if no such importation took place during the whole period the replacement cost is deemed to be equal to the book value at the end of the preceding period as corrected in accordance with variations in the exchange rate of the relevant foreign currency during the whole period;

for goods produced by the taxpayer

— the replacement cost is deemed to be equal to the replacement cost of raw materials (as established under rules shown above) plus labor in accordance with their cost during the last month of production.

If the increase in the value of liabilities and net worth exceeds the increase in the value of assets then a net loss from inflation is reflected through a debit balance in the special adjustment account which must be deducted in calculating taxable profits.

On the other hand, if the increase in the value of assets exceeds the increase in the value of liabilities and net worth then a net profit from inflation is reflected through a debit balance in the special adjustment account which must be added to taxable profits. In Chile there is no possibility of deferring taxation on these profits as is the case in other countries, namely Argentina, Brazil en Uruguay.

X. FINAL REMARKS

The scope of this article has been limited to the adjustment of taxable profits for inflation and to show briefly the principal systems used and provisons enacted for that purpose in Latin American countries. Even so, the subject appears to be a very complex one.

The introduction of adjustment measures has usually been a slow process which in certain countries has not yet begun. In other countries adjustment measures have reached incipient stages and have a partial nature, while in a few countries more sophisticated methods are being used.

The extent and sophistication of adjustment measures are clearly related to the degree of inflation reached in different Latin American countries and especially with the permanence and duration of the phenomenon.

Although the degree and particulars of adjustment measures differ from country to country, there are some common features and developments, especially between countries where adaptation for inflation has reached a similar degree of development. A greater disparity, however, exists between countries leading the process and those just entering it or which have not even begun.

The disparity between different systems, provisions and experiences can represent a useful source of information for further study on the subject and for devising adjustment measures in those countries which are considering such possibility.

It is worthwhile to point out that some countries first used partial adjustment measures and then shifted to a global or intermediary system (Argentina, Brazil, Chile and Uruguay). Those countries which introduced the global system earlier (Chile and Brazil) underwent several years of experience with it and then introduced a complete adjustment system.

This kind of experience, where simpler methods of adjustment are first used and then more accurate methods are introduced, should be taken into account by those countries which are considering the introduction of adjustment methods. Under this approach, the tax administration, tax advisers and taxpayers gradually become acquainted with the adjustment techniques.

It can also be pointed out that although the complete method is not so excessively complex as to exclude its introduction, its widespread use by taxpayers demands a period of development, spreading and training because in most developing countries it is known to a few experts only.

Even in those countries where the integral adjustment method is better known there are issues for which an agreement has not been reached or which are still being discussed. It is, therefore, inconvenient to introduce directly integral methods in countries where adjustment is just beginning to be used. In these countries the complete adjustment can be a final target to be reached gradually after going through partial and intermediary levels of adjustment.

Finally, another feature that must always be kept in mind is that adjustment measures are aimed at improving equity and economic efficiency. They can, however, create new inequalities and discriminations which can encourage economic decisions similar to incentives (e.g. more intensive use of capital, indebtedness, etc.). This is not an undesirable feature by itself but it can be so if those consequences are not taken into account when introducing a particular provision or system, especially if that provision or system is not in line with political decisions of the government.

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Tax Treatment of Donations for Public Benefit

by H.W.T. PEPPER

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I. INTRODUCTION

There are considerable differences between countries in the matter of tax relief for donations by taxpayers to good causes. Some countries have no relief provisions, perhaps considering that charitable or public-spirited impulses may assure the donor of an ultimate place in the paradise of his particular religion, and that he should not also require tax relief!

Until quite recently there has been a continuing trend in industrial countries for governments to take on ever-increasing liabilities in the educational, medical, amenity, and social welfare fields, at an ever-mounting cost in taxation, and, some would argue, in the diminution of the self-reliance and initiative of the average citizen. The inhabitant of a modern "welfare state" was, in the view of some experts, likely to expect more and more to be done for him by the state instead of using the assurance that he would never be left to starve or his family to suffer whatever his economic misfortunes, as a solid base from which to lead a more hard-working and creative life.

One factor in the area of people doing things for themselves instead of looking to governments, is the creation and support of organisations which provide various social benefits on a voluntary basis, usually involving donations by those able to provide cash, and service by those willing to give up some of their leisure hours.

The tax treatment of donations to bodies which exist to render public service was the most generous in the U.S.A., which also, latterly, was a world-leader in the field of industrial innovation and productivity. Curiously enough, though the events are not necessarily connected, since tax relief for charitable contributions was slashed by the Reform Act of 1976, the economic growth rate in the US has sharply declined, and the tax burden, taking into account Federal, State, and City and local levies, has increased.

II. CURRENT TRENDS

A revolt against the apparently inexorable rise in the tax burden came to a head in California, a State where legislation may be initiated by voters, in the shape of Proposition 13, a proposal, eventually adopted, for severely reducing the levy of property tax. The effect of Proposition 13 was to force the State Government to take a serious look at its expenditures, reduce the number of its civil servants, and effect various economies.

A further attempt to reduce taxation, this time to halve the State income tax, in the shape of "Proposition 9", was recently voted down by the Californian taxpayers who were evidently worried that basic services and welfare expenditures by the State might be threatened. Nevertheless the overall effect of both propositions, not only on California, but on other States with similar laws, has been to make legislature keep a more careful watch on the ever-expanding cost of administration.

A somewhat similar trend has commenced in the UK with the accession in May 1979 of a Conservative Government, which has materially reduced direct taxation and announced a 5-year plan which should encourage people to do more for themselves and expect less from Government. The natural concomitant to such a policy was the introduction, in the second (26 March, 1980) Budget of the new Government, of improvements in the (previously very restricted) tax relief for donations to charity referred to later in this text, in contrast to the restrictions by the USA in 1976.

A government may reasonably encourage citizens prepared to take on, at private sector expense, some of the services that Government would otherwise have to provide by granting tax reliefs, but there obviously have to be limitations.

III. RESTRICTIONS ON RELIEF

Some countries limit tax relief to "charities". These have been defined in UK case law — and the definition is widely adopted in other countries — as bodies established for the advancement of education, or religion, or the relief of poverty, or for other purposes beneficial to the public. Bodies have to be officially approved as "charities" under the law, and remain under some jurisdiction to ensure that their activities are consistent with their established aims. These bodies cover such a vast field, and are to some extent in competition with, or opposition to each other, so that wastage must occur and wholesale tax relief involve undue revenue loss. Examples of conflict are the existence of bodies to promote medical research alongside others which oppose the use of live animals for research, which the former bodies would consider essential; and societies for the promotion of family planning exist alongside others which oppose artificial birth control.

The problem is not a simple one and European countries limit the revenue cost by restricting relief to a percentage of turnover or income, rather than by attempting qualitative judgements. On the other hand there is reasonable unanimity among nations in exempting from income tax the *income* of approved charities, and these bodies may also benefit from relief from local taxation such as property taxes.

Sponsorship

A very old method of business support for "good causes" is that of sponsorship, whereby a commercial firm will bear the cost of some charitable enterprise (including sporting events and art exhibitions), and in return look for some advertising benefit from the resulting publicity. Sometimes the advertising value may far outweigh the cost to the firm, but in any case such costs are normally deductible, without restriction, except for the usual tests of relevance and whether the expense is capital or recurring in nature, in computing the firm's taxable profits.

At present the scope of commercial sponsorship seems to be extending widely and governments are coming to realise that tax relief is less costly to them than providing various things for the public good entirely out of public funds.

IV. POLITICAL DONATIONS

It is not usual for countries to give tax relief for "business" donations to political parties, or the campaigns of particular political candidates. There is, however, a tendency in some countries for politicians to try to raise substantial campaign funds from trading organisations in sympathy with their political aims, a tendency which may to some extent pervert the cause of democracy if donors then expect some kind of "pay-off".

W. Germany and Holland, however, allow relief for the cost of *individual* membership of political parties, and the USA has also recently introduced modest relief for political donations by individuals — up to a maximum of $ 100 for an individual and $ 200 for a married couple — to the political party of choice. This has something to recommend it in helping to preserve a democratic system of helping to keep alive various parties that might one day form an alternative government, by popular vote, when the governing party falls out of favour and is defeated at the polls when its legal term has expired.

V. MAINTENANCE OF CHURCHES, MOSQUES, TEMPLES ETC.

Although in the Middle Ages the Christian churches in Europe used to levy tithes and other "taxes", the system has largely been discontinued. In the case of land subjected to such levies in the past, the sums due have sometimes been "bought out" or abolished by law. Some of the levies made in Muslim countries still survive (zacat, fitrah, ushr etc.) though they have less importance than in the early days of their introduction.

W. Germany is prominent among basically Christian countries in levying a "Church Tax" upon all individuals — the rate varies accordingly to the district, usually it falls between 8 percent and 10 percent — who are members of the Jewish, Protestant, and Roman Catholic churches. The taxpayers may indicate to which church he wishes the money to go, and for non-churchgoers the money may go to social welfare. There is relief from income tax in respect of the church tax paid by the individual. Similar levies are made in Denmark and in Liechtenstein, while in Switzerland there are Cantonal levies, the proceeds of which are divided by the governments among the churches.

Although modern states are much more secular than was the case in earlier centuries, it is clear that a case may be made out for tax relief on donations for the benefit of orthodox religion of an established nature, if one accepts that broadly speaking, such religions are an influence for the upholding of moral values generally. The matter is discussed at greater legth later in these notes.

VI. FISCAL SOVEREIGNTY

One factor in the quantity or generosity of relief for donations for charitable causes, towards preserving or extending the National Heritage, is the factor of fiscal sovereignty.

A democratic government which has a mandate from the voters to govern the country should have the right to apply tax revenues to public and social services as it chooses. If donations to "good causes" in the widest sense were fully tax-deductible, wealthier taxpayers might be able to erode unduly their tax base and in effect usurp the prerogative of the Government to the extent that their donations took directions not deemed to be the most urgent or essential charge upon the public revenue.

As mentioned above, restrictions tend to be imposed somewhat unimaginatively by limiting total relief to a percentage of income etc. but otherwise allowed in respect of a wide spectrum of charitable objects. Some countries, however, restrict the objectives rather than the quantum of relief — see notes on Ireland and Malaysia/Singapore. A new approach, for, e.g., a government that deliberately set out to reduce its own grants for specific social purposes, and to encourage the financing being taken over from the private sector, could provide special relief for donations towards those purposes.

VII. POSITION IN CERTAIN COUNTRIES

A. Britain

Relief for charitable donations in Britain had, until 1980, been restricted in two ways. Only donations made by way of covenanted payments under a deed for a period of 7 or more years were admissible, and the tax relief for an individual only extended to tax at the standard rate, most recently 30 percent; if the taxpayer paid at higher rates, which had been as high as 98 percent up to the year 1978-79, he would still have to bear tax on his payments up to a top rate of 68 percent. In practice annual payments are made net of tax by the donor and the charity claims a tax refund from the Tax Department. No capital gains tax is claimed on gifts to charities.

The changes introduced by the March 1980 Budget were a reduction of the minimum period for a covenant from 7 to 4 years, and an increase in the tax relief. For total annual donations up to £ 3,000 per annum the recipient charity will now be able to claim back tax up to the full rate incurred by the donor — the current maximum tax rate is 75 percent. As regards Capital Transfer Tax (= gift tax on gifts inter vivos + succession tax on bequests) there is now exemption on the first £ 200,000 of bequests to charities (including gifts within a year of death) from C.T.T. and the tax also does not apply to gifts made to charities during the taxpayer's lifetime, whatever the quantum of those gifts.

Where a business firm makes donations to charities in the widest sense by way of sponsorship in such a way that the firm obtains a return for its money in the form of advertising, the cost of the sponsorship may well qualify for a deduction in computing profits as advertising expenditure. Further it is established practice to allow deductions of relatively modest amounts that a firm may be more or less obliged to make to local charities in its area of operations, and where gifts are made to charities from whose operations employees of the firm may benefit, such gifts also would probably qualify for deduction.

B. Republic of Ireland

Although a great deal of charitable work in the medical and educational fields has been done over the years by religious orders in Ireland, to the great benefit of the people and the Government, tax relief for charitable donations in Ireland is curiously restrictive.

To a degree Ireland has followed the British system of allowing annual payments under deeds of covenant etc. in favour of certain institutions, but the covenants may be for 3 years or more. The institutions are limited to:

(a) universities or colleges for research or for teaching the natural sciences; and
(b) bodies connected with the U.N. or Council of Europe in the field of human rights.

In addition covenants for 7 years or more covering annual payments to individuals for their own use, or to named individuals qualify the payer for relief.

From 1973 direct payments to Irish universities for research or for teaching approved subjects (defined as industrial relations, marketing, and any other subject approved by the Minister of Finance) qualify for relief without the need for annualisation under a covenant.

Although tax relief for donations in Ireland seems unusually restrictive, it is perhaps indicative of the enthusiasm of taxpayers to use and expand any relief provisions that exist, that the term "natural sciences" in the relief section has in practice been defined to cover two foolscap pages of subjects ranging from astronomy to zoology, from meteorology to paleontology, and mathematics to parasitology.

C. U.S.A.

Tax relief for donations in the USA has for long been more lavish than that in W. European countries, a factor which has handsomely benefitted a number of American institutions. Before the Tax Reform Act of 1976, an individual could erase the whole of his income tax liability by suitably timed donations. For example, a work of art given to a public gallery would qualify the donor for a deduction equal to the current market value of the oeuvre, even though it had been bought originally for a much lower price. Moreover, no gift tax liability would arise.

There was a build-up of propaganda and public indignation against what was seen as over-generous relief to the rich, which finally resulted in the complicated restriction of the 1976 Reform law. It seems possible that the agitation was overdone in not paying sufficient heed to the fact that benefactions to art galleries etc., might consequentially decline, which might involve greater governmental subsidies involving greater tax liability on taxpayers as a whole.

Tax relief in the US for donations, or "contributions", is still more generous than in Europe, and is conceivably a factor in the long-term movement of art treasures to the American continent. A deduction of up to 50 percent of the income of the year is now available and any surplus of contributions may be carried forward for another 5 years. There are, however, marked changes in the treatment of capital gains liability where an appreciated asset is donated, and other ceilings limiting relief.

There are, of course, other material differences between Europe and the USA in that more activities are in the private sector than, e.g., in Britain and some other European countries. Public utilities (Electricity, gas, and water supply, collection of garbage) are almost totally in private sector hands in the US. Traders to some extent discipline members of their trade, in somewhat the same way as professional bodies, by setting up Better Business Bureaux to investigate complaints from the public etc., which tasks might in Britain, for example, be performed by the government's Office of Fair Trading and other governmental agencies. The S.E.C. (Stock Exchange Commission) also does more to control corporate ethics than private sector bodies in other western countries.

D. Canada, Japan, Europe

In Canada there is also an over-riding maximum deduction from income for charitable contributions — the maximum is 20 percent, while in Japan the maximum is 15 percent.

In Europe, Spain follows the more usual pattern of granting direct relief for charitable donations. Individuals may obtain a credit of 15 percent of their gifts to qualifying charities, or to certain public bodies. In each case there is a ceiling of 10 percent of taxable income for ranking donations. Companies may deduct from income donations to qualifying charities up to a ceiling of 10 percent of taxable income.

Belgium gives tax recognition to gifts to universities, Royal Academies, museums, charities, and for scientific research with a maximum of 10 percent of the total net income of the donor, or B.Fr. 10,000,000, whichever is the less. Holland allows a maximum of 10 percent of total income for individuals, and of 3 percent of profits for companies.

Luxembourg has a maximum of L.Fr. 5,000,000, or 5 percent of income whichever is less, but France, Denmark, and Italy are more restrictive, the limit being 0.5 percent of personal income in France for general donations plus another 0.5 percent for grants to Fondations de France, while Denmark allows a maximum of only D.Kr. 1,000 for donations for purposes beneficial to the community.

Italy allows gifts of up to 0.5 percent of the wage-bill of a company, and gifts for scientific research up to 2 percent of business income. A further 2 percent of income froms the ceiling for gifts to universities while support for certain scientific research institutions in the less-developed Mezzogiorno region is encouraged by allowing a deduction for up to 2 percent of income donated to them. Germany allows deductions for gifts to charitable organisations, applying a ceiling of 10 percent of income of the donor — the ceiling is 0.2 percent of turnover for other benefactions.

E. Malaysia/Singapore

An example of a system of tax relief which has encouraged private initiative and munificence for projects acceptable to the government is that applied since the introduction of income tax in 1948 in Malaysia and Singapore, and which has worked satisfactorily for some 30 years. Institutions, and particularly building funds for the erection of schools, clinics, hospitals etc., which are approved by an independent board set up under the tax law under the chairmanship of the Minister of Finance, qualify their benefactors, whether individual or corporate, for a straight deduction from income in respect of the sum contributed. There is no restriction as to amount.

Fund-raisers are thoroughly used to the need for obtaining official (tax) approval, because the first reaction of a would-be donor is to ask whether his donation would be tax-deductible, In practice the governments have benefitted handsomely over the decades from civic pride and local initiative in the construction of schools and other socially-beneficial buildings at a greatly reduced cost to public revenue. Apart from the fact that the cost in tax relief is less than the total cost if the government had to do the building, it is likely that the work will be executed more cheaply if done as a charitable enterprise by members of a community who may well be personally acquainted with the suppliers and building contractors. To finance the project the fund-raisers naturally start by requesting donations from the wealthier members of the community, but also collect a great deal from others in lower tax brackets.

Religious bodies do not qualify when they seek funds for the maintenance or propagation of their particular faith. The line taken is that to a large extent religions compete with each other — there are many functioning in Malaysia/Singapore including Buddhism, Confucianism, Christianity, Hinduism and the various other religions of India, Islam, and Taoism, apart from the numerous sects and cults which seek adherents in the modern world.

The general principle is that tax relief, and the sacrifice of revenue which it entails, should not be afforded to a taxpayer for what amounts to contributions to save his own soul, but should be restricted to gifts made for the benefit of his fellow man. Thus, where a religious, or other, body sets up a fund to build an orphanage, a home for the starving or homeless etc., donations are deductible if the fund is approved.

VIII. RESPECTIVE MERITS OF RELIEF FOR OUTRIGHT GIFTS AND COVENANTED ANNUITIES

An institution is likely to be more economically run if it has to raise its own funds, instead of being able to relax in the knowledge that government grants will always be available to see it through. In one way the 7-year (or 3-year, or 4-year) deed system is useful in ensuring a steady donation income for a few years, although obviously it will be more difficult to sign up donors to pay annuities for several years than to obtain an outright, tax-deductible, gift. On the other hand also success in obtaining a collection of, say, 7-year deeds after a particular intense fund-raising exercise may result in an institution relaxing its efforts until the period is nearing its end.

The subject is a complicated one because even under a tax regime where relief is due for outright gifts, a charity may invite donors to give (cancellable) bankers' orders for annual donations without entering into any form of covenant. While smaller charities, or funds set up to meet short-term projects, may regard fund-raising as an entirely separate operation less important than the work of the charity in fulfilling its objective, the larger charities may make fund-raising and the measuring of the work possible to the amount of funds attainable, a constant and integral part of their operations.

For particular short-term objectives such as raising money quickly to meet a disaster such as an earthquake, flood, fire or famine, there is obviously no purpose in trying to sign up donors for 7-year deeds and tax systems that allow relief for outright deductions, thus encouraging gifts from the public which may absolve the government from itself having to find subsidies from taxation, must be preferable. One would think that in such emergencies special relief setting aside the usual restrictions would make sense. The same special considerations might be applied where a work of art was about to be bought for export abroad, but is regarded as part of the country's cultural heritage, or where there is an opportunity to purchase for public amenity some stately or ancient monument or beautiful tract of countryside, towards which objective the public might be willing to make an instant response.

IX. CONCLUSION

This particular area of tax policy is already important but will become more so in countries where it is realised that greater economic progress may be possible where direct taxation is moderated and that greater participation of the public in promoting good social causes and improving public amenities may produce much more valuable results than the actual cost in tax relief.

Conference Diary

MARCH 1981

Management Centre Europe: Managing and Developing Foreign Subsidiaries (including: Tax in international operations), Brussels (Belgium), March 4-6 (English).

Seminar Services International: International Tax Planning (Seminar), London (United Kingdom), March 18 and 19 (English).

APRIL 1981

Seminar Services International: International Tax Planning (Seminar), Monaco (Monaco), April 6-8 (English).

Managment Centre Europe: Fourth MCE International Tax Conference. Chairman: Prof. J. van Hoorn Jr., Co-Chairman: A.G. Davies C.B.E. Main subjects: Transfer pricing: Government and business views on tax avoidance; Taxation of international leasing, small meeting groups directed by members of the faculty, Munich (German Federal Republic), April 8-10 (English).

MAY 1981

The International Tax Planning Association: 7th Annual Conference (including: Opportunities for using partnerships in international tax planning: a United Kingdom view and a United States view; Tax aspects of investment in oil and gas; Tax aspects of investment in real property; Benefits of treaties with West Indies territories; Hidden pearls in tax treaties), Montreux (Switzerland), May 20-22 (English).

Taxation Institute of Australia: Second International Convention (including: Outline of U.S. taxation; Outline of Canadian taxation; Analysis of double tax agreements: Australia - U.S.A. and Australia - Canada; U.S. network of double tax treaties; Taxation of expatriate employees in Australia, Canada and U.S.A.), Honolulu (Hawaii), May 22-27 (English).

SEPTEMBER 1981

35th Annual Congress of I.F.A.: I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

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

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

Seminar Services International, 146-148 Cromwell Road, GB-London SW7 4EF (United Kingdom).

The International Tax Planning Association, 33a Warwick Square, London SW1V 2AD (United Kingdom).

Taxation Institute of Australia, 19th Floor, Caga Centre, 8-18 Bent Street, Sydney, N.S.W. 2000 (Australia).

Perspectives in Tax Design and Tax Reform

by G. Thimmaiah*

I. INTRODUCTION

The practice of tax design *and* tax reform *has been with us for many centuries in one form or another. But they have not been properly conceptualised by experts in public finance. Even recent attempts to suggest normative economic criteria for "optimal" taxation*[1] *have ignored the close logical as well as practical relation between tax design and tax reform. In these recent attempts, economists have gone on theorising about optimal tax design,*[2] *while tax lawyers have concentrated their efforts mostly on tax reform. But any useful exercise in tax reform should take into account both the theory and practice of tax design. Since tax design and tax reform are both concerned with the practical aspects of the operation of the tax structure, they should be based on the theoretical foundations as well as the practical aspects involved in their actual operation. Their theoretical foundations are not merely rooted in economic theory but also in jurisprudence. Furthermore, their practical operations are determined by the legal acumen, administrative capabilities and such other institutional environments as political and social institutions and their bearing on the attitude towards payment of tax. Thus the study of tax design and tax reform, in order to be more useful in practical application, should encompass economic, legal and administrative aspects. Such a comprehensive approach to these subjects needs to be emphasised in view of the disconnected way in which they have been studied and also because of the isolated attempts of economists and tax lawyers to formulate general guidelines for tax design and tax reform.*

The primary aim of this paper is to present the economic aspect of tax design and tax reform for two reasons. First, though the theory of public finance has developed to a desirable level of sophistication, it has not been properly linked with the practice of tax design and tax reform. Second, in order to cover the legal and administrative aspects as well, one has to be proficient in all these disciplines which is beyond the reach of the present author. Therefore, a modest beginning is made here to show the economic-theoretical foundations of tax design and tax reform and to highlight the practical considerations which need to be taken into account in order to make the tax structure operate in the desired way. Thus, even in the narrow field of the economic aspect, an attempt is made to show the logical connection, if any, between theoretical foundations and their practical applications in both designing a tax or a tax structure and formulating tax reform measures.

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 D. Simplicity of tax administration
V. Some neglected aspects of tax design and tax reform

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1. See for a brief survey of this literature, David F. Bradford and Harvey S. Rosen, "The Optimal Taxation of Commodities and Income", *The American Economic Review* (papers and proceedings), May 1976, pp. 94-101.

2. In this context, A.B. Atkinson has observed that: "Optimal taxation has attracted many people whose background is in economic theory rather than in public finance, and public finance economists have tended to question whether the recent flurry of articles has done any more than formalize what was known already." "Optimal Taxation and the Direct Versus Indirect Tax Controversy", *Canadian Journal of Economics*, November 1977, p. 591.

II. TAX DESIGN AND TAX REFORM

Tax design is concerned with designing a tax or tax structure from its inception, whereas tax reform is concerned with adjusting an already existing tax or tax structure to changed circumstances. Tax design includes (i) introducing an altogether new tax, (ii) replacing an already existing tax by a new tax, (iii) abolishing an already existing tax and making appropriate changes in other taxes, and (iv) introducing a new tax base, a new rate structure, etc. Tax reform includes introducing changes in the existing tax base, tax rates, exemptions, concessions and administrative procedures.

For the sake of clarity, we may classify tax design and tax reform into three categories based on the agency in charge of designing the tax and suggesting tax reforms: (1) tax designing and tax reform by the *legislature*; (2) tax designing and tax reform by the *executive*; and (3) tax designing and tax reform recommended by an *expert committee.*

When a new tax is suggested and its actual design is shaped in the legislative process based on public opinion, and/or the pressure of "self-interest groups", it becomes a tax design by the legislature. This includes the stages of legislators initiating public discussion, pressuring the government to introduce the necessary legislation based on such opinions, changes proposed in the committees of the legislature, and the changes proposed in the legislature while passing the legislation.

Tax design and tax reform by the executive refers to the initiative taken by the bureaucracy to persuade the government to accept its suggested tax design and reform based on its own thinking, review, experience, etc., or influenced by the experiences of other countries or by independent expert opinion.

Finally, tax design and reform suggested by an independent expert committee appointed by the government is the most important and desirable type, because the required necessary information and technical know-how, which go with an expert committee, may be absent in the first two types of tax design and reform. Further, the required objectivity in identifying the desirable characteristics of tax design and tax reform, evaluating dispassionately the existing tax structure, and formulating more objective measures can be expected from an independent expert committee. It is plausible that even this category of tax design and tax reform may be initiated by the legislators' demand and/or bureaucracy's realisation of the need to seek the advice of an independent expert committee. Therefore, in the ultimate analysis, all three processes of tax design and tax reform are interrelated.

Tax design		**Legislature**
	by	**Executive**
Tax reform		**Expert committees**

Thus tax design refers to the tax engineering aspect and tax reform refers to periodical repairs to the structure after it is designed and installed. Tax design is the science and art of creating the structure of a tax and/or the tax structure as a whole. This involves a choice of taxes, a choice of tax bases, a choice of tax rates, a choice of other elements of tax structure such as exemptions, making a tax or a tax structure satisfy certain normative economic criteria which are considered necessary to achieve the objectives of the government. Tax design is concerned with suggesting normative criteria for formulating the tax legislation. These criteria embody economic, legal and administrative norms. In order to design a tax or tax structure the tax designers should find the empirical basis of these norms. It is also necessary to understand existing economic interconnections.

However, it is quite possible that the empirical results may not support the abstract theoretical economic criteria suggested to guide tax design and tax reform. In that case, economic criteria will have to be modified in the light of empirical results, assuming that such empirical results are reliable. If reliable empirical results are difficult to obtain in actual practice, normative economic criteria remain abstract relations without appropriate empirical methods and/or data to support them. Therefore, circumstantial evidence, intuition and practical wisdom should be combined to accept or reject the normative economic criteria.

Once the tax or tax structure is designed on the basis of such criteria, it goes into operation as soon as it is implemented. From its practical operation, not only the tax paying public but the government and the tax administrators learn about the merits and demerits of the tax structure, either on the basis of practical experience or from empirical tests or both. The merits and demerits of a tax or tax structure are examined and identified with reference to the major objectives which the tax or tax structure is supposed to achieve. These objectives are invariably the economic policy objectives or plan objectives which the government is attempting to achieve through the budget. While considering the rationality of tax design and tax reform, we examine them with reference to certain economic policy objectives of the government. Generally accepted objectives include promoting a higher growth rate of national output, reducing wide inequalities of income and wealth, and maintaining stability of the growth of output, prices and balance of payments; these are supporting objectives for the first two. Though these are the broad objectives of a democratic society in normal times, other objectives (e.g. winning a war, rehabilitation of the people and the economy after a war or after another calamity) may emerge. However, such specification of objective functions is also necessary from the viewpoint of the taxpayer. But in the ultimate analysis, we proceed from individual welfare functions to social welfare functions. Social welfare functions are decided by the government keeping in view the preferences of the majority of the voters who are also the taxpayers. Hence it may be assumed that the spectrum of individual objective welfare functions is ultimately reflected in the national policy objectives of the government. The tax design is created to serve these objectives.

If in the course of operation, that tax or tax structure is not found to be serving these objectives, then introduction of the required corrections into the tax design becomes necessary. This is the core of tax reform. It starts with a thorough examination of the operation of the tax or tax structure in relation to the economic policy objectives, discovering empirical facts about its defects, identifying the causes of defective operation, examining alternative measures to set right the defects and recommending specific tax reform measures in order to restore its effectiveness. It would be desirable to enumerate the relative merits and demerits of alternative tax reform measures and leave the choice to the policy makers.

Tax reform may also be necessitated by the (1) changed socio-economic and political situations and (2) changed objectives. Changes in the economic structure may call for certain changes in the tax structure to achieve the same objectives. Change in the government may require change in the priority of different objectives and/or addition of new objectives; hence, changes in the tax structure are inevitable. Thus tax design refers to creation of a tax structure and tax reform refers to changes in the tax structure to adapt to the changed situations and objectives.

It has been rightly observed by Martin Feldstein that: "Although there have been substantial contributions to both the theory and the policy analysis of optimal taxation, all of these studies have dealt with tax *design* rather than tax *reform*. Discussions of optimal taxation implicitly assume that the tax laws are being written *de novo* on 'a clean sheet of paper'. Such tax *design* is a guide for tax policy in the Garden of Eden, in Rawls, 'original position' in the social contracts of Locke, Hume and Rousseau. Optimal tax reform must take as its starting point the existing tax system and the fact that actual changes are slow and piecemeal.[3]

Tax reform is a slow process

This statement underlines the fact that tax design and tax reform are different and that any tax reform attempt should take for granted certain realities of the existing tax structure, and any changes, if recommended, will slowly be injected into the existing tax structure. It also warns the tax reformers that it would be difficult to sell radical tax reform measures in democratic countries, not only because of the operation of the psychological law, viz., an old tax is a good tax, but also because of the complex reactions which radical tax reform measures might encounter from the "self-interest" pressure groups in democracies. Further, "tax reform is a continuous process. Not only can no grand once-for-all reform scheme be realistically expected to be adopted, but even if it were it would never be sufficient for very long. Circumstances change, and policies must change with them."[4]

III. EVOLUTION OF TAX STRUCTURE DESIGN

Traditionally, taxation was intended to raise revenue for financing the expenditure requirements of "minimum" government. The expenditure items of "minimum" government involved mostly "police state" functions. Such functions of the government did not require a sophisticated design of the tax structure for the purpose of raising revenue. Most of the required revenue was collected from land owners and from those who carried on trade across borders. Even the early attempts to introduce income tax in the U.K., the U.S.A., and India during the nineteenth century were motivated by revenue consideration only. The rate structure, exemption and tax base were designed according to the capacity of the administration to identify the taxpayer and to reach the revenue target, rather than to promote any socio-political goals.

Reduction of inequalities by taxation

However, as the society went from a "feudal" to a "capitalist" form, another objective of taxation (in addition to raising revenue), namely, the objective of reducing inequalities of income and wealth generated by capitalism in the process of its operation, came into prominence. This objective required some sort of tax design. While the function of raising revenue could be performed by any tax, the function of reducing the inequalities of income and wealth required a particular form of tax. Economists started developing a theoretically justifiable design of taxation to suit the socio-political philosophy of reducing inequalities of income and wealth: to begin with, proportional taxation (i.e. an equal proportion of tax payment from everybody's income above a certain limit) was justified to achieve the objectives of raising revenue as well as reducing inequalities of income. This was rigorously proved by a Dutch economist, Cohen-Stuart;[5] later on John Ramsey McCulloch,[6] an English economist, took up its advocacy on the grounds of its objectivity. But the range of inequalities created by capitalism was so wide that proportional taxation could not achieve the objective of reducing such wide inequalities of income and wealth, though it could raise revenue. Hence, proportional taxation was questioned on both its dubious objectivity and its ineffectiveness. Then progressive taxation came to be justified, first on the basis of socio-political philosophy,[7] then on theoretical grounds and also its

3. "On the Theory of Tax Reform", *Journal of Public Economics*, July-August, 1976, p.77.
4. Richard M. Bird, "Optimal tax Policy for a Developing Country: The Case of Colombia", *Finanzarchiv*, Vol. 29, 1970, p.51
5. "On Progressive Taxation", in R.A. Musgrave and A.T. Peacock, *Classics in the Theory of Public Finance* (Macmillan & Co., Ltd., London, 1958). Also see M.M. Metwally and G. Thimmaiah, "A Note on the Classical Utility Function for Purpose of the Theory of Taxation", *Finanzarchiv*, Vol. 31, 1972-73, pp.441-455.
6. *The Taxation and Funding System* (Longman, Brown, Green and Longman, London, 1845), pp.142-143.
7. T.N. Carver, "The Ethical Basis of Distribution and its Application to Taxation", *Annals of the American Academy of Political and Social Science*, Vol. 6, July 1895, pp.79-99, and "The Minimum Sacrifice Theory of Taxation", *Political Science Quarterly*, Vol. 19, 1904, pp.66-79.

"effectiveness".[8] But this theoretical justification based on diminishing marginal utility of income came to be questioned, both on the grounds of the impossibility of its measurement and on the weakness of the assumption of diminishing marginal utility of income in a world of ever increasing desires, fashions and the resultant demonstration effect. Even then, its effectiveness in achieving the objective of reducing inequalities of income, as well as its socio-political appeal, made it survive all the theoretical and political opposition, and with this the first major stage of tax design was achieved.

Direct taxes vs. indirect taxes

Economists started identifying taxes on income and wealth as direct taxes and taxes on sales, consumption and other transactions as indirect taxes. The first group — the direct taxes — was so named on the assumption that they were not shifted on to others and hence were borne by those on whom they were levied; the latter group was assumed to be shifted on to other people by those on whom they were levied and hence the payment of tax was indirect. This distinction was based on the shiftability of tax. When this basis of classifying taxes acquired currency, economists started putting these two types of taxes to intensive tests in terms of micro-economic analysis. It was argued for a long time that the action of government should not disturb or distort the allocation of resources achieved by the market mechanism in a country, and from this it followed that the government should raise its required revenue through such tax or taxes which did not distort allocation of resources effected by the market. In this argument was the implicit assumption that the market mechanism always allocated resources of an economy efficiently. It was proved by using Marshallian partial equilibrium analysis (later also using indifference curve analysis) that indirect taxes distorted resource allocation as compared to a direct tax yielding to an equal amount and hence imposed an excess burden.[9] A direct tax would not affect the price by virtue of the assumption that it cannot be shifted. Accordingly, the direct tax was adored as an ideal tax both for raising revenue and for reducing inequalities of income and wealth. This was a major triumph of economic theory, if it can be called one, in justifying direct taxation for achieving these twin objectives in the early stages of capitalism. This economic justification was used by political propagandists to justify a single tax, though the remnants of a single tax programme could be traced to the populist movement of Henry George[10] whose main political motive was to liquidate landlords in the new colonies.

Direct taxes can be shifted

However, the development of economic theory provided better and more comprehensive tools for the analysis of the tax design question. The general equilibrium analysis yielded results which cast doubt on the superiority of direct taxation in the allocation of resources.[11] What is more, the empirical studies cast doubts on the very classification of taxes into direct and indirect taxes based on the assumption of shiftability. The evidence tendered before the Royal Commission on National Debt and Taxation[12] in England and the theoretical work of Black[13] showed that direct taxes, particularly the business income tax, could be shifted. It was also proved by others that a comprehensive sales tax, when shifted, leaves the consumers and the producers in the same position as before, and therefore it was as good or as bad as a direct tax. This conclusion cast doubt on the distorting effect of indirect tax on resource allocation.

By the time the technique of tax design reached this stage, the role of taxation in capitalist economies widened, particularly with the advent of the Great Depression. The use of taxation was advocated to achieve stability, including price stability, employment stability, output stability, and balance of payments stability. This multifaceted stability question required a more complicated design of the tax structure, requiring high as well as low tax rates, taxes on rich as well as on poor, taxes on profits as well as on consumption, all at the same time. Price stability required high taxes during inflation both on consumption and on profits which could cut into real demand and investment. During depression periods, taxes were required which left more money in the hands of consumers and more profits in the hands of investors. This required the simultaneous operation of varying types of direct and indirect taxes. During inflation, the tax levers to achieve the stability objective were consistent with raising revenue and reducing the inequalities of income and wealth. But during depression this did not happen. Hence, for the first time discriminatory types of taxes were required to be combined and logically integrated and dovetailed. In other words, tax design within the group of direct and indirect taxes was expected to make the effects of economic policy objectives consistent with their requirements. Thus, the evolution of tax designing itself has thrown up the desirable characteristics of a well designed tax structure.

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8. F.Y. Edgeworth, "The Pure Theory of Taxation", and "Minimum Sacrifice Versus Equal Sacrifice", in *Papers Relating to Political Economy* (MacMillan & Co., Ltd., London, 1925).
9. See David Walker, "The Direct-Indirect Tax Problem: Fifteen Years of Controversy", *Public Finance*, Vol. 10, 1955, pp.153-176.
10. *Progress and Poverty* (Robert Schalkanbach Foundation, New York, 1931). See also *Tax Philosophers by Harold Grores*, edited by Donald J. Cuffan (The University of Wisconsin Press, Madison, 1974).
11. See George F. Break, "The Incidence and Economic Effects of Taxation", in Alan S. Blinders et al. (eds.) *The Economics of Public Finance* (The Brookings Institution, Washington D.C., 1974).
12. *Report of the Royal Commission on National Debt and Taxation*, Cmd 2800 (HMSO, London, 1927).
13. D. Black, *The Incidence of Income Taxes* (MacMillan & Co., London, 1938).

IV. CHARACTERISTICS OF A WELL DESIGNED TAX STRUCTURE

It has been maintained by economists that the following characteristics should be obtained in a tax structure as a whole in order to make it more effective for the purpose of achieving the economic policy objectives mentioned in the previous section: first, *built-in elasticity of revenue yield* to meet the ever growing revenue needs of the government; second, *progressivity in rate structure* so as to make the distribution of the tax share of individuals more equitable and also to reduce inequalities of income created by the market forces; third, *planned non-neutrality*, in the sense that haphazard and random distortion of resource allocation including consumption, investment, saving, leisure, etc. is absent; and fourth, *simplicity in administering the taxes* so as to minimise both the cost of collection and the cost of tax compliance. These characteristics should be injected into each and every tax if possible. But in view of the difficulty of creating such an ideal situation, the tax structure as a whole should at least have these characteristics.

A. Built-in elasticity of tax revenue

In view of the growing importance of the public sector in both developed and developing countries, the revenue requirements of the governments increase as the countries move from one stage to the next higher stage, for instance, from a primitive semi-feudal stage to a modern capitalistic stage in the case of developing countries, and from an advanced capitalistic stage to a post-industrial stage in the case of developed countries. This is more so in developing countries where the governments are supposed to shoulder certain additional tasks, such as creation of social and economic infrastructure facilities and even undertaking entrepreneurial functions. As a result, it is argued that a tax structure should yield an automatically increasing revenue as the national income increases, without requiring annual alteration in the tax rates, exemptions and coverage. Though there is nothing wrong in altering these, it should be remembered that an element of stability and certainty should be injected into the tax structure, particularly in regard to the tax rates, exemption and coverage, in order to promote saving and investment. Further, frequent changes in tax rates, etc. invite political reactions which may result in tax revolts. Therefore, the democratic countries should have a long-term perspective regarding tax rates, tax exemption and the coverage of the taxes. At the same time, they should be able to raise more and more revenue automatically as the national income increases. Hence, the tax structure should be elastic during the period when the rates, exemption and coverage of the base are kept constant. It has been proved that a progressive rate structure will have a higher yield elasticity than other rate structures. Secondly, it has also been proved that the tax revenue which is related to the price, i.e. the value, of the commodities is more elastic than that related to the quantity or volume of the commodities. In any country where a large proportion of income is produced in the unorganised private sector,[14] it is very difficult to have an elastic tax system only through a direct tax on income. It becomes necessary to have taxes on commodities also. There again, in an attempt to inject an element of progressivity, certain essential commodities will have to be exempted and, in view of such narrowing down of the scope of commodity taxation, high rates on commodities of not-so-essential a nature become inevitable.

Income-elasticity of taxation also serves another purpose. It acts as a built-in stabiliser, particularly in the case of commodity taxation. As the prices of commodities increase as a result of taxation, the consumer will have to pay more tax and real income will consequently be reduced. This reduces real demand and acts as an automatic stabiliser of prices. Thus an elastic revenue system not only yields increasing revenue, but also acts as an automatic stabiliser to whatever marginal extent is possible.

B. Progressivity of tax structure

A progressive rate structure has been advocated in most countries for reducing inequalities of income and wealth. But only in recent years has it been recognised that the progressive rate structure also serves the purpose of revenue elasticity (and built-in flexibility) which helps in achieving the stabilisation objective. Hence, the progressivity of the tax structure has been considered as an important characteristic of the structure as a whole. Since progressivity is mainly intended to aim at equity in the distribution of the tax burden, attempts have been made to design taxes to achieve both horizontal equity (equal tax burden on people whose economic positions are equal) and vertical equity (unequal tax burden on people whose economic positions are unequal). However, such attempts have met with only partial success even with direct taxes because of the administrative complexities they create. Though commodity taxes have been designed to achieve some kind of vertical equity, it is very difficult to design them for achieving horizontal equity. Therefore, the tax designer has to be content with achieving both vertical and horizontal equity through the tax structure as a whole.

C. Planned non-neutrality of tax structure

For a long time the question of absolute neutrality of taxation was considered an important virtue of a tax and a tax structure. But after the Great Depression when the scope of the objectives of fiscal policy was widened, this emphasis on absolute neutrality lost its importance. Today what is relevant is the absence of a

14. "Unorganized sector" refers to all private economic activities (consumption, distribution and production) which are not organised in the legal sense of obtaining licenses, registration, etc. It also includes the now popular "informal sector." Thus, within the private sector there is a further division into organised and unorganised private sectors. This latter subdivision cannot be reached by direct taxes, but can be reached through commodity taxation by taxing the commodities which are generally consumed by all people.

haphazard distortion of the allocation of resources, for it is now accepted that the market mechanism does not necessarily allocate resources in an economically and/or socially efficient way because of monopoly situations, market imperfections and many other institutional factors. Therefore, the government is supposed to influence the resource allocation in the desired way: the way chosen by the government in the form of priorities in its economic policy. Taxation should help the government in influencing the flow of resources in the planned way according to the priorities of the budget of the government, instead of distorting resource allocation haphazardly and creating the traditional excess burden. The planned interference of taxation in influencing resource allocation is considered a rational characteristic of taxation, particularly in developing countries where market forces are distorted by various types of institutional factors. In such countries taxation should change the relative prices of commodities in accordance with the priorities of the budget. Secondly, taxation should influence the choice between saving and investment, between leisure and income, according to the needs and conditions of the country. This means that both direct and indirect taxes should be used to reduce the demand for scarce commodities and to discourage the flow of scarce factors like capital into the production of luxury goods and socially undesirable commodities. Thus discriminatory commodity taxes are required which fall heavily on luxuries and exempt the basic necessities of life. Further, income and corporate taxation should be used to encourage saving in the household and corporate sectors. This, in other words, means that we cannot achieve a socially appropriate allocation of resources through the budget with only one type of tax; hence both direct and indirect taxes, in whatever way we define them, become essential.

Thus in order to inject the characteristics of built-in elasticity, progressivity and planned non-neutrality into the tax structure, it should include a tax on income, a tax on the value of property, a tax on consumption or on sales of final goods and services. Some times it even becomes necessary to resort to certain benefit taxation such as fees and user-charges even though, strictly speaking, they are not taxation. This is because they help in influencing the allocation of resources.

D. Simplicity of tax administration

Even the best designed tax structure may fail to achieve its objectives for want of proper administration. Therefore, simplicity of tax administration is a safeguard, though not a panacea, against administrative failure to implement a well-conceived tax design and tax reforms. In this context, Richard M. Bird has observed that, "Since the quality of tax administration is such an important constraint on the possibility of tax reform, it would appear logical to suggest tax reform which can be administered by a poor administrator. Sound tax policy must be premised on a realistic understanding and appraisal of the capabilities of the tax administration .... A less than ideal tax designed for a poor administration may work better — its effects may be more in line with those desired — than a 'good' tax badly administered."[15]

An important reason for emphasising simplicity in tax administration is that a tax or tax structure designed to possess the three characteristics, viz., built-in elasticity, progressivity and planned non-neutrality, becomes necessarily complicated. Therefore, to put a check on any further growth of complexity it is necessary to keep the process of administration as simple as it is physically and legally possible.

This requires that (i) the complexity of tax law be kept to the minimum and (ii) administrative procedures be as easy to follow and to implement as possible. These simplifications when achieved will, to a large extent, fulfil Adam Smith's canons of convenience, certainty and economy. The tax administration should suit the convenience of taxpayers to pay, and, in case of dispute, to appeal and to receive justice without undue delay. The tax administration should also be able to keep the cost of tax collection and the cost of tax payment within tolerable limits. The tax law should minimise arbitrary interpretation of the coverage of the tax base, application of the rates and allowance for exemptions and concessions. Thus, simplicity of tax administration is as important as the other three characteristics of tax design and tax reform in order to create a more desirable tax structure in democratic countries.

V. SOME NEGLECTED ASPECTS OF TAX DESIGN AND TAX REFORM

Though the above outlined four characteristics (or normative criteria) may be considered desirable for the tax structure of any country, "one must design a tax system for the economic, political and administrative conditions which one finds in a particular country and not for some average abstract hybrid of all countries".[16] No two countries, whether developed or developing, have the same economic, political and administrative situations; hence tax design and tax reform should be dovetailed with specific country situations.

Further, the old colonial practice of transplanting the taxes of the developed countries along with their tax legislation and administrative structure to the former colonies continued even during the post-war period under the new label of providing technical assistance. Tax experts, who were chosen from developed countries, simply tried to transplant their country's tax institutions to the client country, ignoring the changed political situation and economic policy objectives. What is more, some of the tax experts whose fiscal ideas could not find ready acceptance in their own countries tried to experiment with them on the client countries with all the disastrous consequences. A monumental example of this kind of guinea pig treatment was Nicholas Kaldor's attempt to sell his expenditure tax to India. The failure of expenditure tax in India provided easy evidence for even developed countries to reject the tax for ever. A

15. Supra, note 4, pp.50-51.
16. Richard M. Bird, supra, note 4, p.31.

similar experiment was Carl S. Shoup's tax proposals for Japan which were considered impractical.

Furthermore, there are serious limitations in evaluating the government's policies in general and its tax policies in particular in terms of normative economic criteria alone. Such an analytical framework is considered inadequate to comprehend the more mundane forces which operate and influence the process of government policy formulation. This is so especially in the case of formulation of tax policies in a democratic political framework.

The political framework within which democratic governments operate is equally, if not more, relevant in deciding about tax reforms. This has been increasingly recognised in democratic developed countries. Accordingly, government policies and programmes have come to be analysed in terms of positive behaviour of governments, politicians, political parties and interest groups, whose operations are conditioned by the prevailing political framework and the economic system, not to speak of many other factors. Here the economic incentives, e.g. profit motive, higher income, maximising satisfaction, etc. — which are the major determinants of economic behaviour of individuals as well as groups of individuals — are also applied to analyse the political behaviour of politicians, governments, political parties and even bureaucrats. This application of economic theory to the analysis of political behaviour of people and governments has come to be known as public choice theory. Public choice theory analyses the behaviour of governments, particularly the process of formulation and implementation of fiscal policies, so as to understand the actual behaviour and to predict future behaviour in terms of this positive approach.

The normative economic approach to tax design and tax reform is based on the assumption that the general aim of government is to maximise social welfare, or to achieve the objective functions mentioned earlier, and all budgetary tools are intended and used to achieve this objective. This assumption relating to the ultimate motive of a democratic government implies that politicians, and political parties, are also motivated by such a noble mission. In other words, human beings whose economic behaviour is mainly governed by their self-interest, i.e. maximising income, satisfaction, etc., become selfless social welfare seekers as soon as they are elected to political office and, whatever the cost of getting into and continuing in political office, their aim remains noble. But this objective of the government and the basis of it are questioned by public choice theorists like Anthony Downs,[17] James Buchanan,[18] Gordon Tullock,[19] William Niskanan[20] and others.[21] They have analysed the actual positive behaviour of politicians, political parties, governments and even bureaucrats in terms of the same self-interest theory which governs their economic behaviour. According to the economic approach to political behaviour, the aim of the government is to continue in power by maximising votes and the main aim of the politicians and even bureaucrats is to achieve higher income, higher status, more privileges and power: all government programmes and policies are formulated and implemented with a view mainly to maximising these "self-interest" motives.

Professor Richard M. Bird has interpreted the positive theory of tax reform in the following way: "Since most economic analysis is, in a sense, based on the assumption that individual preferences differ, there should be nothing surprising to economists about this obvious proposition that 'tastes' for tax reform differ also .... It is thus most unlikely that there would be any readily discernible widespread agreement (or 'consensus') on the desirability of a particular set of reforms. It is the function of politics to conciliate our differing interests and to enable us to live with one another in a tolerable, if not perfect, fashion. The political system thus fulfils with respect to the 'buying' of tax reform the role of the market system with respect to buying of applies."[22] If this is so, then the implications of this approach to tax design and tax reform are far-reaching. For instance, if economic theory justifies planned non-neutrality as an essential characteristic of a tax structure to achieve the economic policy objectives of the government, then the politicians may not implement the required tax reforms if such reforms face opposition from pressure groups and/or from the voters in general. If, in the calculation of the Finance Minister, the government and the bureaucrats, such tax reforms are going to serve their own self-interest, they might take special interest in implementing them. But such cases arise only by coincidence. Thus if the required tax reforms to improve the effectiveness of the tax structure are consistent with the self-interests of the politicians, and bureaucrats, they will be implemented. Otherwise they will be throttled unless strong countervailing forces threaten the very existence of the government.

Thus, even if a government accepts a particular policy on the basis of its relevance for social welfare, it may not implement it if effective implementation would make it lose or weaken its power. Therefore, if a government finds that a particular tax policy is good from the point of view of the country, but if its implementation results in loss of power because of its impact on certain influential sections of the society, then it may announce the policy on paper and implement it indifferently. Therefore, economists should not stop at suggesting appropriate tax reform measures in terms of normative economic criteria. They should analyse the political implications of such measures to guide the political leaders who are to announce their acceptance for implementation, to guide the political party which has to own up to that policy and to guide the bureaucrats who have to implement it, and suggest appropriate institutional changes as well as a practical compromise to achieve the economic policy objectives.

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17. *An Economic Theory of Democracy* (Harper & Row, New York, 1957).
18. *The Calculus of Consent* (University of Michigan Press, Ann Arbor, 1962).
19. *Ibid.*
20. *Bureaucracy and Representative Government* (Aldine-Atherton, Chicago, 1971).
21. D.G. Hartle, *A Theory of the Expenditure Budgetary Process* (University of Toronto Press, Toronto, 1976).
22. "The Tax Kaleidoscope: Perspectives on Tax Reform in Canada", *Canadian Tax Journal,* September-October 1970, p.52.

This may involve constitutional changes or formal agreement, or strong public opinion.

Therefore, tax design and tax reform should not only satisfy normative economic criteria but also should get over political hurdles in order to make the tax structure achieve the normative objectives of a democratic government. This, in other words, implies that economists should be able to guide the governments in democratic countries not only in designing an efficient tax structure but also in highlighting the political and administrative problems involved in effective implementation of the suggested tax design and tax reforms. This becomes a self-imposed duty of the advisory committees whether or not they are specifically asked to do so through their terms of reference. More often, such advice cannot be openly sought by democratic governments. Hence, it is necessary to analyse the practical implications and to suggest appropriate alternative policy measures even if it is an embarrassing exercise.

IFA NEWS

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3. The paper must not have been published more than 2 years previously, and if it is a thesis for a doctor's degree, the defense of it must not have taken place more than 2 years previously, this period being counted from the 1st of January of the year of publication or defense of thesis.
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7. There is no restriction on the number of pages of the paper. The choice of subjects is unlimited.
8. The Jury will consist of five members, who are appointed by the Executive Committee from among members of the Permanent Scientific Committee for terms of office of no less than two years and not exceeding four years.
9. The winner will receive a medal and an invitation to attend the Congress during which the prize is awarded. Upon application a contribution not exceeding US$ 200.— will be granted towards travel expenses; IFA Congresses are held as a rule in September/October.
10. The Jury's decision shall be made known at least two months before the appropriate Congress.
11. Papers entered for the Prize for a given year should be submitted with eight copies on or before the 1st of May.

Address of the Jury:
General Secretariat of IFA, care of Erasmus University, P.O. Box 1738, Burg. Oudlaan 50, Rotterdam, Netherlands.

ANGLO-DUTCH TAX SEMINAR

The British Branch of IFA announces that an Anglo-Dutch tax seminar will be held in Amsterdam on May 7-8, 1981. The first sessions will start on Thursday afternoon and further sessions will be held on Friday morning and afternoon. The program will include a session on the new Netherlands-United Kingdom tax treaty.

Tax Reform in Portugal in the Context of Accession to the European Communities*

By Paulo de Pitta e Cunha **

A tax reform normally consists of the introduction of qualitative policy measures involving modification of the tax structure. But it may also be that the reform is carried out simply by means of quantitative policy measures, as happens when there is an alteration in rates of tax, with a view to making the tax system conform to significant changes in the order of priorities among the objectives being pursued.

While from a certain viewpoint tax reform may be considered as a process in constant change, in which over a period of time improvements and adjustments are introduced into the tax system, it is certainly true that at some periods a conscious effort is made to effect a general overhaul of the system conceived as a coherent whole in accordance with certain guidelines. A tax reform is thus spoken of with reference to a certain date or a certain period: it was so in Portugal with the reforms of 1929 and of the early 1960s, and the same will surely be true of the reform being studied at present.

Portuguese tax reform in the 1980s

What then are the guiding principles of the Portuguese tax reform of the 1980s? We may divide them into three groups: (i) awareness of the progressive degradation of the tax system and the need to overhaul the tax structure; ii) the embodiment in the Constitution of a certain pattern of taxes; and (iii) the involvement of this country in the integration process being followed by the European Communities and the adaptations of the tax system arising therefrom.

As it stands at present, the Portuguese tax system is still based, with respect to income tax, on the major principles laid down in the reform which, at the beginning of the 1960s, was to be seen in the publication of legislative measures that made regulations for the different kinds of tax.[1]

This reform, which in essence retained the existing tax structure and tax categories by providing for a system of schedular taxes on different categories of income *plus* a complementary tax of a personal nature, concentrated on improving the methods of determining taxable income, which were henceforth based whenever possible on the principle of taxation of real income (as opposed to estimated income).

While recognising the difficulty, in view of the inadequate level of development to which this country had attained, of introducing at the outset a sophisticated system of personal taxation, the tax legislator of 1963 did not fail to foresee a gradual reduction in the number of schedular taxes, postulating the future transformation of complementary tax into the one single tax to be levied on the income of individual persons.

As to taxes on consumption, 1966 saw the introduction of a single-stage sales tax levied on the wholesaler. The choice of this category of tax was influenced by the need for it to be suitably in line with the principle of taxation in the importing country (which operates through eliminating the tax burden on exports, with countervailing taxation of imports), the institution of a value-added tax being left till a later stage.

Developments in the Portuguese tax system as from the end of the 1960s were marked by the introduction of changes in the regulations governing various taxes, which, not being in agreement with the principle of reform as a "continuously evolving process", acted rather so as to weaken the concept that had served as the basis for changes in tax structures and hindered or delayed the introduction of categories of taxes intended to show that the Portuguese tax system had attained a more advanced level.

Thus, with regard to taxes on income, there took place a gradual generalisation among schedular taxes of systems of progressive rates, in a process whose haphazard operation resulted at a certain point in the introduction of an undesirable qualitative discrimination against labour incomes, at the same time as, on the very subject of methods of determining taxable income, there were growing indications of a return to forms of taxation not calculated on the basis of real incomes.

Increasing significance of schedular taxes

The schedular taxes were thus more and more treated as fully independent tax categories, at the same time as the relative importance of complementary tax was declining, whereas in the mixed system of taxation of income in force in Portugal, the predominance of the schedular element was increasing.

It should be added that no improvement was introduced into the mechanism by which schedular taxes were consolidated with complementary tax, the practice being continued of deducting the amounts paid in schedular taxes against the income calculated for purposes of overall taxation, instead of progress being made towards the system of a "principal tax", in which schedular taxes operate as an integral contribution to overall taxation.

* Paper presented at the Closing Session of the Ninth Series of Portuguese, Spanish and Latin-American Fiscal Studies, Oporto, 2 October 1980.

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1. *Editor's note:* See for a brief discussion of the Portuguese tax system *Supplementary Service to European Taxation*, Sections A and B, Portugal.

This characteristic of the increasing importance in the system of the schedular element was not such as to facilitate the change to a single tax on income.

On the other hand, as from 1974 various changes were introduced in the rates of direct taxes in the way of a systematic increase, without these changes being at all related with the overall situation in the economy. At the end of the 1970s the highest marginal rates of taxation on personal income stood at some 90 percent, at the same time as the level was progressively reduced, in nominal terms, at which they became applicable.

The trend in sales tax also took the form of an ever greater diversification in rates and the pattern of the corresponding schedules of products became increasingly complex, no steps being taken towards the adoption of a value added scheme.

Defects of the Portuguese tax system

At the beginning of the 1980s the Portuguese tax system was far from satisfying the criteria by which a good tax structure is normally judged. In fact:

— with regard to the objectives of promoting efficiency and maximising economic growth, the existence of extremely high marginal rates was a significant factor in discouraging private economic activity;

— the continuing preponderance of indirect taxes (and, among these, the increasing importance of categories of no economic significance, as is the case with stamp duty) were a clear indication of the deficiencies in the field of vertical redistribution;

— the introduction of progressive rates into schedular tax tables and the generalised practice of tax evasion and fraud militated against principles of horizontal equity;

— recourse to systematic increases in taxes without any effort to neutralise the effects of inflation indicated the indifference of fiscal policy to variations in the short-term economic situation — or the rejection of the use of taxation as a stablilising instrument;

— numerous alterations introduced for specific reasons into the regulations governing various taxes had contributed to an increasing obscurity in the tax system, the point being reached of creating new fiscal categories as a way of providing for temporary increases in traditional taxes (such as the case of the extraordinary tax in 1979);

— the tax administration revealed a patent incapacity to ensure the effective collection of taxes and faced increased resistance from taxpayers.

On the other hand, while it is certain that the Constitution of 1976, by making express reference to a single and progressive tax on personal income and by giving separate consideration to company taxation, pointed towards a future tax system similar in nature to that of modern industrial democracies, it is no less certain that, in line with the politico-ideological concepts that are at the root of the collectivist tendency in its provisions concerning the economic organisation of this country, it fixed, as the essential and almost the only objective of the tax system, the egalitarian distribution of income and of wealth.

And albeit this objective is to be understood in a merely indicative sense, it is certain that the emphasis with which it is laid down denies the tax structure the flexibility necessary if, as is justly stated in the Meade Report of 1978, the various political choices are to be reconciled in a democratic society.

Rationalisation of the present tax system

Within the framework of a general orientation of economic policy that aims at creating conditions more favourable to activities in the private sector, 1980 saw the introduction in the tax field of a number of measures that represent a first attempt to rationalise the present tax system: a reduction in certain rates; partial updating of the nominal expression of the limits of income brackets and of allowances, bearing in mind inflationary conditions; abandonment of the progressive nature of one of the schedular taxes; establishment of a truce period for taxpayers to regularise their obligations, as a point of departure in an effort to combat tax evasion.

The process of joining the European Communities will imply making the Portuguese tax system compatible with the rules and policies that in this field constitute the "acquis communautaire".

The Treaty of Rome did not provide for the setting-up of a "Community fiscal policy"; it included only concrete rules regarding countervailing charges on imports and remission and repayments in respect of exports as regards indirect taxation, and an attempt was made to confer a juridical basis on later efforts to harmonise national legal systems within the limited perspective of the smooth functioning of the Common Market.

Until today its major achievements have had to do with the introduction of the Community system of value added tax, with special reference to the 6th Directive on this subject, which set up a uniform tax base related to the Community's own system of resources.

While one should not underestimate the difficulties in replacing the present sales tax by the Community value added formula, the experience acquired during almost 15 years of administration of a tax category qualitatively superior to the rudimentary forms of a cumulative multi-stage system is a factor in its favour.

On the other hand, the specific difficulty of introducing VAT with respect to its general application at the final stage in the distribution chain is reduced by the fact that in the Community system itself special schemes have been legalised applicable to small farmers and small retailers, which include situations of tax relief, tax exemption and reduction in rates.

Autonomy of the tax system after entry into the Common Market

If Portugal is granted a reasonable period for adapting to the "acquis communautaire" in this field, it may face with a certain tranquillity the change implicit in membership of the European Communities.

More serious problems may, however, arise if Community provisions with respect to VAT progress towards uniformity in the number and the level of the rates (at present there are considerable differences, from the single rate operating in Denmark to the eight that apply in Italy). When this stage is reached, the problem of the convergence of tax systems will directly present itself, and national autonomy may be questioned in matters of tax policy. In view of the present difficulties in the process of integration with regard to the Nine, it is not, however, probable that this will come to pass in the next few years.

While the achievements of the European Communities concerning tax categories are limited to matters of VAT and of certain excise taxes (and one should note the little progress recorded with respect to the latter), proposals for directives nevertheless exist that should be borne in mind in outlining the future system for corporation tax, to the extent that they envisage not only a certain scheme for reducing economic double taxation, but also concrete levels for the various rates themselves.

It may thus be concluded that, leaving out certain specific areas such as those of sales taxation and a number of excise taxes, Portuguese accession to the European Communities does not affect national independence as regards the Portuguese tax system. This does not mean, however, that, with the exception of those areas of taxation directly concerned in the membership process, the coming tax reform can disregard the implications of membership. The fact is that membership implies making the various economies more uniform, whether in the negative way of removing barriers to trade relations and to movements in the factors of production, or in the positive way of adopting common policies; and in the specific case of the European Communities there exists in addition a political dimension that results from the sharing of a common destiny and from the adoption of a single model of political society.

The dynamics of the process will thus not fail to involve in the long term a convergence in general terms of national tax systems.

Once the fundamental guidelines of the projected tax reform are set, it becomes possible to describe its details in more precise terms and to point to those problems that arise as to its application.

The essentials of a new tax structure

The basic categories have already been defined; they consist of a single tax on individual incomes, a company tax and a value added tax, structured in accordance with the Community model.

So as to allow the tax system to operate as smoothly as it should within the framework of a mixed economy that includes a large private sector, such as Portugal continues to have despite the wide-ranging nationalisation measures of 1975, the structure of progressive rates of taxation on personal income should not lead to unconscionably high maximum marginal rates.

The convenience of practising a qualitative discrimination that particularly favours labour incomes leads to the introduction of a limitation on the "unitary" character of the tax and to allowing certain elements to remain that are a throwback to the analytical method of taxation.

On the other hand, there must be an end to the useless complexity that results from an excessively large number of income brackets. (Complementary tax, which at one stage had as many as 26 income brackets, still has 11, with very low starting rates.)

From the reform now in progress there may thus result a tax on personal income with six brackets and rates of between 10 and 60 percent; a company tax with a range of rates from 35 to 40 percent; and a value added tax with two or three rates (in the latter hypothesis, a standard rate of 18 percent, a reduced rate of 6 percent and an increased rate). These figures are given merely as a personal view, nothing as yet being known concerning this aspect of the official work of reform.

No insoluble technical problems appear to exist in carrying out the reform: the "single" tax on personal income does not exclude, as has been stated, the existence of certain schedular elements resulting essentially from the amalgamation of the present professional and complementary taxes; the company tax will be developed out of the present industrial tax; the value added tax will be the successor to a form of taxation in which there is already considerable experience at wholesaler and producer levels, and with respect to this tax there is the possibility that simplified formulas will be applied in the case of small retailers.

It is thus pertinent to ask why work on this reform is at a standstill and what is the motive for delay in completing the respective projects and commencing a public debate on them.

One of the reasons for the length of the preparatory stage stems from the fear of transitional risks in the change from a system which, notwithstanding its blatant defects, has been with us for a long time, to the still little known territory of new tax categories.

On the other hand, the profound disturbances that assailed the Portuguese economy in the revolutionary stage and the immediately following period were not, as is obvious, such as to provide that climate of study and reflection indispensable to the pursuit of the reform process.

The obstacle of transition can be overcome. The profound imbalances in the public accounts which have been evident in Portugal certainly make particularly acute the problem of ensuring certain levels of tax revenue.

It is thus an indispensable condition of the reform that it should have a revenue target. But the recent working of the tax system, from this point of view, has not been brilliant: to the systematic increases (until very recently) in rates there has been as counterpart a low level of elasticity in tax revenue, which denotes an increasing incapacity to ensure effective collection. This would thus seem the suitable moment to bring about a restructuring of the system.

Tax reform slowed down by uncertainty about future socio-economic structure

But what has really been hindering the carrying-out of the tax reform has been the problem, political in nature, that centres on the ends to be pursued and on their respective scale of preferences.

In fact, the concept of the Portuguese tax structure, with particular reference to the level of the various rates, is affected by the position that is adopted with regard to the functions of the public and the private sectors of the economy and to the attribution to one or the other of responsibility for saving and for capital formation.

In the case of Portugal there is thus a dimension additional to the technical question of tax reform: since the socio-economic structure has not yet been well defined, it is difficult to outline the tax structure that should in a natural manner harmonise with it.

The conflict between the project for economic organisation as set out in the Constitution and the demands of the real situation regarding the socio-economic system of this country have not been resolved, which gives rise to a climate of natural uncertainty not propitious to the introduction of far-reaching tax measures.

The nub of the question thus lies in the need to arrive at a basic political consensus which will make it possible to identify without equivocation a dual responsibility to be given to the tax system: to serve as an instrument for correcting inequalities in income and wealth; and to make possible the operation of a mixed economy system with the incentives necessary to the active participation of the private sector.

In view of the distortions to which has been subjected the tax system that resulted from the reform of the 1960s, the taking of measures intended to give renewed uniformity to the system and ensure its acceptance is an imperative precondition for the coming reform.

Beyond the need to remodel the methods and practices of the tax administration, providing it with human resources and material means adequate to the satisfactory accomplishment of its tasks, and so as to avoid useless inconvenience to the taxpayer, the serious socio-psychological problem has to be faced of discrediting of the tax system, as shown in the attitude of the increasing refusal of taxpayers to fulfil their fiscal obligations.

This discredit certainly stems in part from the recognition of the grave injustices in the tax system over the years by reason of the premature and excessive importance attributed to objectives of vertical redistribution without attending to the priority need to ensure the equitable distribution of fiscal burdens over the population as a whole, which is an indispensable condition for acceptance of the system.

It is while taking steps to ensure an informed public opinion concerning the characteristics of the system now in preparation — which must be uniform, reasonable, fair, efficient and simple, as is any good tax structure — that it makes sense to introduce measures aimed at preventing and penalising tax evasion and fraud.

Possible transitional measures

From among the alterations that could soon be introduced so as to facilitate transition to the new tax structure may be mentioned:

— the transformation of complementary tax into a principal tax and the simultaneous doing away with the progressive nature of schedular taxes;
— a reduction in the highest marginal rates of taxation on personal incomes, the updating of the limits of the brackets and the widening of the tax base, not only by the inclusion of areas not at present covered, but also by the revision of the very treatment accorded to the concept of what constitutes income;
— the generalisation whenever possible of the taxation of real profits in the field of industrial tax;
— a reduction in the number of rates of sales tax and possibly a start with an experiment regarding non-cumulative multi-stage payments within the framework of this tax;
— the revision of the part played by stamp duty in the context of a rationalisation of the tax system.

A concern for realism should thus predominate in the work of reform: realism in the search for solutions, bearing always in mind the inevitable conflict between the degree of perfection and sophistication of possible measures and the capacity for implementing them effectively, attention being paid to the level of development of socio-economic structures (these considerations are concerned especially with the evident proportions of an underground economy in Portugal and the recognised difficulties of reaching the hard-to-tax groups); and realism in the care to be taken with the suitable preparation of the machinery that is to carry out the reform, since it would seem to be a wise saying that *"taxes are no better than the quality of their administration"*.

Malaysia: BUDGET 1981

Extracts from the Budget Speech pronounced by the Minister of Finance, Mulia Tengku Razaleigh Hamzah, on October 17, 1980.

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

1. RATIONALISATION

Revision of depreciation allowance

The existing industrial incentives will also be further rationalised to assist industries. The current system of granting depreciation allowances on plant and machinery for income tax purposes is based on the reducing balance method which provides for an initial allowance of 20 percent and an annual allowance at prescribed rates based on the residual value of the asset. Under this method it takes a long time before the asset can be fully written off. In order to encourage modernisation of plants and machinery, I propose that the present method be substituted by a straight line method under which depreciation allowances will be based on the original value. Therefore capital could be written off faster and over a predetermined period. This would benefit industrialists who would now find it easier to undertake their planning and budgeting. In relation to this the rates of allowances on plant and machinery will be revised.

Excess profit tax

By way of further rationalisation, it is proposed that dividends distributed by companies resident in Malaysia to shareholders being companies (intercorporate dividend) should not be subject to excess profit tax. This is intended to mitigate the effect of multi-stage levy of the excess profit tax on companies income distributed to shareholders.

Residence test and the taxation of expatriates

As Malaysia expands its industrial base and modernises its industry we will need more expertise to help in the transfer of technology. However, the current provisions in the Income Tax Act pertaining to the determination of the residence status of a taxpayer are rather rigid. As a result, there are many cases of expatriate taxpayers who have been taxed as non-residents at a flat rate of 40 percent when it would have been more justifiable to tax them as residents at scale rates. Such a rigid requirement could therefore be a disincentive to the inflow of the necessary foreign expertise. To rectify this situation I propose to amend the relevant provision of the Income Tax Act, so that temporary absence due to (a) sevice matters (b) attending conferences, seminars, or studies abroad connected with the service in Malaysia (c) ill-health involving himself or any immediate member of the family and (d) social visits, not exceeding 14 days, be accepted, as a rule, as forming part of the qualifying period of stay in Malaysia.

Surtax on ships

The Government's objective is to develop Malaysia as a maritime nation. In this connection, I propose to provide a new incentive for shipping. At present there is no import duty on ships of more than 26 tonnes but surtax of 5 percent is applicable. The 5 percent tax could constitute a large amount particularly for bigger ships required for international transportation. I therefore propose to lift the surtax of 5 percent on ships. However, for small vessels namely those weighing 26 tonnes or less, the surtax of 5 percent will remain. This is because the building of small ships could very well be undertaken by domestic shipbuilders who need to be given some degree of protection.

Tax exemption for ships' crews

To ensure that Malaysian ships will be manned adequately, tax relief will be offered to trained seamen who work on ocean-going Malaysian vessels, as an incentive for them to remain working on these ships. I propose to exempt wholly from income tax, the emoluments of ocean-going seamen, provided that they serve on Malaysian registered vessels and have been away from the country throughout the basis period for a year of assessment. For the purpose of this exemption, a stay in Malaysia of not exceeding 60 days for each year will be regarded as part of the qualifying period. For crews who are away for only part of a year, their remuneration will be exempted proportionately.

Real Property Gains Tax

Another source of pressure on the price of houses emanates from purchases by non-residents, many of whom do not occupy them. The present provisions of the Real Property Gains Tax Act treat foreigners at par with Malaysians in so far as the application of declining rates of tax (depending on duration of ownership), tax exemption for one house, and other reliefs is concerned. I, therefore, propose to introduce two changes:

(i) the declining RPGT rate structure (applicable according to the duration of ownership) shall not apply to foreign individuals or non-citizens who are not permanent residents in respect of real property bought by them from today (17th October, 1980 i.e. Budget Day) and they shall be taxable at a flat rate of 40 percent on gains in respect of real property acquired by them from today (17th October 1980 i.e. Budget Day).

(ii) the exemption on gains from disposal of one owned house and the exemption of $ 5,000 or 10 percent of the gain per disposal whichever is the higher is to be restricted to Malaysian individuals or permanent residents only.

Tax exemption for house owners

In addition, I also propose to take this opportunity, to grant exemption to a house owner who has previously enjoyed exemption of one house but subsequently has to leave it for valid reasons, such as when he is on transfer or has to take up new employment or to commence business more than 20 miles away from his original residence.

We need to break the inflationary psychology on house prices, which in turn creates expectations that tend to be self-fulfilling. Indeed, bankers have the responsibility to assist in easing the present tight housing situation by providing bridging finance only to housing schemes that have already been approved and are ready for implementation. They should ensure that the houses they eventually finance are sold to genuine owner-occupied home buyers. Bankers should also monitor, as far as practicable, the cost of these houses to ensure that the prices charged or the escalation rates demanded, bear a reasonable relation to actual costs.

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2. CUSTOMS

Import duty on liquor

From the health point of view at least, some consumption items should be discouraged. Current rates of import duty on liquor are not appropriate because of the application of specific rates of duty. The result is that the more expensive brands of liquor carry a relatively lower duty compared to the cheaper brands. Accordingly I propose to introduce an ad valorem import duty of 45 percent in addition to raising the existing specific rate by 10 percent so that where the specific rates correspond to less than 45 percent ad valorem, the imported liquor will be subject to the ad valorem rate of 45 percent. However, in raising the tariff I also have to bear in mind the danger that too high a duty may encourage smuggling as well as illicit brewing of liquor. That is why I have decided on a minimum duty of 45 percent.

As some items of liquor are produced locally, it is only proper that an appropriate revision to excise duty be made on them. I am accordingly raising the excise duty on beer, ale and stout by 10 percent from $1.14 per litre to $1.25 per litre.

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Import duty on tobacco

There is another imported item which should similarly be subject to higher duty. I am referring to tobacco. Unmanufactured tobacco which is presently subject to a duty of $ 27.12 per kg will be raised by 20 percent to $ 32.54 per kg. Similarly cigarettes and other items of manufactured tobacco will also have their import duties raised by 20 percent. A large number of small scale curers and about 60,000 farming families or about 250,000 people could be expected to benefit from this proposal.

In view of the proposed increase in duty on imported cigarettes, I am also raising the excise duty on local manufactured cigarettes by 20 percent from $ 3.64 per kilogram to $ 4.37 per kilogram.

Import duty on musical instruments

Sports and cultural activities such as music will help to keep our youth away from undesirable and wasteful indulgences. Accordingly, I therefore propose to abolish the import duties on musical instruments of 25 percent. The duties on loudspeakers and amplifiers will be reduced from 45 percent to 35 percent while that on microphones from 35 percent to 25 percent.

Opportunity is also taken to assist the film industry by way of abolishing import duties on basic items required by this industry such as cinematograph films in rolls, cameras, projectors, sound recorders and reproducers.

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3. Mobilisation of savings

In order to further mobilise savings, I propose to raise the amount of tax exemption on interest derived from savings deposits. The present tax concession corresponds in the aggregate to total savings of about $ 30,000. The tax exemption will be raised to cover interest derived from deposits totalling $ 50,000. Of this amount, interest on up to $ 30,000 in savings deposits with the National Savings Bank and up to $ 10,000 in saving deposits with the commmercial banks and other financial institutions will also be tax exempt. In addition I propose that interest derived from fixed deposits amounting to $ 10,000 be exempted from income tax provided these deposits have a maturity period exceeding twelve months.

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4. ROAD TAX

Any inflationary programme is incomplete without measures to conserve energy in order to moderate the impact of imported inflation, particularly rising fuel costs. Since motor vehicles are among the major users of fuel, I propose to introduce a more progressive structure of road tax on motor vehicles for private use. The proposal will however not affect owners of vehicles whose engine capacities do not exceed 1,500 c.c. on which current rates of road tax will continue to apply. Higher rates of road tax will therefore become applicable above 1,500 c.c. with rates ranging from 30 cents per c.c. on the next 500 c.c., and rising to a maximum of $ 1.20 on engine capacities in excess of 3,000 c.c. Owners of private diesel vehicles will continue to pay five times more. It should be noted that this proposal will not affect buses, taxis and hire cars, and commercial vehicles.

APPENDIX 1

Changing the method of computation of depreciation allowance

Under the present method of computing depreciation allowance for plant and machinery, an initial (once and for all) allowance of 20 percent and an annual allowance at the prescribed rates are applied based on the reducing balance method. The annual allowance is applied based on the residual or written-down value of the plant. Thus, the plant can only be written off over a long period of time as the residual value diminishes gradually.

In order to encourage investments and renewal of machinery, industry feeling is that a faster method of write-off which is open to all industries should be introduced to complement the accelerated depreciation allowance which is currently restricted to the manufacturing and processing industries over a limited period.

It is proposed that the method of computing the depreciation allowance be changed from the reducing balance method to the straight-line method and be based on a revised rate schedule.

There is no revenue implication arising from this proposal.

The above proposal will take effect from the year of assessment 1981.

APPENDIX 2

Rationalisation of excess profit tax

Excess profit tax is presently charged on the chargeable income (including dividends) of a person exceeding the prescribed franking limit. The person may be an individual or a company resident or not resident in Malaysia.

Where dividends are distributed by a resident company to a non-resident shareholder residing in a country with which Malaysia has a Double Taxation Avoidance Agreement, the dividend should not be liable to E.P.T., in view of the provision in the Double Taxation Agreement to exempt the dividend from a further tax in addition to the company's tax. Further when the dividend is paid by a resident company to another company resident in Malaysia, the recipient company is subject to E.P.T. on income (including the dividend) in excess of the franking limit. When the recipient company in turn makes its distribution to its shareholders, the shareholders are subject to E.P.T. on chargeable income exceeding the franking limit. There is therefore a multiple levy of E.P.T. on the same income once on the source company, then on the parent company and finally on the shareholders. Such multi-stage levy has deterrent effect on investments in this country.

In order to mitigate the effect of multi-stage levy of the E.P.T. on companies' income distributed to shareholders, it is proposed that dividend distributed by companies resident in Malaysia to shareholders being companies (i.e. intercorporate dividends) should not be subject to the E.P.T. The above proposal will take effect from the year of assessment 1981.

APPENDIX 3

Residence test and the taxation of expatriates

The present tests as provided under Section 7 of the Income Tax Act to determine the residence status of a taxpayer appear not to provide for any flexibility and have led to certain taxpayers being taxed as non-residents at a flat rate of 40 percent when it would be more reasonable to tax them as residents at scale rates, depending on the quality of the circumstances involved. The strictness of the present tests is traced to Section 7 (1) (b) which provides that an individual can qualify as resident for a basis year even if his stay in Malaysia in the basis year is for a period of less than 182 days provided that period forms part of a period of more than 182 consecutive or continuous days of his stay here either in the immediately preceding or following basis year.

The condition of continuity in stay is felt to be too strict on expatriates especially those arriving in the latter half of a year and are unable to qualify as resident under the first residence test (requiring a stay of 182 days or more in one basis year), or the other two tests under Sections 7 (1) (c) or (d) which involve three or more basis years. This is so because expatriates serve in Malaysia for a period of about 2 years generally. Section 7(1) (b) which could be the only section available to them to qualify for residence as it presently stands does not recognise any leave of absence from the country for any reason including for business or official duties even for a break of a single day. This is a discouraging feature of the Act and may inhibit inflow of expertise from abroad into the country which Malaysia requires.

It is proposed that for purpose of Section 7 (1) (b), temporary absence due to (i) service matters, (ii) attending conference, seminar, or study abroad connected with the service in Malaysia, (iii) ill-health involving any immediate member of the family and (iv) social visits not exceeding fourteen days, be accepted, as a rule and not by discretion, as forming part of the qualifying period of stay in Malaysia.

The above proposal will take effect from the year of assessment 1981.

APPENDIX 4

Withdrawal of surtax on ships

At present ships that are registered in Malaysia have to pay 5 percent surtax and in the case of ships weighing less than 26 tonnes, an import duty of 25 percent. This is considered to be against the objective of the government to encourage the registration of ships in Malaysia.

It is proposed that in order to encourage registration of ships in Malaysia and at the same time to protect local builders, surtax of 5 percent on ships exceeding 26 gross tonnes be lifted.

APPENDIX 5

Tax exemption for seamen serving on Malaysian registered vessels

Malaysia's policy of becoming a maritime nation is facing some difficulty presently in respect of crew recruitment. Malaysians trained as seamen have been migrating to foreign vessels where better terms and tax privileges are offered. The migration reduces the number of Malaysian seamen available and cannot be easily replaced given that the supply of trained seamen is an arduously slow process. Thus, it is necessary that incentives be provided to encourage whatever available trained Malaysian seamen to stay back on Malaysian vessels rather than migrate and to attract back Malaysian seamen who are currently serving on foreign vessels.

To provide the above incentive, it is proposed that:

(i) The emoluments of the foreign-going seamen shall be wholly exempted from income tax provided he has been away from the country serving aboard a Malaysian vessel in international waters throughout the basis period for a year of assessment. Return visits to Malaysia will be treated as not breaking the qualifying period of absence from Malaysia provided the stay in Malaysia does not exceed 60 days in each year. Also, leave spent outside Malaysia will not break the qualifying period of absence from Malaysia.

(ii) For other foreign-going seamen serving Malaysian vessels in international waters who are away for only a part of the basis period for the year of assessment, the statutory income from such employment should be abated in the proportion of the period of stay abroad during the basis period to the whole of the basis period.

The above proposal will take effect from the year of assessment 1981.

APPENDIX 6

Proposal to amend the Real Property Gains Tax Act, 1976

The present provisions of the R.P.G.T. Act are currently applicable to every person whether or not resident in Malaysia. Thus foreigners are also applied the declining rates of tax (depending on period property is held), the exemption for one owned house irrespective of occupation and other reliefs allowed.

This made it attractive for foreigners to invest in real property in Malaysia and enjoy exemption without even having to occupy the house. A tightening of the R.P.G.T. Act is therefore necessary here to discourage further investments in real properties by foreigners since such investments are not desired by Malaysia.

It is proposed that:

(i) the declining R.P.G.T. rate structure (applicable according to the duration of the ownership) shall not apply to foreign individuals or non-citizens who are not resident in respect of real property bought by them after Budget Day and they shall be taxable at a flat rate of 40 percent on gains from disposal of property acquired by them after Budget Day.

(ii) the exemption on gains from disposal of one owned house and the exemption of $ 5,000 or 10 percent of the gain per disposal whichever is higher are to be restricted to Malaysians or permanent residents only.

The above proposal will take effect from the Budget Day.

APPENDIX 7

Tax exemption for house owners unable to occupy own home

Under present provisions of the Income Tax Act, a house owner can be exempted on the imputed rental value of the house that he owns and occupies but there is no provision to do so when he has to move elsewhere even on service matters and is unable to continue to occupy the house he owns. Upon transfer, he normally rents out his house for which he receives rentals which are taxable compared to being exempted when he was an owner occupier. At his new place of work, he becomes a tenant-renter and has to make rental payments presumably out of the rent he receives from the owned house that he has rented out. However, because of the taxability of the rental income that he receives from renting his house, the net after-tax receipt is not sufficient to cover the rental payments at the new place of stay (or if he is still installing house payments), to pay for the monthly instalment of his his house). The position can be quite harsh if the house owner has to shift from a low rent area where his own house is located to a high rent area where he has to be a tenant-renter.

It is due to such circumstances that house owners unable to occupy own homes seek parity in tax treatment with their previous position as owner occupiers particularly where they have to vacate their houses due to transfer on service matters.

In view of the above, it is proposed that exemption be granted on the rental income of a house owner who is unable to occupy his own house due to transfer, (to a place beyond a 20 mile limit from his original residence) on service matters or business.

The above proposal will take effect from the year of assessment 1981.

APPENDIX 8

Construction industry

In order to increase the supply of skilled labour within a short span of time, it is proposed to introduce a programme of on-site training of three months to be undertaken by a trainer provided by the contractor/developer. This training will be based on guidelines to be prepared by the Ministry of Labour and Manpower in consultation with the private sector.

The incentive package to support the above training programme will consist of the following:

(i) to the trainer, the government will provide an allowance of $ 23/day; and

(ii) a double deduction for income tax purposes for all expenses incurred by the developer or contractor in employing the trainees for the approved 3-month training period.

The above proposal will take effect from the year of assessment 1981.

APPENDIX 9

Proposed changes in import duties

Import duty is imposed with the objective of raising revenue or to protect the local industry. The duties are reviewed every year in order to fit in with the objectives of the government.

For the 1981 Budget, it is proposed that import duties on the following products be reduced or abolished:

(i) Musical instruments

In order to encourage our youths to take up music and thus keeping them away from undesirable activities it is proposed that import duties on all musical items, except for pianos and organ, be abolished. It is felt that the import duties on pianos and organs be retained at the present level as these instruments are mostly purchased by the rich.

(ii) Microphones

The import duty on microphones is 35 percent. As microphones are not musical instruments, it is proposed that this duty be reduced to 25 percent.

(iii) Loudspeakers and amplifiers

At present there is a protective import duty of 45 percent on loudspeakers and amplifiers. But the local manufacturers are not producing the loudspeakers and amplifiers that are used by musicians, or music bands. It is proposed that the import duty on these items be reduced to 35 percent. The local manufacturers have been enjoying the protective tariff for more than 2 years.

(iv) Cinematographic cameras and other equipment related to movie making

At present, duty on cinematograph film is imposed at the rate of 5 percent and duty on cinematographic cameras and other related equipment is at 20 percent.

With a view to encouraging the growth of local film industry, it is proposed that import duty on cinematograph films, cinematographic cameras and other related equipment be abolished.

(v). Weighing machinery

The duty on weiging machinery ranges from 15 percent to 50 percent. This represents a protective duty but at present there are no local manufacturers producing weighing machinery. In view of this and in order to encourage business to switch to the metric system, it is *proposed* that the duty on this item be abolished. The list showing the existing and the proposed rates of duty is shown in Table 1.[1] The estimated revenue loss is 5.0 million.

(vi) Increases of import duty on liquors and tobacco

At present the specific rate of duty has led to inequality of taxes on liquor. In the case of cheaper type of wine or beer, the duty element may exceed their value whereas for more expensive drinks such as brandy and whisky, the duty element constitutes a small part of the value.

It is proposed that liquor be subject to both specific and ad valorem rates of import duty whichever is the higher. It is also proposed that the specific rate be increased by 10 percent and a minimum ad valorem duty at the rate of 45 percent be introduced.

For tobacco and cigarettes, it is proposed that the existing rate of duty be increased by 20 percent. The new duty structure for liquor and tobacco is shown in Table II.[2]

APPENDIX 10

Proposal to increase excise duty on liquor and tobacco

With the increase in the import duty on liquor and tobacco, the local manufacturers of these two products would be automatically given a higher protective duty unless the excise duty on these products are increased in the same proportion.

One of the objectives of increasing the import duty on liquor and cigarettes is to discourage drinking and smoking among the populace, irrespective of whether the products are imported or locally manufactured.

It is therefore proposed that the excise duty on local liquor and cigarettes be increased as follows:

Item	Description of goods	Present Excise duty	Proposed Excise duty
	Beer made from malt		
2.4	Beer and ale	$ 1.14 per litre	$ 1.25/litre
2.5	Stout and porter	$ 1.14 per litre	$ 1.25/litre
3.1	Cigarettes including paper and filter tips	$ 3.64/kg	$ 4.37/kg

APPENDIX 11

Tax exemption on interest

Consideration is given to the suggestion by the Association of Banks and Bank Negara that the tax exemption on interest be extended to the fixed accounts and the exemption level itself be raised to a higher level.

Given that short-term fixed deposits of up to 1 year have grown impressively over the years, there is little justification to extend the exemption to interest on such deposits. However, fixed deposits with maturity exceeding 12 months have not been attractive to depositors so far. There is a case therefore to extend the exemption to interest on longer-term deposits in order to encourage greater locking-up of funds which would contribute to the anti-inflation stance. At the same time by not extending the exemption to short-term fixed accounts, the growth of deposits in savings account in National Savings Bank will not be adversely affected.

In order to further mobilise savings, it is proposed to raise the amount of tax exemption on interest derived from savings deposits. The present tax concession corresponds in the aggregate to total savings of about $ 30,000. The tax exemption will be raised to cover interest derived from deposits totalling $ 50,000. Of this amount, interest on up to $ 30,000 in savings deposits with the National Savings Bank and up to $10,000 in savings deposits with the commercial banks and other financial institutions will also be tax exempt. In addition, it is proposed that interest derived from fixed deposits amounting to $ 10,000 be exempted from income tax provided these deposits have a maturity period of exceeding twelve months.

APPENDIX 12

Proposal to increase road tax on private passenger cars

Presently the road tax payable on 1,000 c.c. car is $ 130, for 1,500 c.c. car $ 205, for 2,000 c.c. car $ 290, for 2,500 c.c., car $ 385, for 3,000 c.c. car $ 490 per year.

Towards the objective of conserving the use of petroleum products in the face of current world crude oil supply problem, it is proposed that the existing graduated scale of road tax structure be made more progressive on private motor vehicles which consume more fuel. The higher tax will apply to both petrol and diesel powered cars.

The proposed road tax structure for petrol powered cars is as follows:

Engine-capacity		Present	Proposed	Present	Proposed
1. First	1000 c.c.	13c/c.c.	13 ¢ / c.c.	$ 130	$ 130
2. Next	500 c.c.	15c/c.c.	15 ¢ / c.c.	+ 75	+ 75
				$205	$205
3. Next	500 c.c.	17c/c.c.	30 ¢ / c.c.	+ 85	+ 150
				$290	$355
4. Next	500 c.c.	19c/c.c.	50 ¢ / c.c.	+ 95	+ 250
				$385	$605
5. Next	500 c.c.	21c/c.c.	80 ¢ / c.c.	+ 105	+ 400
				$490	$1,005
6. On the balance		23c/c.c.	120 ¢ / c.c.	+ 115	+ 600
				$605	$1,605*

* Assuming a 3500 c.c. car.

The above changes do not affect road tax for taxis, buses and other public transport.

With regard to private diesel cars, the road tax payable will remain at the prevailing rate, i.e. five times that of tax payable on petrol powered cars.

APPENDIX 13

Gazetted value for rubber

At present the gazetted value of rubber for duty purposes is based on the average RSS 1 price over the preceding 4 weeks. The smallholders, whose rubber constitute about 50 percent of the rubber exported, are therefore at a disadvantage. As export duty on rubber is calculated based on the price of RSS 1, the smallholders are in effect paying a higher rate of export duty than what they should be paying based on the quality of rubber exported. It is therefore justified on equity ground, to change the present gazetted value of rubber for duty purposes.

The proposal to change the basis of calculating the gazetted value for duty purpose will lead to a loss of revenue. This loss depends on the grade of rubber used for calculating the export duty. When the RSS 3, which is the quality of rubber normally produced by the smallholders is used, the loss would be $ 35.3 million per year. This loss could be minimised if the government uses different prices for different grades of rubber for purposes of duty:

In view of the above consideration it is proposed that the following values be gazetted:

1. RSS 1
2. RSS 2
3. RSS 3 (to include other RSS)
4. SMR CV
5. SMR L
6. SMR 5
7. SMR 10
8. SMR 20
9. SMR 50 (to include other SMR)
10. Latex – value based on RSS 1
11. Compounded rubber (Masterbatch) – value based on RSS 1
12. Other rubber – value based on RSS 3

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1. Not included in this issue.
2. Not included in this issue.

APPENDIX 14

Lower interest loan to small scale industries

At present even though there are many agencies giving financial assistance to small scale industries, small scale industries still face problems such as:

(i) lack of collateral;
(ii) lack of guarantors;
(iii) higher interest rate; and
(iv) difficulty in getting initial loan.

In order to assist small scale industries, it is proposed that the interest rate for unsecured loans not exceeding $ 50,000 by commercial banks to small scale industries be at prime rate (7.5 percent). This low interest loan is to be administered by C.G.C.

The loss of 2 percent suffered by commercial banks on the unsecured loans to small scale industries will be reimbursed by government, through income tax rebate.

The above proposal will take effect from year of assessment 1981.

APPENDIX 15

Double deduction for interest

At present expenditure on interest is allowable for deduction if the loan secured is used for business purposes.

With the object of giving further relief to the small scale industries, it is proposed that small scale industries be allowed double deduction on the interest paid on the unsecured loans under the C.G.C. scheme.

The above proposal will take effect from 1.1.1981.

APPENDIX 16

Proposal to reduce excise licence fee for bleaching disinfectant solution manufacturers

The manufacture of bleaching disinfectant solution is mostly carried out by small enterprises on family business basis. It is a backyard industry involving very simple process, industry is subject to excise licence fee of $ 2,400 per year and an excise duty of 4 cents per kg. on the product.

To assist this group of small manufacturers it is proposed that the excise licence fee for those producing less than 81,638 kg. per year be at $ 120 per year.

APPENDIX 17

Stamp duty on loan agreements

The stamp duty on loan agreements is at 0.5 percent of the value of the loan. This is a relatively high rate and payment of stamp duty at this rate increases his cost of borrowing. For example an agreement for a loan of $ 50,000 would attract a stamp duty of $ 250.

It is therefore proposed that the rate of stamp duty for loans not exceeding $ 250,000 by qualified small scale industries be reduced from 0.5 percent to 0.1 percent.

The above proposal will take effect from 1.1.1981.

APPENDIX 18

Stamp duty on agreements for lease

At present agreements for lease are subject to stamp duty at rates ranging from 0.4 percent to 1.6 percent, depending on the length of the lease.

To relieve small scale industries from this duty, it is proposed that all agreements for leases not exceeding $ 2,400/year be exempted from stamp duty.

There is a minimal revenue loss arising from this proposal.

This proposal will take effect from 1.1.1981.

APPENDIX 19

Incentives for the development of small scale industries

Indirect taxation

Sales tax exemption

Sales tax was introduced in 1972 and was imposed on both locally manufactured and imported goods. Local manufacturers are required to obtain sales tax licence if the goods produced by them are subject to sales tax. To relieve the small manufacturers from levying and collecting sales tax, manufacturers with sales turnover not exceeding $ 20,000 per year or manufacturers receiving labour charges not exceeding $ 4,000 per year are exempted from being licenced under the Sales Tax Act.

Small scale manufacturers are facing numerous problems regarding sales tax. Even though some small manufacturers are exempted from sales tax, many others are caught under the Sales Tax Act. An exemption limit of $ 20,000 per year is too low. This means that only a manufacturer having a sales turnover of about $ 70 per day is exempted.

The small manufacturers are also facing the problem of getting raw materials free from sales tax. Section 9 of the Act provides that a licensed manufacturer can obtain raw materials without having to pay sales tax by using Form C.J. 5. However, since their purchases are small, they are not able to benefit from this facility.

It is therefore proposed that manufacturers with sales turnover not exceeding $ 100,000 per year or receiving labour charges not exceeding $ 20,000 per year be exempted from being licensed under the Sales Tax Act.

APPENDIX 20

Revision of franking limit of development tax

Development tax is levied at the rate of 5 percent on income from a development source which includes business, profession and rents. In levying the development tax on individual, relief is provided at a level that will not burden the small income earners. The present exemption is $ 3,000. Due to the rising cost of living and given that personal relief for the individual income tax have been increased in the 1980 Budget, it is appropriate for the exemption level of the development tax to be revised accordingly. An upward revision to the franking limit is also required to provide a form of relief to the smaller businessmen who venture into small scale industry.

It is proposed that the relief level for development tax be raised from $ 3,000 to $ 5,000 for an individual. It is also *proposed* that a partner in a partnership be afforded the same and the lower exemption level of $ 2,000 for a partner presently enjoyed be repealed so as to equate his position with that of an individual.

The above proposal will take effect from the year of assessment 1981.

Bangladesh: BUDGET 1980-81

Extracts from the Budget Speech pronounced by the Minister of Finance, Mr. Mohammed Saifur Rahman, on June 7, 1980.

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

1. INTRODUCTORY REMARKS

52. I would now submit tax policy and proposals for the coming financial year.

53. But before that, it would be relevant to mention that Taxation Enquiry Commission appointed by Government had long and thorough deliberations and submitted report containing its recommendations. Earlier some recommendations of the Commission made in the Interim Reports had been accepted at various stages. Some recommendations of the Commission which are consistent with the nation's social and economic objectives have been incorporated in the tax proposals for the next financial year.

54. As in other years this year also certain fundamental principles have been followed as the basis to formulate overall tax policy of the Government. These are: reduction of tax burden on the poor and lower income groups of the population, decrease in the prices of the essential commodities of daily use, provision for increased employment opportunities by helping the growth and expansion of the local industries and, above all, widening of the tax base in the country so as to reduce the role of foreign aid in our ceaseless struggle against poverty as well as to collect additional revenue in order to substantially increase share of internal resources required for the implementation of the Second Five Year Plan. Special attention has, however, been given in formulation of tax proposals to ensure as far as possible that new tax measures are borne by the comparatively well-to-do and richer section of the society rather than the poorer section of the people.

55. Strengthening of the tax administration for improvement of tax collection is an important objective of the government. There was no office of the Central Board of Revenue in Bangladesh. Although National Board of Revenue was established after liberation this could not grow into an effective organisation due to various handicaps. In the context of the need for significant improvement in tax collection it is essential to take steps for strengthening revenue administration by providing adequate manpower, essential facilities like office accommodation and equipments and by arrangement for intensive training and orientation of officials in order to build up an efficient organisation. A crash programme would be undertaken in this direction.

2. CUSTOMS

56. Entire nation and the Government are now engaged in intense efforts to develop agriculture and to boost up agricultural production. In line with the national objective, we have been pursuing a policy to extend duty and tax concessions to all input imports for agriculture. During the current year also, a number of steps have been taken in this regard before the formulation of budgetary measures started off. Pesticides used in agriculture can now be imported free of duty and sales tax in any quantity and in any form of packing by any individual or organization. Shallow tubewells agricultural sprayers have also been given concessionary rate admissible to other agricultural equipments and these are sales tax free. Raw materials for agricultural diesel engine and its spares have been completely exempted from duty and sales tax. The duty rate of 15 percent on fishing trawlers has also been reduced to 2½ percent.

57. After food cloth is the most important item of necessity: The traditional handloom industry of our country employs a large section of the rural population in addition to producing fabrics. The cotton textiles industry is also one of the most important

3. INCOME TAX

96. Our direct tax base is extremely narrow and needs to be widened. Therefore, in accordance with the recommendations of the Taxation Enquiry Commission, I propose to include in the definition of income such receipts as are in the nature of compensation for termination of contracts and licenses, salami or premia in respect of leases, goodwill money, etc. The inclusion of the items will save a lot of litigations and help simplify the tax system. With a view, however, to reduce the incidence of tax owing to the inclusion of salami in lump sum in the year of receipt it is proposed that the receipt would be spread equally over the lease period but not exceeding five years.

97. At present where a residential house or an agricultural land is subject to a mortgage or other capital charge the interest thereof is allowed as a deduction in computing the income from the property or the land, as the case may be, irrespective of whether the money borrowed is utilised for the purpose of the house and the land or for personal purpose. This being contrary to the basic principle of computation of income for the purpose of the tax, it is proposed to delete the provision from the relevant law.

98. It is found quite often that assessees do not maintain proper and regular accounts which makes it difficult to make a fair estimate of their incomes. In such cases, particularly in respect of bigger assessees, the assessments of income might be more realistically based if the tax returns are accompanied with the assessees' statement of assets. It is accordingly proposed that assessees, with total income exceeding Taka 20,000 should be compulsorily required to file their statements of assets and liabilities annually along with the returns of income.

Tax compliance

99. The tax compliance in our country is far from satisfactory. Returns and statements are not submitted in time nor the payment of taxes. As a result assessment and collection of taxes get delayed. Although the assessing officers have discretion to penalise the delinquency, such discretion, however, is sparingly exercised. It is, therefore, proposed to make the imposition of penalty compulsory both for non-submission of returns and non-payment of taxes by due dates. In cases, however, where applications for time are filed, time will be deemed to have been allowed unless informed otherwise.

100. There is at present a large number of persons who are evading tax wholly by remaining outside the tax net. In order to identify such persons and bring them within the tax-fold and in accordance with the recommendation of the Taxation Enquiry Commission, it is proposed to provide for the licensing of all persons carrying on business, profession or vocation by paying rent or owning premises in certain areas as may be prescribed by the National Board of Revenue. The fee for the first licence will be Tk. 100, and for renewal Tk. 50. A failure to obtain a licence will be penalised by an amount not exceeding Tk. 500.

Entertainment expenses

101. There is a provision in the income-tax Act for prescribing a limit on entertainment expenses incurred by business houses or professional concerns, but no limit has yet been fixed. Based on the principles of recommendation of the Taxation Enquiry Commission I now propose to set the following limits in this behalf:

(I)	On the first Taka 5 lakhs of profits and gains of the business or profession...	At the rate of 4 percent or Tk. 20,000 whichever is higher, irrespective of profit or loss.
(II)	On the next Taka 15 lakhs ...	At the rate of 2 percent
(III)	On the next Taka 30 lakhs ...	At the rate of 1 percent
(IV)	On the balance ...	At the rate of ½ percent

These limits will not apply in the case of new concerns for the initial two years.

The amount of entertainment expenses allowed in the hands of the employer in the above manner will include the entertainment allowance paid by the employer to any employee or other persons.

102.It is found that business houses often incur lavish expenditures on account of frequent foreign travels of the employees and their dependents for holiday and recreation. It is proposed to restrict the deduction of expenses on account of such foreign travels of the employees and their dependents to once in every two years.

Capital gains

103. Capital gains arising out of the disposal of an assessee's capital assets acquired before 14th of August, 1947, are now exempt from tax. Since the gains are of an windfall nature and the exemption does not serve any economic purpose it is proposed to withdraw the same.

104. A substantial evasion of taxes and duties like the capital gains tax, wealth-tax, estate duty and stamp duty takes place through widespread undervaluation of capital assets like the land and buildings transferred by sale or otherwise. In order to counteract such evasion of taxes and duties through underhand deals it is proposed to make legal provision reserving the Government's right to acquire such assets at a price 10 percent higher than that shown in the instrument of transfer.

105. There is now considerable evasion of tax by smaller traders and professional persons who do not maintain proper accounts. In order to curb the evasion of taxes by such persons as well as simplify the assessment procedure it is proposed to introduce a system of assessment of such persons on presumptive income basis. Such a presumptive income would be Tk. 15,000 which will remain unchanged for the following two years.

. . .

Tax rates

106. I would now like to address myself to the rationalisation and restructuring of our existing tax rate schedules. There is now a surcharge on tax payable by assessees having income exceeding Tk. 50,000. This has been widely viewed with disfavour. Besides, an additional duty of income-tax called super tax on the income of companies, local authorities and registered firms appears to be a relic of the past when this tax used to be shared between the Central and Provincial Governments. It may be appreciated that in a unitary system of Government as ours the continuance of levy of the two taxes has lost its relevance. I accordingly propose to merge both the surcharge and super-tax into income-tax. There will therefore now be only one tax, namely, the income-tax, for all persons including companies, local authorities and registered firms. This will simplify the system and procedure for the levy and payment of tax.

107. At present there is a multiplicity of income slabs in the existing personal income-tax rate structure with as many as 13 slabs in our schedule as against only 8 or 9 in many other countries. Since there is hardly any justification for so many slabs, it is proposed to reduce them to nine with the initial rate of 10 percent on the taxable income not exceeding Tk. 5,000 and maximum marginal rate of 65 percent on the taxable income exceeding Tk. 100,000. This will make the rate structure more rational. I similarly propose to simplify the rate schedule for registered firms by integrating the few initial slabs with the rate of 10 percent, as in the case of other personal rates, while retaining the existing marginal rate of 30 percent on income exceeding Tk. 1,50,000.

108. The existing corporate rate structure based on an artificial income differential inhibits the growth of optimum sized companies and penalises effort, initiative and higher profit making. In a production-oriented economy as ours there is a far greater need to provide fiscal incentives to the manufacturing companies. It is accordingly proposed to revise the company rate structure providing for a unified income-tax with merger of super tax and surcharge, as follows:

		Rate
(a)	In the case of industrial companies wholly or mainly using indigenous raw materials.	50%
(b)	In the case of other industrial companies	55%
(c)	In other cases including banks, financial institutions	60%

At present intercorporate dividend suffers tax at the rates of 15 percent and 20 percent depending mainly on whether they are public or private companies respectively. Such a differential treatment is prejudicial to the growth of a viable private corporate sector and particularly inhibits the inflow of foreign capital. In order therefore, to accelerate the pace of industrialisation of the country through a strong private corporate sector particularly with foreign participation, it is proposed to remove the existing distinction in the rate of taxation of intercorporate dividend, for which the more favourable rate of 15 percent is proposed.

Since most of the companies are now in the public sector, it is proposed to do away with the preferential treatment to these companies in the matter of tax rebates. In order to encourage, however, the bringing in of income from abroad, it is proposed to allow a tax rebate at the rate of 10 percent on the foreign income of Bangladeshi companies not otherwise entitled to the benefit of export rebate scheme on their income brought into Bangladesh.

109. In the rate structure for capital gains there are anomalies. Whereas companies and registered firms are taxed at a fixed rate of 25 percent on the entire gains, other assessees are taxed on a part of the gains based on the period of holding the assets. In the present inflationary conditions, when substantial gains are made as mere windfalls, any exemption of the gains even partially will only provide fuel to inflation and widen economic disparity.

It is accordingly proposed to withdraw the partial exemption of the capital gains and tax them in the following manner:

(a) Capital gains arising within 2 years of the date of acquisition of assets are to be taxed at the full personal rate of the tax-payers as revenue gains of the year of sale.

(b) Capital gains arising between 2 to 5 years are to be added to other income and taxed at the average rate or 35 percent, whichever is lower.

(c) Capital gains arising after 5 years are to be added to other income and taxed at the average rate or 30 percent, whichever is lower.

Companies and registered firms will continue to be taxed as at present.

Tax incentives

110. I now turn the proposals for reliefs, concessions and administrative streamlining. The tax holiday scheme for industrial undertakings which expires by June, 1980 is proposed to be given a fresh lease of life for the next five years upto June, 1985 to be in conformity with the duration of Second-Five-Year Plan. Similarly the tax holiday scheme for residential buildings is proposed to be restricted only to those under the low cost housing scheme with plinth area upto 1000 sft., for the next five years upto June, 1985. The present exemption limit of Tk. 8,400 is, however, proposed to be raised to Tk. 12,000 in respect of the residential buildings with plinth area exceeding 1000 sft., for the next five years.

111. There is a great need to provide incentive to entrepreneurs engaged in the production and supply of fish, meat, eggs, fruits, etc. This is inextricably linked with our programme of agricultural revolution. Since investments in these areas are extremely shy, I propose to allow tax exemption to all enterprises in fish farming, poultry farming, duckery farming, cattle farming, dairy farming and horticulture for 10 years from 1st July, 1980. The facility will be available to all persons engaged in these enterprises, irrespective of whether they are companies or not. In order, however, to make the scheme meaningful and create a stake in the enterprises, it is proposed to allow the benefit to the entrepreneurs investing Tk. 10,000 and more.

Allowances

112. Under the existing law there is a discrimination in earned income allowance as between the salaried and the non-salaried group of assessees. This has been widely criticised. It is accordingly proposed to abolish the distinction between the two groups of assessees in the matter of earned income allowance which would now be available uniformly to all assessees qualifying for the purpose @ 20% of their total income or Tk. 5,000 whichever is less.

113. Education allowance for children is at present admissible @ Tk. 800 per child subject to a maximum of Tk. 2,400. I propose to raise the limit of allowance to Tk. 1,000 per child but restricted for two children only. This will be in conformity with the objective of our national population control programme. In pursuance of the same programme personal allowance for bachelors is also proposed to be brought at par with married persons at Tk. 3,000.

Partnerships

114. Under the present law the income of an individual from a partnership firm in which the individual's husband or wife is also a partner is assessed by clubbing together the income of both the husband and wife. This causes hardship to the professional persons who are prevented by law from forming themselves into companies and can work together only through formation of firms. It is only fair and equitable that such partners are assessed separately on their respective share income from firms. The provision of the Income-tax Act is accordingly proposed to be amended.

Time limits

115. An assessing Officer can now make an assessment within three years from the end of the relevant assessment year and an assessment or re-assessment in consequence of an appellate or revisional order within four years of such orders. Such a long period for completion of an assessment occasions a host of problems to the department as well as the assessee in the matter of timely determination and payment of tax. Based on the recommendation of the Taxation Enquiry Commission propose the limitation of the period for completion of assessment to two years from the end of the relevant assessment year and for an assessment or reassessment in consequence of an appellate or revision order to one year from the end of the year in which such order is made.

116. There is now no time limit for decision of appeals before the Appellate Joint Commissioner of Taxes and the Income-tax Appellate Tribunal and revision petitions before the Commissioner of Taxes. Consequently there is a huge backlog of such appeals and revision petitions resulting in a substantial locking up of taxes causing serious concern for the administration as well as the tax payers. In order to relieve the situation it is proposed to prescribe a time limit for disposal of appeals before the Appellate Joint Commissioner and revision petitions before the Commissioner of Taxes to one year from the end of the year of their filing. The present pendency of appeals and petitions would be required to be decided within two years by June, 1982. And for the purpose the number of Appellate Joint Commissioners would be increased, if need be. Two more benches of the Income-tax Appellate Tribunal at Dacca and Khulna will likewise be set up.

117. Representations have been received from various associations against the practice of setting aside of assessment orders by different appellate authorities. The practice of setting aside of cases instead of solving the taxpayers' problems only complicates them. It is proposed to do away with the power of setting aside of orders by the appellate authorities who would henceforth be called upon to decide the cases as otherwise provided by law.

118. Delay in refunds of tax creates frustration in the minds of the tax payers. This also impairs the department's public relation and makes tax compliance difficult. It is proposed to provide for granting of refunds within two months of their becoming due, failing which the assessee would be entitled to an interest @ 12% per annum on the amount of due refunds from the third month upto the date of issue of the refund order.

Conveyance expenses

119. Having regard to the hardship of assessees of the salaried group in this inflationary days, it is proposed to enhance (1) the deductible conveyance expenses by 50%, for those who do not receive any conveyance allowance from their employers, and (2) the limit of tax free conveyance allowance by Tk. 1,200 per year for those who receive the conveyance allowance from their employers. A similar enhancement for the latter categories of employees in respect of entertainment allowance is also proposed.

Miscellaneous

120. A proposal is made to authorise the National Board of Revenue to disclose the particulars of income-tax to the government and non-government agencies in the interest of tax recovery.

121. In addition to the changes just discussed, amendments in law are proposed to:

(i) exempt capital gains arising from the sale of Government securities and stocks and shares of approved public companies, if the sale proceeds are re-invested within two years in the acquisition of similar securities, stocks and shares. This will provide incentive to capital formation and investment;
(ii) exempt the winnings from lotteries upto Tk. 2,000 as for other windfall gains;
(iii) raise the exemption limit of the income on non-professional writers, journalists or artists from Tk. 5,000 to Tk. 10,000 for artistic or literary work;
(iv) raise the limit of furnishing the statements of payment of interest, commission, royalty, brokerage or annuity from Tk. 400 to Tk. 3,000;
(v) extend the benefit of the exemption of premia for insurances taken on the life of the minor children of the assessee;
(vi) restrict the definition of a relative for the purpose of appearance before the income-tax authorities or the income-tax Appellate Tribunal;
(vii) require the appellants to pay the entire amount of undisputed tax prior to filing appeals before the Appellate Joint Commissioners and the Tribunal and revision petitions before the Commissioners.

4. SALES TAX

122. The standard rate of sales tax is 20 percent. Certain goods, however, are taxed at enhanced rates of 25 percent and 30 percent, while others at reduced rates varying from 7½ percent to 15 percent. Multiple rates of tax tend to be discriminatory and create administrativy complications. I, therefore, propose to merge the enhanced rates into the standard rate of 20 percent and allow only one reduced rate of 10 percent for all items enjoying multiple reduced rates.

5. URBAN IMMOVABLE PROPERTY TAX

123. At present the valuation of land and buildings for the purpose of the tax is based on municipal valuation. Since such a valuation often does not reflect the current rental of the holdings, it is proposed to change the basis of valuation of the holdings to the annual rental as adopted by the Tax department who administers the tax. In order, however, to provide relief to the poorer section of the people, it is proposed to raise the limit of exemption from Tk. 1,000 to Tk. 6,000 of the annual value. The rate schedule is at the same time proposed to be simplified and revised at 5 percent in respect of rented holdings and 3 percent in respect of self-occupied holdings.

At present there is no provision for vacancy allowance. In order to relieve the possible hardship of the tax payers it is proposed to provide for a vacancy allowance at the rate of 3/4 of the tax due for the vacant period if the vacancy exceeds 60 days in the year.

6. ADVERTISEMENT TAX

124. This tax has a rather narrow coverage comprising of advertisements made through cinema slides and films, radio and television. It is, therefore, proposed in accordance with the recommendation of the Taxation Enquiry Commission to extend the tax also to charge for advertisements made through daily newspapers excepting for tenders and employment notices at the rate of 10 percent. It is also proposed to revise the existing rates for advertisement through cinema slides and films, radio and television to 15 percent. Details will be provided by Rules to be made by the National Board of Revenue.

7. STAMP DUTY

125. The Taxation Enquiry Commission examined the existing position of the Stamp Duty and noticed various inequities and anomalies in the system. The rate schedule was found to be old, archaic, regressive, and inadequate to meet the needs of a developing economy. Occasional changes in the rates were made on ad hoc basis mainly to meet the exigencies of revenue and no efforts were made to rationalise the system as a whole. In keeping with the principles of recommendation of the Taxation Enquiry Commission I now propose to simplify and rationalise the structure, integrate the additional and normal duties into unified ad valorem rates, considerably reduce the outdated slabs and apply thereon a few realistic rates in keeping with the imperatives of our revenue, administrative cost and containment of inflation. The proposed schedule is annexed herewith.

8. FOREIGN TRAVEL TAX

126. A tax like this is prevalent in quite a number of countries. There is justification for the levy of such a tax on the foreign travel of the well-to-do section of our people as has been recommended by the Taxation Enquiry Commission. It is accordingly proposed to levy a tax on foreign travel by air by Bangladeshi nationals, irrespective of the country of origin of the journey or the place of purchase of the ticket. The proposed rate is 5 percent of the fares subject to a minimum of Tk. 100 and maximum of Tk. 750 per ticket. Exemption from the tax will, however, be made in respect of travel on government/government sponsored account, by Parliamentary delegations, children below 18 years of age, and for medical treatment and Hajj. Details in this behalf will be prescribed by the National Board of Revenue.

9. LAND DEVELOPMENT TAX

127. Due to implementation of various development projects by the Government the value and income of urban and other non-agricultural land have greatly increased. It has, therefore, been proposed to enhance the Land Development Tax of these lands at the rates shown below:

Category of Non-agricultural land	Existing rate per decimal (in Taka).		Revised rate per decimal (in Taka).	
	Used for Commercial Industrial purpose.	Used for residential purpose.	Used for Commercial Industrial purpose.	Used for residential purpose.
Certain areas of Dacca, Narayanganj, Chittagong and Khulna.	15.00	3.00	22.50	6.00
Municipalities at District Headquarters.	3.00	1.50	7.50	3.00
Other Non-agricultural area	3.00	1.50	5.00	2.25

CORRECTION

In the article: "Economic Development, Foreign Investment and Taxation in the Trust Territory of the Pacific Islands", by Elizabeth S. Udui, published in the *Bulletin for International Fiscal Documentation* (Vol. 34 - 1980/11 at 501-507), the following two sentences on page 505, section 11. Treatment of losses, should be deleted:

"Allowable losses incurred by a business arising out of change of ownership may be taken in the same manner as an additional tax liability.

Setting off refunds and additional tax liability may be made provided that the refunds and the additional tax liabilities have been determined using the appropriate tax rate in the year incurred or otherwise accrued."

ZIMBABWE: Financial Statements 1980

Extract from the Financial Statement 1980
presented to the House of Assembly
by the Minister of Finance on July 24, 1980

...

PART II. TAXATION PROPOSALS

I. INCOME TAX

1. Rates of tax

A. Persons other than companies

The rates of tax are already fixed in the Finance Act and are shown below. No changes are proposed to the existing rates of tax. A surcharge of 10 percent to the income tax so calculated in the year of assessment ending March 31, 1980 and March 31, 1981 is payable.

Rates of tax	Married Tax-payers %	Single Tax-payers %
On the—		
First $ 1 000 of taxable income	10	14
Second $ 1 000 of taxable income	12	16
Third $ 1 000 of taxable income	14	18
Fourth $ 1 000 of taxable income	16	20
Fifth $ 1 000 of taxable income	18	22
Sixth $ 1 000 of taxable income	20	24
Seventh $ 1 000 of taxable income	22	26
Eighth $ 1 000 of taxable income	24	28
Ninth $ 1 000 of taxable income	26	30
Tenth $ 1 000 of taxable income	28	32
Eleventh $ 1 000 of taxable income	30	34
Twelfth $ 1 000 of taxable income	32	36
Thirteenth $ 1 000 of taxable income	34	38
Fourteenth $ 1 000 of taxable income	36	40
Fifteenth $ 1 000 of taxable income	38	42.5
Sixteenth $ 1 000 of taxable income	40	45
Seventeenth $ 1 000 of taxable income	42.5	45
Balance of taxable income	45	45

B. Companies

The rate of tax is already fixed in the Finance Act at 45 percent and no change is proposed. A surcharge of 10 percent in the years of assessment ending on March 31, 1980 and March 31, 1981 is payable.

2. Abatements

A. Level of abatements

The abatements are already fixed in the Finance Act and are as follows—

		$
Family taxpayer:	primary abatement	3,000
	each child	500
Single person:	primary abatement	1,800
Dependant:	maintained to the extent of at least $ 120 and not exceeding $400	120
	maintained to an extent exceeding $ 400	400
Maximum of foregoing abatements:	family taxpayer	6,000
	single person	3,600
Blind person		2,000
Blind spouse		2,000
Insurance premiums, contributions to benefit funds: actual expenditure, not exceeding		360
Medical expenses in excess of $ 72, invalid appliances and contributions to medical aid societies		actual expenditure
Immigrants:	family taxpayer: primary	800
	each child	100
	single person	400
Disabled persons expenses:		
	taxpayer: actual expenditure, not exceeding	2,000
	spouse: actual expenditure, not exceeding	2,000
	child: actual expenditure, not exceeding	2,000

Elderly persons abatement: (persons aged 60 years or more)

(a) in the case of a family taxpayer, at the rate of one dollar for each dollar by which the taxable income is less than $ 4,000, and

(b) in the case of a single taxpayer, at the rate of one dollar for each dollar by which the taxable income is less than $ 3,000.

Married women's earnings allowance:

The exclusion of one-sixth of taxable income derived from the carrying on of business or from employment with a minimum of $ 300 (or the amount of the income if less than $ 300) and a maximum of $ 1,800.

B. Disabled persons expenses

With effect from the year of assessment beginning on April 1, 1980, it is proposed to allow certain capital expenditure incurred by disabled persons to rank for abatement.

3. Tax credit for blocked income diminished by currency devaluations

It is proposed to apply the formula for determining the credit in respect of tax assessed on any part of taxable income the use of which is effectively lost to a taxpayer by reason of its having been blocked in another country and subsequently diminished, in terms of the Zimbabwe dollar, because of a devaluation occurring before the income is released by the other country in years of assessment following that beginning on April 1, 1979.

4. Ex gratia payments to former employees, partners and dependants

It is proposed that, where former employees, partners or dependants are in receipt of pensions from a pension fund, there shall be a limit to the amount that may be claimed by the taxpayer in respect of further *ex gratia* payments to such persons.

5. Expenditure during enforced cessation of business

It is proposed to allow as a deduction expenditure incurred by a business during any period between April 1, 1967, and March 31, 1981, while the business was unable to earn any income for security or economic reasons beyond its control, where the business is recommenced before March 31, 1981.

6. Expenditure on passenger motor vehicles

It is proposed to increase, with effect from April 1, 1979, from $ 7,000 to $ 9,000 the amount of expenditure incurred by a taxpayer on passenger motor vehicles which may be claimed for tax purposes.

7. Exemptions from income tax

It is proposed to exempt from income tax the receipts and accruals of the Commonwealth Development Corporation, other bodies and individuals entitled to exemption in terms of any aid or co-operation agreement entered into by Government with any other government or international organization and extend the previous exemption of the value for quarters granted to judges of the High Court to March 31, 1983.

8. Staff housing

It is proposed to make provision for staff housing costing no more than $ 5,000 per residential unit in place of the existing income tax deductions for African housing.

9. Transfer of assets from external companies to locally registered companies

It is proposed to provide that externally registered companies that transfer their assets and operations to locally registered companies may do so without creating an unusual tax liability which would not otherwise have arisen.

10. Depletion allowance

It is proposed to reduce with effect from April 1, 1980, the depletion allowance in respect of gold and silver production from 15 percent to 5 percent.

11. Comments on the tabulated examples of tax liability

General explanation:

For taxpayers, other than companies, rates of tax are fixed for successive segments of taxable income. There is a scale of these rates for family taxpayers and a separate scale for persons other than family taxpayers. The gross income tax so ascertained is then reduced by that part of it which is attributable to such portion of the taxable income, beginning with the first dollar thereof as is equal to the total of the abatements available to the taxpayer. In other words, a threshold — called the "abateable amount" and equal to the taxpayer's total abatements — is established and tax is payable only on the segments of taxable income above this threshold at the appropriate rates fixed for those segments.

Companies pay tax at the flat rate on taxable income and do not qualify for abatements.

Marginal rate:

The term "marginal rate" used in the following tabulation is the rate of tax which would be payable on the next segment of taxable income derived by the taxpayer.

For example, in the table where the taxable income of a family taxpayer with two children increases from $ 10,000 to $ 11,000 the marginal rate of tax applicable to the difference of $ 1,000 in taxable income is 30 percent, since the tax payable on a taxable income of $ 11,000 ($ 1,680) exceeds the tax payable on a taxable income of $ 10,000 ($ 1,380) by $ 300, which is 30 percent of the difference in taxable income between the two segments ($ 1,000).

Average rate:

The term "average rate" is the tax payable at a particular level of taxable income expressed as a percentage of that taxable income. For example, the average rate of tax payable on a taxable income of $ 10,000 derived by a family taxpayer with two children is 14 percent (rounded to the nearest whole number) $(\frac{1,380 \times 100}{10,000})$ that is, the tax payable on $ 10,000 ($ 1,380) expressed as a percentage of $ 10,000.

II. STAMP DUTIES

1. Cheques

It is proposed to increase the stamp duty on a cheque from 3 cents to 5 cents with effect from January 1, 1981.

2. Registration of the acquisition of property

It is proposed to introduce new rates of duty on the registration of the acquisition of property in the Deeds Registry with effect from October 1, 1980, as follows—

	$	c
So much of the value as does not exceed $ 5,000—		
for every $ 100 or part thereof of the value		50
So much of the value as exceeds $ 5,000 but does not exceed $ 15,000—		
for every $ 100 or part thereof of the value	2	00
So much of the value as exceeds $ 15,000—		
for every $ 100 or part thereof of the value	4	00

III. LICENCE FEES

1. Copper dealers' licences

It is proposed to increase the fee for a copper dealer's licence from $ 2 to $ 10 with effect from January 1, 1981.

2. Moneylenders' licences

It is proposed to repeal the provision dealing with moneylenders' licences with effect from January 1, 1981, when these licences will fall to be covered by a proposed amendment to the Usury Act [*Chapter* 299].

IV. SALES TAX

1. Sales on commission

It is proposed to make sales on commission conducted by a trader liable to sales tax.

2. Sales by motor dealers

It is proposed to extend sales tax to all goods sold by a motor dealer, and not only goods related to his normal business as such as at present.

3. Cancelled sales

It is proposed to confine the deduction in respect of cancelled sales to cases where the whole contract is cancelled.

4. Taxation of certain services

It is proposed to extend sales tax to the following services with effect from October 1, 1980—

Accommodation at an hotel or boarding house—
(a) in Zimbabwe; or
(b) outside Zimbabwe if the contract therefor is entered into in Zimbabwe.

Air transport for a passenger—
(a) in Zimbabwe; or
(b) wholly or partly outside Zimbabwe if the contract therefor is entered into in Zimbabwe.

Transport for a passenger by contract car or taxicab—
(a) in Zimbabwe; or
(b) wholly or partly outside Zimbabwe, if the contract therefor is entered into in Zimbabwe.

Transport for a passenger by road, rail or sea, otherwise than wholly within Zimbabwe, if the contract therefor is entered into in Zimbabwe.

Telecommunications services.

It is also proposed that the purchase of goods used in the provisions of such services by the provider shall be taxable.

5. Refunds on sales tax on goods of a capital nature

It is proposed that purchases of goods of a capital nature after October 1, 1980, shall not qualify for a refund of sales tax except those made by local authorities and statutory corporations.

6. Additional exemptions

With effect from August 1, 1980, it is proposed to exempt the following goods from sales tax—
fish — other than that in bottles or tins;
milk — in all its forms;
paraffin — illuminating.

V. CUSTOMS AND EXCISE: MOTOR SPIRIT AND MINERAL OILS

It is proposed to increase the tariff rates of customs and excise duty on motor spirit and mineral oils but at the same time to limit the effect of the increase to the customs duty on motor spirit (item 195(1)(a) of the customs tariff) and diesel fuel (item 200(b) of the customs tariff) and to the excise duty on certain motor spirit (item 13 of the excise tariff) and diesel fuel (item 14(a) of the excise tariff) by suspending the increases to the effective rates shown.

It is also proposed to further reduce the excise duty on motor spirit (item 13 of the tariff) when such spirit is—

produced from coal gas; or

produced from a mixture of ethyl alcohol and benzol.

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

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Tenth edition of reference book providing a survey of African countries south of the Sahara. It provides an introduction to the African continent as a whole, deals with history and development, religions, etc. and lists all the major African regional organizations with details of their officials and activities. Separate chapters deal with all the countries south of the Sahara including political parties, banks, trade and industry, transport and education.
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Informative guide explaining business and taxation aspects of investment operations in Argentina.
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Biennial review and appraisal at the regional level of the international development strategy for the Second United Nations Development Decade, 1978. Bangkok, United Nations, 1979. 167 pp.
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AUSTRALIA

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Board of Review decisions. Editors: E.F. Mannix and D.W. Harris. Volume 23. Chatswood, Butterworths, 1980. 980 pp.
Compilation of Australian tax cases concerning income tax.
(B. 51.646)

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Melbourne, Australian Taxpayers' Associations, 1980. 178 pp.
Extensive survey of the main aspects of income taxation in Australia, together with summaries of payroll taxes, sales tax, land tax, gift and death duties and stamp duties.
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MARIA THERESIA

Zollordnung und Tarif für das Land Tirol aus dem Jahre 1780. By Alfons Pausch. Cologne, Peter Deubner Verlag, 1980. 32 pp. 12.80 DM.
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Revised booklet providing investors interested in Colombia with basic facts and information on foreign investment and taxation in Colombia.
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TAXATION IN COLOMBIA

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Quadrilingual compilation (French, English, German and Italian) of four essays by various authors relating to foreign investments in France. The topics are: "The position for taxation purposes of chargeable persons domiciled abroad and foreign companies holding real property in France" by Paul Puyraveau; "The tax treatment of company acquisitions and some practical solutions" by Raymond Chuilon and Pierre Demazière; "Takeover of a French firm by a foreign company, labour and social security law aspects" by Roger Descotte and Marguerite Gonnard; "Abuse of law" by Raymond Chuilon and Joëlle Rioux.
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INHALTSVERZEICHNIS

James C. Redmond:

Die Bestimmung der Einkunftsquelle – Die Besteuerung nach dem "unitary system" 99

Der Verfasser untersucht das "unitary system", dass derzeit u.a. im Staate Kalifornien statt dem "separate accounting system" angewandt wird. Beide Systeme haben Vorteile und Mängel, wobei der Verfasser zu der Auffassung neigt, dass das "unitary system" eines Tages aufgegeben werden muss.

Stellungnahme des Beirates der niederländischen Arbeitgeberverbände VNO und NCW zur Besteuerung nach dem "unitary system" 107

Am 26. März 1980 reichten die niederländischen Arbeitgeberverbände beim Finanz- und Steuerausschuss des Senats von Kalifornien eine Stellungnahme ein, in der sie ihre Bedenken zur Besteuerung nach dem "unitary system" zum Ausdruck bringen. Diese Stellungnahme wird in dieser Ausgabe des Bulletin im vollen Wortlaut wiedergegeben.

Angel Q. Yoingco und Sutadi Sukarya:

Asiatische Studiengruppe zur Steuerverwaltung und Forschung auf dem Gebiet des Steuerrechts (SGATAR) – Ein Experiment regionaler Zusammenarbeit auf dem Gebiet des Steuerrechts 110

Die Verfasser stellen die Arbeit der Studiengruppe vor, die in den letzten zehn Jahren geleistet wurde, und sie kommen zu dem Schluss, dass diese Studiengruppe ein wertvolles Instrument für den Austausch von Meinungen und Informationen auf steuerlichem Gebiet in Asien und im Pazifik war und ist.
Sie sagen voraus, dass diese Studiengruppe noch viele Jahre bestehen wird.

Indien: erneute Steueramnestie 119

Die indische Regierung hat zum zweiten Mal innerhalb der letzten fünf Jahre Immunität für Steuervergehen angeboten; dies ist ein weiterer Versuch, "schwarzes Geld" aufzustöbern.

N.R. Vasudeva Murthy:

Finanzpolitik und Sparpolitik der Regierung in einem Entwicklungsland – Erkenntnisse, nachgewiesen am Beispiel Indiens 120

Das durch den Verfasser zu behandelnde Thema besteht in erster Linie darin, den direkten Zusammenhang zwischen Besteuerung, Steuereinnahmen und Ersparnisbildung der Regierung in Indien in den Jahren 1960-76 zu untersuchen und den Einfluss zu bestimmen, den die Besteuerung auf die Ersparnisbildung der einzelnen Haushalte wie auch insgesamt in Indien in den genannten Jahren auszuüben vermochte.

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L'auteur étudie le système unitaire d'imposition – qui est déjà, entre autres, en application dans l'Etat de Californie – comme opposé au système de comptabilité séparée. Les deux systèmes ont leurs avantages et leurs inconvénients et l'auteur s'attend finalement à la possibilité d'interdiction du système unitaire.

Le Conseil de la Fédération Néerlandaise des Employeurs VNO et NCW, et le système unitaire d'imposition 107

Les organisations des employeurs hollandais ont exposé le 26 mars 1980 au Comité Sénatorial sur le revenu et l'imposition de l'Etat de Californie leurs objections à l'égard d'un système unitaire d'imposition. Cet exposé est reproduit intégralement dans ce numéro du Bulletin.

Angel Q. Yoingco et Sutadi Sukarya:

Groupe d'étude sur l'administration et la recherche fiscale en Asie (SGATAR) – Une expérience en matière de coopération fiscale régionale 110

Les auteurs commentent la travail effectuée par le Groupe d'étude sur les dix dernières années et concluent qu'il a été un document valable quant à l'échange de vues et d'informations sur les activités fiscales en Asie et dans le Pacifique. Ils supposent que ce Groupe d'étude existera encore pendant de nombreuses années.

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The author discusses the unitary system of taxation — which is currently, inter alia, used in the State of California — as opposed to the separate accounting system. Both systems have their advantages and defects and the author expects that the unitary system may possibly be eventually prohibited.

THE COUNCIL OF THE NETHERLANDS FEDERATION OF EMPLOYERS VNO AND NCW ON THE UNITARY SYSTEM OF TAXATION 107

On March 26, 1980 the Dutch employers' organizations submitted a statement to the Senate Committee on Revenue and Taxation of the State of California setting forth their objections against the unitary system of taxation. This statement is reprinted in full in the present issue of the Bulletin.

Angel Q. Yoingco and Sutadi Sukarya:

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The authors discuss the work of the Study Group over the past ten years and conclude that it has been a valuable instrument for the exchange of views and information on fiscal activities in Asia and the Pacific. They predict that the Study Group will exist for many years to come.

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The Government of India has for the second time during the last five years offered tax immunity in an attempt to unearth "black money".

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FISCAL POLICY AND GOVERNMENT SAVINGS IN A DEVELOPING ECONOMY — Some empirical evidence in the Indian economy 120

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The Unitary System of Taxation

Identification of the Source of Income

by James C. Redmond*

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I. INTRODUCTION

A sovereign, so the argument goes, has the right to levy taxes upon those individuals and business entities who derive benefit from activities carried on within that sovereign's jurisdiction. While this is taken as axiomatic today, there are always disagreements about the scope of a sovereign's authority to tax, in what amounts and under what conditions.

As if it were not difficult enough to deal with the tax authorities of one sovereign within a given geographical region, the United States offers the taxpayer an added dimension of complexity due to its division of authority between the Federal government and each of the fifty state governments. And since both are considered to be sovereign, each with some exclusive powers and some overlapping powers, the taxpayer will face a day of reckoning with each.

While most foreign taxpayers are aware of the purpose behind the tax laws of the *Federal* government of the United States, they often find dealing with the *state* tax provisions confusing, costly and in conflict with what the taxpayer sees as the interest of the Federal government. The unitary method of taxation, used by some of the states to tax corporate income, is one of these provisions. The purpose of this article is to describe the most common methods of corporate income allocation in use by the states, with particular emphasis on the unitary and combined reporting methods, and the problems which they have caused.

II. THEORY AND CONSTITUTIONAL LIMITS OF STATE TAXATION

The supremacy clause of the U.S. Constitution [1] provides that any state law which is in conflict with the Federal Constitution, a Federal law or a U.S. treaty is void. Two specific provisions of the U.S. Constitution which have been construed to place limits upon a state's power to tax businesses engaged in interstate or foreign commerce are *the commerce clause*, [2] and *the due process clause* of the Fourteenth Amendment. [3]

A state tax law which imposes a burden on *interstate commerce* must meet several requirements in order to be valid under the commerce clause. Such a tax will be upheld as long as it:

1. is applied to an activity with a "substantial nexus" with the taxing state;
2. is fairly apportioned;
3. does not discriminate against interstate commerce; and
4. is fairly related to the services provided by the state. [4]

The burden on interstate commerce that is often alleged in litigation is the risk of multiple taxation.

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1. U.S. Const. Art. 4.
2. "Congress shall have the power ... to regulate commerce with foreign nations and among the several states. "U.S. Const. Art. 1, Sec. 8, c1.3.
3. A state may not " ... deprive any person of life, liberty or property without due process of law." U.S. Const. Amend XIV.
4. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 443 (1980) citing *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977). Note that more stringent requirements must be met if a burden is placed upon the *instrumentalities* of foreign commerce (such as cargo containers). There the state law must not unreasonably increase the risk of multiple taxation on an international level, and it must not interfere with the federal power to regulate commerce with foreign nations. *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, (1978). It is not clear if the Supreme Court would apply these additional requirements to a state income tax which burdened foreign commerce but dicta in *Exxon Corp. v. Wisconsin Department of Revenue,* 48 U.S.L.W. 4687, (June 10, 1980) indicate that it would not. See discussion of these cases infra.

The *due process clause* of the Fourteenth Amendment is the second broad restriction on state power. This provision has been construed to prohibit a state from taxing income which has its source in activities outside the state. Two requirements, which overlap to some degree those under the commerce clause, must be met for a state tax to withstand a due process challenge. There must be:

1. a "minimal connection" or "nexus" between the business activities and the taxing state; and
2. a rational relationship between the income attributed to the state and the intrastate values of the enterprise. [5]

If a taxpayer wishes to challenge a state tax law on constitutional grounds s/he must bear a substantial burden of proof that the state method is wholly unreasonable and results in gross distortion. [6] The court has noted that any method of allocating income for state tax purposes is bound to be imprecise, so the method or its application must be shown to result in more than a minimal amount of overtaxation. [7]

III. METHODS USED BY STATES TO IDENTIFY SOURCE OF INCOME

In order for a state to determine how it will compute the taxable income of a business, it initially must decide three basic questions:

1. the income of which corporation or corporations is to be considered, i.e. what is the "defined enterprise";
2. what income of the defined enterprise is sufficiently identifiable with a given location to be specifically allocable there, and what income is not allocable and must be apportioned among the states where its income generating activities occur; and
3. for income that must be apportioned, what method most fairly divides the income among the states involved.

The issues concerning allocation and apportionment will be dealt with first and the more controversial issue of what constitutes the defined enterprise will be saved for last.

In trying to locate the activities which give rise to the generation of income, the states face a problem which has yet to be resolved by economists and tax theorists. While recognizing that no theory will adequately identify the geographical source of income in all situations two major methods have been developed to attempt to give a situs to income for purposes of taxation. These are specific allocation and formula apportionment.

Historically there has been a distinction made between a corporation's "business income" and its "non-business income". Income which falls into the first category is generally defined as "... income which arises from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations". [8] Non-business income is simply "all other than business income". [9]

The types of income which have usually fallen into the residual non-business income category include "intangible" income such as dividends, interest, royalties and the like. These types of income are then "specifically allocated" to the state of commercial domicile on the theory that the central management is responsible for earning such income through its investment decisions. [10]

Trying to locate the source of business inccome on the other hand presents much greater difficulties. When corporations began to operate across state boundaries to a significant degree, state tax authorities found it necessary to devise some method of apportioning a corporation's income among the states in which it operated, since manufacturing, distribution and sales in addition to management all play some role in generating income, and these activities ususally spread over several states. Formula apportionment was the method developed to attempt to distribute the business income in a way that, hopefully, would approximate the distribution of activities which earned it.

When formula apportionment was first introduced in the United States many states utilized one factor formulae apportioning income based on such things as the ratio of instate sales to total sales. Over time most states imposing a corporate income tax have adopted a three factor formula which considers sales, property and payroll of a corporation. [11] In 1957 an equally weighted three factor formula was promulgated as part of the Uniform Division of Income for Tax Purposes Act (UDITPA), a model [12] law which has been copied by many states.

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5. *Exxon*, 48 U.S.L.W. at 4690.
6. See *Butler Brothers v. McColgan*, 315 U.S. 501, 507 (1942).
7. *Moorman MFG. Co. v. Bair*, 437 U.S. 267, 278(1978). Note that there has been only one case where a taxpayer has succeeded in challenging a state's apportionment method. *Hans Rees' Sons. Inc. v. North Carolina Ex Rel Maxwell*, 283 U.S. 123,(1931).
8. Uniform Division of Income for Tax Purposes Act (UDITPA) Sec. 1(a).
9. UDITPA Sec 1(c).
10. Originally this income was allocated to the state of incorporation but since the practice of incorporating in one state and operating out of another has become widespread, the allocation of this income to the commercial domicile became necessary. See Corrigan, Toward Uniformity in Interstate Taxation, Tax Notes, September 15, 1980 at 508.
11. 43 states and the District of Columbia use a three factor formula. These states are: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Virginia and Wisconsin.
The equally weighted three factor formula is commonly known as the "Massachusetts Formula".
12. "Uniform acts" are those drafted by the National Conference of commissioners on uniform state laws, for recommendation to state legislatures, and are formulated after suggestions from legal scholars, judges and lawyers have been considered. These recommendations are in no way binding upon the states, and may be adopted in whole, in part, or not at all. One of the most successful of the "uniform" laws has been the uniform commercial code, adopted in some form by most of the states.

The uniform act provides that the property, payroll and sales factors will consist of:

1. owned and rental real and tangible personal property used in the trade or business;
2. wages, salaries and other forms of remuneration paid to the employees who are performing services for the corporation in its regular business activities;
3. sales from general business transactions. [13]

While the three factor formula is generally regarded as providing a more realistic apportionment of income to the states in which it is generated than other methods, at least one state still uses a one factor formula and this practice has been upheld by the United States Supreme Court. [14]

The general form of the three factor formula in use is described by the equation $F = \alpha A + \beta B + \gamma C$, where F is the apportionment factor applied to the apportionable income, A is the ratio of instate sales to total sales, B is the ratio of instate property to total property, C is the ratio of instate payroll to total payroll, and the coefficients α, β & γ are the respective weights given to the factors. The method is illustrated by the following example.

Suppose that corporation X is a manufacturer and distributor of a certain commodity through branch offices within the United States. Its sales total \$50,000,000, its total owned and rented real and tangible personal property is valued at \$10,000,000 and its total payroll is \$25,000,000. If state Y determines that the sales, property and payroll figures which relate to the corporation's activities within state Y are \$10,000,000, \$8,000,000 and \$20,000,000 respectively, and State Y uses the equally weighted UDITPA formula then the computations are as follows:

$$\frac{\text{instate sales}}{\text{total sales}} = \frac{\$10{,}000{,}000}{\$50{,}000{,}000} = \frac{1}{5}$$

$$\frac{\text{instate property}}{\text{total property}} = \frac{\$\ 8{,}000{,}000}{\$10{,}000{,}000} = \frac{4}{5}$$

$$\frac{\text{instate payroll}}{\text{total payroll}} = \frac{\$20{,}000{,}000}{\$25{,}000{,}000} = \frac{4}{5}$$

Since the formula is equally weighted $\alpha = \beta = \gamma = 1/3$, thus

$$F = \frac{1}{3}\left(\frac{1}{5} + \frac{4}{5} + \frac{4}{5}\right) = \frac{3}{5}$$

Therefore 3/5 of whatever state Y determines corporation X's apportionable income to be will be attributed to state Y and taxed there.

Some states have deviated from the UDITPA formula and weigh the factors unevenly. [15] New York State, for example, uses a value of 25 percent for both the property and the payroll coefficients and increases the sales coefficient to 50 percent. While some state tax authorities feel that this unequally weighted system is a more accurate assessment of where income is generated, it also has the effect of providing an incentive for a corporation to locate its manufacturing facilities (or other labor intensive operations) in such a state, as long as the other states retain the equally weighted formula.

Most states have also adopted the business/non-business income distinction of the UDITPA and thus use a combination of specific allocation and formula apportionment, allocating non-business income to the commercial domicile and apportioning the rest. The use of both methods has come under criticism by scholars and by the Multistate Tax Commission, primarily due to the complexity caused by combining both methods.

Recommendations have been made to simplify the system by eliminating the distinction between business and non-business income and using formula apportionment on all corporate income. [16] To date this recommendation has not been widely accepted despite the problems caused by the combination of the systems of attributing income.

The final variable, and the focus of this discussion, is the description of the "defined enterprise" whose income will be subject to specific allocation, formula apportionment, or both. The most general form of the method used by the states to determine taxable income can be described by the expression:

taxable income = amount of defined enterprise income which is specifically allocable + formula apportionment factor (apportionable income of the defined enterprise)

As we have seen, some states specifically allocate income, others apportion all income and a variety of methods are used to compute the formula apportionment factor. The determination of the defined enterprise is the area where there is the most diversity among the states and is currently the issue causing the most controversy.

The most common method used to identify the defined enterprise is known as separate accounting. As the term is most often used it describes a method whereby each corporation is viewed as a defined enterprise for apportionment purposes. [17] Thus, if a corporation is the

13. Unitary apportionment and worldwide combination: Hearings before the California Assembly Revenue and Taxation Committee, November 13, 1979, vol. III at 12 (hereinafter cited as Hearings). Note that the UDITPA formula was recommended for use in taxing manufacturing and mercantile firms. Many states have specialized formula for dealing with certain industries such as banks, airlines, commercial fishing, and motion picture and television production.

14. Iowa's formula was tested in *Moorman MFG. Co. v. Bair*, 437 U.S. 267(1978).

15. Florida, Massachusetts, Minnesota, New York and Wisconsin all have unequally weighted factors.

16. See Corrigan, Toward Uniformity in Interstate Taxation, supra note 10. Note that the Supreme Court in *Mobil Oil* rejected the argument that dividends had to be attributed to the state of commercial domicile and thus proclaimed that specific allocation was not constitutionally required. 445 U.S. at 445.

17. The term is also used to describe a system where divisions of one corporation are treated individually as defined enterprises and the income of each is apportioned. See Oldman and Shoettle, State and Local Taxes and Finance 559(1974). This type of "functional separate accounting" was at issue in the *Exxon* case. For purposes of simplicity, separate accounting as it is dealt with here will be discussed in terms of transactions between corporations but the principles could be applied to clearly defined divisions within the same corporation as well.

only part of a multistate or multinational business which is operating within the separate accounting state, then only the income of that corporation will be considered for allocation and apportionment.

Separate accounting, therefore, dictates that the corporate boundaries define the limits of taxable income. While this concept has appeal it could lead to widespread tax avoidance. Consider the following example.

Corporation A, domiciled in state X, is engaged in manufacturing and distributing a certain product. Its manufacturing operations take place in state X and its sales occur mostly in state Y where its sales personnel are located. Under the separate accounting system generally in use state X would allocate and apportion the income of corporation A and arrive at a figure for taxable income.

If state Y has a lower tax rate than state X, tax planning considerations might dictate the following course of action. If corporation A incorporates its sales division in state Y, forming B corporation, then it would be possible for the manufacturing corporation A to sell its goods to its affiliate B corporation at cost and thus corporation A would show no profit (or even a loss) for its state X operations. When B corporation sells the products it will derive all of the gain. Since we presumed the tax burden is smaller in state Y than X, the business, which now is split in two, will have an overall tax saving.

To prevent this type of artificial income shifting the "transfer pricing" or "arm's length" method of evaluating transactions between related corporations has been developed. This system involves the auditing of transactions between related companies to assure that the value attached to the transfer of goods, services etc., accurately represents the value that would have been given to the same item in an "arm's length" transaction between two unrelated parties. The separate accounting/transfer pricing system is currently used by some of the states, by the Internal Revenue Service [18] and has been endorsed by the OECD as the fairest method of applying tax laws. [19]

Although the separate accounting system is widely accepted, some states have chosen a different method of determining the defined enterprise. This alternative system, known as the "unitary method", differs from separate accounting in that it does not recognize the integrity of corporate boundaries for tax purposes [20] but instead defines a "unitary business", which may include parts of many corporations both within and without the state. Once the scope of the unitary business has been determined an apportionment formula is applied to its business income and the state taxes the portion or the income attributable to it.

Most of the states which use the unitary method confine its application to corporations operating within the United States. Thus, as long as a foreign parent corporation operates within the U.S. through a subsidiary, the foreign and domestic portions of the business will not be unified by those states for purposes of apportionment. [21] A few states, however, do not limit a unitary business to domestic operations and extend the reach of the unitary net to the worldwide activities of multinational corporations. [22]

What constitutes a unitary enterprise has not been clearly defined. In California, the leading proponent of the worldwide application of the unitary system, [23] the rough guidelines are provided primarily by case law. [24] The basic characteristics of a unitary business there are (1) that the corporation's operations are "dependent upon or contribute to the business conducted by the group", and (2) that there be at least a 50 percent common ownership or control between the corporation and the corporate group. [25]

In order to determine the income of the unitary business the California Franchise Tax Board requires that corporations which are part of the unitary group file a "combined report" in addition to separate returns for all corporations doing business in California. [26] The report must contain the combined profit and loss statements for the unitary group, ignoring certain intercompany transactions, listing certain deductions claimed by the unitary group and providing information concerning the total sales, property and payroll along with the amounts of Califonia sales, property and payroll.

The effect of the unitary method is to concentrate on the substance rather than the form of a business arrangement, and to treat an integrated business the same for tax purposes whether it is operated in the form of one corporation with branches or through separate corporations. This method also shifts a substantial burden off state tax authorities since they need only determine what constitutes a unitary business rather than attempt to measure the arm's length value of the multitude of intercompany transactions. As has been pointed out by one defender of the unitary system, while the determination of what constitutes a unitary business is in itself no easy task, especially with the complexity of modern multinationals:

18. I.R.C. Sec. 482; Treas. Reg. Secs. 1.482-1(a)(6).
19. See Transfer Pricing and Multinational Enterprises, report of the OECD Committee on Fiscal Affairs, 1979.
20. The California Franchise Tax Board claims that "... the separate corporate entities of the group are not disregarded by use of the combined report approach". California Franchise Tax Board, Guide for Corporations Filing a Combined Report, 3. Despite this disclaimer, the very foundation of the unitary system would seem to require tax authorities to look beyond corporate boundaries.
21. Note that a foreign corporation operating through a "permanent establishment" within a state may, in theory, be protected if there is an applicable double taxation treaty. See Kaplan, Taxing Foreign Firms by Formula, Tax Management International Journal, September 1979, 3-9.
22. The states currently using this method are California, Oregon an Alaska.
23. Since California's use of the unitary method on a worldwide scale appears to have caused the most controversy, examples concerning this method will refer to the California approach unless otherwise indicated.
24. See *Butler Bros. v. McColgan*, 17 Cal. 2d 664, Aff'd 315 U.S. 501; *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472; *Superior oil Co. v. Franchise Tax Board, 60 Cal. 2d 406; Honolulu Oil Corp. v. Franchise Tax Board*, 60 Cal 2d 417; and *Standard Register Co. v. Franchise Tax Board*, 259 Cal. App. 2d 125.
25. Guide for Corporations Filing a Combined Report, supra note 20, at 4.
26. Id. at 3.

"... it will generally not have to be performed de novo every year. The information needed to determine the existence and scope of a unitary business is likely to remain relevant for a period of years. By contrast, the arm's length method would involve the states in examining literally thousands of intercorporate transactions every year." [27]

On occasion the unitary method may be more advantageous to a multinational than the separate accounting method. This would occur when the business activities in the unitary state are profitable but the total unitary business is registering losses. If separate accounting is used, the tax authorities, once satisfied that there was no income shifted out of the state, would impose a tax on the profitable instate operation. However, if the unitary system is used there would be a net loss for the unitary business as a whole and thus little or no tax owed. [28]

IV. ALLEGED PROBLEMS CAUSED BY THE USE OF THE WORLD-WIDE UNITARY SYSTEM

In spite of, or perhaps because of, the claims of more effective tax administration there has been widespread dissatisfaction with the use of the unitary method. The critics of the unitary system, which include individuals from business, government and organizations such as the OECD have a plethora of complaints about both the theoretical foundation of the system and its practical application.

The major arguments put forward against the unitary method are as follows:

1. The unitary system allows the states too much discretion in the determination of a "unitary business". This often results in alleged double taxation since one state's decision to include a corporation within a unitary business may result in taxation of that income under the unitary formula, and another state or country may also tax the same income if its method of apportionment is different. [29]
2. The unitary system has the effect of taxing income earned outside the state and is thus unconstitutional. [30]
3. Compliance with the reporting requirements is difficult and costly at best, and impossible at worst. A multinational operating in countries with vastly differing accounting methods must adjust the information from the books of all portions of the unitary business and provide it to the state in the required form. Multinational enterprises claim that this information is not routinely prepared and thus must be compiled specially at great cost. [31]
4. The domestic law of countries where part of the unitary business operates may prohibit disclosure of certain types of information. For example, information about corporations with military contracts or information concerning financial institutions may be restricted. This places the taxpayer in the uncomfortable position of either complying with the domestic law, with the resulting increased tax burden, or complying with the tax authorities' requests and face civil or criminal sanctions in the countries of operation. [32]
5. Another compliance problems faces corporations with old assets. California requires that assets be valued at historical cost for purposes of applying the apportionment formula. Some corporations hold assets for which there are no records of historical cost either due to business practice or calamity. [33] The alleged result is that there is an overallocation of income to California since the value of the undocumented assets cannot be established and the assets in California will skew the formula applied to apportion income. [34]
6. The unitary method and combined report do not satisfactorily deal with currency conversion problems created by the need to compile information from corporations which operate in countries whose currency may fluctuate and thus create artificial gains (or losses) which distort the proper allocation of income. [35]
7. The unitary system ignores genuine losses which often occur during the startup period of a new enterprise. Thus it is claimed that although a new business beginning operation in a unitary state may be actually experiencing a loss, the income from other parts of the unitary business could be taxed in that unitary state. [36]
8. Profits earned by operations in high risk countries should not be equated with profits earned in low risk countries. Since the high risk profits are really a "contingency reserve" or a compensation for the risk, income is unfairly shifted to the unitary state if this business reality is ignored. The same arguments are made concerning the disparity of labor costs and productivity between different countries. [37]
9. Information which is required by tax authorities could harm a corporation's competitive position if the information were to be made public. This disclosure would most often occur when a tax assessment is appealed to the courts since the information becomes part of the public record. Thus the "unitary business" must decide the relative disadvantages or foregoing an appeal of a tax assessment and the risk of disclosure of harmful information to competitors if an appeal is taken. [38]

The critics allege that the use of the unitary system acts as a disincentive for corporations to locate in the states using the method, and the corporations already present

27. Church and Pomp, The Unitary Method: Thirteen Questions and Answers, Tax Notes, June 16, 1980, 894.
28. See *Superior Oil. Co. v. Franchise Tax Board*, 60 Cal. 2d 406.
29. See Taxing Foreign Firms by Formula, supra note 21, 7 n.24.
30. See Hearings, supra note 13, at 46, 85, 86.
31. Id. at 44, 66, 67.
32. Id. at 42.
33. Id. at 67, 74.
34. Id. at 74.
35. Id. at 91.
36. Id. at 95.
37. Id. at 115, 174, 175.
38. Id. at 77.

attempt to reduce their activities in those states.[39] A fear is also expressed that the unitary system may be adopted by countries who will abuse the method by manipulation of the definition of a "unitary business" and thus exact unfair taxes.[40] Finally, the fear is expressed by American based business that other countries may retaliate against the United States by enacting unfavorable laws in response to some states' use of the unitary method.[41]

The OECD report, in its endorsement of separate accounting and transfer pricing, and rejection of "so called 'global methods'", states that:

> "Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or the contrary)."[42]

Thus despite admitted drawbacks with the transfer pricing system, the OECD feels that administration is easier, and the determination of corporate income is fairer than with the unitary method.

V. REBUTTAL

The proponents of the unitary tax method (who consist primarily of the tax authorities of states using that method) have attempted to counter these charges and have pointed out the substantial deficiencies with the separate accounting/transfer pricing approach as well. The response of the defenders to the previous points are:

1. While admitting the potential for error in any system of income allocation, the proponents claim that the concept of a unitary business is sufficiently definite and is consistently applied. The unitary method is fair in that it accurately reflects where income is generated, and although there are frequent charges of double taxation, no one has put forward a case where double taxation has in fact occurred.[43]
2. There is no taxation of foreign income where the income does not have a connection with some instate activity. To tax income without the presence of this "nexus" would be unconstitutional[44] and the taxpayer would have recourse to the courts.[45]
3. Compliance costs are not prohibitive since often the information is already prepared in a usable form in intergroup financial reports. While admitting the problem caused by the variation in accounting methods, the proponents claim that the conversion in most cases is not burdensome.[46]

4/5. The tax authorities claim that problems such as disclosure restrictions under local law and problems of documentation are routinely dealt with in an equitable way. They deny that accommodations are not made to adjust formulae which would otherwise be skewed and point out again that a taxpayer whose income was unfairly allocated could appeal that determination to the courts.[47]

6. Unitary method proponents dispute the claim that multinational enterprises normally have problems with currency conversions. On the contrary, the question is raised how a multinational could assess the profitability of its various operations without some regular computations involving currency conversion.[48]
7. If the instate business meets the requirement that there be a "relationship of dependency and contribution between the portions of the business within and without the taxing state", and thus there is a unitary business, then the fact that startup losses occur will be taken into account through deductions to the income of the unitary business as a whole. As long as there is this interrelation among the members of the group then it is clear that some of the total unitary income was generated by the instate corporation's activities and should thus be taxed.[49]
8. As in the case of other unique situations (e.g. the particular disclosure problems in some countries) profits from high risk countries, large differences in productivity of labor, etc., will be given consideration in apportioning income. The tax authorities again reject the claim that they constitutionally can, or do apply the formula as rigidly as is alleged.[50]
9. A taxpayer may choose not to appeal a tax assessment for a variety of valid business reasons. The danger that such an appeal may result in disclosure of information is only slightly greater than the appeal of a tax assessment in a transfer pricing situation, and in any event serious damage to a corporation's competitivie position is relatively remote.[51]

In response to claims that the unitary method is a strong disincentive for business to locate elsewhere, proponents cite a recent study to indicate that tax

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39. Id. at 57.
40. Id. at 120, 150.
41. Id. at 40.
42. Transfer Pricing and Multinational Enterprises, supra note 19, at 14.
43. See the Unitary Method: Thirteen Questions and Answers, supra note 27, at 893, A Point of View, Taxes International, September 1979, 6.
44. See Discussion of the Due Process Clause of the Fourteenth Amendment, supra.
45. See the Unitary Method: Thirteen Questions and Answers, supra note 27, at 893.
46. See Hearings, supra note 13, at 20, 129, 130; note that some tax officials claim that a full transfer price audit would be much more costly than the preparation of the combined report. Id. at 20.
47. See Hearings, supra note 13, at 130; The Unitary Method: Thirteen Questions and Answers, supra note 27, at 893.
48. See Hearings, supra note 13, at 23, 24.
49. Id. at 130.
50. See The Unitary Method: Thirteen Questions and Answers, supra note 27, at 893.
51. See Hearings, supra note 13, at 77.

considerations are not paramount in the decision on where to locate, and that California, at least, ranks high among chosen locations in spite of its use of the unitary method.[52] Even if some business is discouraged through the use of the unitary system, state tax authorities claim that the alleged gains to be made by reverting to a separate accounting/transfer pricing system are speculative and that there will be significant amounts of revenue lost as a result.[53]

The unitary system defenders are as quick to point out the deficiencies of transfer pricing as their opponents are to praise its virtues. It is noted that the OECD report recognizes the serious problem in estimating the "fair market value" for such items as patents and intercorporate services, and even the Internal Revenue Service uses a unitary system instead of separate accounting in some situations.[54]

State tax officials claim that enforcement of transfer pricing is not practical for national tax authorities and is much less so for the states, since extensive audits, often in many different countries, would be required. The budget of a state tax administrator is relatively limited and they claim that what multinational enterprises really want (and expect) is no audit at all.[55]

It has been suggested that if the unitary states were to accept separate accounting that their tax authorities could utilize information about taxpayers acquired through IRS transfer price audits. However, this presents problems in practice. Due to the division of power within the United States between the state and federal governments, the states oppose ceding any authority to the federal government, especially in an area as central to a government's operation as taxation. In addition, the states fear that the IRS may not conduct a transfer price audit when asked or will compromise a claim in a way that works to the disadvantage of a particular state.[56]

VI. ATTEMPTS TO LIMIT THE USE OF THE UNITARY METHOD

Pressure on the states to modify or abandon the unitary system has increased in recent years with attacks coming from business, foreign governments and some American political leaders. The forum where the assault on the unitary method is most frequently launched is in the courts, and the number of cases attempting to have the use of the system struck down or modified have been increasing.

When the U.S. supreme court ruled in the *Japan line*[57] case that a California ad valorem property tax imposed on foreign cargo shipping containers did not meet the stringent requirements necessary to assure that there was no unreasonable burden on foreign commerce,[58] there was optimism among business leaders that the unitary method might be the next to fall.[59] However, hopes that the perspective of the court had shifted to one more likely to put restrictions on state taxing power were dashed with the opinions in the *Mobil Oil*[60] and *Exxon*[61] cases.

In *Mobil Oil* the court was faced with a challenge to an apportioned Vermont tax on the business and certain non-business income of a New York based corporation operating in Vermont. The court rejected a call by the corporation to rule that the inclusion of dividends from foreign affiliates within the apportionable tax base was per se unconstitutional and found that Mobil had failed to meet its burden of showing gross overallocation, since its foreign and domestic operations were part of a unitary business.

The *Exxon* case invoved a claim by Exxon corporation that its three functional departments, exploration and production, refining, and marketing should be treated as separate taxable entitites, and that since only the marketing division had operations in Wisconsin, only the income of that division could be apportioned and taxed there. The court, noting that a company's internal accounting methods are not binding on a state for tax purposes, held as in *Mobil Oil*, that the corporation had failed to meet its burden of proof that its operations were not part of a unitary business, and thus rejected Exxon's commerce clause and due process claims.

Observing that private litigation has not been particularly fruitful, many governments, expressing concern for their business enterprises, have attempted to persuade the federal government to place restrictions on the states'

52. Facility Location Decisions, a Fortune Market Research Survey, September 1977, Exhibit 30, Hearings, supra note 13, at 133.

53. The amount of revenue which would be lost has been estimated to be as high as 20-25 thousand million dollars annually for the state of Oregon alone. States' Unitary Tax Method Spurs Congressional Debate, Tax Notes, April 7, 1980, 511.

54. "At least four situations exist in which the IRS applies some form of the unitary method. First ... in those cases where the arm's length method proves unsatisfactory, the IRS relies on methods that comport with the unitary approach. Second, in allocating certain costs between foreign and domestic affiliates, the regulations under Sec. 861 of the Code view the affiliated corporations as a unit. Third, the formula apportionment method is used in allocating income between a parent corporation and its DISC; one of the reasons given for adopting this method was to avoid the complexities of the arm's length standard. Fourth, the regulations provide for the use of a formula apportionment under Sec. 863 of the Code if the circumstances make it impossible to determine an independent factory or production price — the regulations provide for a two-factor formula, using sales and property". The Unitary Method: Thirteen Questions and Answers, supra note 27, at 896.

55. See Hearings, supra note 13, at 20.

56. Delaware Tax Authorities had this fear realized in its attempts to audit the Getty Oil Company. In response to this problem a bill was introduced in the Delaware Legislature to adopt the unitary method. However the chances of such a proposal being approved appear slim. State Survey, Investment/U.S.A., August 1980, 15.

57. *Japan Line Ltd. v. County of Los Angeles,* 441 U.S. 434. (1978).

58. See Culp, A Look at the Limitations on State Power to Tax Foreign Commerce, Bulletin for International Fiscal Documentation, 1979, 550.

59. See Taxing Foreign Firms by Formula, supra note 21, at 8.

60. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425, (9180).

61. *Exxon Corporation v. Wisconsin Department of Revenue,* 48 USLW 4687, (June 10, 1980).

use of the unitary system. The most recent diplomatic effort [62] was in conjunction with the United States — United Kingdom double taxation treaty which was negotiated with the U.K. by the U.S. Treasury Department. When the treaty was signed on December 31, 1975, it included a provision, article 9(4) [63], which shielded British corporations operating in the U.S. either through branches or controlled U.S. subsidiaries from application of the unitary method by the Federal government or the states. After consideration by the U.S. Senate, which must ratify U.S. treaties, the part of article 9(4) which would have prevented the states from utilizing the unitary method in taxing U.K. companies was reserved. [64]

Since the British had made concessions in the treaty which favored certain U.S. business interests [65], partly in return for the restriction on state use of the unitary method, there was an understandable feeling by the British that they were being treated unfairly. This situation threatened approval of the treaty by Parliament, but after a protocol was negotiated which removed some of the advantages of the treaty for the U.S., the treaty was ratified. [66]

Although both the United States and Britain recognized the need for a new treaty, the British were particularly emphatic about obtaining protection from the use of the unitary method. After the reservation of part of article 9(4), discussions began with Members of Congress concerning possible Federal legislation to prohibit the use of the unitary method by the states. [67] Some Members of Parliament seemed to feel that there was an implicit agreement with Congress that, in exchange for ratification of the treaty by Britain, Federal legislation restricting the states would be forthcoming. [68]

H.R. 5076 and H.R. 5903, now pending before the U.S. House of Representatives, and S. 1688, pending before the Senate, would achieve the objective sought by opponents of the unitary method. [69] The effect of these bills, which are supported by the business community and opposed by most state governments, would be to prevent the states from using the unitary system to include foreign affiliates within the defined enterprise. Additionally, the bills would exclude from the income of domestic corporations dividends paid to them by foreign corporations.

The arguments put forward both for and against the bills are mainly of the form noted before. The bills' supporters in Congress argue that without these restrictions there will be retaliation against all U.S. business by foreign countries and that the threats by the U.K. are only the most recent example. There is also the desire for a more uniform system of determining income and they feel that separate accounting/transfer pricing is a more realistic and more acceptible method to other governments and international business. The portions of the bills which would alter the treatment of "foreign source" dividends deal more with the situation faced by Mobil Oil in its battle with the Vermont tax authorities. This problem is different than that posed by the worldwide application of the unitary method, and the support of these parts of the bills is more qualified.

The opponents of the legislation argue, as before, that the unitary system is theoretically sound and the only practical way for the states to police multinational enterprises, given the limited resources at the disposal of state tax authorities. Many congressional leaders also have sympathy for the "states rights" philosophy which resists any further inroads by the Federal government into the autonomy of the states. These members point out that the power to tax is a fundamental governmental power and that a restriction such as this would not only be a blow to states, already reeling from decreasing revenues due to recession and other causes, but that this type of law would set a dangerous precedent which will accelerate the erosion of state authority.

These bills are only the latest in a series of similar proposals considered almost annually by Congress for more than a decade. But while previous legislative attempts to limit the states have met with little success, the pressure on Congress to act does seem to be mounting, and with the new Republican majority in the Senate the chances of some limitation appear more likely than ever. [70]

VII. CONCLUSION

It remains a fact of life that those wishing to do business within the United States will have to deal with state tax authorities in addition to the Internal Revenue Service. While uniformity among the states as to the method used to tax corporate income is clearly a desirable

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62. Opposition to the unitary method is voiced quite frequently during treaty negotiations with the United States. See the quotations from a letter to the U.S. Treasury Secretary from Canada's Minister of Finance in (September 30, 1980) 344 Tax Treaties (CCH) IP 1317 P. The same views were expressed by the French Ambassador to the U.S. Department of State in a letter quoted in Hearings, supra note 13, at 78, 79.
63. Compare article 9 of the Model Double Taxation Convention on Income and on Capital, OECD, 1977.
64. The treaty was ratified by the U.S. Senate in June 1978, with the reservation.
65. See U.K. Backs Down on Unitary Taxation. 1 Investment/U.S.A. 3, April 1979, at 3.
66. The third protocol was signed on March 15, 1979 and ratified by the U.S. Senate on July 9, 1979. The U.S./U.K. treaty, as modified, was approved by Parliament on February 18, 1980.
67. There is some uncertainty about the constitutionality of a provision such as the original article 9(4), which attempts to place serious restrictions on the states through the treaty process. The power to limit the states is greater through Federal legislation, in part because both Houses of Congress must approve Federal legislation whereas only the Senate's approval is needed to ratify a treaty.
68. See Leonard, the Proposed Limitation to a State's Power to Tax Foreign Source Corporate Dividends, Tax Management International Journal, June 1980, 4.
69. AB 525, a bill which was introduced in the California legislature in 1979, would have placed a limitation on that state's ability to use the unitary method to tax all but certain types of foreign affiliates. Although the bill was approved by the California Assembly, it was defeated in the California Senate. See Treasury Says That Tax Preferences for Foreign Investment Undesirable, Tax Notes, January 28, 1980. 100.
70. Note that Frank Church, one of the most influential opponents of limitations on state use of the unitary method, was defeated in his bid for reelection to the U.S. Senate.

goal, the question still exists whether the uniform system should be one of separate accounting/transfer pricing, or a unitary method. Unfortunately, neither method is completely satisfactory.

A few of the arguments raised against the unitary system appear to be makeweight and some of the support of separate accounting probably represents an effort by those who view taxation generally as an unsound economic practice to gain more flexibility for tax planning to reduce their tax burdens. However the critics of the unitary system do have some legitimate complaints. For example, the unitary method, as it is now applied, shifts most all of the work of gathering data for the tax authorities to the taxpayer. Although such a system is obviously attractive to tax authorities with limited resources, it adds to the paper work problems facing businesses, who are already subjected to a massive amount of federal regulation.

Thus, in order to achieve the desired uniformity among the states a choice will hve to be made between the unitary system, which places added reporting burdens on business and on occasion results in overtaxation or the separate accounting system which can result in undertaxation of businesses. It appears that the conflict with the states on this issue will continue, but in view of the troubled world economic situation those who favor giving tax relief to business both directly, through reduced tax rates, and indirectly, by allowing more flexibility in tax planning, are gaining support, and a prohibition on state use of the unitary method is probably not far off.

The Council of the Netherlands Federation of Employers VNO and NCW on the Unitary System of Taxation

On March 26, 1980 representatives of the Council of the Netherlands Federation of Employers VNO and NCW (Raad van Nederlandse Werkgeversverbonden VNO en NCW)[1] presented the Council's views on the application of the unitary tax method in California and elsewhere and to submit evidence in support of the Hughes-Mori Bill, AB 525. The following statement was submitted to the California Senate Committee on Revenue and Taxation.

STATEMENT

Scope of Netherlands interests

1. The Netherlands, although being a small country, is nevertheless the largest direct foreign investor in the U.S.A. I may refer to the figures given as an annex to our written document. According to these figures, derived from the survey of U.S. Department of Commerce, the total foreign direct investment in the U.S.A. at the end of 1978 amounted to \$ 40.9 billion, of which from the Netherlands \$ 9.8 billion, or nearly 24 percent. Of the increase during 1978, in total \$ 6.2 billion, the Netherlands took \$ 1.9 billion or about 31 percent. These figures show how involved the Netherlands is in the international tax climate and especially that in the U.S.A.
2. Dutch business circles are gravely concerned about the problems of the unitary tax method, as applied by the California Franchise Tax Board. When the present wide application of the unitary method by the California Franchise Tax Board made itself felt around 1973, consultations between the Dutch Ministry of Finance and the Dutch industry were held to investigate the possibility of a solution via tax treaty negotiations with the Government of the U.S.A. This plan, however, was suspended when it became known that the United Kingdom was already going to negotiate with the U.S.A. for a similar protection. For us, this matter has now become urgent again because of the decision of the U.S. Senate not to act on this issue via a clause in double taxation treaties.

U.S. — Netherlands Friendship Treaty

3. We should like to mention that in the meantime the Dutch industry reached the opinion that the application of the unitary tax method to subsidiaries of Dutch parent companies should already be prevented by the "Treaty of Friendship, Commerce and Navigation" of 1956 between the United States and the Netherlands. We refer in particular to Article XI, paragraph 4, of this treaty, which says that both Parties "shall not impose or apply any tax, fee or charge upon any income, capital or other basis in excess of that reasonably allocable or apportionable to its territories". In view of the generally accepted international tax rules, such reasonable allocation or apportionment can only refer to the "permanent establishment" and "arm's length" rules. These rules have been incorporated not only in United States tax treaties, but also in the Model Double Taxation Convention on Income and on

1. VNO stands for Verbond van Nederlandse Ondernemingen or Dutch Employers' Federation.
NCW stands for Nederlands Christelijk Werkgeversverbond or Netherlands Federation of Christian Employers.

Capital of the OECD, the United Nations Guidelines for Tax Treaties between Developed and Developing Countries and the tax laws of almost all foreign nations. It is our belief that also other provisions of the Friendship Treaty are being violated by the application of the California unitary formula to the worldwide income of certain Dutch parent companies. This belief is shared by the Netherlands Government, which has recently approached the State Department with regard to the unfair treatment of certain American subsidiaries of one of our members by the California Franchise Tax Board.

International opinion

4. Apart from this point the Dutch Federation would like to declare its full adherence to the arguments and views put forward in Document No. 180/195, adopted by the Executive Board of the International Chamber of Commerce on 26th September, 1979. In the Resolution contained in that document it is stressed that the unitary approach "could easily become a most important threat to international trade". We assume that you are familiar with this document because it has been submitted by our U.K. sister organization during the Assembly hearings on Bill AB 525. In addition to this we have learned that most recently a statement from all the nine Common Market countries endorsing these views has been submitted to the Chairmen of the Congress Committees in Washington who are dealing with this matter and that Governor Brown of your State has received a copy of this statement.

Objections against application of the unitary method

5. Although we have the impression that all the main arguments against the international application of the unitary method have already been submitted to the California legislature, we would like to summarize them here also from our point of view.

Consideration of principle

6. As a matter of principle it seems inappropriate to measure business profits arising in a certain country with yardsticks applying under widely different circumstances to companies or branches in other countries. Such a yardstick may be defensible in very specific cases and then only between adjacent jurisdictions — for instance with regard to railroad companies — but a wider application of this method on an international scale may not only lead to a highly distorted picture of reality, but also to falsifying competition. One can easily imagine a single Californian business with a profit of say $ one million competing with a comparable subsidiary of a foreign group, also earning $ one million profits. If the non-Californian profits of this group are on a substantially lower level, the Californian subsidiary would pay lower taxes on similar profits than its fully independent Californian competitor, even if there were no further distortions through the unequal relevance of the yardsticks for all countries concerned. On the other hand the Californian tax burden on the subsidiary would be higher in the reverse case, which can easily happen in the starting-up period of a business or during a period of poor profits. In this respect the unitary method seems to have a counterproductive result, because it would likely give refunds of tax to highly profitable Californian subsidiaries, whereas low-profitable or even loss-making subsidiaries are penalized. In the latter case double taxation is almost inevitable.

Practical difficulties for Netherlands parent companies

7. In addition to these considerations of principle, there are many practical objections against the unitary tax method as it is being applied by the California Franchise Tax Board. In the first place it is by no means clear how far the unitary principle would have to be applied within a group. Among our members there are cases where some eight different subgroups could be construed. Can the parent company then be resonably required to recalculate the worldwide profits not only once, but even eight times on the basis of the Californian tax accounting rules, in order to be sure that eventually it has got the right figure? One must stagger at the possibility that other American or non-American States would follow this example. Moreover, the Netherlands has always taken a very liberal attitude to taxing foreign operations and gives in most cases a full tax exemption for dividends received by Dutch parent companies from their foreign subsidiaries. This system avoids any necessity to recalculate for tax purposes the profits of those subsidiaries. Dutch parent companies are not equipped to comply with requirements from other States to make such a recalculation.

The burden of complying with demands for information

8. The cost of compliance with the demands for information and accounting, taking into account all the necessary adjustments, is devastatingly high and could well surpass the taxes involved. In some cases to meet that demand, many hundreds of companies belonging to a single group would be required to translate and convert their accounts which are kept in numerous currencies. Such companies may be located in countries which place restrictions on the transmittal of financial and operating information which would be needed to comply with the tax laws of a jurisdiction other than the parent company itself. In addition we are of the opinion that, because the attempt to tax subsidiaries of Dutch parent companies on a unitary basis is violating the Friendship Treaty, it follows that also the demands for information to that purpose are not allowed under that Treaty.

Need for adjustments

9. Other objections to the international application of the unitary method are the incomparability of most factors used and the distortions caused by exchange differences. How for instance can wages in Africa and Asia be compared with Californian wages? And what large differences are there not between de-

preciation allowances in the various countries? The problems involved in the translation of exchange differences are a chapter itself. Practice has learned that enormous distortions are likely to result and that the specific elements of California's apportionment formula often inflate the Calironia income of a multinational group.

Extra-territorial application of the unitary method should be avoided

10. For all those aforementioned reasons the Dutch Employers' Federation welcomes any step to curb the application of the unitary tax method. We do not say that within a country the unitary method is absolutely inappropriate; this must be left to the country's own discretion. We only stress that once the system has been adopted, all measures should be taken to avoid its extra-territorial application, as has been done for instance in Switzerland.

Discrimination of certain business sectors

11. Although it may be evident that we fully support the general objectives of the Hughes-Mori Bill AB 525, we still are very unhappy with the fact that this Bill discriminates against certain important branches of industry by excluding them from its application. In our view these exclusions would continue to present all the objections mentioned above for a limited but important class of companies. Moreover, no compelling explanation has been offered or can be found for these exclusions. In particular, we do not understand the statement in section 2 of Bill AB 525 with regard to the energy exclusion and feel that it gives no justification for that exclusion. After all, the application of the arm's-length principle to transfer prices protects California's interests in this respect.

Energy exclusion

12. The energy exclusion will hurt strongly one of our members. In fact, the exclusion will leave in existence problems of the member which brought about the approach made by the Netherlands Government to the U.S. State Department on the basis of the Friendship Treaty. The subsidiaries of this Dutch member company appear to be the only Californian taxpayers which are prejudiced by this exclusion. We are allowed to mention some figures which may illustrate the quixotic effects of the unitary method in this case. One of our member's subsidiaries operating in California is a nuclear energy research company, which suffered a loss of about $ 400 million during the years 1973 to and inclusive 1976. Nevertheless this company, which is the only nuclear energy company within this group, is being assessed for California franchise taxes at an amount of $ 4.3 million over that period. On the other hand we believe that the estimates of the total amounts involved in the energy exclusion as mentioned during prior hearings, are highly exaggerated. Those amounts ranged upward from $ 20 million per year. In order to correct a wrong impression we would like to mention that according to information received from our member company the annual revenue involved in this exclusion is unlikely to exceed an amount of $ 2.5 to 3 million per year. This amount is based on the latest computations made by the auditors of the California Franchise Tax Board. The subsidiaries themselves believe that further downward adjustments of these amounts would be justified.

Exclusions and sunset provisions should be removed

13. For all the reasons mentioned above we hope that the Hughes-Mori Bill will be accepted, but without the exclusions. The same applies to the sunset provisions included in this Bill, for which we can see no foundation either. Because of the intrinsic deficiencies of the unitary method, at least on an international scale, we think that actions undertaken by the legislators in the States themselves are very important, because they show a good understanding of the problems caused by the method as such. As we have said before, Dutch industry is very active on an international scale. Among our members there are companies which already now hesitate to invest in California. The enactment of Bill AB 525 without the exclusions and sunset provisions would be an important step towards greater economic co-operation between Dutch business and that in the State of California.

In the next issue we will publish the opinion of the International Chamber of Commerce, Paris, or the unitary system of taxation.

Study Group on Asian Tax Administration and Research (SGATAR)

~ An Experiment in Regional Tax Cooperation ~ Part I

By Angel Q. Yoingco * and Sutadi Sukarya **

TOPICS DISCUSSED AT SGATAR MEETINGS

1st Meeting (Manila, Philippines; 14-21 February 1971)
Chairman: Artemio Al. Loyola
Secretary General: Angel Q. Yoingco

1. Fiscal incentives to promote domestic and foreign investments
   (a) Incentives to enterprises:
      (1) upon entry
      (2) while operating
      (3) with respect to ploughing back of profits
      (4) on remittances – e.g., capital, profits, royalties, etc.
2. Some aspects and/or problems of tax administration relating to the operation of fiscal incentives
3. Exchange of information
   (a) Exchange of information on tax fiscal matters, including statistics, economics and legal studies, etc.
   (b) The feasibility of conducting seminars and conferences on taxation in the future
   (c) The need for a permanent body to act as clearing house for the exchange of information and to conduct seminars and conferences

2nd Meeting (Jakarta, Indonesia: 21-25 February 1972)
Chairman: Sutadi Sukarya
Secretary General: Sikwan Sutanto

1. The role of sales taxes in developing countries
   (a) Development of sales taxes in developing countries
   (b) Problems in the field of sales taxes
   (c) Concepts of collection systems
2. Some aspects of income tax evasion or avoidance
   (a) Status principle
   (b) Source principle
   (c) Principle of economic activities
3. Some aspects of tax treaties between developing and developed countries
   (a) Fiscal domicile
   (b) Permanent establishment
   (c) Shipping and air
   (d) Dividends, interest and royalties
4. Exchange of information – reports of further study with regard to the proposed creation of an Asian Center for Tax Administration and Research (ACTAR)

3rd Meeting (Tokyo, Japan; 28 May–1 June1973)
Chairman: Michitaka Kondo
Secretary General: Torao Aoki

1. Taxation of natural resource-based industries
2. Relationship between taxpayers and tax authorities
3. Exchange information with special reference to the creation of ACTAR

4th Meeting (Kuala Lumpur, Malaysia; 22-27 July 1974)
Chairman: Sallehuddin bin Mohamed
Secretary General: Mohd. Ramili Bin Mat Wajib

1. Taxation structure and problem of:
   (a) Corporation and shareholders
   (b) Royalty, interest and rent
2. The income tax collection machinery and techniques employed in recovery of arrears
3. Administration and enforcement problems of sales tax

5th Meeting (Bangkok, Thailand, 12-18 May 1975)
Chairman: Nukul Prachaybmoh
Secretary General: Vid Tantayakul

1. Estate and inheritance taxes
2. Fiscal measures to encourage export
3. Development of personnel
4. The organization structure of an income tax office
5. A common nomenclature

6th Meeting (Singapore; 25-30 October 1976)
Chairman: Wan Fook Hoy
Secretary General: Tan Boen Eng

1. Scheme for effective income tax administration and experience in increasing compliance of taxpayers
2. Financial leasing
3. Property tax
4. Glossary of tax terms

7th Meeting (Canberra and Sydney, Australia; 20-25 November 1977)
Chairman: Trevor Boucher
Secretary General: John O'Reilly

1. Aspects of investigation and audit of a taxpayer's taxation affairs with particular reference to:
   (a) Criteria used in the selection of cases for investigation and audit
   (b) Ascertainment and policing of values of trading stock
   (c) Practice regarding imposition of penalties and other sanctions to facilitate tax collection
2. The role of internal auditors in government in general, and in a taxation office in particular
3. Roles in taxation offices for computers, microfilming and other modern office facilities
4. Review of the revised glossary of tax terms

8th Meeting (Wellington, New Zealand; 13-17 November 1978)
Chairman: Ray P. Kellaway
Secretary General: Paul Spicer

1. Practical problems in dealing with the taxation of multinational companies
2. Methods of dealing with increases in the volume of tax returns, e.g.
   (a) Streamlining
   (b) Simple checking
   (c) Tolerances
   (d) Computer checks
   (e) Legislative assistance
   (f) Delegation
   (g) Others
3. Problems and recent developments in dealing with tax avoidance arrangements
4. The organization and implementation of staff training

9th Meeting (Manila, Philippines; 11-17 November 1979)
Chairman: Efren I. Plana
Secretary General: Angel Q. Yoingo

1. Problems in dealing with family-owned or closely-held corporations
   (a) Information on the growth of such corporations
   (b) Tax avoidance practices among family-owned or closely-held corporations
   (c) Legal provisions directed against such tax avoidance practices
   (d) Audit procedures introduced to determine the correct tax liabilities of such corporations
2. Management practices in the enforcement of the income tax law
   (a) Control of tax returns filed
   (b) Work assignments with regard to assessment and/or examination of income tax returns
3. Problems and recent improvements made in the tax collection machinery
   (a) Methods of collecting taxes
   (b) Control of taxpayers and tax payments
   (c) Problems related to tax receivables
4. Problems and recent developments in dealing with tax evasion
   (a) Tax evasion practices
   (b) Development of tax fraud cases
   (c) Methods of investigation used in fraud cases
   (d) Legal impediments in investigating tax fraud cases

10th Meeting (Jakarta, Indonesia; 17-21 November 1980)
Chairman: Sutadi Sukarya
Secretary General: Sikwan Sutanto

1. Land taxation
   (a) History of land taxation
   (b) Existing statutory laws and regulations of land taxation
   (c) The role of land taxation in the overall tax revenue picture
   (d) Relations of land taxation to other taxes in general
   (e) Relationship of administration of land taxation to other government bodies administering land matters
   (f) Problems of policy and administration of land taxation
2. Development of fiscal incentives to promote domestic and foreign investments
   (a) Differences between the existing and previous laws and regulations with regard to fiscal incentives to promote domestic and foreign investments
   (b) Results of changes in attracting domestic and foreign investments in the 1970s and the overall assessment of the results of the fiscal incentives vis-a-vis domestic and foreign investments since the adoption of fiscal incentives measures
   (c) Problems of policy and administration of fiscal incentives
3. Reporting and statistical system for tax administration purposes
   (a) Outline of the existing reporting and statistical system
   (b) Problems relating to reporting and statistical system
   (c) Suggestions for improving the reporting system
4. Administrative implementation of income tax treaties
   (a) Income tax treaties implementation
   (b) Practical problems relating to the administration and implementation of income tax treaties
   (c) Experiences in meetings between the competent authorities in implementing income tax treaties
   (d) Procedures of exchange of information and cooperation in tax collection and problems arising therefrom.

I. INTRODUCTION

Despite the multi-faceted diversity of conditions existing in Asia and the Pacific, there have been increasing efforts through the years among the nations within this sphere to promote regional solidarity and cooperation. Such efforts have become imperative not only in the spirit of good neighborliness but more importantly in the face of challenges brought about by global interaction. Experience will show that a cohesive regional group in this era and in the future stands a better chance for survival and growth.

The field of taxation is one area where cooperation can pave the way for the institution of more effective tax systems and efficient tax administration. Taxation being one of the tools in fiscal planning and control, it deserves the most serious attention and careful thought from government policymakers.

The *Study Group on Asian Tax Administration and Research (SGATAR)* has provided an appropriate mechanism for the exchange of views on tax matters and for the exchange of information on the fiscal activities of the region. In its ten years of existence, it has discussed 39 major topics and issues all relating to taxation; 22 topics involving various aspects or problems in tax administration; five covering direct taxation (including property taxation); four covering tax incentives; one on indirect taxation; and seven on the exchange of information and others.

In addition, two group projects have been completed at the close of the seventies. These are the *Glossary of Tax Terms* and *Tax Systems of SGATAR Member Countries.* Two other group projects, namely, *Tax Administration Procedures* and *Property Valuation Methods*, are scheduled for completion in 1981 and 1982.

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This paper is based substantially on a study by the same authors entitled: *The First Decade: A Brief History of SGATAR,* published in November 1980.

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II. FOUNDING OF SGATAR

The idea for the creation of a Study Group on Asian Tax Administration and REsearch can be traced to a proposal submitted by the Philippine delegation headed by Finance Minister Cesar Virata during the Fifth Southeast Asian Ministerial Conference for Economic Development (SEAMCED) held in Jakarta and Jogjakarta, Indonesia from 22-25 May 1970. As contained in the proposal, the aim of the Study Group would be "to determine how countries could benefit from each other reviewing their present tax structures, policies and administration as they affect national and regional development". The Study Group would also look into "how tax systems could be harmonized to provide investment flow to priority areas without much loss of revenue on the part of the host countries".

Recognizing the validity and significance of the proposal, the Conference adopted the Philippine recommendation and Paragraph 20 of its Joint Communiqué states:

"The Conference adopted the proposal of the delegation of the Philippines to organize a study group for the review and exchange of information about the tax structure in the countries of Southeast Asia and invited the Philippines to host the study group and to report to the Sixth Ministerial Conference."

Thus, the Study Group on Asian Tax Administration and Research (SGATAR) was born.

III. OBJECTIVES AND MEMBERSHIP OF SGATAR

Although there is no formal enumeration of the objectives of SGATAR, it is more or less clear to the member countries that the Study Group provides an opportunity for their tax officials to get together and exchange information, ideas and experiences in the field of taxation considering the increasingly important role assumed by taxation in promoting economic development.

SGATAR has likewise no formal membership requirement other than that the country must be a member of the Southeast Asian Ministerial Conference for Economic Development. The original participating countries in SGATAR included: Cambodia, Burma, Indonesia, Japan, Laos, Malaysia, Philippines, Singapore, Thailand and Vietnam. In 1974, however, the Study Group's membership was expanded to include the countries in the Pacific, namely, Australia and New Zealand.

IV. FIRST SGATAR MEETING IN MANILA

Pursuant to the Joint Communiqué of the 5th SEAMCED the first meeting of the Study Group on Asian Tax Administration and Research was held in Manila, Philippines, 15-21 February 1971. Elected Chairman of the meeting was Congressman Artemio Al. Loyola, Chairman of the Joint Legislative-Executive Tax Commission (now National Tax Research Center) who headed the Philippine delegation. Dr. Angel Q. Yoingco, Executive Director of the Joint Legislative-Executive Tax Commission, acted as Secretary-General.

A total of 23 delegates representing eight countries (Indonesia, Japan, Laos, Malaysia, Philippines, Singapore, Thailand and Vietnam) attended the meeting. In addition, the Khmer Republic (Cambodia) sent an observer in the person of Mr. Long Boret.

The Philippines' Secretary of Finance, Cesar A. Virata, welcomed the delegates on behalf of the Philippine government. He spoke on the need for the members of the Study Group to join hands and work in unison in improving their tax systems. He further pointed out that it is in a forum such as the Study Group that resolute steps can be taken to ensure concerted and coordinated action in the tax field.

The meeting discussed three major topics, namely: fiscal incentives to promote domestic and foreign investments; problems of tax administration relating to the operation of fiscal incentives; and the possibilities of exchanging information on tax and other fiscal matters on a more or less permanent basis. The meeting was conducted through round-table discussions and presentation of working papers on each of the topics by the participating delegations.

1. Fiscal incentives to promote domestic and foreign investments

On the first topic of fiscal incentives to promote domestic and foreign investments, the delegates were unanimous in admitting that fiscal incentives contribute to promoting economic development by attracting investments into those areas which urgently need to be developed.

However, it was also pointed out that tax incentives, which entail costly sacrifice in terms of public revenues, can be pushed to a point where they constitute a drag on economic progress. It is important, therefore, that an acceptable balance be reached whereby the development of certain industries is not pursued at the cost of tremendous governemnt revenue loss.

As can be expected, considering the unique circumstances that affect a particular country's policies and decisions, the forms of fiscal incentives granted vary from country to country. But the most common fiscal incentives are in the form of income tax relief for a limited number of years, investment tax credit and exemption from import and export duties. To encourage foreign investments, several of the SGATAR member countries have concluded double taxation agreements with other countries.

2. Problems of tax administration relating to the operation of fiscal incentives

On the question of tax administration problems relating to the operation of fiscal incentives, the delegates noted that using tax concessions as an avenue for tax evasion has been their major problem. Organizational problems in the tax administration agency have also led to problems in assessment and collection. Inability on the part of the government to monitor the activities of the grantees of tax exemptions has further aggravated the problem. The delegates, however, reported that steps have been taken to minimize these problems and to develop an effective incentives system that would call for the least amount of sacrifice in terms of revenue losses on the part of the government without compromising the objectives for which the incentives system has been developed.

3. Exchange of information

The third topic discussed was the need for the exchange of information and ideas on tax and other fiscal matters. It was pointed out that such an exchange of information will enable countries whose tax systems can still bear some improvement to learn from the experiences and practices of others. The Philippine delegation then discussed the possibility of creating a permanent body, the Asian Center for Tax Administration and Reseach (ACTAR), to act as the clearing-house for the exchange of information to conduct seminars and conferences. Due to the varied reactions to the proposal, the Philippine delegation was requested to make a further study on the subject.

The Study Group then stressed the need for a continuous exchange of information, and realizing the successful result of this first meeting, was of the opinion that meetings of this nature should be encouraged. It was on this note that the first SGATAR meeting ended.

V. SECOND SGATAR MEETING IN JAKARTA

After the first SGATAR meeting held in Manila, a report was submitted to the Sixth Ministerial Conference for Economic Development of Southeast Asia which was held in Kuala Lumpur from 3-5 May 1971. The Conference noted the report of the Study Group and "agreed that further meetings could usefully be held to exchange information and views on tax matters and accepted with appreciation the offer of the Indonesian Delegation to host the second meeting of the Study Group".

Thus, the second meeting of the Study Group on Asian Tax Administration and Research was held in Jakarta, Indonesia 21-25 February 1972. A total of 23 delegates, eight observers and seven Indonesian consultants attended the meeting. With the exception of Laos and the Khmer Republic, all the countries present at the first meeting were again represented.

Due to the demise of Mr. Artemio Al. Loyola, Chairman of the first meeting of the Study Group, Director Angel Q. Yoingco, Secretary-General of the first meeting, presided over the second meeting as temporary chairman. The Study Group then unanimously elected Drs. Sutadi Sukarya, Director General of Taxes, Ministry of Finance of the Republic of Indonesia, as Chairman of the meeting. Mr. Sikwan Sutanto, Director for Legal Affairs and International Tax Relations of the Ministry of Finance, acted as Secretary-General.

Indonesian Finance Minister Prof. Dr. Ali Wardhana welcomed the delegates on behalf of his government. In his opening address, he stressed the fact that in the desire of developing countries to hasten their economic development, there has been a heightened awareness of the vital role that tax reform plays. He therefore considers the idea of discussing problems and experiences in the field of taxation as highly contributory to that heightened awareness.

Mr. Frans Seda, Indonesian Minister of Communications, also addressed the meeting and told the delegates that he was convinced of the necessity for holding SGATAR meetings which he said would have far-reaching results that could affect the shaping of the economic future of the various member countries.

The meeting discussed three topics, namely: (1) the role of sales taxes in developing countries; (2) some aspects of income tax evasion or avoidance; and (3) some aspects of tax treaties between developing and developed countries. In addition, the meeting also took up the report of the Philippine delegation on the further studies it made regarding the proposed Asian Center for Tax Administration and Research.

1. The role of sales taxes in developing countries

On the first topic discussed, it was learned that only Indonesia, the Philippines and Thailand were imposing a general sales tax. Singapore did not have a sales tax; Vietnam used to have a multi-stage sales tax but it was abolished in 1957 and was replaced by what they call a production tax; Japan had consumption taxes levied on special articles like liquor and tobacco and on certain other commodities; and Malaysia was only about to pass a sales tax law. For those imposing a sales tax, however, many similarities were noted. For one, the tax was levied at a single stage in all three countries. For another, it was highly productive, contributing a sizeable amount to total revenue. It was pointed out furthermore that developing countries rely more on indirect rather than on direct taxes because of the former's relative ease in administration, wide coverage and hidden nature.

2. Some aspects of income tax evasion or avoidance

On the second topic, income tax evasion and avoidance, all the participating countries agreed that this was indeed a serious problem faced by all tax agencies and that it was imperative that remedial steps be taken to curb it. On the issue of domestic tax evasion and avoidance, it was learned that all the participating countries have more or less taken steps to minimize the problem. It was, however, in the area of international tax evasion that the delegates felt that the Study Group could play a more significant role. It was pointed out that the influx of foreign investments into the developing countries and the attendant outflow of investment income almost always lead to international tax evasion; to combat this, the developing countries need to band themselves together and agree on ways to solve it. During the discussions, two methods by which the problem may be solved surfaced: the exchange of information and the use of tax treaties. Due to certain problems spawned by both methods, however, the delegates agreed to give this matter more thorough study.

3. Some aspects of tax treaties between developing and developed countries

With the exception of Vietnam which did not have tax treaties with other countries, all the other participating countries believe in the importance of tax treaties in the development process of the Southeast Asian region. The most common reasons cited for the conclusion of tax treaties were the avoidance of international double taxation, facilitation of smoother economic transactions and promotion of economic cooperation and cultural exchange. In this connection, the Indonesian delegation proposed the setting up of an Ad Hoc Sub-Working Group that will have the task of drafting common guidelines for Southeast Asian countries in tax treaty negotiations. The majority of the delegates were favorably disposed towards the proposal but since they were not in a position to decide on the issue, they promised to make a report to their respective governments to seek guidance on the matter.

Finally, as agreed upon during the first SGATAR meeting in Manila, the Philippine delegation reported on its assignment to conduct further studies regarding the proposal to create the Asian Center for Tax Administration and Research (ACTAR).

VI. THIRD SGATAR MEETING IN TOKYO

In pursuance of Paragraph 16 of the Joint Communiqué of the Seventh SEAMCED, the third meeting of the Study Group on Asian Tax Administration and Research was held in Tokyo, Japan, from May 28 to June 1, 1973. All the participating countries of the Ministerial Conference which are also members of SGATAR, namely, Indonesia, Japan, Laos, the Khmer Republic, Malaysia, the Philippines, Singapore, Thailand and Vietnam, were represented at the meeting. A total of 41 delegates, observers and advisers attended the meeting.

Mr. Michitaka Kondo, chief delegate of the Japanese delegation and Commissioner of the National Tax Administration Agency, was unanimously elected Chairman of the meeting. Mr. Torao Aoki acted as Secretary-General.

Mr. Kiichi Aichi, Japan's Minister of Finance, delivered the opening address and welcomed the delegates. He told the participants that much of value can be accomplished by the Study Group through the exchange of information on the tax problems confronting each member country and the discussion of their possible solutions.

There were three items on the agenda, namely: (1) taxation of natural resource-based industries; (2) relationship between taxpayers and tax authorities; and(3) exchange of information with special reference to the creation of ACTAR.

1. Taxation of natural resource-based industries

As background to the first topic, it was noted that the development plans of most SGATAR countries are geared to a large extent on the maximum utilization and exploitation of their vast natural resources and the potential revenue returns these would bring to their respective economies. This objective, however, is hampered by the lack of indigenous capital that is needed to finance the requirements of capital intensive natural resource-based industries. Thus, Asian countries have been compelled to adopt incentive policies for development in order to attract substantial foreign investments, and one way of attracting these foreign investments is through the grant of tax incentives.

Most of the SGATAR countries have adopted tax incentive policies to develop their natural resource-based industries. These industries enjoy preferential tax treatment and the tax concessions given vary from country to country. Programs designed to attract foreign investments have likewise been implemented. It was noted, however, that although these policies and programs have the primary aim of exploiting the natural resources for economic development, a rational and coordinated program of conservation and utilization is also being followed to ensure that these resources are wisely used.

2. Relationship between taxpayers and tax authorities

On the second topic, the delegates agreed that it is the goal of the tax administration to establish an environment in which taxpayers file the proper returns and pay their taxes voluntarily. Taxpayers should be made to understand the significance of taxation so that they are induced to pay their taxes honestly and willingly. To attain this objective, the SGATAR countries have taken more or less similar steps which may be broadly classified under either of the following two categories:

(a) measures taken to improve the level of compliance of taxpayers through public information, tax education and constant consultation between the tax authorities and the taxpayers; and

(b) measures taken to promote the integrity and competence of tax officials through the appropriate education and training and the enforcement of self-discipline.

3. Exchange of information with special reference to the creation of ACTAR

After a thorough discussion of the proposal to create an Asian Center for Tax Administration and Research (ACTAR), the Study Group decided not to endorse it in view of the existence of SGATAR and other organizations which already serve the same purpose for which ACTAR was to be created. It was hoped that the International Seminar on Taxation for Asian Countries (ISTAC) which Japan was sponsoring and the National Tax Research Center of the Philippines would expand their present activities to include fully or partially the functions envisioned under the proposed ACTAR.

Finally, since there was no objection and considering the usefulness of and the benefits derived from the three SGATAR meetings, all delegations agreed to continue the practice of meeting annually. Thus, the delegates were told that they would be informed of the next SGATAR meeting as soon as one of the member countries has offered to host it.

VII. FOURTH SGATAR MEETING IN KUALA LUMPUR

The fourth meeting of the Study Group on Asian Tax Administration and Research was held in Kuala Lumpur, Malaysia, 22-27 July 1974. For the first time, Australia and New Zealand sent representatives to the meeting while, for one reason or another, Laos, the Khmer Republic, Vietnam and Burma were unable to attend. A total of 30 delegates representing eight countries attended the meeting. Since then, these eight countries, namely: Australia, Indonesia, Japan, Malaysia, New Zealand, Philippines, Singapore and Thailand, are the ones who have actively taken part in SGATAR's annual meetings.

Mr. Sallehuddin bin Mohamed, leader of the Malaysian delegation and Tax Division Undersecretary of the Ministry of Finance, was unanimously elected Chairman of the meeting while Mr. Mohamed Ramli bin Mat Wajibs, Principal Assistant Secretary of the Treasury's Tax Division, discharged the duties of the Secretary-General.

Datuk Mohamed bin Rahmat, Malaysia's Deputy Minister of Finance welcomed the delegates on behalf of his government and the Malaysian people.

The meeting tackled three major topics, namely: (1) the taxation structure and problems of the corporations and shareholders and of royalties, interest and rent; (2) the income tax collection machinery and techniques employed in recovery of arrears; and (3) the administration and enforcement problems of the sales tax. The Philippine delegation withdrew the topic of ACTAR from the agenda in view of the general consensus from the last three meetings that it did not yet seem to be the proper time for the creation of a permanent body such as ACTAR.

1. Taxation structure and problems of the taxation of corporations and shareholders

Regarding the first topic, the meeting discussed the various systems adopted by the member countries in taxing corporate and dividend income as well as the administrative and technical problems relating to these systems. With some modifications, each of the SGATAR member countries uses one of the three major systems of taxing dividend income, namely: the classical system, the dual or split rate system and the imputation system. New Zealand, Australia and the Philippines use the classical approach whereby dividend income is taxed twice — at the company level and in the hands of the individual shareholder. Economic double taxation is somewhat eased up by the implementation of certain relief measures such as the preferential tax treatment of dividends in the hands of shareholders deriving lower incomes from this source as practiced by New Zealand.

Japan uses the split rate system which allows shareholders a tax credit of ten percent while Malaysia and Singapore use the imputation system where the shareholder receiving a dividend is given full credit for the tax paid by the company.

On the need to avoid or reduce economic double taxation of income at the corporation and individual levels, a number of delegates were of the view that some form of integration of the tax on corporate income with personal income tax is needed. They agreed that the problems which need to be considered in choosing the appropriate system are:

(a) the effect on corporate financing policy;
(b) budgetary and administrative considerations;
(c) the fairness with which the proposed system removes the additional tax burdens at various levels of income; and
(d) the extent of other anomalies and inequities in the system which may need to be removed before relief can be given to shareholders.

2. The income tax collection machinery and techniques employed in recovery of arrears

On the second topic of income tax collection machinery and techniques employed in the recovery of arrears, it was the consensus of the delegates that the tax consciousness of the public has an important bearing on the methods employed for tax collection and also on the effectiveness of the collection machinery. The case of Japan, which has a relatively high level of public tax consciousness and therefore fewer difficulties in tax collection, was cited.

As gleaned from the reports and discussions, there are several methods of collecting taxes that the SGATAR countries have adopted and the most common of these are:

(a) the PAYE system;
(b) annual assessments and installment plan for employees;
(c) annual assessment for self-employed persons;
(d) provisionsal assessments and payments;
(e) withholding of tax; and
(f) self-assessment.

On the recovery techniques for tax arrears, most countries start recovery proceedings with the service of notices of demand. All countries have legal provisions to counter failure to pay taxes; in some, the tax authorities bring criminal actions to court. Resorting to seizure and sale of properties is also a common action among the SGATAR countries.

3. Administration and enforcement problems of the sales tax

The last topic concerned the administration and enforcement problems of the sales tax. Except for Singapore which has no sales tax, all the rest of the SGATAR countries impose sales tax or a modified version of the sales tax. In Australia and New Zealand, the sales tax is a single-stage tax imposed at the wholesaler's level, while in Indonesia, the Philippines and Malaysia, the sales tax is imposed at the manufacturer's level. Each country has adopted different rates of taxes to different types or classes of goods or services. But certain policies are observed to be common among the SGATAR countries with regard to the imposition of the sales tax: essential goods such as foodstuffs are exempt and luxury goods are subjected to a higher rate of tax. Thus, in most countries, goods are classified into three or four broad categories, namely, essential goods, raw materials, luxury items and others. Preferential rates are, of course, given to the essential goods.

Problems of tax evasion are observed to be the most common among the participating countries. The basic preventive measure practiced by most of the countries is a system of periodic investigation and inspection carried out on a taxpayer's accounts and this is found to be highly successful in preventing evasion.

The fourth SGATAR meeting ended on the note that it should be repeated in view of the following:

(a) immeasureable benefits were derived from the exchange of information among the participating countries;
(b) the meeting presented an opportunity for the member countries to discuss problems and their possible solutions;
(c) it presented opportunities for participating countries to keep abreast of new tax legislation and developments in the other countries;
(d) it gave a chance to the participating countries to share their experiences; and
(e) there were still a great many subjects on taxation yet to be discussed.

VIII. FIFTH SGATAR MEETING IN BANGKOK

The fifth meeting of the Study Group on Asian Tax Administration and Research was held in Bangkok, Thailand, 12-18 May 1975. In attendance were 42 delegates representing SGATAR's eight member countries.

Elected Chairman of the meeting was Mr. Nukul Prachuabmoh, head of the Thai delegation and Director-General of the Revenue Department.

Mr. Vid Tantayakul, Deputy Director-General, also of the Revenue Department, acted as Secretary-General.

Mr. Amnuay Viravan, Undersecretary of State for Finance, read the address of Finance Minister Boonchu Rojanastien who was unable to come. The address emphasized the importance of exchanging views, particularly on such a vital issue as tax collection. Minister Rojanastien's message was that there is much to learn from each other considering that tax administration procedures and techniques trespass national boundaries.

The meeting discussed five topics, namely: (1) estate and inheritance taxes; (2) fiscal measures to encourage export; (3) development of personnel, (4) the organization structure of an income tax office; and (5) a common nomenclature — a glossary of tax terms.

1. Estate and inheritance taxes

On the topic of estate and inheritance taxes, it was found that there is no common levy of death duty among the SGATAR countries. Some countries favor an inheritance tax while others opt for estate duty. Despite the use of different systems, however, the objectives are always the same, namely, the redistribution of wealth and the raising of revenue. In administering the tax, most of the SGATAR countries seem to be facing problems, the most common of which are tax avoidance, lack of skilled personnel, difficulty in determining the rates of tax and the absence of criteria in fixing limits and magnitudes of exemptions and exclusions. All the participating countries, however, reported that they have taken measures to more or less combat these problems and one of these measures is the imposition of a gift tax.

2. Fiscal measures to encourage export

On the topic of fiscal measures to promote development, the meeting discussed the various forms of concessions and incentives to encourage exports some of which are as follows:

(a) double deduction of export promotion expenses;
(b) refund of payroll tax paid by exporters;
(c) full relief (for varying lengths of time) or delayed payment of income tax;
(d) investment tax credit;
(e) location incentive tax relief;
(f) export allowance;
(g) accelerated depreciation allowance;
(h) exemption from customs duties, excise duties and sales tax;
(i) tax relief for expansion of approved industry.

It was generally recognized that all concessions and incentives should be open to review and possible change with clearly stated time limits on measures such as tax holidays and deferred tax payments. It was also recognized that if all countries in the region were to promote exports, a conflict of interest may arise where two countries are manufacturing and exporting the same product, particularly if the countries involved are exporting intra-regionally and are competing for foreign investments. The Conference noted, therefore, the importance of bearing in mind that developing countries should not compete excessively with one another in their export concessions.

3. Development of personnel

The third topic discussed was the development of tax personnel. From the papers presented and the discussions that followed, it was learned that most countries have both formal and on the job training for their tax people. In some countries, however, formal training is hampered by lack of facilities and lack of trained instructors. Problems in recruitment are also encountered due to the relatively higher salaries that the private sector offers. In proposals for future improvement, the need for increased use of computers was agreed upon, not only for routine tasks which will free persons for more field work but also for the more sophisticated techniques of tax administration.

4. The organization structure of an income tax office

The fourth topic concerned the organization structure of an income tax office. It was learned that with the exception of Singapore, the income tax offices of all the SGATAR countries consist of a head office with numerous district offices. The role of the head office and the degree of its control over the district offices vary from country to country. In most countries, however, the district offices have a high degree of independence in dealing with local matters. The possibility of differing interpretations of taxation laws among the district offices is avoided through the training of staff personnel, circulation of information and instructions by the head office to the district offices and holding of meetings for directors of district offices at the head office. This aspect, therefore, poses no problem among the SGATAR countries. The issue, however, of whether the functions of assessment and collection should be handled by the same office was raised and the delegates differed in their opinions regarding this. In some countries both functions are performed by the same office while in others the functions are done by different bodies. Despite the differences in practice, it was the consensus of all the delegates that whatever system their countries may have adopted seems to be the most suitable for them.

5. A common nomenclature – Glossary of tax terms

The last topic discussed in the meeting was the subject of common nomenclature. Indonesia presented a proposal requesting the Philippine National Tax Research Center (NTRC) to compile a glossary of commonly used tax terms with definitions as used by the individual member countries. The Philippine delegation agreed to the proposal and all members promised to cooperate in supplying materials and information to the Philippine National Tax Research Center.

IX. SIXTH SGATAR MEETING IN SINGAPORE

The sixth SGATAR meeting was held in Singapore, 25-30 October 1976. The eight member countries of SGATAR were all represented with a total of 44 delegates attending.

Mr. Wan Fook Hoy, the chief delegate of Singapore and Acting Commissioner of the Inland Revenue Department, was unanimously elected Chairman of the sixth meeting while Mr. Tan Boen Eng, Acting Deputy Commissioner, also of the Singapore Inland Revenue Department, acted as Secretary-General.

The meeting discussed four topics, namely: (1) scheme for effective income tax administration and experience in increasing compliance of taxpayers; (2) financial leasing; (3) property tax; and (4) glossary of tax terms.

1. Scheme for effective income tax administration

On the first topic, of effective income tax administration, the delegates agreed that the distinguishing feature of an effective tax system is voluntary compliance and this calls for a sense of civic and social responsibility on the part of the taxpayers. On the part of the tax administrators, meanwhile, greater efficiency is demanded which would require the institution of such programs as staff training and measures to improve staff motivation and productivity; decentralization of administration; and the use of computers and modern management techniques where these are practical and cost-effective.

It was recognized, however, that no matter how efficient a tax administration may be, anti-avoidance and anti-evasion measures are needed. It has been generally agreed that there should be provision for substantial penalties for tax evaders, including possible terms of imprisonment in extreme cases of fraud, to achieve the necessary deterrent effect. It was learned that in some countries, the publication of the names of tax evaders has a deterrent effect.

2. Financial leasing

With the exception of Australia, Japan and New Zealand, the second topic of financial leasing is a relatively new concept to SGATAR's member countries. Briefly, financial leasing involves using the legal form of a lease in an arrangement which is in essence designed to finance the acquisition of an asset to be used in a taxpayer's business. In such cases, deductions are allowed to the lessee for the rentals paid and receipts are taxable in the hands of the lessor. What most member countries of SGATAR are concerned about in this kind of arrangement is the possible manipulation that would result in the cost of an asset being written off at a faster rate than the normal depreciation allowance.

Australia and New Zealand have solved this problem by enforcing a set of guidelines on what is acceptable in a financial lease transaction and these guidelines are followed by the leasing companies. In the other SGATAR member countries, some rules and guidelines discouraging the abuse of financial leasing have also been laid down, the most common of which are:

(a) that the rate of write-off each year should not be very much higher than the normal rate of depreciation of the asset,
(v) that there should not be an option for purchase of the asset by the lessee at the end of the lease or, if this were impossible, the sole price should not be very much lower than the market value based on the durable life of the asset; and
(c) that financial leasing should not be used for fixed assets such as elevators and silos for, by their inherent nature, it is impossible to return them to the lessor after their lease has expired.

3. Property tax

The third topic discussed was the property tax which has varied connotations among the member countries but whose more common concepts are those of taxes on land, on net wealth, on the usage of land and/or buildings, on the profits on sales of land, and on inheritances or gifts. Most member countries impose the property tax to raise revenue for local development, to redistribute wealth, to discourage property speculation and to promote better utilization of land.

It was learned that the property tax is usually imposed at progressive rates, although differential rates are sometimes applied based on the location and usage of each lot or property. Exemptions are also usually provided for land or building used exclusively for religious, education and charitable purposes.

The problems encountered by most member countries in the administration of the property tax include the non-availability of information, lack of trained valuers, inadequate land surveys and title records and a lack of civic consciousness on the part of the property owners.

4. Glossary of tax terms

Finally, the Philippine delegation presented its report on the Glossary of Common Tax Terms, a project agreed upon during the Fifth SGATAR meeting in Bangkok. It was agreed that the Glossary may be used as reference by the member countries and made a continuing project of SGATAR with periodic modifications and updating by the Philippines.

X. SEVENTH SGATAR MEETING IN CANBERRA AND SYDNEY

The seventh SGATAR meeting was held in Canberra and Sydney, Australia, 20-25 November 1977. A total of 36 delegates representing SGATAR's eight member countries attended the meeting.

Mr. Trevor Boucher, Second Commissioner of the Australian Commission of Taxation, was unanimously elected Chairman of the meeting. Mr. John O'Reilly, Executive Officer of the Head Office, A.C.T., discharged the duties of the Secretary-General.

The meeting discussed three topics, namely, aspects of investigation and audit of taxpayers' taxation affairs, the role of internal auditors in a taxation office and the roles of computers, microfilming and other modern office facilities in taxation offices.

1. Aspects of investigation and audit of a taxpayer's taxation affairs

For facility of discussion, the first topic, the investigation and audit of a taxpayer's affairs, was divided into three sub-topics, namely, (a) the criteria used in the selection of cases for investigation and audit, (b) the ascertainment and policing of values of trading stock, and (c) the practices regarding the imposition of penalties and other sanctions to facilitate tax collection.

On the first sub-topic, it was learned that the methods and procedures for selection and investigation and audit of cases vary from country to country. It was agreed, however, that the success of investigation and audit action would rest to a large degree on the skill and experience of the investigator. It should, therefore, be the aim of all tax administrators to upgrade the standards of their investigation staff. In addition, all delegations acknowledged the importance of having the right information in the selection of cases for investigation and audit. Thus, all member countries reported that they are continually striving to improve their data collection.

The discussion on the ascertainment and policing of values of trading stock was necessitated by the generally recognized possibility of manipulating stock values in order to avoid or defer the payment of tax. This is made possible since even if in all the participating countries trading stock valuations are based on generally accepted accounting principles, these are not always explicitly written into the taxation laws. Thus, the taxpayer has certain options regarding the valuation of stock for as long as he is consistent and his method is not contrary to law. It was agreed that policing is made difficult where stock records are not held or are inadequate and that the best stock records are generally those maintained by larger businesses.

On the third sub-topic, it was learned that all participating countries impose various types of penalties and surcharges for a wide range of taxpayer defaults. Penalties are acknowledged by the delegates as a necessary supplement to taxation laws because they serve as a deterrent against non-compliance.

The amount of the penalty or surcharge to be imposed is generally affected by the degree of culpability of the taxpayer. Other factors taken into account in some countries include whether or not the taxpayer voluntarily disclosed an omission or understatement, personal hardship, ability to pay and age or health of the taxpayer.

2. Role of internal auditors in a taxation office

On the second major topic, the role of internal auditors in a taxation office, it was agreed that auditors are an indispensable tool of management in its efforts to ensure that the organization's objectives are met. The taxation offices of all the participating countries are subject to both external and internal audits of some form.

In most of the participating countries, the audit role has grown from the traditional role of verifying accuracy of financial and other records to one of active assistance to management. As reported by some delegations, auditing has led to the detection of defective or weak controls which could have given rise to fraud and malpractice. Also, auditing has helped in the supervision of work performance and conduct of personnel and the detection of inefficient and uneconomic practices.

to be continued

India: New Tax Amnesty

Our correspondent, Mr. Kailash C. Khanna from Calcutta, reports that the Indian Government recently decided to grant tax amnesty to persons investing "black money" in certain State Bonds. He writes:

"On 12th January 1981, the President of India has promulgated 'The Special Bearer Bonds (Immunities and Exemptions) Ordinance 1981'. A Press Note dated 12th January issued by the Ministry of Finance, Department of Revenue, giving the salient features of the Ordinance, is attached herewith for your information.

This is the second time during the last five years that the Government of India has come out with tax immunity in an endeavour to unearth unaccounted black money and wealth. In the year 1975, a Voluntary Disclosure Scheme was announced which met with partial success.

The decision to issue the Special Bearer Bonds has, by and large, met with adverse criticism. The Press and the Opposition have condemned it as 'a surrender to tax dodgers, profiteers and smugglers'. Some economists have said that the Bonds will prove a flop since unaccounted black money is not lying idle but is being actively used with very high and lucrative returns; others have opined that the Bonds will meet with some success from the weaker and smaller sections of the parallel economy. The President of the Federation of Indian Chamber of Commerce and Industry 'is not enthusiastic about it' and feels that it may lead to further proliferation of black money which has undoubtedly assumed considerable magnitude in recent years."

The Press Release, which is entitled *The Special Bearer Bonds (Immunities and Exemptions) Ordinance 1981*, gives the following description of the new measures:

The Government today announced the scheme of Special Bearer Bonds, 1991 through a Presidential Ordinance.

The scheme offers an opportunity to persons who have unaccounted moneys to invest the same in these Bonds. This will enable the canalisation of such moneys for productive purposes in the overall interest of the economy. The broad features of the scheme will include an assurance that the source of moneys invested in the Bonds will not be questioned. The scheme will be completely independent of the Tax Administration.

PERIOD OF OPERATION

The Special Bearer Bonds are expected to be available from the 1st week of February, 1981 and will remain on tap until such date (not being a date before 30th April, 1981) as the Central Government may notify in this behalf.

SALIENT FEATURES

(i) The Special Bearer Bonds, 1991 of the face value of Rs. 10,000 will be issued at par with a maturity period of 10 years. The holders of the Bonds will be entitled to receive Rs. 12,000 for every bond on maturity.

(ii) The Bonds will be available for subscription at the offices of the Reserve Bank of India in the specified cities and in any branch of the State Bank of India in India or abroad.

(iii) The subscription to the Bonds outside India will be made in foreign exchange. However, the repayment in all cases will be made in India in Indian rupees.

(iv) There will be no limit on investment in the Bonds.

(v) There will be immunity for the original subscriber or the possessor of the Bonds from being questioned about the possession of the Bonds or about the source of money from which the Bonds have been acquired. As a result, the mere fact of being in possession of the Bonds will not make the person liable to tax, penalty or prosecution under the direct tax laws.

(vi) The premium payable on the redemption of the Bonds will be free from income-tax and the value of the Bonds will be exempt from wealth-tax. Transfer of the Bonds on resale will not attract liability towards capital gains tax. Likewise, transfer of the Bonds by way of gift will be free from gift-tax.

(vii) The Special Bearer Bonds scheme will be completely independent of the tax system. No holder of the Bonds will accordingly be entitled to claim any set off or relief in any proceeding under the direct tax laws on the ground that he has subscribed to or otherwise acquired the Bonds. Further, he will not be entitled to demand reopening of any of his completed assessments on the ground that he has subscribed to or has otherwise acquired these Bonds. It will not be permissible for any taxpayer to claim in his wealth-tax assessment proceeding that any asset owned by him has been converted into the Bonds. Further, it will not be competent for any person to claim at any time before the date of maturity of these Bonds that any sum credited in his Books of account or otherwise held by him, represents the amount received by him on the transfer of these Bonds. It will, however, be open to investors to bring the moneys received on redemption of Bonds in their books of account without attracting any tax liability.

(viii) No holder of the Bonds will be liable to any penalty or prosecution for any offence under the Indian Penal Code or any other Central Act for the time being in force on the ground merely that such a person has subscribed to or otherwise acquired the bonds or is in possession thereof. This immunity will not, however, extend to offences under Chapter IX or Chapter XVII of the Indian Penal Code or under the Prevention of Corruption Act, 1947, that is to say, offences by public servants and those relating to property — theft, extortion, robbery and dacoity, criminal mis-appropriation of property, criminal breach of trust etc.

(ix) Commercial banks will be authorised to give advances within the framework of credit control against the collateral security of the Bearer Bonds.

(x) The banks will, however, not be permitted to purchase the Bearer Bonds and thus such Bonds will not form part of the Government securities statutorily required to be held by them.

The Central Government has been empowered to remove, by an order, not inconsistent with the provisions of the Ordinance, any difficulty in giving effect to the provisions of the Ordinance.

Fiscal Policy and Government Savings in a Developing Economy

Some Empirical Evidence in the Indian Economy*

by N.R. Vasudeva Murthy **

I. INTRODUCTION

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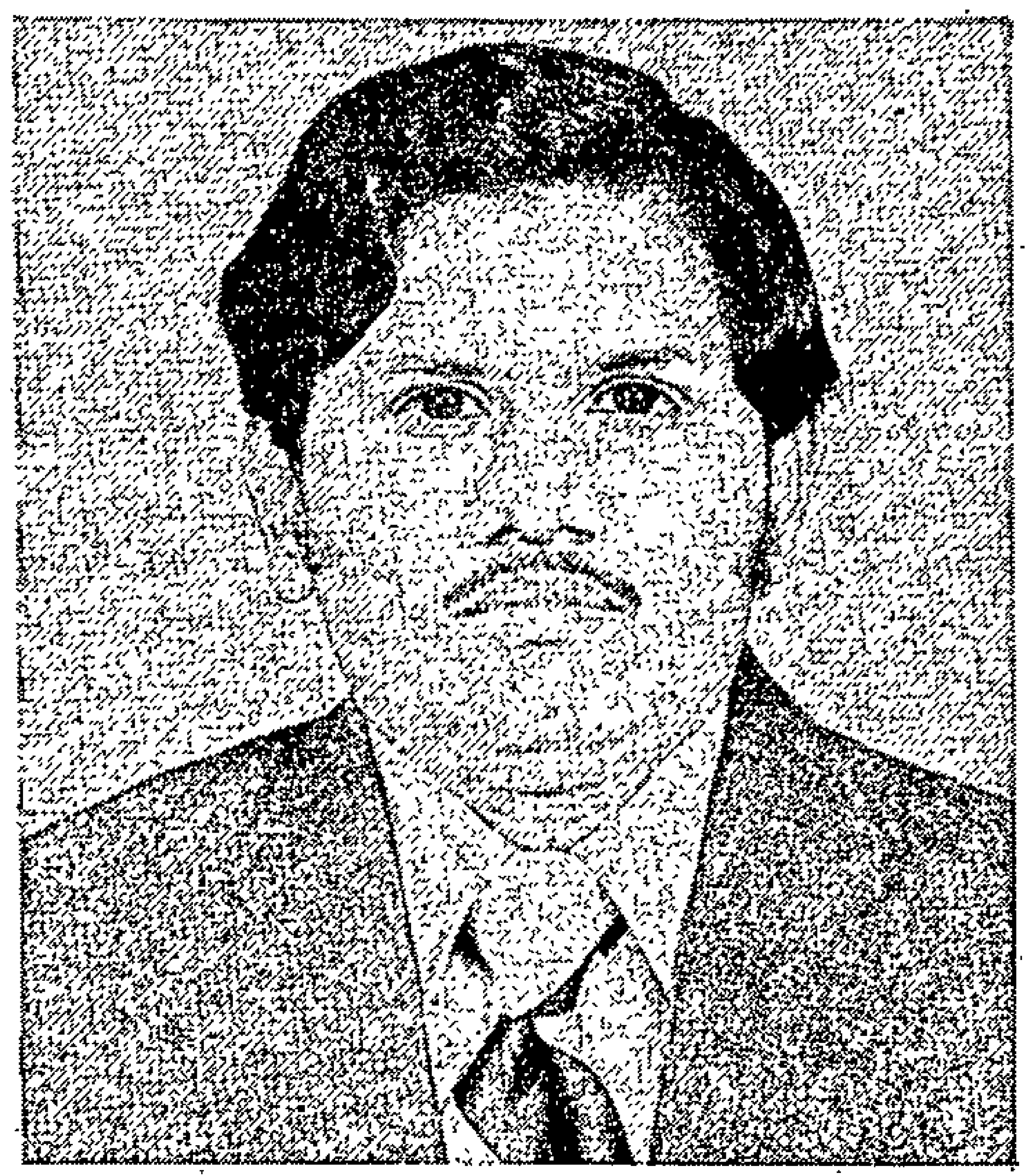
It is almost widely accepted by many economists, statesmen and planners that capital formation plays a crucial role in a developing economy's growth. Economic theorists have amply illustrated through their mathematical exercises, as in the famous Harrod-Domar theory [1, 2],[1] that in the labor-affluent economies, increasing savings ratio, which finances capital formation, will accelerate economic growth. The recognition of this direct relationship between savings ratio and economic growth in the context of a developing nation which is aspiring for higher living standards for both economic and political reasons, has resulted in many econometric explorations on the supply sides of savings and investment. A considerable number of insights into the savings behavior in the developing economies are presented by Mikesell and Zinser [3] in their pioneering survey. The crucial significance of household savings affecting such paramount economic issues as economic stabilization and growth are extensively discussed theoretically and presented with some empirical evidence in development literature. (Singh, [4], Houthakker [5]). With regard to government savings and the fiscal role of the government in economic growth, we have studies by Cutt [6], Heller [7], Kaldor [8], Kurihara [9], Morss [10], Brothwell [11], Ranis [12] and Reynolds [13] that stress the impact of fiscal policy on economic development. The role of government savings as a source of public investment in infrastructure and social overhead capital in a developing economy necessitates a detailed empirical analysis. In addition to this emerging need, the available evidence, for 1953-1971, presented by Chelliah, Baas and Kelley [14] and most recently, for 1972-1976, by Tait, Gratz and Eichengreen [15], shows that in most of these countries tax ratios have been increasing. Although the average level of taxation in developing countries is still below that in developed countries, the observed increasing tax-ratios and tax efforts in modern developing countries, along with changes in their structure, point out that as greater proportions of national product and resources are transferred from the private sector to the public sector, the division of responsibilities between these two sectors becomes apparent. Concurrently, the government has to assume a greater role in the task of effecting economic development. Musgrave [16, p. 439] alludes to this contention when he remarks that "tax revenue must be looked on as a precious and scarce resource, hard to come by, and many a development plan has come to grief as a result of the profligate spending policies of the government, which in turn was often acting under political pressure." In the words of Ranis [17, p. 338], "*one cannot say that high tax effort is essential to rapid economic growth. But should it in any case be regarded as helpful? Rising tax revenues* permit *government to direct more resources toward growth acceleration; but they do not* ensure *that resources will be directed in this way.*"



However, empirical studies, based on time-series, dealing with government savings and the effect of fiscal policy, i.e. taxation on differential saving — saving by households, government and overall saving are limited in number and scope.

* This is a revised version of a paper presented to the Southern Economic Association Meeting on November 9, 1979, in Atlanta, Georgia, U.S.A.
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1. The figures between [ ] refer to literature listed at the end of this Article.

This paper has two major objectives:
(1) To test for a direct influence of direct, indirect and overall taxation and general total government revenue on government saving behavior in the Indian economy, during the sample period, 1960-1976.
(2) To determine the extent of influence of taxation — direct, indirect taxation and government revenue — on household and overall saving behavior in the Indian economy during the sample period.

The present study differs from earlier studies, pertaining to this aspect of the Indian economy, by Diwan [18], Krishnamurthi [19], Murthy [20], National Council of Applied Economic Research [21], Singh [22], and Thimmaiah [23], [24], [25], in terms of data coverage, quality of data, and specification of the estimated functions. The justification for conducting this empirical investigation emerges from two observed phenomena in the Indian economy, viz., its savings and tax structures.

IIA. SAVINGS STRUCTURE

Table I presents the savings structure in the Indian economy for the sample period 1960-1976. Total domestic savings in India originate from three sectors: the household sector, the corporate sector and the government sector. In the Indian economy, the government sector is comprised of the central government, state and local governments and public enterprises. The household sector includes individuals, non-corporate businesses, educational and charitable institutions. Finally, the corporate sector sovers joint-stock companies, corporations, industrial credit and investment corporations. It is evident from Table I that in the Indian economy, on the average, over the period 1960-1976, households contributed nearly 74 percent to total net domestic savings. Next to the household savings, in importance, government savings form a major source of savings. Government savings account for nearly 20 percent of total net domestic savings. Corporate savings represent an average of 6 percent. Although the share of government savings in total net domestic savings has been declining, government savings still form a sizable portion of total savings and have been growing at an annual rate of 3 percent. [2] Therefore, it is clear that the government contributes a significant proportion to the supply of real savings. Table II reveals that central government savings form a substantial portion of government savings. While state and local authorities do contribute an appreciable amount of savings, public enterprises save almost an insignificant amount and have been net borrowers rather than savers. Further research is needed to explore various aspects of the public sector savings structure in the Indian economy.

IIB. TAX STRUCTURE AND TAX RATIOS

Table III shows the tax structure and tax ratios in the Indian economy during the period 1960-1976. These ratios are expressed in constant prices. The tax ratio, i.e. ratio of taxes to Gross National Product, has increased during this period from 9.72 percent in 1960-61 to

TABLE I

The saving structure of the Indian economy, 1960-76

Years	*(1) Household savings*	*(2) Corporate savings*	*(3) Government savings*
	(Percentage share of total net domestic savings)		
1960-61	67.90	8.82	23.28
1961-62	61.12	10.54	28.34
1962-63	64.44	9.13	26.43
1963-64	62.30	8.17	26.43
1964-65	64.61	5.19	30.20
1965-66	73.03	3.86	23.11
1966-67	83.48	3.44	13.08
1967-68	85.54	2.38	12.08
1968-69	80.11	2.55	17.34
1969-70	80.82	3.56	15.62
1970-71	78.04	4.55	17.41
1971-72	79.85	5.42	14.73
1972-73	81.86	4.70	13.44
1973-74	78.22	6.70	15.08
1974-75	66.54	8.75	24.71
1975-76	71.21	3.74	25.05
Average	73.69	5.72	20.59

Sources: [26, pp. 32-33] and [27, pp. 22-23].
Note: Columns (1), (2) and (3) are computed using the data in current prices.

TABLE II

The Government savings structure in the Indian economy, 1960-76

(Current prices: Rs. Crores)

Years	*(1) Net Government savings*	*(2) Central Government savings*	*(3) State Government savings*	*(4) Local Authorities' savings*	*(5) Savings of public enterprises*
1960-61	309	113	121	64	11
1961-62	363	236	49	81	− 3
1962-63	408	202	117	89	0
1963-64	539	242	177	94	26
1964-65	611	312	175	111	13
1965-66	592	376	97	69	50
1966-67	407	148	190	70	− 1
1967-68	355	59	217	84	− 5
1968-69	522	196	251	96	− 21
1969-70	645	338	221	67	19
1970-71	804	364	324	43	73
1971-72	739	197	483	40	19
1972-73	719	317	334	11	57
1973-74	1080	410	523	31	116
1974-75	2190	809	991	41	459
1975-76	2506	864	1319	40	283

Sources: [26, pp. 52-53] and [27, pp. 40-41].

2. $$\frac{S_G}{S_T} = 25.77 - \underset{(2.00)}{0.61t} \qquad R^2 = 0.21$$

$$\ln S_G = 6.2905 + \underset{(1.66)}{0.030t} \qquad R^2 = 0.17$$

Where S_G = government savings, S_T = total net domestic savings, ln = natural logarithm, t = time and t-values are in the parentheses.

TABLE III

The tax structure of the Indian economy, 1960-76

Years	(1) Ratio of direct taxes to GNP	(2) Ratio of indirect taxes to GNP	(3) Ratio of taxes to GNP	(4) Ratio of indirect taxes to direct taxes
1960-61	2.80	6.93	9.72	247.50
1961-62	2.92	7.45	10.37	255.14
1962-63	3.86	8.23	11.59	244.94
1963-64	3.60	8.72	12.32	242.22
1964-65	3.31	8.38	11.69	253.17
1965-66	3.21	9.43	12.64	293.77
1966-67	3.01	9.38	12.39	311.63
1967-68	2.66	8.61	11.27	323.68
1968-69	2.73	9.06	11.79	331.87
1969-70	2.83	9.10	11.93	321.55
1970-71	2.72	9.61	12.33	353.31
1971-72	2.95	10.43	13.38	353.56
1972-73	3.08	10.83	13.91	351.62
1973-74	2.81	9.98	12.79	355.16
1974-75	2.82	10.72	13.54	380.14
1975-76	3.55	11.99	15.54	337.75

Sources: [26] and [27].
Note: Ratios are computed using the figures in constant prices.

TABLE IV

Composition of tax revenues in the Indian economy, 1951-1976

Taxes	1951-52 (%)	1961-62 (%)	1971-72 (%)	1975-76 (%)
I. Direct taxes	28	27	21	22.56
(a) Corporation tax	17	33	37	33.40
(b) Other income taxes	62	48	56	58.33
(c) Land revenue	21	19	7	8.27
II. Indirect taxes	61	69	74	76.22
(a) Customs duties	44	18	15	16.28
(c) Exicise duties & sales tax	25	61	69	71.04
(c) Stamps	5	4	3	2.46
(d) Other taxes & duties	26	17	13	10.00
III. Miscellaneous taxes	11	4	5	1.22

Sources: [27], [29], [30] and [31].
Note: Ratios are computed using the figures in current prices.

TABLE V

Indices of tax efforts: India, 1966-76

Years	Index of tax efforts
1966-68	1.052[a]
1969-71	1.093[b]
1972-76	1.252[c]

Sources: For a, [28, pp. 254-327]; b, [14, pp. 187-205]; and c, [15, p. 130].
Note: For 1972-76, the preferred term is index of international comparison (ITC Index). For details see [15].

15.54 percent in 1975-76. This increase may be attributed to increased tax effort on the part of the central and local governments. Also this increasing tax ratio provides some evidence to the fact that in the Indian economy during the sample period a significant proportion of income and resources are transferred from the private sector into the public sector. The average ratio of indirect taxes to GNP is 9.30 percent whereas the average ratio of direct taxes to GNP during the same period is 3.02 percent. It is clear that indirect taxes bring in a higher percentage of GNP as revenue to the government. In addition to this phenomenon, relatively speaking, indirect taxes as a percentage of GNP have been growing more rapidly as it is evident from the following estimated equations:

$$\frac{T}{Y} = \underset{(5.68)^*}{10.2570 + 0.243t} \qquad R^2 = 0.69 \quad [1.1]$$

$$\frac{Tid}{Y} = \underset{(8.97)^*}{7.1593 + 0.252t} \qquad R^2 = 0.85 \quad [1.2]$$

$$\frac{Td}{Y} = \underset{(-.55)}{3.1000 - 0.009t} \qquad R^2 = 0.02 \quad [1.3]$$

Where:
T = total tax revenue
Tid = total indirect taxes
Td = total direct taxes
Y = gross national product
t = values are present within the parentheses
* = significant at the one percent level.

Table IV throws some light on the composition of tax revenue and the diversification of revenue sources in the Indian economy during the period 1951-1976. The table reveals that there have been significant changes in regard to some major taxes within the category of indirect taxes. While the ratios of stamp duties and other indirect taxes and duties have fallen, the ratio of excise duties and sales tax has increased to a considerable extent. The ratio of direct taxes to total taxes has decreased, except for a small increase during 1975-76, indicating that the structure of taxation in the Indian economy is tending more toward indirect taxes, which, at least theoretically under certain assumptions, should increase savings.

As revealed in Table V, the tax effort index, which is defined as the ratio of actual to predicted tax ratios, has been increasing steadily in the Indian economy. According to a recent study, relative to her tax efforts, India can be categorized and "high and rising tax efforts" (ITC index).[3] The study observes that "*if an evaluating comment were made solely on the basis of charts 3 and 4, it would be that if the objective of tax policy is to mobilize resources for the public sector, then the countries in the 'low and falling' category should be most concerned about their failure to improve their position, while those in the 'high and rising' category should be*

3. See [15].

TABLE VI

Marginal tax rates and tax rate elasticities, 1961-1976

Taxes	*Marginal tax rate* $\Delta T/\Delta Y$	*Elasticities* $\Delta T/T \div \frac{\Delta(T/Y)}{T/Y}$
Total taxes	0.21	1.68
Indirect taxes	0.17	1.84
Direct taxes	0.03	1.03

Sources: Computed at the mean, based on the following regression equations using CSC data [26] and [27].

$$T_d = -10.7866 + \underset{(5.502)^*}{0.031Y} \qquad R^2 = 0.68 \quad [1.1']$$

$$Tid = -2747.10 + \underset{(15.168)^*}{0.174Y} \qquad R^2 = 0.93 \quad [1.2']$$

$$T = -2757.89 + \underset{(13.19)^*}{0.205Y} \qquad R^2 = 0.93 \quad [1.3']$$

Note: * Significant at the one percent level.

TABLE VII

Savings, taxation and Government revenue in the Indian economy, 1960-76: Regression results

[4.1] $S_T = -793.7490 + \underset{(12.46)^*}{0.915Y_G}$ $\quad R^2 = 0.92$, DW = 1.65

[4.2] $S_T = -504.2359 + \underset{(14.273)^*}{0.974T}$ $\quad R^2 = 0.94$, DW = 1.75

[4.3] $S_T = 184.035 - \underset{(-0.871)}{0.656Td} + \underset{(8.289)^*}{1.28\,Tid}$ $\quad R^2 = 0.94$, DW = 2.01, F = 131.23

[4.4] $S_H = -753.29 + \underset{(8.26)^*}{0.71Y_G}$ $\quad R^2 = 0.82$, DW = 1.15

[4.5] $S_H = -517.4395 + \underset{(8.579)^*}{0.758T}$ $\quad R^2 = 0.84$, DW = 1.19

[4.6] $S_H = 749.27 - \underset{(-2.897)^{**}}{2.24Td} + \underset{(8.345)^*}{1.33\,Tid}$ $\quad R^2 = 0.93$, DW = 2.47, F = 81.51

[4.7] $S_G = 120.3638 + \underset{(3.481)^*}{0.1760Y_G}$ $\quad R^2 = 0.46$, DW = 0.57

[4.8] $S_G = -66.9172 + \underset{(3.571)^*}{0.188T}$ $\quad R^2 = 0.60$, DW = 0.60

[4.9] $S_G = -675.2719 + \underset{(2.984)^*}{1.628\,Td} - \underset{(-0.763)}{0.763\,Tid}$ $\quad R^2 = 0.66$, F = 12.62, DW = 1.37

Note: * Significant at the one percent level.
** Significant at the five percent level.

seen as following successful tax policies worthy of emulation. If the objective were to minimize governmental interference with the private sector, precisely the opposite view should be taken" [15, p. 134]. In addition to this finding of a high tax effort which is presented in Table V, it is discernible from Table VI (the values of income elasticities of total taxes) that indirect and taxes indicate that the government has been able to divert a significant proportion of additional national output to its sector. Here, in the table, tax revenue time-series are not adjusted for the effects of discretionary tax measures. The size of elasticity of tax revenue is influenced by many factors.[4] High income elasticities place more tax resources in the hands of the government in the future, without increasing tax rates, as economic growth. Thus, the available evidence shows that with the growth and diversification of its economy and increased tax productivity, India has been relying more on sales and excise taxes.

III. SPECIFICATION OF THE RELATIONS, DATA AND METHODOLOGY

Economic theory, earlier related studies, simplicity and the availability of reliable and revised data on variables relevant to the analysis dictated the choice of variables included and the form of the equation specified in this paper. The linear statistical versions of the following relations are specified for estimation purposes:

$$S_T = f(Y_G) \qquad [2.1]$$
$$S_T = f(T) \qquad [2.2]$$
$$S_T = f(Td, Tid) \qquad [2.3]$$
$$S_H = F(Y_G) \qquad [3.1]$$
$$S_H = F(T) \qquad [3.2]$$
$$S_H = F(td, Tid) \qquad [3.3]$$
$$S_G = \phi(Y_G) \qquad [3.4]$$
$$S_G = \phi(T) \qquad [3.5]$$
$$S_G = \phi(Td, Tid) \qquad [3.6]$$

Where:
S_T = total net savings
S_H = household savings
S_G = government savings
Y_G = total government revenue
T = total taxes
Td = total direct taxes
Tid = total indirect taxes

The theory behind all these specifications lies in the notion that the government, in the context of economic development, may supplement the savings of the households by appropriate fiscal policy and promote private savings.

The Planning Commission in India did justify the increases in indirect taxation, especially commodity taxation, on the grounds that indirect taxes bring about a

4. For a rigorous and highly enlightening analysis of this problem, see [32].

reduction in the level of conspicuous consumption of the rich [33, p. 72]. Musgrave, for instance, underlines the role of tax policy when he contends that "*practical policy must therefore make do with a less perfect approach, i.e. a set of excise taxes which impose higher rates on items that weigh more heavily in the outlays of high-income households. To this may be added a progressive property tax on residences to deal with housing consumption. In this way, revenue can be obtained by drawing on the pool of luxury consumption, thereby reducing consumption inequality while stimulating rather than depressing saving*" [16, p. 745]. The same view is shared by an Indian tax authority, Chelliah, who observes that "*taxation, if well conceived, is also the best means of raising the increasing saving ratio, which is one of the crucial determinants of growth*" [34, 35]. Thus, the coefficients of the linear specifications of [2.1] through [3.6] should have positive signs.

The most recent, extended, revised and consistent data, used for estimation purposes on household savings, government savings, total taxes, direct taxes, indirect taxes, and total government revenue are gathered from two sources published by the Central Statistical Organization [26, 27]. In this present study, total government revenue includes direct and indirect taxes, income from public sector undertakings and property and miscellaneous government receipts. All these relevant variables are converted to 1970 prices by using the consumer price index obtained from *International Financial Statistics* [36, pp. 204-5]. The simple and multiple regressions of the ordinary least-squares (OLS) type are employed to estimate the linear statistical version of specifications [2.1] through [3.6]. It is assumed that the error terms of the specified relations satisfy the assumptions of the classical regression model and they are not related across equations. [5]

IV. EMPIRICAL RESULTS

The estimated equations are reported in Table VII. The computed t-values, in all equations, are presented beneath their respective regression coefficients within the parentheses. With regard to the overall savings, it is evident from equations [4.1], [4.2], and [4.3] that, in the Indian economy, during the sample period, total government revenue, total taxation and indirect taxes influenced the savings behavior. In terms of t-values, coefficient of determination and the computed Durbin-Watson statistics, barring the statistical insignificance of direct taxes, [4.1], [4.2], and [4.3] indicate that fiscal policy has contributed, based on the specifications implied in the analysis, significantly to the process of capital accumulation in India. One implication of our results is that the overall savings ratio in the economy will increase as a result of economic growth in light of the observed higher elasticities of taxes and government revenue with respect to income. [6] Our empirical results provide some statistical evidence on the relative impact of indirect taxes on savings in the Indian economy. The statistical significance, sign and magnitude of the regression coefficient of indirect taxes in equation [4.3] confirm, at least for this sample, the line of reasoning that indirect taxes do not act as a disincentive to produce monetary income and they raise the costs of consumption relative to saving leading to an increase in the proportion saved. Our time-series results are consistent with a recent theoretical analysis by Afexentiou [38] and empirical studies by Morss [10] and Brothwell [11].

Equations [4.4], [4.5] and [4.6] portray the savings behavior of the households in the context of fiscal policy. In all these equations, the independent variables, total taxes, total indirect taxes and the total government revenue explain an increasing proportion of the variations in the dependent variable, household savings. While indirect taxes bring in increases in household savings, direct taxes reduce household savings. The observed role of indirect taxes, as found in this empirical analysis, is consistent with the a priori notion that in an underdeveloped economy commodity taxes increase savings through changes in efficiency, incentives, factor proportions and choice of technique, curtailment of consumption of the rich whose consumption and spending patterns are subject to the international demonstration effect.

The estimated equations, in the government sector, [4.7], [4.8] and [4.9] imply the existence of a positive relationship between government savings and taxation. Total government revenue, total taxes, and direct taxes increase government savings. The relevant regression coefficients are statistically significant at the one percent level. Indirect taxes seem to exert no influence on government savings. The presence of auto-correlation, as indicated by the observed Durbin-Watson statistics, in equations [4.7] and [4.8], despite their good fit, renders hypotheses-testing and statistical inference difficult. Therefore, [4.9] is the preferred equation in terms of statistical and econometric criteria. The overall evidence presented in this paper shows that taxation, especially indirect taxation, promotes government savings. While this finding is consistent with Houthakker's study on a cross-section of underdeveloped economies [5], National Council of Applied Economic Research's study [21] and Diwan's investigation of government savings in the Indian economy for the period 1951-1963 [18], it contradicts the Please thesis [49] that there is a negative relationship between savings and tax revenues.

V. CONCLUSIONS

From the empiricial findings and discussions presented in the previous sections, the following conclusions emerge:

(1) The estimated results denote vividly that in the Indian economy, during the period under empirical observastion, fiscal policy has brought in more resources into the hands of the government. The government, through its tax and revenue policy has encouraged overall savings, household savings and government savings. Our results confirm the hypothesis that the tendency for government to save a portion of its additional revenue, transferred from the private sector, enables the economy to pursue its objective independently of deficit financing.

(2) Of all the measures of revenue, indirect taxes play greater roles in financing capital accumulation. The

5. See [37].
6. See Table VI.

changing structure of the Indian economy in favor of indirect taxes and the higher value of income elasticity of indirect tax reveal that with a proper tax policy indirect taxation acts as an effective means of furthering economic growth.

(3) It is suggested that further research be conducted on the effects of various forms of taxation, on overall savings and sectoral savings, in the Indian economy brought about by changes in tax efforts, efficiency, choice of techniques, incentives and distribution. Our results also indicate that tax revenues and government revenues are not the only variables that account for saving behavior in the economy.

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O.E.C.D. Report on Tax and Social Benefit Payments and the Disposable Income of Households*

Between 1974 and 1978, real purchasing power at the level of average earnings in manufacturing industry increased in almost all OECD countries.

One component of disposable income, however, cash transfers given to families with two dependent children, grew in most countries by less than gross earnings, and in just over half the OECD area, they grew more slowly than the price index, so that their real buying power fell.

The system of taxing the incomes of husband and wife together does not entail discrimination against women in paid employment.

These are among the main points made in the latest in a series of biennial reports published by the OECD Fiscal Affairs Committee, showing the income taxes and social security contributions paid, and the family allowances received, by typical family units at different levels of income.[1] A companion volume updates the position of a typical taxpayer to 1979.[2]

Trends between 1974 and 1978

Some of the other main findings of the report are summarised below, and in the one table and five charts attached.

Average rates of income tax paid by one-earner families at the Average Production Worker's income level in 1978 are shown in Chart 1. Between 1974 and 1978, countries with low income tax rates tended to raise them and those with high rates to lower them.

Employees' social security contributions proved to be roughly proportional to gross income up to average earnings or somewhat above, then to become regressive in varying degrees. Over the period, these contributions tended to increase by more than gross earnings in all countries except Finland and Japan.

* "The Tax/Benefit Position of Selected Income Groups in OECD Member Countries 1974-1979", OECD, Paris, 1980. ISBN 92-64-12132-3.

1. The comparisons are based upon the average production worker (APW), who is defined as a male full-time manual worker with earnings equal to the average for all such workers in the manufacturing sector and various multiples of this earning level.
2. The two reports are published together under the title "Tax/Benefit Position of Selected Income Groups 1974-1979".

Indices of gross earnings, after-tax pay, take-home pay, disposal income and consumer prices

Case of a one-earner family with two children at APW's income level (1978)

Country	Gross earnings (1)	After-tax pay (2)	Take-home pay (3)	Disposal income (4)	Consumer prices (5)
	1974 = 100				1974 = 100
Australia	147	148	148	153	161
Austria	138	127	124	135	127
Belgium	155	151	150	150	138
Canada	154	160	160	158	140
Denmark	153	164	165	162	146
Finland	164	167	169	172	162
France	164	163	160	159	146
Germany	132	131	128	137	118
Ireland	201	197	196	194	174
Italy	247	239	236	220	181
Japan	140	139	138	138	133
Luxembourg	141	145	144	145	134
Netherlands	137	137	137	137	133
New Zealand	159	157	157	154	172
Norway	155	160	162	159	143
Portugal	225	213	210	200	197
Sweden	143	140	144	142	148
Switzerland	122	125	124	123	111
United Kingdom	172	169	167	177	177
United States	142	141	141	141	132

The proportion of earnings left at the disposal of one-earner households with two children varies markedly between countries (Chart 2), and the same is true for single people and childless couples. In all countries, however, the proportion of earnings retained by households falls as income rises; this shows that the progressivity of income tax and family benefits outweigh the regressive effects of social security contributions as they are generally levied.

Chart 3 shows that countries are more or less evenly divided between those where average earnings grew by more than disposable income and those where the contrary occurred. The attached table shows the relationship between disposable income and consumer prices.

Taxation and married women

Despite the trend toward separate taxing of husbands and wives, the report casts doubt on the view that pooling of spouses' earnings for tax purposes necessarily entails higher tax burdens for two-earner married couples. Chart 4 shows that pooling or non-pooling plays a subsidiary role to other factors — such as tax rates, the shape of the tax schedule, the amount and nature of allowances — in determining tax burdens. The analysis also shows that, in most countries, tax liability of a two-earner couple remains roughly unchanged on marriage and that, once married, a couple can normally increase its joint earnings at a lower *tax* cost if the wife enters the labour market than if the husband increases his work effort.

Assistance for families

The various factors likely to influence the choice between using the tax system (tax allowances and credits) or the social welfare system (cash payments), or some mix of the two, to assist parents with dependent children are discussed.

These include income distribution and equity effects: the visibility of the amount of aid; whether the mother or the father should receive the aid; and the different sorts of administrative problem arising under the two systems. Between 1974 and 1978, a move from tax reliefs to cash transfers is noted and quantified.

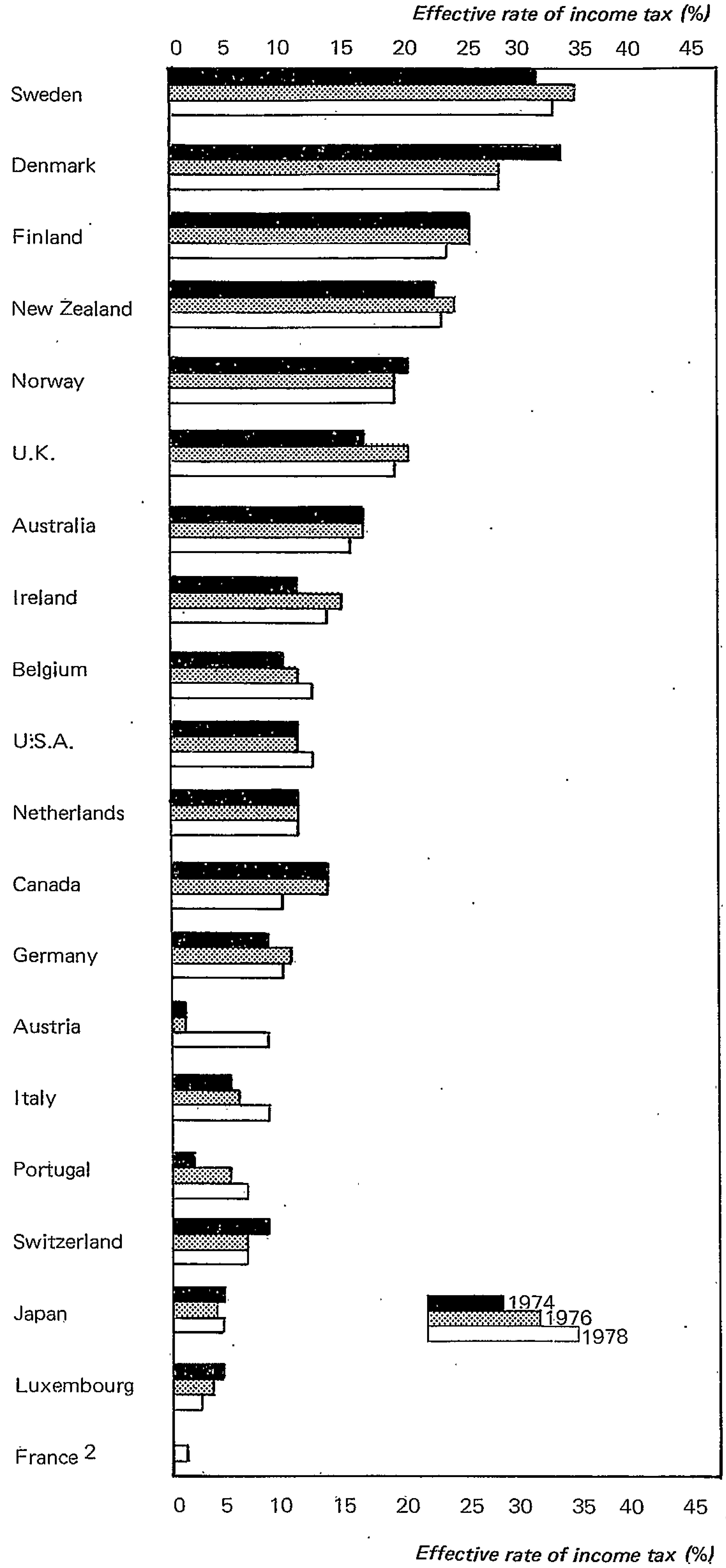
The typical worker in 1979

Chart 5 shows the disposable income as a percentage of gross earnings of a typical worker from 1972 to 1979.

CHART 1

Income tax as percentage of gross earnings

One-earner families at the APW's wage [1] 1974-1978



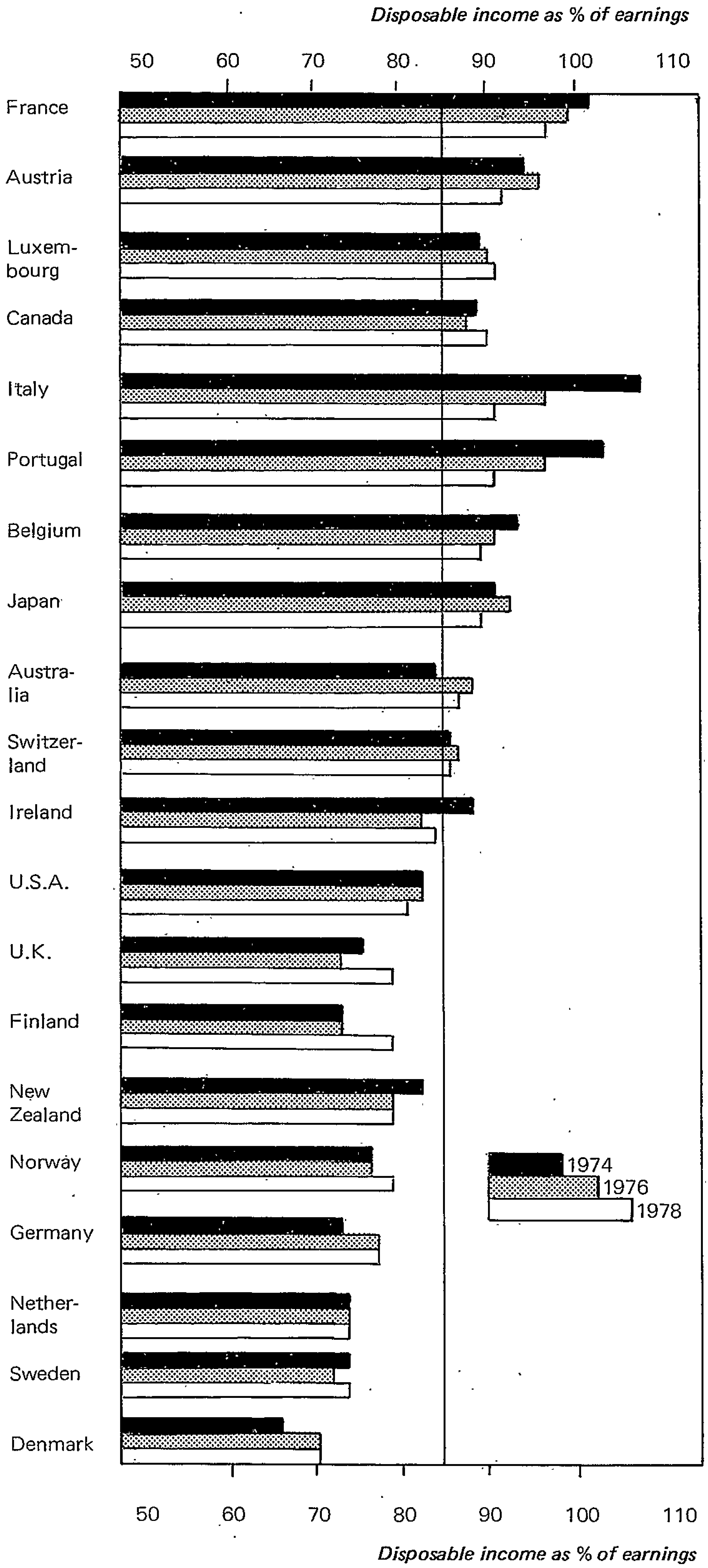
1. Countries are ranked by the rate of income tax paid in 1978.
2. No income tax was payable at this income level in 1974 and 1976.

Source: Table 25.

CHART 2

Disposal income as percentage of gross earnings

One-earner families at APW's wage level [1,2] 1974-1978



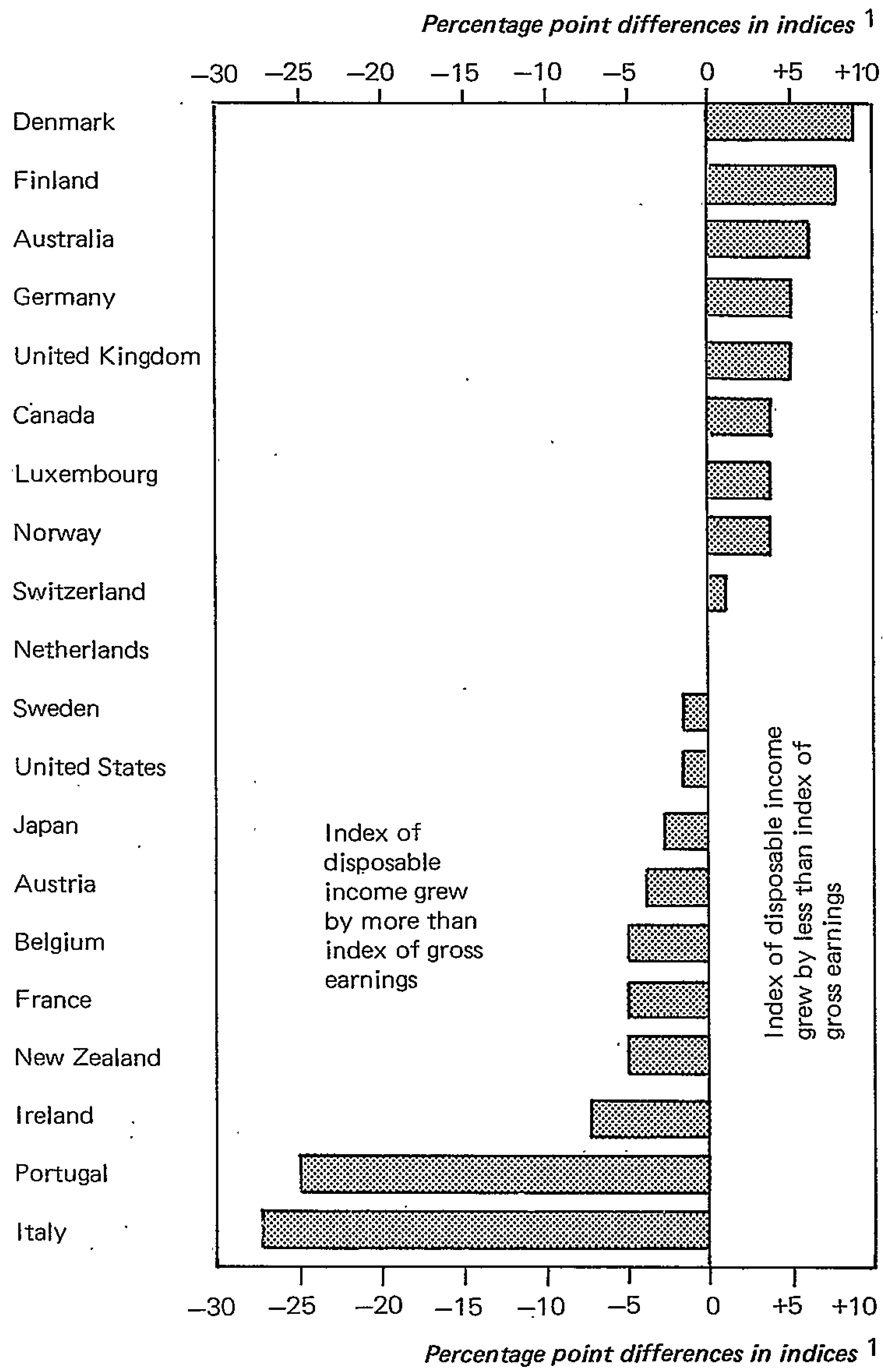
1. Disposable income equals gross earnings minus income tax and employees' social security contributions paid plus cash transfers received.
2. Countries are ranked by the percentages relating to 1978.

Source: Table 35.

CHART 3

The relationship between the growth of gross earnings and disposable income

One-earner families at the APW's wage level 1974-1978

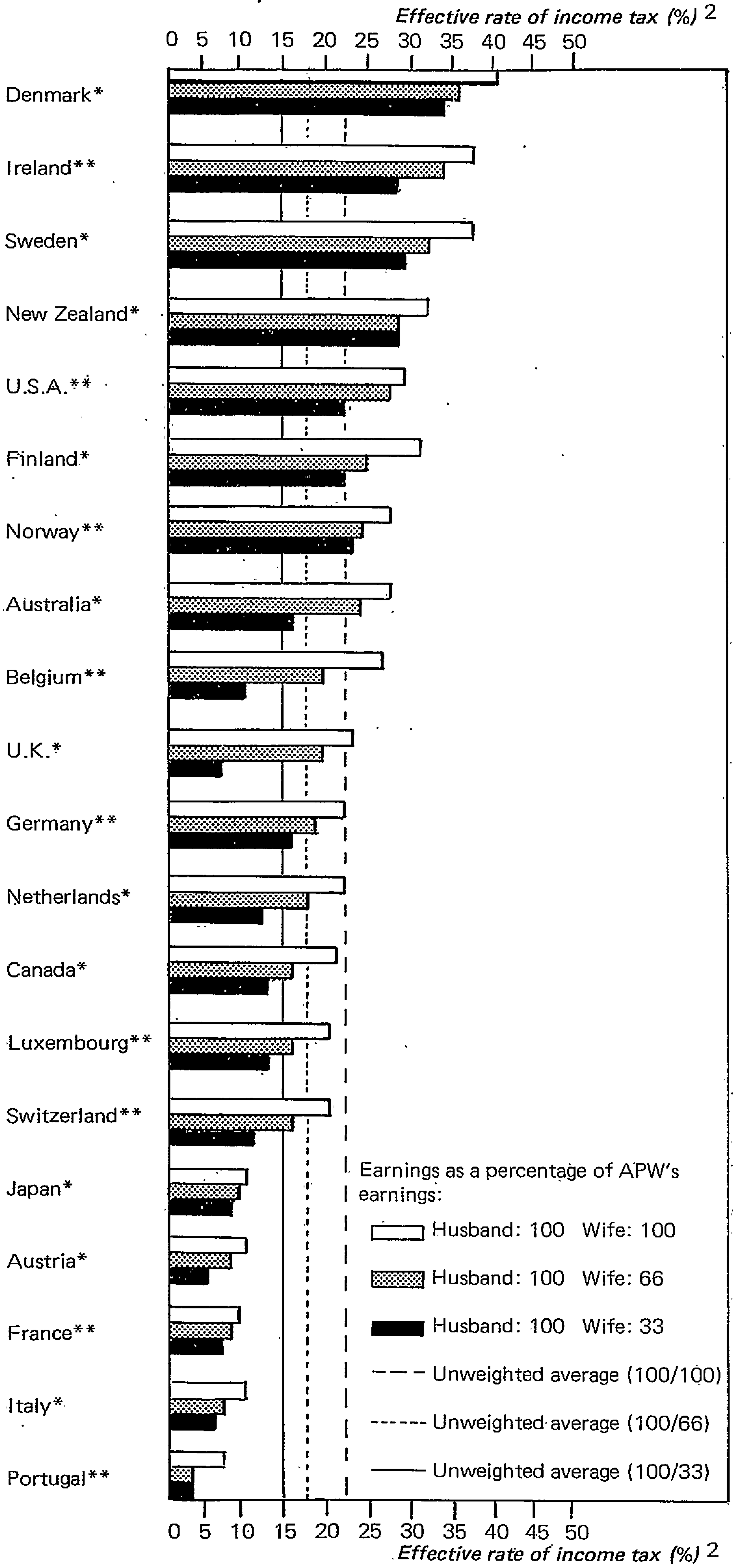


1. These figures represent the difference between the 1978 index of gross earnings (1974 = 100) and the 1978 index of disposal income (1974 = 100). A positive figure indicates that the index of disposable income grew by more than that of gross earnings; a negative figure indicates that the index of disposable income grew by less than that of gross earnings.

CHART 4

The additional income tax paid when the wife enters the labour force at different levels of gross earnings as a percentage of the wife's earnings [1]

Family with two children 1978



* Individual taxation (the United Kingdom is classified as an individual taxation country).

** Joint taxation.

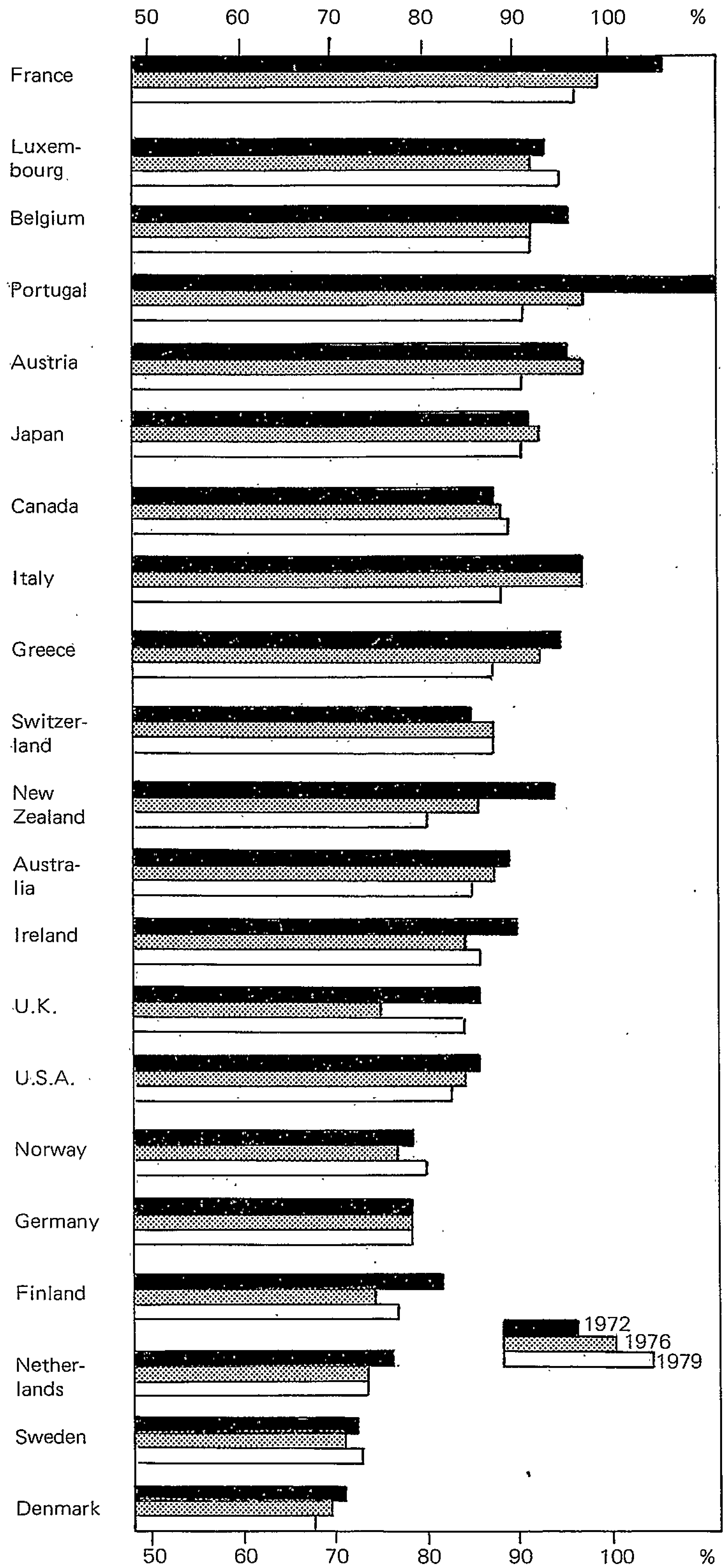
1. Countries are ranked by the figures which relate to the case where the husband earns the APW's wage and the wife 66% of this amount.
2. The change in tax paid by the family divided by the wife's earnings.

Source: Table 48.

CHART 5

Disposable income as percentage of gross earnings [1]

One-earner families at APW's wage level



1. Countries are ranked by 1979 figures

Note: Disposable income equals gross earnings minus income tax and employees' social security contributions paid plus cash transfers received.

TAX GLOSSARY

by H.W.T. PEPPER *

UNEARNED INCOME — Income derived other than from personal exertion (see also EARNED INCOME RELIEF) which in some income tax systems is taxed more heavily than earned income, either by applying higher rates to the former or granting deductions or abatements in respect of the latter. The term "unearned income" is now somewhat out of favour and such income is usually referred to instead as "investment income" because taxpayers object to having income which is derived from the investment of savings they have made from their earned income described as "unearned", which may be thought to have the connotation of "undeserved". (See also PASSIVE INCOME.)

UNFRANKED INVESTMENT INCOME — See FRANKED INVESTMENT INCOME.

UNIFIED TAX — The system of personal taxation, from fiscal year 1973/1974 in Britain, to replace the system of income tax and surtax. Unified tax applies a single schedule of graduated rates of tax to aggregated income, the system which is generally adopted in other countries which apply graduated income taxation.

UNIFIED TRANSFER TAX — The tax imposed in the U.S.A. from 1976 on gifts inter vivos and bequests on death, formerly comprising two separate tax levies. On death, however, the tax is still broadly the same as Estate Duty, the only relief in respect of heirs being the "marital deduction" from the value of the estate passing to a surviving spouse, limited to one half of the total estate or $ 250,000, whichever is the greater sum, and the exclusion of gifts to charity. (See also ESTATE DUTY.)

UNILATERAL RELIEF — Where residents of one country are subjected to tax in that country on income from a foreign country, the country of residence may grant relief for foreign tax where the income is taxable in both countries. Such relief may be granted under a mutual double taxation treaty between the two countries, but where no such treaty exists the country of residence may provide the relief unilaterally so as to preserve domestic tax equality by avoiding an extra tax burden on those with foreign income compared with others whose income is derived locally.

UNIMPROVED VALUES TAX — A tax on land values (either on the basis of the capital value or annual, or rental, value) without regard to structures thereon and improvements that may have been made to the land by the owner or occupier. (See also SITE VALUE TAX.)

UNITARY TAX — A new system of taxing the profits of multinational companies operating in the U.S.A. has been introduced by three states, Alaska, California and Oregon, and is being contemplated by about 20 other states in the U.S.A. The idea is to decide what proportion of a multinational company's world-wide operations fall within the state and then tax that proportion of its world-wide profits. There seem to be indications, however, that where such a calculation produced a figure less than the profits arising in the state by ordinary accounting methods, a way would be found to tax the latter figure. The issue also arises in the U.S.A. and other federal states where a large corporation trades within several different states with various levels of profitability arising from the different operations. In double taxation treaties there is usually a provision to prevent profits being manipulated by transfer pricing and many countries have anti-avoidance sections for the same purpose. (See also TRANSFER PRICING.)

UNIT OF PRODUCTION METHOD OF COMPUTING DEPRECIATION — This method may be appropriate for plant and machinery used in mining, or in producing goods measured in units such as tons, gallons, litres. For example, if an article of mining equipment could be expected to handle a total through-put of 200,000 tons in its total working or service life, and the through-put actually achieved in the accounting year is 25,000 tons, the basic depreciation allowance on a straight-line computation would be 25,000/200,000 = 12.5%.

UNIT TRUST — An institution in the U.K., broadly similar to a closed-end REGULATED INVESTMENT CORPORATION (q.v.) or mutual trust in the U.S.A., which invites investors to buy "units", or part shares, in the total invested funds of the trust. The income of the trust is normally fully distributed to the unit-holders as it arises. For tax purposes, the tax department "looks through" the trust and taxes the unit-holders, but where capital gains are realised by the trust there may be, as in the U.K., a provisional tax on the trust in respect of such gains which will be credited in due course to the unit-holder when he realises his holding of units.

UNIVERSAL VALUES — The system whereby assets, generally land and real property, are valued for taxation purposes at a figure which may then be adopted for other purposes. For example, the capital value adopted for a property tax on capital values may also be used in calculating the capital gains tax (as the excess of disposal price over the taxed value), death duties, and also the figure at which compensation would be fixed if the government decided to acquire the property for public purposes under its requisition powers. (See also DROIT DE PREEMPTION.)

UNREMITTABLE FOREIGN INCOME — Where a taxpayer has income arising in a foreign country, which because of the laws of that country (e.g., exchange control restrictions) he is not able to remit to his country of residence, it is usual to allow any tax liability on the foreign income to be suspended until remittance restrictions are removed.

UNTAGELSE FRA SKAT — (Denmark) Exemption from tax.

UPLIFT — A feature of the purchase tax forrmerly levied in Britain, and of wholesale and retail sales taxes in general, where the tax base is the price or value at which goods normally are sold, at either the wholesale or retail level, but the transactions to be taxed have been made at the ex-factory price. The price where a sale has, exceptionally, been made at ex-factory

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

level has to be adjusted upwards or "uplifted" to bring it to the level at which the tax is imposed. In Britain the rate of uplift to be applied in certain cases is often agreed between the Customs and Excise Department and the relevant trade associations.

UPSTREAM DIVIDENDS — A term used in referring to dividends in the case of parent/subsidiary company relationships. Dividends received by the parent from a subsidiary company (subsequently re-distributed as dividends of the parent) may be termed UPSTREAM DIVIDENDS to distinguish them from the parent's dividends, e.g., in a tax law.

USEFUL LIFE — A term sometimes used (also service life, working life) to refer to the period it is expected that a depreciable asset will continue to be employed by the taxpayer using it in his business.

USE TAX — A tax on goods which are used within the taxing area, although the purchase has been made outside the territory of the tax administration. (See SALES AND USE TAX.)

USHR — A tax imposed on agricultural produce under Koranic law.

UTILITY TAX — See PUBLIC UTILITY TAX.

V

VAERDIFORRINGELSE — (Denmark) Depreciation, depletion.

VALUATION, ELEMENTS IN — See ELEMENTS IN VALUATION.

VALUATION OF STOCK-IN-TRADE, INVENTORY — See STOCK-IN-TRADE, VALUATION OF.

VALUE-ADDED TAXATION (V.A.T.) — The sales tax system which imposes tax on the value added by each trader involved in the production and distribution of goods and services. The value added may also be defined as the gross profit, or mark-up or margin between the trader's purchase and selling price, which factor represents the amount he is charging for the services he has rendered. The "services" may merely be the purchase, with or without temporary storage of goods, and their distribution in unchanged form to another trader, or may include an element of manufacturing, processing, mixing, blending, assembly, etc.
The term "value-added tax" is strictly a misnomer because the tax not only bears on the value added by each trader but also on the initial or basic value of the raw materials or ingredients, or components, from which the finished products are made. V.A.T. differs from single stage taxes in that the tax is payable "fractionally", i.e., each trader pays that part of the total tax which is proportionate to the value he has added, except that initially the first producer or trader must pay tax on the raw material besides the added value. Accordingly, V.A.T. has been defined, with some validity, as a "retail sales tax, collected by installments".

VARELAGER — (Denmark) Stock-in-trade or inventory of goods or merchandise.

VASTE INRICHTING — (Holland) Permanent establishment.

VEHICLE TAX — A tax on vehicles, usually in proportion to the size, weight or engine capacity, where the vehicle makes use of public roads, etc. Vehicles are also commonly subjected to customs and excise duties and/or sales taxes in the same way as other machinery.

VENNOOTSCHAPSBELASTING — (Holland) Corporate income tax.

VERBRAUCHSTEUER — (Germany) Excise tax.

VERDRAG TER VOORKOMING VAN DUBBELE BELASTING — (Holland) Treaty for the avoidance of double taxation.

VERLUSTVORTRAG — (Germany) Loss carry forward.

VERMOGENSBELASTING — (Holland) Net wealth tax.

VERMÖGENSTEUER — (Germany) Net worth tax.

VERMOMD DIVIDEND — (Holland) Disguised dividend.

VERSCHMELZUNG (also FUSION) — (Germany) Merger.

VERTICAL INTEGRATION TAX — See ZUSATZSTEUER.

VIRKSOMHED — (Denmark) Establishment, enterprise, undertaking

VISITOR — A visitor to a country is not normally regarded as resident there for tax purposes unless he is present in the tax year for six months or more. A visitor's tax liability would only extend to his income from the country visited (which tax would arise even if he did not visit the country) and not to his foreign income.
In the U.K. (and the position is broadly similar elsewhere), a visitor who makes annual visits of over three months per annum on average, or who maintains a residence in the country for his use on visits, would be regarded as resident and liable to U.K. tax on world income. (See also RESIDENCE, FISCAL; TOURIST TAX.)

VOID RELIEF — Relief from property taxes or "rates" is given in some countries in respect of property which is empty, e.g. because the property is being reconstructed, or because it cannot be let profitable owing to economic recession. Relief is usually given as a proportion on a time basis for the period the property is "void".

VOLUNTARY PRINCIPLE IN TAXATION — It has sometimes been suggested as a somewhat Utopian notice that taxes at the higher rates on incomes should be replaced by a scheme where the wealthy might be invited to make voluntary contributions in addition to their basic income tax. Some tax systems which combine very high top personal income tax rates with provisions for tax deductions in respect to voluntary donations to charity, including social welfare and other expenditure of government, come near to adopting a voluntary principle, since the taxpayer is able to dispose of income, perhaps at some "social" credit to himself, most of which would otherwise have been payable to the government in taxation. In addition, death duties may often be avoided by the taxpayer making distributions of his wealth during his lifetime which are not necessarily contrary to the intention of death duties where these are regarded as a re-distributive taxation. To some extent, there is a "voluntary" element in the taxation of the income from bearer securities in the income tax systems of countries which levy extra taxation by deduction or withholding at source where the owner of the bearer securities is not prepared to disclose his ownership to the tax authorities.
In a number of sales tax systems a trader may have the option of being or not being taxed on his sales. If he chooses not to be taxed, however, the consequence is normally that his purchases of goods will have already been subjected to tax. Indirect taxes on luxuries may be regarded as voluntary in the sense that one may avoid the tax on whisky by not drinking any.

That a tax is a "voluntary" one is sometimes a jibe at the inadequate efforts of a tax administration to combat legal avoidance and illegal evasion. (See REGISTRATION FOR SALES TAX.)

VOLUNTARY TAX — See VOLUNTARY PRINCIPLE IN TAXATION

VOORRAAD, IJZEREN — (Holland) Base stock (method of valuation).

VOORRAADWAARDERING — (Holland) Inventory valuation.

VRIJSTELLING — (Holland) Exemption.

W

WAIVER, (of DIVIDENDS, REMUNERATION) — The waiving, or foregoing of dividends or remuneration by an individual in a sense constitutes a transfer of assets (cash), but, e.g., in the U.K., is exempt from CAPITAL GAINS TAX (q.v.), a tax which incorporates GIFT TAX (q.v.).

WAR DAMAGE CONTRIBUTION — A levy upon the annual value of real property in Britain imposed during World War II as a form of compulsory insurance against war damage, the yield from which was eventually used in meeting claims by those whose property had suffered damage.

WAR TAX — A tax imposed in Belgium after World War II on wealth made in the war (see, also, EQUALISATION OF BURDENS TAX).

WAR WOUNDS, EXEMPTION — Where pensions are granted to members of the Armed Forces of a country in respect of disability caused by wounds incurred in war, it is fairly usual to grant income tax exemption for such pensions. This is the case, e.g., in the U.K., which also grants exemption from the pension attached to the award for bravery in war known as the Victoria Cross.

WASH SALES — A tax avoidance device whereby a dealer in stocks and shares claims a loss on disposal of securities but has, in fact acquired (or contracted to do so) substantially the same securities. Where the contract to reacquire is entered into during a period from 30 days before the sale to 30 days afterwards, the loss is disallowed (U.S. Tax Code, Section 1091).

WASTING ASSET — The term was formerly applied mainly to mineral deposits, but is now more widely used for most types of asset which depreciate in use for the purposes of a trade and qualify for CAPITAL ALLOWANCES (q.v.). Special rules may be made for such assets in computing capital gains tax on their disposal.

WEALTH, EXTERNAL SIGNS OF — See EXTERNAL INDICIA OF WEALTH.

WEALTH TAX — An annual tax on the wealth or net worth of a taxpayer, usually at a modest rate percent, and sometimes advocated as an alternative to the imposition of the higher rates of income tax in a graduated scale. Wealth taxes are employed in some European countries and some developing countries but usually involve a certain lack of equity in that although the annual valuations of wealth are necessary to determine the tax accurately, the correspondingly high administrative costs would normally preclude such valuations being made, so that further inequity or illogicality results from the fact that assets tend to be taxed on out-of-date values, high yielding fixed interest securities usually have a lower market value than "growth stocks" which return a low yield but are likely to appreciate in value, so that tax falls more heavily, relative to the income derived, on the latter than the former although it may be in the national interest to encourage investment in equities. (See also CAPITAL TAX.)

WEAR AND TEAR — It is usual in an income tax system to allow deductions in calculating the profits of a business using buildings, plant, and machinery which are subject to wear and tear in the course or producing the goods and services which the business supplies. The allowances granted are usually calculated as a percentage of the cost or value of the qualifying assets. (See also CAPITAL ALLOWANCES, DEPRECIATION, WRITING DOWN ALLOWANCES.)

WEHRSTEUER — (Switzerland) The Federal Defence Tax.

WELFARE RECIPIENTS, TAX CREDIT FOR HIRING — Under the U.S. Tax Code a tax deduction may be claimed of 20% of the salary paid to persons taken into employment who are recipients of welfare relief. In the U.K., in contrast, a cash grant is made to employers who take on extra employees in order to reduce unemployment. A somewhat similar measure is taken by some countries in asking employers with large labour forces to take on a small percentage of partly disabled workers, whose earnings, however, will in practice be augmented by a state disability allowance.

WESENTLICHE BETEILIGUNG — (Germany) Participation by a shareholder of more than 25% of the capital of a resident or non-resident company.

WESTERN HEMISPHERE TRADE CORPORATIONS — Under Section 931 of the U.S. Income Tax Code the status of "Western Hemisphere Trade Corporation" is granted to a domestic corporation which carries on business wholly in North, Central, or South America and the West Indies, and

(1) 95% or more of its gross income of the previous three years was derived outside the U.S.; and
(2) 90% of its gross income was derived from the "active conduct of a trade or business".

Where the corporation qualifies for Western Hemisphere Trade Corporation (W.H.T.C.) treatment, it is granted relief which effectively reduces the tax rate applicable to its taxable income by 14 percentage points (so that if the total combined rate of corporation tax and surtax amounted to 52%, a W.H.T.C.'s income would be taxable at 38%. The relief is to be phased out by 1980.

WHOLESALE BRANCH, UNLICENSED — A concept adopted in connection with the Canadian manufacturers' sales tax which applies to sales by manufacturers. Where the manufacturer sells direct to a retailer or a consumer the price level for the sale would be above that to which the tax was meant to apply (in effect, sales by manufacturers to wholesalers) and, accordingly, manufacturers are allowed to create, in form if not in substance, "unlicensed wholesale branches" through which sales can be made (often as mere paper transactions) to which the tax would then apply. In effect, the process is one of allowing an official "markdown" of the selling price for tax purposes, in contrast to the UPLIFT (q.v.) applied in the case of wholesale and retail sales taxes in certain circumstances.

WHOLESALE SALES TAX — A tax levied on sales by wholesalers to retailers. Although the yield at a fixed percentage rate of tax is less than a similar tax levied on retailers' sales to consumers, the administrative advantage is that there are far fewer taxpayers from whom to collect the tax.

WHOLE TIME SERVICE DIRECTOR — See FULL-TIME WORKING DIRECTOR.

WHOLLY, EXCLUSIVELY, AND NECESSARILY — That an expense should be "wholly, exclusively, and necessarily incurred" in the performance of the duties is the somewhat stringent test applied under U.K. tax law before the item can rank as a deduction from remuneration for tax purposes. In the case of businesses and professions, the test is whether the expense is incurred "wholly and exclusively" for the purposes of the trade, etc.

WIDOW ALLOWANCE — Some tax codes provide additional tax relief for widows compared with other single women. In the U.K. a widow may claim a deduction if she employs a housekeeper, and in Japan there is an extra allowance for widows under 65 with incomes below a certain level — after 65 they receive the same extra allowance as that afforded to other old persons.

WIDOWER ALLOWANCE — In the U.K. and some other countries an extra tax allowance is granted to a widower who employs a housekeeper.

WIDOWS' PENSIONS — In some tax regimes exemption from tax is accorded to widows' pensions arising from the death of the husband on war service.

WIFE ALLOWANCE — See SPOUSE ALLOWANCE.

WINDFALL EXEMPTION — Canadian capital gains tax provisions specifically exclude from liability "windfalls" such as sweepstake and gambling wins. Such exclusions are also common to other countries' income tax and capital gains tax laws, with the corollary that gambling losses are non-tax-deductible. Governments normally prefer to collect revenue from gambling as a percentage of stake money, admission charges to casinos, etc. See also TALENT TAX.

WINDFALL TAX — A tax that has been projected in the U.S.A. as an extra levy on oil companies in respect of their enhanced profits arising from the large price increases of oil products decreed by OPEC combined with the decontrol of domestic crude oil prices in the U.S.A. While there appears to be strong support for extra tax, there seems also to be feeling that the companies should have an opportunity to use some of the windfall profits to stimulate domestic production.

WINDOW TAX — A tax imposed in Britain in 1696 on the windows in a building, the rate of tax initially being £ 0.10 for less than 10 windows, £ 0.30 for from 11 to 20 windows and £ 0.50 for more than 20 windows. Apart from evasion of the tax through the temporary closure of windows when the tax collector was reported to be in the vicinity, legal avoidance was also practised by the "permanent" blocking of windows to bring properties into a lower category of charge. The tax was combined with INHABITED HOUSE DUTY (q.v.) in 1798. Although window tax eventually produced material revenue the levy is nowadays regarded as a historical example of what not to tax.

WIRTSCHAFTSJAHR — (Germany) Financial year.

WITHHOLDING TAX — An income tax imposed by withholding a certain percentage of the income at source, the amounts withheld or deducted being payable to the tax department.

"WOBBLE" TAX — See REGULATOR TAX.

WOODLANDS TAX — In Britain, tax under Schedule B is imposed on the occupation of woodlands, which also covers the liability on any profits arising from the exploitation of the timber. Where the income from timber is less than the Schedule B assessment, a claim may be made to have the profits assessed under Schedule D instead of under Schedule B in order to reduce the tax due.

WORKING DIRECTOR — See FULL-TIME WORKING DIRECTOR.

WORKING STUDENT — In Japan a fixed special deduction from tax is granted to a working student whose total income is below a certain maximum.

WORKS OF ART — Various countries provide exemption from capital gains tax where works of art are donated for the public benefit, and the exemption often extends to gift taxes and capital transfer taxes. In the U.K. exemption also extends under certain conditions to works of art, historical buildings, etc. passing at death. In general, there is a growing realisation among taxing authorities that special tax provisions are necessary if works of art, etc. are to be retained within the country for "national heritage" reasons.

WRITING DOWN ALLOWANCES — These allowances represent the annual allowances for depreciation granted in the U.K., along with initial and balancing allowances. See CAPITAL ALLOWANCES.

WRITTEN DOWN VALUE — The value of an asset which is depreciable for income tax purposes, determined by deducting from the total cost including installation, etc., the allowances that have been made for wear and tear or depreciation in previous tax years.

Y

YUGEN KAISHA — (Japan) Private company. A private company in Japan must not have more than 50 members nor less than 110,000 yen issued capital. A private company is taxed as a corporation (joint stock company) but with special provision for FAMILY CORPORATIONS (q.v.).

Z

ZAKAT — A wealth tax which used to be, and in some cases still is, imposed on Muslims in respect of their "Amwale-Zahirah" (visible assets) according to Koranic law, for the benefit of the poor. (See also RELIGIOUS TAXES, EXTERNAL INDICIA OF WEALTH). In Saudi Arabia the tax is charged at 2.5% on Saudi nationals, and on Saudi firms on capital employed.

ZERO BRACKET AMOUNT — Under the U.S. Tax Code a comprehensive basic allowance for federal income tax purposes is now granted to individuals at the rate of $ 3200 for married couples submitting (filling) joint returns, $ 2200 for single individuals, and $ 1600 each for married persons filling separate returns.

ZERO RATE — A concept used in connection with V.A.T. whereby an exempt person may be permitted to opt for taxation at a zero rate which, where he has borne V.A.T. on goods and services supplied to him, may be more favourable to him than exemption since he may be able to obtain refunds if he is subjected to V.A.T. rather than excluded from taxation. Particular goods or services may also be zero-rated and the seller of those may claim a refund of any relevant INPUT TAX (q.v.).

ZOLL — (Germany) Customs duty.

ZOLLVEREIN — The customs union into which the German states entered and which led to some economic co-ordination before political unity was achieved under Bismarck.

ZUSATZSTEUER — A tax operated in Germany to counteract tax avoidance under the cascade tax (UMSATZ-STEUER) by vertical integration in the certain industries. The tax applied, for example, (a) to retail sales by manufacturers and (b) to internal transfers of yarn from the spinning department to the weaving department of the same firm. (See, by contrast, ORGANSCHAFT.)

Addenda

BOWS AND ARROWS TAX — See SPORTING TAX.

CLAWBACK — In the U.K. the term was used to refer to the additional tax levy upon individuals with higher incomes who were entitled to and received the standard cash child allowances under the National Health Insurance scheme, but who were discouraged from claiming the allowances as having no real need of them. The term was also used regarding deductions made from payments due under a life assurance policy cancelling tax relief already given in certain circumstances. See also RECAPTURE.

FLAG OF CONVENIENCE — See SHIPPING CENTRE.

LAFFER CURVE — A graphical illustration by its inventor, Prof. Arthur of the University of Southern California, of his proposition that "there are always two tax rates that yield the same revenue". The curve is a simple parabola drawn to demonstrate that if the income tax rate were 100% revenue would be zero, while a tax rate of 0% would also produce zero revenue. The former proposition cannot be sustained (see SPECIAL CHARGE, SPECIAL CONTRIBUTION) and is merely an extreme way of setting out the argument that as tax rates rise, revenue increases also, but only up to a point where tax avoidance and evasion expand, people prefer leisure and unemployment to work, and economic growth slows or stops. At that point tax revenues may also decline (see also DIMINISHING RETURNS) and a country may find that cuts in taxes result in increased revenue. (See also PROPOSITION 13.)

MULTIPLE ASSET ACCOUNT — The U.S. term for grouping or pooling for depreciation calculation purposes assets of the same category instead of itemising them. The method also simplifies computations. See also POOL BASIS.

OFFSHORE FUND — In the U.S.A. a REGULATED INVESTMENT COMPANY (q.v.) or "Mutual Fund" which is operated overseas, and the resources of which are invested overseas but controlled by U.S. residents.

PASSIVE INCOME — Income in respect of which, broadly speaking, the recipient plays only a passive role, merely sitting back and waiting for it to come to him, e.g., dividends, interest, rent, etc. The distinction is usually drawn with the object of providing a reason for taxing such income at higher rates. The recipients would probably argue that their role was considerably more than passive! (See also UNEARNED INCOME.)

PATENTS — The inventor of a new article or process usually registers his invention with a Government Department which confers on him the sole right (known as patent rights) to use the invention, or license others to do so, generally for a fixed period, e.g., 16 years. The inventor may usually claim capital allowances or writing-down allowances to write off his research and development costs against his income from exploiting or licensing the patent. The licensee of a patent normally pays ROYALTIES (q.v.) for the privilege and may deduct these from his income from using the patent. See also RESEARCH.

PAY AS YOU GO — See PAY AS YOU EARN.

PIGGY-BACKING — See REVENUE SHARING.

PREFERENCES, TAX — See TAX PREFERENCES.

In next issues:

Some aspects of tax laws in Bangladesh
— by *K.A. Gofran*

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Commissioner of Inland Revenue should be given power to increase the amount taxable in respect of the value of quarters by reference to the net assessable value of such quarters.[19] The Government's view is that the estimated yield from these two sources is too trivial to justify the administrative costs involved.

Recommendation H on resident shipowners' tax liability has been rejected by the Government. The recommendation would add little to the revenue yield from this source, according to the Government. *"The amending legislation would be, on the one hand, controversial and, on the other hand, still open to avoidance devices unless steps were taken to go considerably beyond the Review Committee's recommendations"*.

Recommendation I, that the existing rules regarding deductible expenditures and allowances for capital expenditure should not be altered, has been accepted. The Government has also accepted the Review Committee's suggestion to adopt a system of "pooling" of capital expenditure as a means of simplifying the calculation of depreciation allowance. It has however rejected a related recommendation that relief should be granted for premiums, akin to rent in advance, for certain short leases.

One other relatively minor recommendation, not classifiable under the above major headings, is that non-trading clubs should not pay property tax on club premises. This has been accepted by the Government and the Inland Revenue Ordinance has been amended to give effect to it from April 1, 1979. By analogy with clubs, the exemption has been extended to trade and business associations, clans and families, provided that in all cases, the property is not exploited commercially.

In short, the Hong Kong Government has either deferred or rejected those tax reform recommendations that are likely to arouse strong opposition from vested interests or are administratively difficult to enforce and unpromising in terms of revenue yield. Only in the case of the working wife's allowance is the argument for rejection based on possible horizontal inequity.

IV. CONCLUSION

As may be seen from the above account of tax changes and reforms, since 1976 there has been further simplification and rationalization of Hong Kong's tax system, which on balance has resulted in a lower burden of personal taxation, higher tax yield and hence a larger fiscal surplus. The past five years have also been notable for their double-figure growth, the average growth rate of the economy in real terms being an astounding 11.3 percent. While no facile correlation can be established between tax developments and economic growth in this short period, over the longer span of the post-war period there can be little doubt that Hong Kong's tax system has provided a highly conducive and stable environment for entrepreneurial activity. At a time when "supply-side economics", with its emphasis on the reform of punitively high tax rates, is attracting more attention and allegiance from economists, tax experts and policy-makers, Hong Kong's experience in this regard will be of more than local interest.

19. In Hong Kong, the valuation of free or subsidized accommodation is fixed at 10 percent of an employee's salary. Therefore, if a person's remuneration is artificially low, he may derive substantial benefits in kind from his employer.

APPENDIX I – Concessions on Personal Taxation, 1976-80 (Hong Kong dollars)

Category	*Remarks*	*Percentage change*
Personal allowances	Increased from $ 10,000 to $ 12,500 for single persons and $ 20,000 to $ 25,000 for married persons effective fiscal year 1979-80; further increased from $ 12,500 to $ 15,000 for single persons and from $ 25,000 to $ 30,000 for married persons effective fiscal year 1980-81	50 percent increase in two consecutive years
Supplementary allowances	Supplementary allowances subject to a "claw-back" introduced effective 1976-77 at $ 2,500 for single persons and $ 5,000 for married persons; further increased to $ 7,500 for single persons and $ 15,000 for married persons effective fiscal year 1980-81; claw-back rate reduced from 15 percent initially to 10 percent and finally to zero	more than 200 percent increase in four years
Child allowances	Increased from $ 3,000 to $ 4,000 for the 1st child, from $ 2,500 to $ 3,000 for the 2nd child, and from $ 1,500 to $ 2,000 for the 3rd child effective 1976-77; further increased from $ 4,000 to $ 5,000 for the 1st child, from $ 3,000 to $ 4,000 for the 2nd child, from $ 2,000 to $ 3,000 for the 3rd child, from $ 1,000 to $ 2,000 for the 4th, 5th, and 6th child, and from $ 500 to $ 1,000 for the 7th, 8th and 9th child effective 1979-80; then further increased from $ 5,000 to $ 7,000 for the 1st child, and from $ 4,000 to $ 5,000 for the 2nd child effective 1980-81	more than 130 percent increase for 1st child, and 100 percent for 2nd child onwards to 9th child in 4 years
Dependent parent allowances	Reintroduced with effect from 1978-79 at $ 4,000 for each parent; increased to $ 5,000 each 1979-80; further increased to $ 7,000 each 1980-81	75 percent increase in two consecutive years

The Government's decisions on these recommendations up to February 25, 1981 are summarized in Appendix V. As may be seen, the Government has on the whole accepted three recommendations, rejected three, partly accepted one, and deferred decision on the remaining two. The reasons for these decisions may be briefly explained as follows.

On recommendation A, that some form of a comprehensive income tax be introduced to replace the present schedular system, the Government's view is that the legislative and organizational changes implicit in a transition to a mandatory system of aggregate assessment would be very considerable, and hence further consideration should be deferred for the time being, especially as the "*Inland Revenue Department is currently in the throes of a major computerization programme which involves the implementation of an integrated data base system*". Since recommendation G, that the existing property tax be abolished by treating actual rental income as part of aggregated income, is interlocked with recommendation A, decision on this should, according to the Government, also be deferred.

Recommendation B, that a special allowance be granted to a working wife against not only her salary but also, where appropriate, her trading or professional income, has been categorically rejected. Prior to 1973 there was in fact a modest allowance against a working wife's salary which was repealed in that year. The Government is opposed to the re-introduction of working wife's allowance in an augmented form because "*such an allowance offends the principle that to vary allowances according to the conditions of, and the standard of living expected or enjoyed by, different classes of taxpayers is inequitable. To give relief for expenditure which is domestic and private, specifically disallowed as a deduction by the Inland Revenue Ordinance, is also inequitable*".

Recommendation C, that the 1975 plan to introduce a dividend withholding tax be abandoned and that the present surcharge on corporation profit tax be retained, has already been accepted and was implemented in 1977. As stated in the earlier section, the surcharge has recently been reduced from 2 to 1.5 percent.

With regard to recommendation D on the widening of the ambit of interest tax, the Government accepts the argument that all significant flows of income which are the result of economic activity carried on in Hong Kong should be taxed. The Government Working Party was concerned, however, "*that the lender would not be able to calculate his tax liability, if any, until the use of the funds by the borrower had been established; and that, when the lender is not a bank or a corporation carrying on a trade or business in Hong Kong, the borrower would be, under the Review Committee's recommendation, responsible for deducting tax at source. Thus complicated questions of apportionment of funds used partly to generate Hong Kong profits and partly for other purposes would arise*". In principle, a supplementary source test related to the activities of the borrower can be justified, but the Government finally takes the view that the implications of applying such a test (i.e. of such a deeming provision) are unacceptable. The Government does accept however two relatively minor recommendations relating to interest tax. One is that relief should be granted to trustees who become subject to withholding tax on interest received and thereafter are obliged to deduct interest tax a second time from interest paid to beneficiaries of the trust fund. The other is that a possible lacuna in legislation in regard to the chargeability to tax of surpluses arising from the redemption or realization of certificates of deposit and other similar entitlements should be rectified. This recommendation has become even more topical now than when it was first proposed four years ago, as many banks and financial institutions, in their keen competition for deposit funds from the public, have devised various monetary instruments that may appear to exploit the existing loophole. The relevant legislation is now being amended to implement these two recommendations.

On recommendation E, that profits tax should extend to profits made by a business actively carried on in Hong Kong without the substantial intervention of any branch elsewhere, the Government's conclusion, reached reluctantly, is that this recommendation is "*uncertain in purpose and limited in effect and would, incidentally, give rise to practical difficulties in administration; rather, in the context of modifying the scope of the profits tax charge, specific targets should be selected and defined*". One of such targets is interest income derived by a bank or financial institution based in Hong Kong from funds lent or invested overseas. The Government accepts the argument that the net income from such business can be brought within the profits tax net without violating the territorial source criterion. Accordingly, the recommendation with regard to the tax liability of banks and financial institutions was carried into effect in the fiscal year 1978-79. As noted in a previous article by the present author, this piece of reform met with strong opposition from international banks with branches and subsidiaries in Hong Kong, many of whom at that time threatened to transfer their business elsewhere.[18] Initially there was indeed a drop in the volume of loans and advances abroad, but this decline proved only temporary. From 1979 onwards offshore loans have resumed their rapid growth, so that such loans made by the licensed banks and deposit-taking companies rose sharply from HK$ 37,576 million at the end of 1978 to HK$ 68,806 million at the end of February, 1981. Thus both the Review Committee and the Government have been vindicated in their contention that a significant loophole can be plugged without endangering Hong Kong's status as a financial centre.

Recommendation F, that the existing treatment for salaries tax purpose of benefit in kind should, with certain minor exceptions, be maintained, has been accepted in general by the Government. However, the exceptions mentioned by the Review Committee have not been accepted. The Review Committee suggests that where an employer meets the utility bills or the wages of domestic servants, these benefits should be included as remuneration from employment for tax assessment purposes, and that where a director's remuneration from a director-controlled company is artificially low, the

18. See Y.C. Jao, "Hong Kong's New Tax on Offshore Banking Profits", this *Bulletin*, Vol. 33, 1979, pp. 15-18.

Even in the remaining three areas of commercial activity on which stamp duty is still chargeable, it has been thought necessary to make further concessions. In order to encourage home ownership, stamp duty on conveyances of low value property has been reduced thrice, in 1977, 1980, and 1981. Space precludes any detailed description, suffice it to say that in the latest change, the limit for the fixed concessionary rate of HK$ 20 has been raised to HK$ 250,000 while that for the concessionary ad valorem rate of 1 percent, to HK$ 500,000. In 1978, stamp duty on contract notes in respect of share transactions was reduced from HK$ 8 to HK$ 6 per mille when the stock market was relatively inactive.[15]

While most business sectors and individuals have benefited from these concessions, one exception is the fund management industry. This arises from the attempt by the Inland Revenue Department to apply stamp duty on the redemption and purchases of shares in unit trusts, mutual funds, and other forms of open-end investment fund, as well as to impose corporation profit tax on the surplus from "habitual trading" in Hong Kong securities. These proposals have aroused strong opposition from the representatives of foreign investment funds based in Hong Kong, numbering about 80, who claim that the proposed application of stamp duty will result in double taxation, since holders of shares in unit trusts or mutual funds which invest on the Hong Kong stock market have already paid stamp duty on the first buy and sell of Hong Kong securities by their funds. Many of them have threatened, therefore, to leave for other centres like Singapore which is now actively wooing foreign investment funds in its effort to become a fund management centre. At the time of writing (May 1981), the Government has agreed to reconsider the matter and it is understood that some relief will be provided by amending the relevant sections of the new Stamp Duty Bill before it is enacted.

(f) Miscellaneous

One minor tax concession not classifiable under any of the above categories concerns the tax liability of credit unions which, as is well known, are thrift institutions that receive savings from their members and make loans to them exclusively for provident or productive purposes. In 1980 interest income earned by a credit union on loans to its members was exempted from interest withholding tax.

Other minor tax changes during the past three years have been the increases in two consecutive years (1978-79) in the initial registration tax on motor cars, an increase in the excise duty on imported cigarettes in 1978 and an increase in the business registration fee in 1979.

III. THE TAX REFORM COMMISSION

In 1976 the Hong Kong Government appointed a commission of experts to examine the tax structure covered by the Inland Revenue Ordinance with a view to recommending suitable reforms. This tax reform commission, officially called the Third Inland Revenue Ordinance Review Committee, made a total of twenty-three recommendations under the following headings: voluntary aggregation under personal assessment, the taxation of husbands and wives, dividends and corporate profits, interest and relief for interest paid, ambit of the charges, benefits in kinds, property tax, specific classes of taxpayers and relief for expenses.[16]

After the submission of the Committee's report, the Government in turn appointed a working party consisting of government officials to study the feasibility and implementation of the recommendations. Of the twenty-three recommendations, the Government considers nine of them to be major ones. These are as follows:

A. The existing system of voluntary personal assessment should be replaced by a mandatory system of assessment on total income from salaries, business profits, interest and rent.

B. The existing system of aggregating a wife's income with that of her husband should continue, but a special allowance should be granted to a working wife.

C. The plan to introduce a dividend withholding tax should be abandoned but the tax rate on corporate profits should continue to be one or two percentage points higher than the standard rate.

D. The charge to interest tax should be extended to include in its ambit interest paid by a person carrying on a trade or business in Hong Kong on money borrowed by him or employed or expended in or in connection with the production of the assessable profits of that trade or business.

E. In broad terms, the existing restriction of the various charges in the Ordinance to income having a Hong Kong source should be maintained but business profits accruing to a trade or business exercised in Hong Kong, which are not substantially caused by the action of a branch outside Hong Kong should also be brought to charge, including business profits taking the form of interest derived by banks and allied institutions.

F. The existing treatment for salaries tax purposes of benefits in kind should, with certain minor exceptions, be maintained.

G. Property tax, based as it is on estimated rental values supplied by the Commissioner of Rating and Valuation, should be completely abolished and replaced by including the actual net rent in the aggregated return and assessment mentioned in recommendation A above.

H. Resident shipowners should be charged tax on all charter hire with the limited exception of charter hire receivable under general charters (trip or voyage charters) without demise.

I. The existing rules regarding deductible expenditure and allowances for capital expenditure should not be altered.[17]

15. In 1973, when the stock market boom approached its peak, stamp duty was increased from HK$ 4 to HK$ 8 per mille to check rampant speculation.

16. See *Report of the Third Inland Revenue Ordinance Review Committee*, Hong Kong 1977.

17. *The 1977-78 Budget Speech*, Annex 8, pp. 2-7.

(c) Depreciation allowances

The Hong Kong economy is highly dependent on its export-oriented industries, which are now facing the twin problems of rising protectionism in the industrialized countries and competition from newly industrialized nations like Singapore, South Korea and Taiwan. A government-appointed committee to examine the prospects for the economy and the appropriate policy responses in the 1980s and beyond has stressed the need for broadening the industrial base and diversifying Hong Kong's products and markets. On fiscal policy the report of the committee makes the point that "*although Hong Kong's existing fiscal system has no features which provide a positive incentive to entrepreneurs to diversify their investments, its inherent neutrality — as regards its impact on the internal cost/price structure and on investment decisions — is such that we do not consider that it operates in any way as a disincentive to the process of diversification within the economy; quite the contrary when considered in the context of the Government's general attitude towards industry and commerce*".[9]

Nevertheless, in an environment of rising inflation and rapidly changing technology, there is a clear need for accelerating depreciation allowances in order to induce entrepreneurs to replace and upgrade their capital equipment, machinery and plant. Accordingly, in the 1981-82 Budget it was proposed that the existing depreciation table, under which 33 categories of machinery and plant attracted annual depreciation rates ranging from 5 to 30 percent, be replaced by a simpler one whereby the same 33 heads are regrouped under three rates of annual allowance of 10, 20, and 30 percent respectively. The net outcome of this change is to add another 5 percentage points to the rate applicable to most relevant assets. Furthermore, the initial allowance has also been increased from 25 to 35 percent. In effect, a capital asset ranking for the annual allowance rate of 30 percent can now have over half of its value written off for tax purposes in the year of purchase.[10]

(d) Estate duty

In Hong Kong, estate duty (or inheritance tax) is levied on the value of the net assets of a deceased person, over a certain exemption limit, at graduate rates ranging from 7 to 18 percent. Over the years the exemption limit has been raised on several occasions: from HK$ 200,000 to HK$ 400,000 in 1977 and further to HK$ 600,000 in 1980. In recognition of the inflationary impact on asset values, the exemption limit has now been raised again to HK$ 1 million following the approval of the 1981-82 Budget.

Two other relatively minor changes regarding estate duty during the past five years may also be mentioned in passing. One was the plugging of a loophole in the controlled companies provisions of the Estate Duty Ordinance that enabled a wealthy person to escape the duty. The other was the raising of the duty-free limit of HK$ 5,000 on gifts inter vivos made less than three years before death (or one year in the case of charitable donations) to HK$ 50,000. Both these changes were made in 1979.[11]

(e) Stamp duty

The present Stamp Ordinance in Hong Kong was first enacted in 1921 and as a tax on legal documents it has always been regarded, in the words of the Financial Secretary, as "an esoteric and antiquated revenue law". In 1978, a major "surgical exercise" was carried out, whereby the ambit of the duty was drastically reduced.[12] To understand the rationale of this operation, one can do no better than to quote the Financial Secretary in extenso: "*Statute law cannot keep pace with commercial practice and economic reality in a rapidly changing world. Our Stamp Ordinance has been amended no less than 21 times in the last ten years alone, but it remains, I fear, a somewhat archaic piece of tax legislation. Some of its provisions are arbitrary in their effect, some are difficult to interpret in relation to present-day documents and some are quite unenforceable. This latter point has been recognised elsewhere (e.g. in the United Kingdom) where the stamping of documents is largely voluntary. Here stamping has always been compulsory, but now that there is such a multiplicity of different documents — and literally millions of documents are stampable — the application and attempted enforcement of the provisions of the Ordinance are complicated and expensive tasks. As I doubt whether a wholesale redrafting of the Ordinance would be worthwhile, and as it is axiomatic that a revenue law should not, if at all possible, impede economic development, I have concluded that its ambit should be drastically reduced. That is to say, I think the Ordinance should, in future, apply only to three major sources of duty, namely, contract notes on shares and marketable securities, assignments of immovable property and, because of the peculiar position in Hong Kong where almost all property is held on a leasehold basis, leases and assignments of leases.*"[13] Although the immediate loss to revenue was not inconsiderable, it was thought that in the long run this would most likely be more than offset by administrative savings to both the Government and private sector (especially banks and financial institutions). Moreover, the abolition of ad valorem stamp duty on foreign exchange transactions and the issue of marketable securities is required by, and will in turn facilitate, Hong Kong's development as an international financial centre.[14]

9. *Report of the Advisory Committee on Diversification* 1979, Para. 549.
10. 35% + (65% x 0.3) = 54.5%.
11. *The 1979-80 Budget Speech*, Paras. 178-183.
12. Although this operation was technically a reform, it did not emanate from the deliberations and recommendations of a tax reform committee. Hence it is treated as a part of "tax changes" in this paper.
13. *The 1978-79 Budget Speech*, Para. 215.
14. Readers interested in the background and significance of Hong Kong's emergence as a major financial centre may like to consult Y.C. Jao, "The Rise of Hong Kong as a Financial Centre", *Asian Survey*, July 1979, pp. 674-694.

(a) Personal taxation

Under the Hong Kong tax system, personal taxation covers salaries tax and personal assessment, the latter being an option open to a resident taxpayer to have his income from different sources aggregated for taxation purposes. Because of the acceleration of inflation in recent years, personal taxation has always been a favourite target for various pressure groups clamouring for higher personal and family allowances. Faced with these pressures, the Government has made a series of concessions designed especially to benefit the lower-income groups. Thus, with effect from 1976-77, supplementary personal allowances subject to a "claw-back" mechanism were introduced and child allowances were increased;[5] with effect from 1978-79, the claw-back rate was reduced from 15 to 10 percent, a dependent parent allowance was reintroduced, and the 30 percent marginal rate was abolished; with effect from 1979-80, personal allowances themselves were increased, the claw-back mechanism was abolished, and child and dependent parent allowances were further increased.

The latest concessions announced in the 1981-82 Budget Speech require fuller description. First, the level of personal allowances has been increased again from HK$ 12,500 to HK$ 15,000 for single persons and from HK$ 25,000 to HK$ 30,000 for married persons. Furthermore, supplementary personal allowances have also been increased from HK$ 2,500 to $ 7,500 for single persons and from HK$ 5,000 to $ 15,000 for married persons without any "claw-back". In other words, personal allowances and supplementary allowances now total HK$ 22,500 and $ 45,000 respectively, representing a 50 percent upward adjustment over the previous fiscal year. Second, child allowances have been increased from HK$ 5,000 to HK$ 7,000 for the first child (or by 40 percent) and from HK$ 4,000 to HK$ 5,000 for the second child (or by 25 percent). Third, the dependent parent allowance has been raised from HK$ 5,000 to HK$ 7,000 (or by 40 percent). This package of concessions takes effect retroactively from the beginning of the 1980-81 fiscal year. According to the Financial Secretary, these concessions exempt some 140,000 existing or potential taxpayers from tax payment. Of the 255,000 remaining in the tax net, some 237,000 will benefit by way of reduced liability. Only 18,000 persons, or 7 percent of the total number of taxpayers, will not benefit, for their incomes have already reached the level where they are required to pay the standard rate of 15 percent (i.e., the maximum effective rate) on their total income.

Details of the concessions over the period 1976-80 are given in Appendix 1. As may be seen, the increases in various allowances range from 50 to more than 200 percent. Inasmuch as the consumer price indices increased on average by about 44 percent during the same period, it can be said that the adjustments have more than offset the inflationary impact.[6] Appendix II gives a hypothetical example of tax payable under salaries tax/personal assessment by various taxpayer categories with the same annual income of HK$ 72,000 (approximately US$ 13,200), which is fairly typical of a middle-class family in Hong Kong. As can be seen, the effective rate ranges from 10.2 percent for a single person to only 0.14 percent for a married person with two children and two dependent parents. Note that a sliding scale of progressive rates is applicable to net chargeable income though the top marginal rate of 30 percent, as mentioned earlier, was scrapped with effect from the fiscal year 1978-79. For details the reader is referred to Appendix III. It can be demonstrated that, had there been no concessions described above for the period under review, then for the same income level appropriately corrected for inflation (i.e., $ 72,000/(1 + 44 percent) = $ 50,000), a much higher tax burden would have resulted. As may be readily seen from Appendix IV, the effective tax rates for all categories of taxpayers are higher than those in Appendix II. Thus, contrary to widespread belief, inflation has not pushed people in Hong Kong into higher income tax brackets and subjected them to heavier taxation. Indeed, if anything, the reverse seems to be true due to the successive adjustments in allowances.

(b) Business taxation

The standard rate of tax on the profits of all forms of business used to be 15 percent. In 1975, pending the introduction of a dividend withholding tax, the Government added a surcharge of 1.5 percent to the standard rate on the profits of incorporated businesses. The 1976 tax reform committee, however, rejected the dividend withholding tax proposal, but recommended instead that the surcharge on corporation profits be retained at one or two percentage points higher than the standard rate.[7] In 1976, in order to raise additional revenue, an extra half percentage point was added on to the surcharge, thereby resulting in a 17 percent tax rate on corporation profits. Subsequently, tax revenue has grown at such a healthy rate that the Government has been able to record substantial fiscal surpluses for five consecutive years.[8] The extra half percent surcharge has clearly become unnecessary and accordingly, in the latest 1981-82 Budget, the Government abolished this half percent loading, thus returning the effective rate on corporation profits to 16.5 percent. The reduced rate is to take effect from the final profit tax assessments for 1980-81.

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5. By "claw-back" is meant a tax device whereby the supplementary allowance is, by the application of a percentage reduction, progressively withdrawn and eventually eliminated when assessable income exceeds a specified limit.
6. There are three consumer price indices in Hong Kong, each being based on the expenditure pattern of a representative household within a certain income group.
7. For a fuller account, see Y.C. Jao, "Tax Reform and Fiscal Policy in Hong Kong", this *Bulletin*, April 1977, pp. 178-179.
8. The estimated deficit of HK$ 355 million for the fiscal year 1976-77 eventually turned into an actual surplus of HK$ 903 million. The surpluses for subsequent years were: HK$ 1,235.7 million for 1977-78, HK$ 1,466.9 million for 1978-79, and HK$ 2,923.8 million for 1979-80. For 1980-81, the latest revised estimate is for a staggering surplus of HK$ 9,323 million. *The 1981-82 Budget Speech*, Para. 66-67.

TAX CHANGES AND REFORMS IN HONG KONG

by Y.C. Jao*

I. INTRODUCTION

The tax system of Hong Kong is noted for its relative simplicity and low level of tax rates. Although Hong Kong is by no means a tax haven, as often alleged in the "tax-planning" literature, the combination of simplicity and low taxation, to the extent that it minimizes the adverse effects of taxation on work effort, saving and risk-taking, has played its part in Hong Kong's remarkable post-war economic growth and development.[1]

The Hong Kong Government has always stressed that for an externally-oriented and free enterprise economy like Hong Kong's, the tax system must be able to meet certain basic requirements. The latest version of these requirements is contained in the 1981-82 Budget Speech by the Financial Secretary, Sir Philip Haddon-Cave, on February 25, 1981. The first requirement is "to help to generate sufficient recurrent revenue to finance a major proportion of a given level of total expenditure and to maintain our fiscal reserves at a satisfactory level". The second is that "the tax system is as neutral as possible as regards the internal cost/price structure, the supply of human effort and private investment decisions". The third is that "the laws governing the tax system are adapted from time to time to make them compatible with changing commercial practices". The fourth is that "each and every levy — be it direct and indirect — is simple and easy to administer for both the Government and the taxpayer and does not encourage evasion". The fifth is that "the tax system is equitable as between different classes of taxpayers or potential taxpayers and between different income groups". Only in exceptional circumstances should another requirement be added, namely, that "the tax system must be capable of being used to achieve non-fiscal (economic and social policy) objectives when necessary".[2]

It is said that tax changes introduced in the past five years have all been consistent with one or more of these requirements. Apart from these discretionary fiscal measures, certain recommendations of a tax reform committee apointed in 1976 have also been implemented.[3] Some of these changes and reforms have been noted in previous articles in this *Bulletin* by the present writer.[4] The purpose of this article is to review the latest developments since 1978, ending with the 1981-82 budget proposals. Section II summarizes tax changes during the past few years, while Section III deals with tax reform proposals that have either been accepted or rejected, or are still under consideration by the Government.

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II. Tax changes resulting from discretionary fiscal policy decisions
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II. TAX CHANGES RESULTING FROM DISCRETIONARY FISCAL POLICY DECISIONS

Tax changes resulting from discretionary fiscal policy decisions during the past three years may be treated under the following categories: personal taxation, business taxation, depreciation allowances, estate duty, stamp duty and miscellaneous.

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1. For a comprehensive treatment up to 1976, see H.C.Y. Ho, *The Fiscal System of Hong Kong,* London, Croom Helm, especially chapter 4.
2. *The 1981-82 Budget,* Speech by the Financial Secretary, Feb. 25, 1981, Para. 93-100.
3. The recommendations are contained in *Report of the Third Inland Revenue Ordinance Review Committee,* Hong Kong, 1977.
4. See Y.C. Jao, "Tax Reform and Fiscal Policy in Hong Kong", Vol. 31, April 1977, pp. 175-184, and "Hong Kong's New Tax on Offshore Banking Profits", Vol. 33, Jan. 1979, pp. 15-18.

Royalties paid to non-residents are subject to withholding tax on gross receipts at different rates as follows:

(i) royalties for the use or temporary use of copyrights on literary, artistic or scientific work including movie films and tapes for radio and television: 10 percent;

(ii) royalties for the use or temporary use of patents or rights on discoveries or improvements, trademarks and for advertising: 42 percent; and

(iii) royalties for the use or temporary use of designs or models, plans, formulae or processes and industrial, commercial or scientific equipment and sums paid for information related to industrial, commercial or scientific experiences and, in general, for technical assistance or transfer of technology: 21 percent.

Payments for professional or technical services related to items referred to above are considered to be royalties.

X. FINAL REMARKS

In conclusion, it is useful to stress, once again, that the discussion has been limited to the corporate income tax, the taxation of particular items representing investment income, and the taxation of income derived by non-residents.

Within these areas, the relevant rules have not been covered in full due to the need to adjust to the normal limits of an article. For instance, deductions allowed by the law in computing taxable income have been discussed only to the extent important changes have been introduced by the new law. The same applies to other subjects included in the article.

Moreover, there are areas of the income tax law which have been only occasionally referred to, if at all, as is the case with advance payments, taxation of non-business entities and sole proprietorships, and the personal income tax of resident individuals.

After having discussed the new legislation within the limits stressed above, it is useful to refer briefly to certain significant features of the new Mexican income tax law and to some implications of its provisions.

As regards the tax jurisdiction, with the enactment of the new law, Mexico has abandoned the principle of taxation of world-wide income of its nationals irrespective of their place of residence, as the United States of America still does. In addition, the new law includes a definition of the concept of permanent establishment similar to that in the OECD Model Convention as well as more comprehensive rules for defining the concept of Mexican-source income. Also the foreign tax credit has been extended in order to allow an indirect credit on dividends for the proportional part of the corporate tax paid on them.

It can therefore be expected that all these rules will contribute to a better handling of international problems related to income taxation.

As regards companies, the corporate income tax is now applicable to business companies only. Moreover, several rules are introduced which contribute to alleviate the taxation of business companies, e.g. the period for the deduction of losses extended, intercorporate dividends are fully exempt, the adjustment of profits for inflation is maintained and improved, and the calculation of capital gains is made taking inflation into account.

As regards foreign enterprises it seems to be more convenient to do business in Mexico through a subsidiary which is organized as a business entity rather than through a branch office, because in the first case the withholding tax will be levied only on those profits actually distributed or remitted abroad. In addition, certain benefits are granted by the new law to foreign investors: (i) gains derived from the transfer of shares sold publicly through the stock exchange under general rules established by the government (Secretaría de Hacienda y Crédito Público) are exempt from tax and (ii) income from bonds, acceptances, debt and other securities in foreign currency placed abroad publicly under rules established by the government or from financing granted to the Federal government are exempt from tax.

Finally, a personal impression acquired upon the direct study of the new law as compared with the old one indicates that the new law seems to be more systematic and its provisions can be more easily studied and dealt with, all that said, of course, in the relative sense proper to that complex subject which is income tax.

come and are subject to a 20 percent tax on gross receipts (no deductions may be taken). If the acquirer is a resident of Mexico or a non-resident having a permanent establishment in that country, the tax must be withheld at source.

If the non-resident taxpayer has a representative in Mexico who complies with certain requirements provided in the income tax law, [5] the taxpayer can elect to pay 30 percent on gains calculated under the same rules available for resident individuals (see Sections VIII. B.2. and 3. above). The election is available only if the transfer is made through a public deed (escritura pública) or refers to non-amortizable certificates of participation in immovable property (certificados de participación inmobiliaria no amortizables). However, the deduction of losses is not allowed for non-residents. The tax must be paid either by the notary within one month from subscription of the public deed or by the representative of the taxpayer within 15 days from receipt of the gain, as the case may be. When the time limit in which the price of a transfer made through a public deed must be paid exceeds 18 months, payment of the tax may be delayed until collection of the installments and then paid on a pro-rata basis, provided security is given to the Treasury.

Gains derived from the transfer of shares in Mexican companies are deemed to be Mexican-source income. The same gain is subject to a 20 percent tax on gross receipts (no deductions may be taken). If the acquirer is a resident of Mexico or a non-resident with a permanent establishment in Mexico, the tax must be withheld at source.

If the non-resident taxpayer has a representative in Mexico who complies with certain requirements established in the income tax law, [6] the taxpayer can choose to pay 30 percent on gains calculated under the same rules available for resident individuals (see Section VIII. B. 2 and 3. above). However, the deduction of losses is not allowed for non-residents. The tax must be paid by the representative within 15 days from receipt of the gain.

Gains derived from the transfer of shares sold publicly through the stock exchange under general rules established by the government (Secretaría de Hacienda y Crédito Público) are exempt from tax.

E. Taxation of dividends paid to non-residents

Dividends and profits distributed by resident companies are considered to be Mexican-source income and taxed accordingly, even if paid to non-residents.

Dividends and distributed profits paid to non-resident individuals, non-resident legal entities or branches of foreign corporations are subject to a 21 percent withholding tax which is final.

Interest paid by a resident enterprise to a non-resident connected company is treated as dividend for income tax purposes, in the following instances:

(i) if the debtor is under written obligation to pay his debt in full or in part, at the creditor's will;
(ii) if the debt is convertible into shares or equity interest, except if certain conditions established in regulations to the law are complied with;
(iii) if the creditor has a right to intervene in the management of the debtor in case the debtor fails to pay; and
(iv) if the interest is dependent on or related to the debtor's profits.

F. Taxation of interest paid to non-residents

Interest on capital placed or invested in Mexico is considered to be Mexican-source income and taxed accordingly, even if paid to non-residents. Capital is deemed to be placed or invested in Mexico if the payor of the interest is a resident of Mexico or has a permanent establishment in that country, with the right of rebuttal.

As regards the taxation of non-residents, the term "interest" is deemed to include income from claims of any kind, whether secured by mortgage or not and whether carrying a right to participate in profits or not; income from public debt, bonds or other debts, inclusive of discounts and premiums; commissions or payments made upon the granting of financing; and the premium or loss derived from sales of foreign currency on future dates.

Interest paid to non-residents is subject to withholding tax at different rates, as follows:

(i) interest paid to financial institutions which belong to foreign states, to foreign banks registered with the Mexican government or through foreign establishments of financial institutions authorized to operate in Mexico: 15 percent;
(ii) interest not subject to the 15 percent rate mentioned in (i) above paid by credit institutions or on any kind of bonds, certificates issued by credit institutions, debts, mortgage bills, and participation certificates: 21 percent; and
(iii) interest not mentioned in (i) and (ii) above: 42 percent.

If the interest is paid on bearer securities or through establishments located abroad belonging to credit institutions authorized to operate in Mexico, the withholding tax is a final tax.

Income from bonds, acceptances, debts and other securities in foreign currency placed abroad publicly under rules established by the government (Secretaría de Hacienda y Crédito Público) or from financing granted to the Federal government is exempt from tax.

G. Taxation of royalties paid to non-residents

Royalties for property or rights utilized in Mexico are considered to be Mexican-source income and taxed accordingly, even if paid to non-residents. The property or rights are deemed to be utilized in Mexico if the payor of the royalty is a resident thereof or has a permanent establishment therein, with a right of rebuttal.

5. See note 4.
6. See note 4.

Income derived by individuals from the leasing of real property, the rent of which is frozen by law, is exempt from income taxation.

IX. TAXATION OF INCOME DERIVED BY NON-RESIDENTS

A. General rules for the taxation of non-residents

As stated above, non-residents even if they have Mexican nationality, are taxed on income arising from Mexican sources only.

Income from Mexican sources derived by non-residents is subject to a final withholding tax at different rates, the principal of which are:

(i) for salaries and in general for income from dependent personal services: 30 percent on gross receipts;
(ii) for fees and in general for income from independent personal services: 30 percent on gross recceipts;
(iii) for rents from the leasing of immovable property: 21 percent on gross receipts;
(iv) for gains from the transfer of immovable property, shares or company interests: 20 percent on gross receipts; and
(v) for that part of the income of a non-business entity belonging to a non-resident: 42 percent of the entity's income, irrespective of actual distribution.

Rates for the taxation of dividends, interest and royalties derived by non-residents are discussed in Sections IX.E., F. and G. below.

B Taxation of income derived through branches

Non-residents with a permanent establishment in Mexico are taxed both on income which is attributable to the establishment and on income otherwise arising from Mexican sources.

Income which is attributable to a permanent establishment includes both income from business activities (actividades empresariales) carried on by the permanent establishment and income derived from sales of merchandise carried out in Mexico by the final head office directly or by any of its branches.

Business companies not resident in Mexico that have one or more permanent establishments in Mexico must, in calculating taxable profits, compute all receipts which are attributable to those establishments.

The same companies are allowed to take deductions under general rules, even for expenses incurred abroad. However, the deduction of expenses incurred abroad is disallowed if they are allocated on a proportional basis between the Mexican branch and head office or other establishments located abroad.

The cost of merchandise received by branches of foreign enterprises from their head offices is established according to the price appearing in the invoice used for customs clearance provided it corresponds to the market price. If the price appearing in the invoice differs from the market value the tax administration determines the deductible amount taking into account the current price in the domestic or foreign market or, if that is not possible, the lowest of the invoice, official or assessed prices.

Remittances made by a permanent establishment located in Mexico to the head office or other establishments located abroad are disallowed as a deduction even if they represent royalties, fees or similar payments for patent or other rights, commissions, or interest.

The profits of branches of foreign companies which are engaged in business activities in Mexico are subject to the corporate income tax and additionally to a 21 percent withholding tax whether or not the profits are actually distributed or remitted abroad. This 21 percent tax *on after tax profits* is levied on the amount remaining after the corporate income tax and profit distributions to employees have been deducted.

Consequently, it is generally considered more convenient to do business in Mexico through a subsidiary which is organized in Mexico as a business entity rather than through a non-business entity or branch office so that the withholding tax will be levied only on those profits actually distributed or remitted abroad.

C. Income from construction services and spectacles

Income derived by non-residents from construction services and related activities and public spectacles is subject to income tax under special rules.

In fact, income derived by non-residents from construction, installation, maintenance, assembly or inspection services performed in Mexico on immovable property is deemed to be Mexican-source income. This income is subject to a 30 percent withholding tax on gross receipts.

However a non-resident having a representative in Mexico who complies with certain requirements established in the income tax law [4] can elect to pay 42 percent of net income. In calculating net income, ordinary deductions relating directly to the income can be taken, irrespective of the place where they are incurred.

In addition, income derived by public entertainment enterprises from spectacles performed in Mexico is deemed to be Mexican-source income. This income is taxed at a 30 percent rate on gross receipts (no deductions may be taken).

D. Capital gains derived by non-residents

Gains derived from the transfer of immovable property located in Mexico are deemed to be Mexican-source in-

4. The requirements to be met by the representative of the non-resident in Mexico are:
(i) to be a resident of Mexico and keep for a period of five years from the payment of the tax the documentation related thereto;
(ii) to secure the rights of the Treasury under general rules enacted by the Finance Ministry (Secretaría de Hacienda y Crédito Público); and
(iii) give notice of the appointment to the tax administration, together with the filing of the first return of the non-resident.

(ii) specified transactions representing disguised distributions of profits;
(iii) unreported receipts or incorrectly registered purchases from the company;
(iv) global income assessed or estimated by the tax authorities;
(v) profits arising in periods for which the corporate income tax was paid on an estimated basis;
(vi) payments to shareholders or interest holders that are non-business entities;
(vii) payments to minors unless they can prove that the investment from which the dividend is derived was financed with resources other than gifts; and
(viii) payments on bearer shares, other than shares publicly sold under general rules established by the tax administration (Secretaría de Hacienda y Crédito Público).

Where the first system (21 percent tax) is not compulsory, dividends paid and profits distributed to individuals can be included in the personal income of the recipient who is granted a tax credit for the corporate tax paid on the same income.

To include dividends and distributed profits in the personal income of individuals, it is necessary to gross them up with the credit.

In calculating the credit — due to the fact that the corporate tax is a progressive one — it is necessary to arrive at the medium or effective rate paid by the corporation. The tax credit rate is then calculated as a percentage of that medium (effective) rate (partial credit). The credit is variable (from 2 to 77 percent) and increases along with the medium (effective) rate paid by the corporation, as shown in Table 2.

TABLE 2

Medium (effective) income tax rate (percent) of the distributing corporation, between		Creditable percentage of the medium (effective) rate
41.5	42.0	77
40.5	41.5	74
39.5	40.5	71
38.5	39.5	68
37.5	38.5	65
36.5	37.5	62
35.5	36.5	59
34.5	35.5	57
33.5	34.5	54
32.5	33.5	51
31.5	32.5	49
30.5	31.5	47
29.5	30.5	45
28.5	29.5	42
27.5	28.5	40
26.5	27.5	38
25.5	26.5	36
24.5	25.5	34
23.5	24.5	32
21.5	23.5	30
19.5	21.5	27
17.5	19.5	24
15.5	17.5	21
13.5	15.5	17
11.5	13.5	14
8.5	11.5	11
5.5	8.5	8
3.5	5.5	5
0.1	3.5	2

Provision is made by the law in order to deny the credit for that proportional part of dividends or distributed profits representing non-taxable receipts of the distributing corporation.

If profits are distributed by means of stock dividends or bonus shares through an increase of company capital, the tax is due upon refund of capital. The same rule applies where distributed profits are reinvested in the same distributing company by subscribing to new shares or payment of a capital increase, provided this is effected within 30 days of the distribution date.

D. Taxation of interest paid to residents

Interest paid to resident business companies is not subject to withholding tax but is included in the taxable income of the recipient company.

Interest paid to resident individuals is subject to a 21 percent withholding tax which is final. Nevertheless, resident individuals who are duly registered may choose to include interest in their personal income tax return and have prepayment withheld at source at a 15 percent rate. This prepayment is creditable against the final liability to the personal tax.

E. Taxation of roylaties paid to residents

Royalties paid to residents are subject to tax as ordinary income and are normally included in the taxpayer's gross income.

Mexican enterprises, however, may choose either to include technical asssistance fees and royalties *received from abroad* in their gross income or exclude them and pay a separate tax at the rate of 10 percent of the amount received. Whether or not the taxpayer excludes the technical assistance fees and royalties from abroad, costs and expenses related to the fees and royalties may still be deducted from the taxpayer's gross receipts.

F. Taxation of rentals paid to residents

Income from immovable property is taxed as ordinary income and must be included in the income of business companies.

Individuals receiving rental payments from real property may deduct certain actual expenses and investments from the rent or take a deduction equal to 50 percent of the rent as estimated expenses. Sublessors can deduct only the rent actually paid.

Individuals are subject to prepayments of 20 percent of net income from immovable property, to be offset against the final liability to the personal income tax, Moreover, individuals must include income from real property in their personal income which is taxed according to rates of the personal income tax ranging from 3.1 to 55 percent.

and company shares is reduced by 10 percent (20 percent for transportation vehicles) for each year elapsed between acquisition and transfer dates. If more than ten years (five years for transportation vehicles) have elapsed between the acquisition and transfer dates, the cost of personal property shall not be deductible. The balance is further adjusted under rules mentioned in (iv) below. In case of personal property, the value of which is not subject to depreciation, the taxpayer can be authorized by the tax administration to deduct the full acquisition cost without any reduction but adjusted under rules mentioned in (iv) below.

(iv) The cost of land, buildings, securities, company shares and other personal property, as reduced where appropriate under rules mentioned above, is subsequently adjusted by a factor which is calculated in an adjustment table established every year by the Congress and which is a function of the length of time the property was held.

In addition to the adjustment mentioned above, where more than six months have elapsed between acquisition and transfer, the cost of shares and company interest is further adjusted as follows:

(a) the cost of each share, as adjusted under the rule mentioned in (iv) above, is increased (or reduced) by that part of profits derived (or losses incurred) by the issuing company in each year elapsed between acquisition and transfer which can be proportionally allocated to the share.

For this computation each part of profits (or losses) which must be added to (or subtracted from) the cost of the share must first be multiplied by the relevant factor calculated under the rules mentioned in (iv) above; and

(b) the cost of each share as adjusted under the rules mentioned in (iv) above is reduced by profits actually distributed on each share. For this computation the profits actually distributed on the share must first be multiplied by the relevant factor calculated under the rules mentioned in (iv) above.

If more than five years have elapsed between acquisition and transfer of the shares and company interests, the adjustments mentioned in (a) and (b) above are calculated taking into consideration the last five years only.

Under the foregoing rules it can be said that the taxable capital gain is represented by the transfer price or assessment value, less adjusted cost and allowed deductions.

Individuals transferring real property acquired before January 1, 1973 may choose to compute taxable capital gains under rules mentioned above or under somewhat different rules.

4. *Computation of the tax*

The computation of the income tax on capital gains of individuals is governed by the following rules:

(i) 20 percent of the capital gain is added to other taxable income of individuals in order to calculate the personal income tax on the aggregate income;

(ii) the personal income tax calculated as explained in (i) above is then dividend by the taxpayer's income in order to arrive at an average or effective rate;

(iii) the average or effective rate just mentioned is then used to tax the remaining 80 percent of capital gains which are not taxed under the rules mentioned in (i) above;

(iv) the final liability of the individual is the aggregate of the taxes mentioned in (i) and (iii) above.

In addition to the personal income tax calculated as mentioned above, capital gains of individuals are subject to prepayments that can be set off against the final liability.

5. *Exempt capital gains*

Capital gains arising for individuals are exempt from income tax in several instances discussed below.

Capital gains arising from the transfer of property are not taxed if the transfer occurs through inheritances, legacies, gifts or company mergers. In these case special rules are provided for the computation of costs in the acquirer's hands (see Section VIII. B.2. above). However, gifts can be subject to income taxation in the acquirer's hands.

A special exemption is available to individuals who sell the house where they have lived for at least two years and invest the sale proceeds in Mexico in a new house for dwelling purposes, or for leasing purposes in development zones. The investment must be carried out within one year from sale but this may be extended to a second year. It is also possible to use the sale proceeds to pay a debt incurred to buy a house for dwelling purposes provided the purchase was carried out during the year preceding the sale of the old house.

Likewise, capital gains realized by individuals on sales of shares carried out in Mexico are exempt provided the shares are sold publicly through the stock exchange.

Capital gains realized by individuals from the transfer of personal property other than company shares and securities are exempt from income taxation provided the gains arising in the relevant year are not above a certain sum (minimum salary for the year). If capital gains so realized are above the aforesaid sum, only the excess is taxable.

C. Taxation of dividends paid to residents

Dividends and profit shares paid by any kind of resident business company to another resident business company are not subject to income tax either upon distribution or in the hands of the recipient.

Dividends paid and profits distributed to individuals are taxed under either one of two different systems. Ordinarily the taxpayer may choose one of the systems but in certain instances he is compulsorily subject to one of them.

Firstly, dividends paid and profits distributed to individuals can be subject to a 21 percent withholding tax which is final. This system is compulsory for:

(i) profits arising in periods ended before January 1, 1979;

2. *Computation of capital gains (adjustment of costs)*

In calculating gains from the transfer of land, buildings, company interests, registered shares and bearer shares publicly sold, costs can be adjusted under the following rules:

(i) the cost of land, shares and company interests is multiplied by a factor which is calculated in an adjustment table established every year by the Mexican Congress and which is a function of the length of time the property was held;
(ii) the cost of buildings, as reduced by depreciation allowances, is multiplied by a factor calculated under the rules mentioned in (i) above.

In addition to the adjustment mentioned above, where more than six months have elapsed between acquisition and transfer, the cost of shares and company interests is further adjusted as follows:

(a) the cost of each share, as adjusted under the rule mentioned in (i) above, is increased (or reduced) by that part of profits derived (or losses incurred) by the issuing company in each year elapsed between acquisition and transfer which can be proportionally allocated to the share.

For this computation, each part of profits (or losses) which must be added to (or deducted from) the cost of the share must first be multiplied by the relevant factor calculated under the rules mentioned in (i) above;

(b) the cost of each share as adjusted under the rules mentioned in (i) and (a) above is reduced by profits actually distributed on each share. For this computation the profits actually distributed on the share must first be multiplied by the relevant factor calculated under the rules mentioned in (i) above.

If more than five years have elapsed between acquisition and transfer of the shares and company interests, the adjustments mentioned in (a) and (b) above are calculated considering the last five years only.

For holding and real estate companies, the amount of the adjustment of costs mentioned above is reduced in accordance with the degree of indebtedness of the company, under special rules provided by the law.

Under the foregoing rules it can be said that the taxable capital gain is represented by the transfer price or assessment value less adjusted cost and allowed deductions.

B. Taxation of capital gains (resident individuals)

1. *Taxation rules*

Capital gains derived by individuals from the transfer of real property, securities and personal property are taxed according to special rules discussed below. In certain instances, capital gains arising from the acquisition of property may also be taxed under ordinary rules for personal income taxation.

Taxable capital gains of individuals are calculated by deducting several items from the consideration received for the transfer or, if there is no consideration, from the assessed value of the property. The assessed value of the property shall also be used for real property acquired before January 1, 1973 where the taxpayer chooses to compute the capital gains under special rules provided by the law for such property.

2. *Computation of capital gains*

The items that can be deducted from the consideration or assessed value in calculating the taxable capital gain are the following:

(i) the acquisition cost as adjusted under rules discussed below;
(ii) amounts invested in construction of buildings, improvements and expansions, exclusive of maintenance expenses, and adjusted under rules discussed below;
(iii) taxes and notary fees paid by the transferor for the acquisition and transfer of the property;
(iv) commission and brokerage fees paid by the transferor for the acquisition and transfer of the property; and
(v) losses incurred in the transfer of real property, shares and company interests carried out during the last three years (for shares and similar company interests, certain conditions established in regulations to the law must be complied with).

As a general rule, the acquisition cost is the consideration paid for the acquisition exclusive of interest and expenses mentioned above.

For securities and similar company interests the acquisition cost is the actual contribution or the value of shares representing capitalization of profits. A greater cost can be accepted only if, upon acquisition, a withholding tax was paid on the excess.

For share issues upon mergers, the acquisition cost is the cost of the shares of the old company.

For property acquired by means of inheritances, legacies and gifts, the date of acquisition and the acquisition cost to the deceased or donor are carried over (this rule does not apply to certain gifts which are subject to personal income tax in the hands of the person receiving the gift).

3. *Adjustment of costs*

The acquisition costs and investments mentioned above are adjusted under the following rules:

(i) The cost of land is deducted from the acquisition cost of real property in order to arrive at the cost of buildings. If the actual calculation is not possible it shall be deemed that the cost of the land is 20 percent of the total cost of the real property. The cost of land is adjusted under rules mentioned in (iv) below.

(ii) The cost of buildings (exclusive of the cost of land) and improvements is reduced by 3 percent for each year elapsed between acquisition and transfer dates. The balance is further adjusted under rules mentioned in (iv) below. If more than 33 years have elapsed between the acquisition and transfer dates the cost of the building shall not be deductible.

(iii) The cost of personal property other than securities

F. Estimation of income

The tax administration is authorized to estmate a taxpayer's taxable income in the following instances:

(i) if tax returns are omitted;
(ii) if accounting books, documents and sustaining tax returns, or reports are not produced by the taxpayer;
(iii) if accounting records are not properly kept;

VI. TAX RATES

The rates under which corporate income is subject to taxation are the same as those of the repealed law and are shown in:

TABLE 1

Taxable income between (in pesos)		Fixed amount on lower limit (in pesos)	Percentage levied on excess over lower limit
0.01	2,000.00	—	—
2,000.01	3,500.00	—	5.00
3,500.01	5,000.00	75.00	6.00
5,000.01	8,000.00	165.00	7.00
8,000.01	11,000.00	375.00	8.00
11,000.01	14,000.00	615.00	9.00
14,000.01	20,000.00	885.00	10.00
20,000.01	26,000.00	1,485.00	11.00
26,000.01	32,000.00	2,145.00	13.00
32,000.01	38,000.00	2,925.00	16.00
38,000.01	50,000.00	3,885.00	18.00
50,000.01	62,000.00	6,045.00	19.00
62,000.01	74,000.00	8,325.00	20.00
74,000.01	86,000.00	10,725.00	21.50
86.000.01	100,000.00	13,305.00	22.50
100,000.01	150,000.00	16,455.00	24.10
150,000.01	200,000.00	28,505.00	26.76
200,000.01	300,000.00	41,885.00	29.64
300,000.01	400,000.00	71,525.00	34.00
400,000.01	500,000.00	105,525.00	38.00
500,000.01	—	210,000.00	42.00

If the taxable income is between $ 500,000.01 and $ 1,500,000.00 the amount which results from applying a 6.65 percent rate to the diference between $ 1,500.000.00 and the taxable income is deductible from the fixed rate of $ 210,000.00

The normal rates applicable to corporate income are reduced when applied to income from agriculture. The reductions are as follows:

(i) for taxpayers devoted to agriculture, cattle breeding or fishing the reduction is equal to 40 percent of the normal tax liability;
(ii) for taxpayers mentioned in (i) above who submit their products to industrial processes the reduction is equal to 25 percent of the normal tax liability; and
(iii) for taxpayers mentioned in (i) above who additionally derive up to 50 percent of their gross receipts from commercial or industrial activities the reduction is also equal to 25 percent of the normal tax liability.

VII. MEASURES TO AVOID DOUBLE TAXATION

In order to avoid double taxation, the income paid in a source country other than Mexico can be credited against the Mexican income tax liability of a resident. The credit is limited to the Mexican income tax calculated separately on the income to which the credit relates.

This foreign tax credit has been extended by the new law in order to allow an indirect credit for dividends, i.e. the credit covers that proportional part of the income tax paid by a non-resident company on profits out of which dividends or profit shares are distributed to a resident of Mexico, provided the recipient has in the paying company an equity interest of not less than 10 percent.

However, the tax sparing credit allowed by the previous income tax law has been eliminated by the new law.

VIII. TAXATION OF PARTICULAR TYPES OF INCOME

It is worthwhile to discuss separately the taxation of some particular items of income representing capital or non-business income, that is to say, income derived from transactions or investments other than those carried out by an enterprise in the ordinary course of its business. This group includes capital gains, dividends, interest, royalties and rent, all of which have special and distinctive features and are covered by special provisions of the law. Moreover, they are of interest for both enterprises and investors.

A. Taxation of capital gains (business enterprises)

1. Taxation rules

Capital gains derived by business enterprises from the transfer of their fixed assets and capital gains resulting from mergers, liquidations or capital reductions of companies of which the enterprise is a partner or shareholder are normally included in gross receipts and are subject to the corporate income tax.

Capital gains resulting from the sale of immovable properties representing fixed assets will be exempt if the sale price is invested in regions to be developed. If only part of the sale price is so invested, the exemption will be available in the same proportion.

Capital losses can normally be deducted from gross receipts according to general rules. Nevertheless there are some capital losses that cannot be deducted, namely: (i) losses sustained by the taxpayer if they arise from mergers, capital reductions or liquidations of companies in which the taxpayer is a shareholder or partner; and (ii) losses arising from the sale of shares, debts and other transferable securities whose purchase and sale do not comply with rules established by the Government.

percentage points over LIBOR. [3] However, the taxpayer can choose to deduct 91 percent of the interest actually paid and in this case there is no limit for the deduction.

The new law also provides that operating losses can be deducted in the preceding year and in the four years following the year in which they arose. However, a deduction not taken in the relevant year cannot be carried forward.

On the other hand, losses incurred before January 1, 1981 can only be deducted within four years following the year in which they arose. However, losses arising in the taxable period starting during the year 1980 may also be deducted in the preceding period (carry-back).

Any distribution of profits involving a postponement of the amortization of losses will reduce such amortization up to the amount of the aforesaid distribution. In case of mergers, pending losses can be deducted only from profits earned in the same field of activity in which the loss was incurred.

Losses incurred upon payment of a debt or collection of a debt claim in foreign currency as a consequence of a fluctuation in the exchange rate are deductible upon payment or collection, as the case may be. The taxpayer can choose to amortize the loss in four periods starting with the period in which it was sustained.

As regards depreciation allowances, maximum rates of annual depreciation are authorized, depending on the type of assets, the use made of them or the type of undertaking utilizing them. The new law makes some minor changes to the maximum rates.

The percentages selected by the taxpayer are in principle fixed, i.e. constant, and must be applied within the maximum rates providing by the law, the taxpayer can change depreciation percentages, giving notice of the change to the tax administration. However, if less than five years have elapsed since the last change, the new change must be done under the authorization of the government.

At the request of the taxpayer and provided certain requirements are met, the government (Secretaría de Hacienda y Crédito Público) may authorize accelerated depreciation.

Under the new law, the deduction of expenses incurred abroad is disallowed if they are allocated on a proportional basis between the Mexican branch and head offices or other establishments located abroad. Likewise the deduction of entertainment expenses is also disallowed.

D. Adjustment of profits

To arrive at taxable profits, net profits must be adjusted as explained in Section IV.A. above.

As regards such an adjustment, special enphasis should be placed on the adjustment of profits for inflation (discussed in the following section).

E. Adjustment of profits for inflation

In order to compensate for inflation, a special deduction from taxable income was introduced at the end of 1978 which was amended in December 1980 by the new Income Tax Law. The special deduction is currently available for business companies and government agencies performing business activities. Development companies (sociedades de fomento), credit institutions, insurance institutions and credit auxiliary organizations are not eligible for this special deduction.

The special deduction is calculated under the following rules:

(i) The depreciation allowance of goods acquired up to December 31, 1978 is multiplied by an adjustment factor which is calculated on the basis of factors established every year by the Mexican Congress (Congreso de la Union), taking into account the number of years elapsed from December 31, 1978 to December 31 of the year preceding that in which the income tax return is filed.

(ii) The depreciation allowance of assets acquired after December 31, 1978 is multiplied by an adjustment factor which is calculated on the basis of the factors established every year by the Mexican Congress, taking into account the number of years elapsed from the acquisition year up to December 31 of the year preceding that in which the income tax return is filed.

(iii) The average of the financial assets at the end of each month of the calendar year preceding that in which the tax return must be filed is multiplied by the factor established every year by the Mexican Congress.
For this purpose financial assets include only:
— securities, exclusive of shares and non-amortizable participation certificates;
— receivables, exclusive of those from partners and shareholders; and
— deposits in credit institutions.
Company holdings are not included in financial assets.

(iv) The average of liabilities at the end of each month of the calendar year preceding that in which the tax return is filed is multiplied by the factor established every year by the Mexican Congress.

(v) This special deduction is the result of the calculation described in paragraph (i) or (ii), as the case may be, plus the result of the calculation described in paragraph (iii), minus the result of the calculation described in paragraph (iv).

Assets and liabilities belonging to establishments located abroad are not taken into account in calculating the special deduction discussed herein. On the other hand, the special deduction can be used either to reduce taxable income or to increase business losses.

The book value of assets, which is used as the basis for calculating depreciation allowances, is not directly changed by the special deduction. Nor is the special deduction taken into account in calculating profit shares belonging to workers.

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3. London Interbank Offered Rate, i.e. rate of interest charged by leading London banks to each other.

A taxpayer selling property on an installment basis can choose to report the whole price in the year a sale occurs or to report only sums actually received, provided he receives less than 50 percent of the price during the period in which the sale occurs. However, if the taxpayer selling property on an installment basis receives at least 50 percent of the price during the period in which the sale occurs, the taxpayer must compute the entire price in that period. A similar choice is granted to taxpayers transferring property by means of financial leasing.

V. THE COMPUTATION OF NET PROFITS

A. General income concepts

As explained above, in order to calculate taxable profits (resultado fiscal) it is necessary to establish the amount of net profits (utilidad fiscal) which in turn are computed by deducting from gross receipts (ingresos acumulables) the allowed deductions.

B. Gross receipts

In calculating taxable profits, resident taxpayers subject to the corporate income tax must compute all income whether in cash, kind, services or debt claims, inclusive of those derived through establishments located outside Mexico.

Gross receipts include:

(i) gross income as computed or estimated by the tax administration, where appropriate;
(ii) for payment in kind, the difference between the book value of the assets (initial value less accumulated depreciation or amortization) and the assessment value stated by a credit institution at the date of transfer of ownership;
(iii) in the case of taxpayers engaged in cattle raising, excess of inventory value, on the final inventory for the financial year, as compared with the value at the beginning of the year;
(iv) construction, installations or permanent improvements made to immovable property by the tenant which under the relevant contract belong to the owner of the property. The income is deemed to accrue at the end of the contract and to be equal to the value of the investment on the same date;
(v) gains derived from the sale of fixed assets of the enterprise, as well as those deriving from merger, liquidation or reduction of capital of companies in which the taxpayer is a partner or shareholder;
(vi) sums collected from bad debts which were previously allowed as a deduction;
(vii) sums received as a compensation for losses;
(viii) sums received as a compensation for a loss in productivity derived from death, injury or illness of technicians or managers; and
(ix) gains arising upon the payment of a debt or the collection of a debt claim in foreign currency, as a consequence of the fluctuation in the exchange rate.

Items that are not considered to be receipts include:

(i) capital increases;
(ii) payments made by shareholders to cover losses;
(iii) premiums received upon the sale of shares or upon revaluation of fixed assets and capital; and
(iv) the value added tax shifted by the taxpayer to another person.

C. Deductions

Taxpayers subject to the corporate income tax are allowed to take the following deductions in calculating net profits:

(i) restitutions, discounts and bonuses;
(ii) costs;
(iii) business expenses;
(iv) depreciation allowances;
(v) in the case of taxpayers engaged in cattle raising, deficit of inventory value, on the final inventory for the financial year, as compared with the value at the beginning of the year;
(vi) losses of property due to force majeure;
(vii) losses arising from transactions in foreign currency and bad debts;
(viii) contributions representing up to 1 percent of the taxpayer's income, made under the provisions of the income tax law to special funds in order to finance research and technological development; and
(ix) contributions to reserve funds in order to finance pensions to be granted to employees in addition to those payable under the official social security system.

Deductions are normally allowed only if they comply with the following general conditions:

(i) they are strictly necessary for the business activity;
(ii) they are substantiated with documents or other proof specified in the regulations to the law;
(iii) they are duly registered;
(iv) the taxes on the deducted item have been paid when withholding is provided by the law;
(v) if the deductible item is paid to a person who should be enrolled in the Federal Taxpayer Register, the relevant number is provided; and
(vi) if the transaction is subject to VAT, the tax is specifically and separately indicated in the relevant document.

The new income tax law specifically refers to some other items which are allowed as deductions in the computation of taxable profits. Most of these rules are similar to those included in the repealed income tax law. However, the new law introduces some changes in this field, especially as regards the deduction of interest and losses. The following discussion shall be limited to the deductible items that have been amended by the new law.

The deduction of interest paid to financial institutions which belong to foreign states, to foreign banks registered with the Mexican government or paid through foreign establishments of financial institutions authorized to operate in Mexico is limited to a sum equal to two which are similar to those used in the OECD Model Convention.

For income tax purposes the term "permanent establishment" means any place of business in which business activities are wholly or partly carried on. The term "permanent establishment" includes, especially, branches, agencies, offices, factories, workshops, installations, mines, quarries and other place of exploration or extraction of natural resources.

An individual, other than an agent having an independent status, acting in Mexico on behalf of a non-resident is deemed to be a permanent establishment as regards all the activities performed on behalf of the non-resident, if he has and exercises an authority to conclude contracts in the name of the non-resident.

Construction work or installation, maintenance, assembly or inspection services connected with immovable property are deemed to constitute a permanent establishment when they exist for more than 365 days.

The law further provides for the following activities that do not constitute a permanent establishment:

(i) the use or maintenance of facilities solely for the purpose of storage or display of goods or merchandise belonging to the non-resident;
(ii) the maintenance of a stock of goods or merchandise belonging to the non-resident solely for the purpose of storage or display of the aforesaid goods or merchandise or for processing thereof by another person;
(iii) the maintenance of a place of business solely for the purpose of acquiring goods or merchandise or for collecting information for a non-resident; and
(iv) the use of a place of business solely for the purpose of carrying on, for the non-resident, any activity of a preparatory or auxiliary character such as advertising, supply of information, scientific research, preparation of loans and similar activities.

D. The concept of Mexican-source income

Under the terms of the new income tax law, Mexican-source income includes the following items:

(i) income from exports;
(ii) salaries and other income derived from dependent personal services rendered in Mexico exclusive of those paid by non-residents. However, the salary or income paid by an establishment [1] a non-resident has in Mexico, or which is related to such an establishment, is deemed to be Mexican-source income;
(iii) fees paid by resident companies to members of boards of directors, control and other boards, as well as fees paid to managers and controllers;
(iv) fees and other income arising from independent personal services rendered in Mexico exclusive of those paid by non-residents. When any part of a professional service is rendered in Mexico, the total fee is deemed to be Mexican-source income, unless the taxpayer can prove that a portion of the service is rendered abroad. The fee or income paid by an establishment [2] a non-resident has in Mexico or which is related to such an establishment is deemed to be Mexican-source income;
(v) rent arising from immovable property located in Mexico;
(vi) rent arising from movable property devoted to trade, industry, agriculture, cattle raising and fisheries if the property is utilized in Mexico. The property is deemed to be utilized in Mexico if the tenant is a resident thereof or has a permanent establishment therein, with right of rebuttal;
(vii) rent arising from movable property not mentioned in (vi) above if the property is delivered to the lessee in Mexico;
(viii) gains arising from the transfer of immovable property located in Mexico;
(ix) gains from the transfer of shares issued by, or equity interest held in, Mexican companies;
(x) dividends and profits distributed by resident companies;
(xi) interest on capital placed or invested in Mexico. The capital is deemed to be placed or invested in Mexico if the payor of the interest is a resident thereof or has a permanent establishment therein, with right to rebuttal;
(xii) royalties for property or rights utilized in Mexico. The property or rights are deemed to be utilized in Mexico if the payor of the royalties is a resident thereof or has a permanent establishment therein, with right to rebuttal;
(xiii) income from construction, installation, maintenance, assembly or inspection activities related to immovable property, when these activities are conducted in Mexico; and
(xiv) income derived by a public entertainment enterprise from public spectacles presented in Mexico.

E. Registration or allocation rules

Under Mexican law, income is taxable whether it is received in cash or in kind, or in the form of services rendered to the taxpayer or if he acquires a debt claim.

For business, the taxable period is normally 12 months. In special cases (e.g. the starting period), the taxable period may be shorter but not longer than 12 months. The closing date is the last day of the calendar month chosen by the taxpayer.

The closing date can be anticipated by the taxpayer giving notice to the tax administration. However, if less than five years have elapsed from the last change in the closing date, the date cannot be moved without prior authorization of the tax administration.

A special rule provides that in case of mergers or liquidations the taxable period is closed on the date on which the merger occurs or the liquidation begins. The entire liquidation period is treated as a single taxable period but a calculation of profits arising during the liquidation and a prepayment of income tax must be made every six months.

1. Even if it is not a "permanent" establishment under the rules discussed above.
2. Even if it is not a "permanent" establishment under the rules discussed above.

III. TAXABLE PERSONS

The corporate income tax is applicable only to business companies (sociedades mercantiles) and to government agencies engaged in business activities. Income derived by individuals from business activities is no longer subject to the corporate income tax but instead to the personal income tax levied on individuals. Likewise, all income derived by civil partnerships, cooperative societies and non-business companies is subject to personal income taxation in the hands of partners or members, irrespective of actual distribution. However, the income of the aforementioned entities is also subject to prepayments to be made by the entity on account of the personal income tax levied on its members.

Under the Fiscal Code of the Mexican Federation, the following persons are exempt from income tax:

(i) the State, Federal District and the Municipalities;
(ii) public service enterprises belonging to the government;
(iii) legally recognized political parties and workers' unions;
(iv) commercial, industrial, agricultural, cattle breeding and fishery unions (cámaras);
(v) employers' unions and professional associations;
(vi) teaching establishments belonging to the government;
(vii) teaching establishments, approved by the government, belonging to private individuals or institutions;
(viii) charities approved by law;
(ix) institutions with scientific, political, religious, cultural, or sporting aims; and
(x) certain cooperatives and mutual societies.

IV. THE CONCEPT OF INCOME

A. General income concepts

The corporate income tax is levied on taxable profits (resultado fiscal). In order to calculate taxable profits it is first necessary to establish the *net profits* (utilidad fiscal), computed by deducting from gross receipts (ingresos acumulables) the allowed deductions.

To establish *taxable profits*, net profits must be subsequently adjusted by deducting the following items:

(i) operating losses incurred in other periods;
(ii) a special deduction representing an adjustment of income for inflation which shall be discussed in Section V.E. below;
(iii) capital gains resulting from the sale of immovable properties representing fixed assets, provided the sale price is invested in regions to be developed under requirements to be specified in regulations to the income tax law. If only part of the sale price is invested, the exemption will be available in the same proportion;
(iv) dividends and profit shares paid by any kind of resident business company provided the recipient is a shareholder or partner thereof; and
(v) fiscal incentives granted by the Federal Executive Branch.

B. Tax jurisdiction

Individuals and legal entities are subject to the Mexican income tax under the following rules:

(i) residents are taxed on a world-wide basis;
(ii) non-residents, even if they have Mexican nationality, are taxed on Mexican-source income only; thus Mexican nationals residing abroad are no longer taxed on their foreign-source income;
(iii) non-residents who have a permanent establishment in Mexico are taxed both on income which is attributable to the establishment and on income otherwise arising from Mexican sources;
(iv) employment income is exempt from taxation if it is derived by:
- foreign diplomatic agents;
- foreign consular agents in the discharge of their duties, provided the same treatment is granted by their country to Mexican agents;
- foreign embassy and consulate employees, provided they have the nationality of the country for which they work and the same treatment is granted by their country to Mexican employees;
- foreign representatives of foreign countries;
- foreign members of scientific and charity delegations,
- foreign representatives, officials and employees of international organizations having a seat or office in Mexico, provided it is so established in a treaty;
- foreign technicians hired by the Federal government, provided it is so established in an agreement concluded between their country and Mexico.

Income which is attributable to a permanent establishment includes both income from business activities (actividades empresariales) carried on by the permanent establishment and income derived from sales of merchandise carried out in Mexico by the head office directly or by any of its branches.

For the above-mentioned purposes, "business activities" cover the following activities:

(i) commerce;
(ii) industry;
(iii) agriculture and forestry, including the first sale of non-processed products thereof;
(iv) cattle and poultry raising, including the first sale of non-processed products thereof; and
(v) fishing, including the first sale of non-processed products thereof.

In defining tax jurisdiction rules, the exclusive economic zone located adjacent to the territorial waters is deemed to be part of Mexican territory.

C. The concept of permanent establishment

The new income tax law provides several rules for defining the concept of "permanent establishment"

Developments in Latin America –

The Mexican Income Tax (1980)

by Pedro Massone*

INTRODUCTION

At the end of 1980 Mexico enacted several laws introducing various amendments to direct and indirect taxation. The changes cover different tax laws and include the following measures:

(i) enactment of a new income tax law which contains important changes concerning tax jurisdiction, extent of the corporate income tax, taxation of business income of individuals and taxation of income of non-residents;

(ii) amendments to the value added tax which include the introduction of a zero rate for food and for some other items which were previously exempt from the tax;

(iii) introduction of a "Special Tax on Production and Services" which is an excise tax that replaces previous taxes on soft drinks, alcoholic beverages, beer, gasoline, processed tobacco, life insurance and telephone services; and

(iv) introduction of other changes concerning the Customs Code, customs value, registration of vehicles, the tax on new cars, the tax on holding and use of vehicles, the tax on the acquisition of sugar, cacao and other goods, the tax on urban unimproved land, and some other minor charges.

The most important development is the enactment of the new income tax law which is effective as from January 1, 1981 and shall be the subject of this article. We will not, however, refer to the new income tax law in its entirety; it shall focus only on the principal features of the new law and especially on those areas where important changes have been introduced or which have special interest for enterprises, investors and non-residents. This means that the discussion shall refer principally to the corporate income tax, taxation of investors and specific rules for the taxation of non-residents.

II. HISTORICAL BACKGROUND

The Mexican income tax was first introduced in 1921 under a schedular system. In 1964, a global income tax system was established for enterprises and individuals whose income was above a certain limit. The schedualr system was maintained for individuals whose income was below that limit and for certain capital income such as interest and dividends.

The global feature of income tax was then strengthened by subsequent reforms until the recently enacted income tax law which contains basically two taxes: a corporate income tax and a personal income tax. In addition, the new income tax law contains a special and separate set of rules for the taxation of non-residents as well as other rules.

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X. FINAL REMARKS

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question (most taxpayers do not answer the question) and because the reporting requirement is not comprehensive. The report recommends changing of the placement of the question and requiring that the beneficial ownership of assets acquired or managed by a foreign intermediary be reported. A follow up to taxpayers who fail to file and penalties for tax return preparers are also suggested.

3. Penalties

With respect to reporting requirements generally, the report recommends that penalties for failure to file or adequately complete forms be so significant in amount as to be meaningful.

4. Gathering of information from abroad

A number of unilateral changes to make international information more accessible are suggested, including: asserting the taxpayer's burden of proof in establishing the tax consequences of a transaction (see V.A.1, above); amending existing regulations to require that books and records of foreign subsidiaries of U.S. taxpayers relevant to tax liability in the U.S. be maintained within U.S. territorial jurisdiction; amending the venue provisions to establish venue in a particular U.S. district where the party summoned is subject to the summons jurisdiction of the IRS but resides abroad; amending the Federal Rules of Evidence to exempt foreign business records received by the IRS from existing admissibility requirements which make it difficult to admit such records in court, while maintaining safeguards for the reliability of the evidence; and streamlining the IRS review process for exchange of information requests.

Treaties and other bilateral agreements, however, are often the best way to overcome the exchange of information and the conflict of laws problems that arise between the U.S. and other jurisdictions. The report sets forth a number of bilateral approaches to these problems:

(a) entry into mutual assistance treaties in which the U.S. and its treaty partner agree to provide assistance in criminal investigations. Efforts should be made to include fiscal crimes and tax offenses within the treaty provisions;
(b) limited tax treaties might be negotiated with tax havens which would include exchange of information articles overriding bank and commercial secrecy laws;
(c) Congress can empower the president to enter into bilateral executive agreements with foreign jurisdictions for the exchange of tax information;
(d) revision of the model exchange of information article to require countries to use their best efforts within the framework of their internal systems, even if the requesting country does not have or cannot use similar procedures; and
(e) isolating abusive tax havens from which the U.S. receives little or no cooperation. Options with respect to these tax havens could include: increasing the tax imposed on amounts paid from the U.S. to foreign individuals or corporations from 30 to 50 percent; taxing as ordinary income proceeds from loans not proven to be bona fide loans; deeming that, for purposes of Sec. 902 (which concerns the payment of and credit for taxes paid by foreign corporations with U.S. shareholders), foreign corporations organized in designated tax havens have not paid any taxes, and treating their income from tax havens as U.S. source income; disallowing deductions for transactions connected with tax havens unless they are established by clear and convincing evidence, including records in the hands of third parties; prohibition of U.S. airline service and other direct service to designated tax havens; and prohibiting U.S. banks from conducting business in designated tax havens.

VII. ADMINISTRATION

With respect to IRS administration of tax haven and international transactions, the report recommends improved coordination within the IRS, and between the other federal agencies involved in international transactions (e.g. Commodities Future Trading Corporation, Drug Enforcement Administration). The report also suggests: increased audit coverage of tax haven cases especially in the international trust, partnership and shelter areas; a step which would decrease the chances for successful taxpayer abuse in these areas; the expansion of training of IRS international examiners to include non-corporate issues; the expansion of training of IRS agents in the general program, to make them aware of tax haven issues, providing additional technical and legal expertise to IRS agents; the expansion of the Simultaneous Exchange Program (a program involving the coordinated exchange of information) between the U.S. and its treaty partners with respect to designated taxpayers; and, the appointment of an attorney as the international evidence gathering expert for the IRS chief counsel.

IX. CONCLUSION

The report provides a good overview of tax haven use and control efforts, and presents a number of options for IRS action in response to problems created by the abuse of the U.S. tax system through the use of tax havens. The options, which are presented from a tax policy standpoint, should be considered by tax planners as an example of current thinking on tax havens. Should the report be adopted by the IRS and treasury as its position on tax havens, it may serve as the basis for future action in this area.

with persons not entitled to this exemption by a tax treaty.

7. *Clearly define the type of income earned by personal services companies in order to clarify how it is to be taxed.*

C. Legislative approaches

A number of legislative options to deal with treaty problems are set forth in the report. These legislative changes could apply to all tax treaties or to tax haven transactions only.

1. *Reduction of the rate of tax on fixed or determinable income*

Legislation could be used to decrease the current 30 percent tax on fixed or determinable income paid to foreigners in response to criticisms that the current rates are too high. These rates could be brought down by new treaties or legislation which would then either override treaties or establish a maximum rate of tax with treaties still taking precendence. With respect to tax havens, the present 30 percent rate (or another high rate) could be continued.

2. *Anti-treaty abuse provisions*

Inclusion of anti-treaty abuse provisions in the IRC could take the form of a provision denying treaty benefits to persons not contemplated beneficiaries of treaties. The provision would enable the IRS to deny treaty benefits to persons coming within the literal language of the treaty which were not anticipated by negotiators.

3. *Imposition of a branch profits tax*

This option is intended to eliminate the problems arising from the "second withholding tax" (see VI.B.5). Legislation could provide for the imposition of a branch profits tax equal to the withholding tax on the fixed and determinable U.S. source income of a U.S. branch of a foreign corporation when the branch remits income to the foreign corporation. Thus tax could be waived in appropriate treaties with countries which were not tax havens.

VII. INFORMATION GATHERING

A section of the report examines the information gathering practices of the Treasury department. Special problems exist with respect to the gathering of information. U.S. tax laws governing international transactions are among the most complex in the IRC. The acquisition of information is difficult or impossible. Distance and language difficulties exist. Internal laws and practices may prevent or procedurally complicate the acquisition and material. Investigative needs often clash with political interests.

1. *Reporting*

Problems associated with reporting include: inadequacy of information requested from taxpayers; the poor quality of information supplied by taxpayers; an overlap among forms requesting information; ambiguity in filing requirements; and IRS processing difficulties. The following options are presented in the report for remedying the existing shortcomings: revising IRS forms, the primary source of taxpayer supplied information, to fill existing reporting gaps;[12] streamlining the forms; combining existing forms into fewer forms; and combining all existing IRS forms for reporting foreign related items into a single clear and concise form. An alternative suggestion is the creation of an all-encompassing IRS "international" form for taxpayers engaged in international transactions or having an interest in a foreign account or entity.

The report also suggests imposing additional reporting requirements. For example, the report recommends: requiring individuals engaged in international transactions to submit a balance sheet identifying assets held overseas if the individual's total positive income is above a certain level; requiring individuals to report any international transactions with foreign entities; requiring U.S. partners in foreign partnerships to report requirements similar to those used by U.S. shareholders of controlled foreign corporations; and amending regulations so that stock owned by a foreign trust will be considered as being owned proportionately by the trust's beneficiaries or grantors.

2. *Bank Secrecy Act Forms*

The Bank Secrecy Act of 1970 authorizes the Secretary of the Treasury to require the reporting of: transactions with domestic financial institutions; the transport of currency into and out of the United States; and relationships with foreign institutions. Thus, the Act provides the IRS with an additional source of information with respect to tax haven related transactions.

The report recommends the following steps to increase the usefulness of the Bank Secrecy Act: improving the processing of information submitted in the Currency Transaction Reports (reports by financial institutions of currency transactions of greater than $10,000); verification of addresses in tax haven related transactions and reports; increased use of existing computer printouts; and, obtaining the assistance of the Comptroller of the Currency in improving reporting.

The Bank Secrecy Act also requires persons who transport or cause to transport more than $5,000 in currency or bearer instruments into or out of the U.S. to report the transaction on Treasury Form 4790. The report recommends changing the legislation to make it illegal to attempt to import or export currency and to give Customs greater authority to conduct searches.

Taxpayers filing an income tax return are required to answer a question on the return form whether they at any time during the taxable year had an interest in or signature authority in a foreign bank, securities or other financial account. The report states that the usefulness of the question is limited by the placing of the

12. See 31 *Bulletin for International Fiscal Documentation* 7 at 313 (July 1977).

5. *Improving the quality of routine information received from treaty partners.*

6. *Taking an aggressive stance with respect to tax haven treaties in rulings*

The report recommends using the rulings to impress upon taxpayers that the IRS does not condone treaty shopping.[9] For example, the IRS could issue a ruling that back-to-back royalties paid by corporations in a treaty country are U.S. source income and are therefore not exempted by the treaty language.[10] This ruling would result in treating as U.S. source income royalties paid by a U.S. licensee to a company in a treaty country which are then paid to a third company.

The report also recommends the use of rulings to inform investors that certain transactions will be scrutinized to determine whether parties are entitled to get the benefit of treaty provisions.

7. *Closer coordination between the International Tax Counsel, the IRS and the Tax Division of the Department of Justice.*

B. Changes in treaty policy

To limit the use of tax haven treaties by third country residents, the report suggests several policy changes.

1. *Changes in the treaty network*

The strongest suggestion set forth by the report to limit treaty abuse is for the U.S. to terminate treaties with tax havens. Treaties specifically mentioned as abused are those with the Netherlands Antilles and former U.K. territories. Recognizing that non-tax considerations may prevent such an anti-treaty stance, the report recommends that treaties with tax havens be limited, as possible, and that the treaties include provisions overriding local secrecy laws.

To prevent countries from becoming tax havens, the report recommends that limited treaties be entered into with potential tax havens. Such treaties should contain: provisions with procedures for dealing with transfer pricing and allocation problems by competent authorities; non-discrimination provisions; strong exchange of information provisions; and termination provisions which would allow either party to terminate the treaty if anti-abuse provisions were not being enforced or other obligations were not met.

2. *Change to source country taxation*

The report recommends a move from the present system which gives primacy to tax to the income earner's country of residence (except for business income and income from real property, which are taxed at the source country). This policy should be reexamined in light of the abuse of the provisions by tax haven jurisdictions and jurisdictions with the potential to become tax havens. The report suggests a policy giving the source country the primary right to tax income, as well as a restriction of income that is considered business profits.

3. *Anti-holding company and anti-conduit approaches*

Presently, Article 16 of the U.S. Model Treaty[11] and a number of existing treaties contain provisions which seek to limit the use of treaties through investment and holding companies. However, the report states that these provisions do not appear to be effective in preventing the abuse of treaties through the use of holding companies. The report suggests the following options to help eliminate third country use of treaties:

(a) amendment of the holding company provisions (Art. 16) to deny reduced rates of taxation of companies that are either:
  (i) owned 25 percent or more by non-residents of the treaty partner; or
  (ii) whose income is subject to tax in another state at a rate substantially less than the normal applicable corporate rates;

(b) amendment of Art. 16 to deny treaty benefits to a company if more than a certain percentage of its gross income is passive income; and

(c) a direct approach, denying treaty benefits to taxpayers structuring certain activities (i.e. royalties) solely to take advantage of reduced tax rates.

4. *Extension of anti-abuse provisions to active businesses*

This proposal would expand Art. 16 and other treaty shopping provisions, such as the anti-holding company rules, to all activity carried on by corporations owned by third-country residents.

5. *The second withholding tax*

The U.S. imposes a tax on dividends and interest of foreign corporations earning a certain percentage of their income in the U.S. This tax is waived in some treaties.

The report recommends requiring the imposition of this tax when the treaty partner does not impose a tax on payments out, a move which would prevent the income from being paid by the treaty country to the owner of the income free of tax (see VI.C.3.).

6. *Insurance premium exemption*

The U.S.—U.K. treaty exempts payments of insurance premiums to a U.K. enterprise from the excise tax on insurance premiums paid to foreign insurers. To eliminate abuse of this provision, e.g. through payments of premiums to residents of treaty partners to companies located in tax havens, the report suggests elimination of this exemption. Another option is to limit this exemption to those foreign insurers who do not reinsure risks

9. One such ruling is Rev. Rul. 80-362, which is reproduced in 35 *Bulletin for International Fiscal Documentation* 4 (1981) at 178.

10. Back-to-back royalties are royalties paid through a tax haven entity (i.e. from a U.S. entity to a Netherlands Antilles entity and then to another entity) in order to take advantage of a tax reduction provided for in a tax treaty.

11. The report recommends, for example, requiring U.S. persons doing business overseas to report the nature of their transactions in order to enable the IRS to identify returns where audits would be appropriate.

and audited. The report set forth several technical options for eliminating the use of straddles, but does not address the problem of straddles in tax havens specifically.

11. Requiring documentary evidence with respect to tax haven deductions

The specific disallowance of tax haven related deductions unless clear and convincing evidence establishing the occurrence and substance of the transaction, and its amount, would emphazise that the burden of proof with respect to such transactions is on the taxpayer.

12. Adoption of a no-fault penalty

The report states that adoption of a no-fault penalty (i.e. a penalty in which the fault or reason for the deficiency need not be decided) of 50 percent of any substantial tax haven related deficiency would place the taxpayer at some risk in respect to questionable tax haven transactions and would curb the use of abusive deduction generating transactions.

13. Amendment of loopholes in the foreign trust expatriation and residence provisions

The report recommends eliminating the sale or exchange exception (in Sec. 679 of the IRC) with respect to foreign trusts, consideration of provisions to minimize the use of foreign trusts by persons who later become residents, and elimination of the exceptions for testamentary transfers.

VI. TAX TREATIES

A major section of the report is devoted to a discussion of the use of tax treaties to decrease U.S. tax liability. While the use of tax treaties is often not fraudulent, the report states that some of it is abusive and counter to U.S. tax policy and provides a number of examples to this effect. Despite the abuse of treaties, a number of treaties without any legitimate economic purposes are still in effect. The abuse of the treaties takes place through transactions within the literal language of the IRC and the treaties, because of the following conflicting policy objectives: encouraging foreign investment in the U.S. and the free flow of investment capital; not treating foreign investment differently from investment by U.S. persons; and not providing incentives for foreign investment by U.S. companies.

One of the areas of abuse with which the report is concerned is "treaty shopping": the use of tax treaties by residents of third countries. While the benefits of tax treaties are in principle intended to inure to residents of treaty countries and treaties often limit their benefits to residents, the term "resident" is broadly defined in treaties. As a result, treaty advantages often inure to third country residents. Third country residents then minimize U.S. income tax on U.S. investments by taking advantage of the reduced rates of tax on income paid from the U.S., the low tax rates in the tax haven, and the low rate of tax on distributions to the investors from the tax haven.

After a discussion of the U.S. treaty network, the forms of use of tax treaties, the use of treaties for the evasion of U.S. tax, the problems which result from treaty shopping, and the administration of the treaty network, the report gives several reasons as to why the effective administration of tax treaties and their anti-abuse provisions is limited:

(1) effective enforcement is dependent upon the full and willing cooperation of the treaty partner's tax administration, including a commitment of resources and availability of expertise;
(2) a meaningful exchange of information, necessary for the proper administration of treaties, depends upon the scope of the exchange of information article of the treaty. These articles do not override local commercial secrecy laws or customs, with the result that the U.S. cannot get information to determine whether the treaties are being used improperly;
(3) greater resources must be devoted to administration; and
(4) practical considerations, such as the attitude of countries towards auditing tax haven entities.

The report also states that IRS rulings have been inconsistent with respect to treaty shopping, a reflection of the inconsistent attitudes of Treasury and Congress, and that there is a lack of adequate coordination between Treasury's Office of International Tax Counsel, the IRS, and the Tax Division of the Department of Justice.

To limit the abusive use of treaties, the report suggests a number of administrative, legislative and treaty policy changes.

A. Administrative changes

1. Move to a refund system of withholding

The report suggests replacement of the existing withholding system by a refund system. After the withholding of taxes normally due, the reduced rates allowed by a treaty would be available only upon application for a refund by the investor. As an alternative to or part of the refund procedure, certification that the investor qualifies for the treaty benefits could be required from the treaty partner. The certification system is used today by several European countries to verify the applicability of treaty benefits.

2. Expansion of audit coverage of foreign investors claiming treaty benefits

Increasing audits and clearer directions to revenue agents are recommended.

3. Periodic review of treaties

This option could include providing notice of termination of treaty partners with whom existing treaties are abused, coupled with priority reneogtiation of the treaties.

4. Strengthening the exchange of information article to override local bank secrecy provisions.

This would ensure that information necessary for effective tax administration is available.

or managed and controlled in a haven. Another approach would be to treat income of controlled foreign corporations not taxed above a certain level as subpart F income. The addition of such a "targeted approach" to the Code would provide a clearer focus to the IRC, give more certainty to foreign transactions, and eliminate some of the technical issues encountered in tax haven transactions. This approach would require definition of the term "tax haven".

An alternative approach would be to target subpart F so that it would apply exclusively to tax havens. However, the report recommends expanding subpart F rather than narrowing it, so that non-tax havens used in a manner similar to tax havens will be subject to subpart F.

2. *Adoption of a management and control test for asserting United States taxing jurisdiction over foreign corporations*

This proposal would subject to U.S. taxation those foreign corporations which under present law are taxed only on their U.S. source income. If used in addition to the present rule, it would facilitate IRS taxation of foreign source income and eliminate the need to use Sec. 482 to allocate income from tax havens.

3. *Change in control test*

To decrease attempts to decontrol tax haven corporations (thus avoiding subpart F treatment), the report suggests reducing the percentage ownership test for foreign controlled corporations to 50 percent (at present, ownership of more than 50 percent is required), and to reduce to one percent (from 10 percent) the level of stock ownership used for determining when a U.S. person is a U.S. shareholder. Consideration of a 25 percent control threshold for corporations formed in tax havens is also suggested. Here, as with the administrative proposals, the report recommends amendment of the treatment of "paired" stock (i.e. when shares of two corporations can only be transferred as a unit) so that stock of one corporation "paired" with the stock of a second corporation will be considered as owned by the second corporation (see V.A.5, above). This change would subject the corporation to subpart F treatment.

4. *Service and construction income*

The common use of tax havens by these industries presents unique problems. The report's concern with enforcement and resource limitations is evident through the report's discussion of taxation of these industries. The report suggests:

(a) with respect to services income, adding a branch rule to the foreign base company services income provisions. Such a provision, already found in the sales provisions of subpart F, would result in treatment of the services income of a branch as though it was derived by a wholly owned subsidiary of a controlled foreign corporation. This would subject to subpart F treatment any such services income, thus resulting in U.S. taxation of undistributed profits from tax haven activities;
(b) with respect to services income, to treat services income performed outside the country of incorporation by controlled foreign corporations as subpart F income. This proposal has the advantage of being easier to administer than (a); and
(c) addressing the issues of whether service and construction income should be left alone for competitive reasons and whether the export of technology without the taxation thereof should be continued.

5. *Merger of the foreign personal holding company and subpart F provisions*

The report recommends the merger of the foreign personal holding company provisions into subpart F to simplify and rationalize their application and to eliminate the avoidance of investment in U.S. property rules of subpart F by structuring investment through a foreign personal holding company.

6. *Income of foreign banks*

As an alternative to the regulatory solution offered in V.A.8, above, the report suggests amending the code to give taxpayers an irrevocable election to treat income as effectively connected or not. If the election is made to treat income as effectively connected, any treaty benefits with respect to the interest payments would also have to be waived.

7. *Captive insurance companies*

Two legislative changes are proposed to decrease the use of captive insurance companies. First, subpart F could be extended to include premiums received by a controlled foreign corporation for insuring related persons. An alternative would be to clarify the application of the foreign base company services income provision to captive insurance companies.

8. *Shipping income*

Existing provisions exempt shipping income reinvested in the shipping business from subpart F income: the report recommends consideration of measures to tax this income directly.

9. *Amendment of the IRC de minimus exclusion from foreign base company income*

Present IRC provisions exempt from taxation as foreign base company income all income of controlled foreign corporations with less than 10 percent of their income as foreign base company income. To eliminate the use of this exception by large companies sheltering significant amounts of income, the report suggests amendment of the de minimis exclusion to include a dollar limitation on the exception.

10. *Adoption of provisions to eliminate commodity shelters using tax straddles*

Tax straddles are paper transactions motivated solely by tax considerations, used to defer income by producing ordinary losses in one year and capital gains in the next year. The taxpayer benefits by the difference between the tax saved on the ordinary loss and the tax paid on the capital gain. Straddles can exist as either domestic or tax haven situs transactions, the latter being used to decrease the chance of the transaction being discovered

Two problem areas specifically mentioned by the report are the allocation of income from the performance of services and the transfer of intangibles.

3. Subpart F regulations

The subpart F sections of the IRC tax U.S. shareholders of controlled foreign corporations on their proportionate share of certain activities of undistributed profits from tax haven and certain other activities. Existing regulations require subjective judgements to determine whether a transaction falls within subpart F. The report recommends reviewing the regulations with a view to eliminating the need for these requirements. In particular, the report recommends clarifying the regulations interpreting foreign base company service income (i.e. income subject to subpart F).

4. Sec. 269 and the accumulated earnings tax

Sec. 269 of the IRC allows the IRS to disallow a tax benefit if the principal purpose of the acquisition of control of one corporation by another is the evasion or avoidance of tax by securing a tax benefit. The accumulated earnings tax imposes a penalty tax when a corporation unreasonably accumulates earnings for purposes of avoiding the income tax on the shareholders by accumulating instead of distributing the earnings. The report indicates that the extent to which Sec. 269 and the accumulated earnings tax could apply to tax havens has not been explored and recommends a review of these provisions and the publication of a series of rulings to show their applicability to tax haven transactions.

5. Reconsideration of Revenue Ruling 54-140

Rev. Rul. 54-140 [4] held that a distribution of the stock of a subsidiary to the shareholders of the parent is a dividend which results in a brother/sister relationship and not a parent/subsidiary relationship. Taken together with Rev. Rul. 80-213, which applied the ruling to the "pairing" of stock, [5] the ruling enables corporations to avoid controlled foreign corporation status, and therefore to avoid subpart F treatment. The report encourages the IRS to reevaluate its position in Rev. Rul. 54-140.

6. Revocation of acquiescence in CCA, Inc.

In *CCA, Inc.* v *Commissioner* [6] the Tax Court held that a foreign corporation in which 50 percent of the voting rights were held by U.S. shareholders and 50 percent by non-U.S. shareholders was not a foreign corporation. As a result, such corporations are not considered controlled foreign corporations. The IRS acquiesced to this result. The report encourages the IRS to review its position, stating that, in this case, the powers held by foreign shareholders in the company did not differ significantly from those held by foreign shareholders in cases won by the IRS.

7. Captive insurance companies

Captive insurance companies are wholly owned subsidiaries formed to insure risks of the parent and its affiliates. These insurance companies are formed because while no deduction is allowed for self-insurance, companies considered insurance companies for tax purposes which assume the full risk of insuring can realize income free of tax. The IRS has ruled, and the Tax Court has upheld, in *Carnation Co. v. Commissioners*, [7] that premiums paid by a domestic corporation and affilates to a captive insurance company or to an independent insurance company with reinsurance by a captive are not deductible because there is no shifting of the risk. The ruling and case also held that these companies are not insurance companies for tax purposes. [8]

The report states that captive insurance companies continue to exist, despite the results of the ruling and Tax Court case, and that they are beginning to underwrite unrelated risks in an effort to avoid the *Carnation* holding. According to the report, the IRS should consider publishing a ruling that a captive insurance company can be fragmented for purposes of determining deductibility of premiums. If this is done, premiums paid by related companies would not be deductible even if a certain amount of premiums was paid by unrelated companies.

In a case decided after the publication of this report the Ninth Circuit has upheld the Commissioner in an appeal by Carnation, rejecting the company's claim that it was entitled to deductions for the portion of an insurance premium ceded by an independent insurance company to Carnation's captive insurance company.

8. Foreign bank income

To prevent the avoidance of U.S. tax by foreign banks through the booking of loans at tax haven branches, the report recommends the amendment of regulations so that income of any foreign bank loans negotiated is deemed effectively connected with the U.S. regardless of where booked. Effectively connected income is subject to U.S. tax.

B. Options requiring legislation

The report states that the levels of use of tax havens and the potential for eroding the U.S. tax base through the use of havens merit consideration of legislative changes in the way the U.S. taxes tax haven income. It sets forth the following options.

1. Expansion of subpart F.

The report recommends the expansion of subpart F by adding a provision which would tax all of the tax haven income of controlled foreign corporations. Two suggested provisions are mentioned. First, the report suggests inclusion, in subpart F, of income of controlled foreign corporations formed or resident in tax havens,

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4. 1954-1 C.B. 116.
5. 1980-28 I.R.B. 7. The pairing of stock occurs when the shares of two companies are tied together and can be transferred only as a unit.
6. 64 T.C. 137 (1975), *acq:* 1976-2 C.B. 1.
7. Rev. Rul. 77-316, 1977-2 C.B.53; 71 T.C. 400 (1978); affirmed, No. 79-7218 (9th Cir., Mar. 6, 1981).
8. There is a U.S. tax advantage to being taxed as an insurance company. One result of this case is that premium payments by subsidiaries to captive insurance companies are treated as constructive dividends to the parent and a contribution of capital to the captive.

(2) tax motivated transactions which are consistent with the letter and spirit of the law (e.g. to increase the amount of foreign taxes paid and credited against U.S. taxes);
(3) use (through "aggressive tax planning") that takes advantage of an unintended or administrative loophole (e.g. using captive insurance companies and investment companies); and
(4) use of tax havens for tax evasion, where the taxpayer tries to escape legal obligations through fraudulent means.

The report states that decisions to not tax transactions or to attempt to attract offshore business are legitimate policy decisions of foreign governments. The U.S. tax advantage from using tax havens is provided because the low tax rates are used together with the U.S. system of deferral of earnings of foreign corporations and the U.S. system of consolidation of world-wide foreign tax credits.

Several reasons for the use of tax havens in addition to low tax rates are given: confidentiality; freedom from currency and banking controls; the receipt of higher interest rates and the ability to borrow at low interest rates; and the protection of assets of companies operating in potentially unstable countries. [1]

IV. OBJECTIVES IN U.S. POLICY TOWARDS TAX HAVENS

In summarizing U.S. policy towards tax havens to date, the report points out a conflict between a U.S. tax policy against tax haven use and other policy objectives, such as maintaining the competitive position of U.S. businesses exporting and investing abroad, maintaining tax equity as between investment in the U.S. and investment abroad, the need for fair rules for taxing foreign investment, administrative efficiency, foreign policy considerations, and the promotion of investment in the U.S. These conflicts, the report continues, are reflected in the ambiguities and compromises found in the present U.S. legislation intended to deal with international taxation in general and tax havens in particular. Throughout the report, references are made to the complexity of the legislative provisions that apply to international transactions in general and to tax haven transactions in particular.

V. OPTIONS FOR CHANGE

After an extensive discussion of the patterns of use of tax havens and the provisions of U.S. tax law that apply to tax havens, the report presents a number of administrative and legislative changes which might help in curtailing tax haven use and easing the government's administrative burden in this area. The options presented are directed toward restricting the legitimate, i.e. legal, use of tax havens. While recognizing that fraudulent uses of havens would not be prevented by changes in substantive rules, the report states that additional administrative efforts and rational tax rules might discourage fraudulent use and make it easier to detect. Throughout the discussion of the options for change, the report comments on the difficulties which may be encountered in bringing about changes in this area. Thus, if the options set forth in the report are adopted, additional resources must be devoted to international enforcement efforts. Conflicts between fiscal and other policies must be reconciled: the options set forth by the report are presented purely from a tax administration standpoint.

A. Administration options

The following options could be pursued without changes in legislation.

1. Burden of proof

The taxpayer now has the burden of proof to establish the tax consequences of a transaction. To encourage agents to ensure that this burden has been met, IRS agents could be given instructions, and taxpayers given notice through a series of regulations or rulings, to deny deductions or reallocate income when the taxpayer has not established entitlement to a deduction or when valuations or proper pricing methods have not been established.

2. Section 482 regulations

Sec. 482 regulations empower the IRS to ensure that transactions between related parties are conducted at arm's length by allowing the IRS to make allocations to determine the true taxable income of group members if taxable incomes are understated. Problems exist with respect to the present Sec. 482 regulations because of dependence on comparable uncontrolled prices as a measure for arm's length prices and because of the subjective judgements which must be made.

The report recommends that the Sec. 482 regulations be analyzed with a view toward amending them to ease administrative burdens on taxpayers and on the IRS, and to achieve greater certainty in pricing international transactions. The report does not suggest any specific solutions, but rather recommends that a major study be undertaken, with the involvement of the business community, to identify and resolve problems. Several examples of approaches that might be taken to Sec. 482 are given. [2] New regulations might take a profit-splitting approach where the IRS would look at the functions of the related entities and attempt to split the profits between them. Another approach would be based on the unitary tax system now used by several states. [3]

1. The report limited its study to those countries having low tax rates and high levels of bank or commercial secrecy. Additional characteristics of tax havens often include: the importance of banking and other financial activities, modern communication facilities; lack of currency controls on foreign deposits of foreign currency, and self-promotion as an offshore financial center.
2. The report cites as a problem with adopting new Sec. 482 regulations a report by the OECD describing acceptable transfer pricing practices very similar to the present Sec. 482 regulations. The OECD report was intended to encourage uniformity in transfer pricing practices.
3. For a discussion of the unitary tax, see Redmond, J.: "Identification of the Source of Income - The Unitary System of Taxation", 35 *Bulletin for International Fiscal Documentation* 3 (1981) at 99.

Highlights of the U.S. Treasury Department Report on Tax Havens and their Use by U.S. Taxpayers

by V. Tkachenko *

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I. INTRODUCTION

On January 12, 1981, a report entitled "Tax Havens and Their Use by United States Taxpayers - An Overview" was released by the Department of the Treasury. Written by Richard A. Gordon, then Special Counsel for International Taxation in the Internal Revenue Service, the report contains an extensive discussion of tax havens, with sections on the characteristics of tax havens, statistical data on the use of tax havens, the U.S. provisions for the taxation of international transactions and the anti-avoidance provisions, patterns of use of tax havens, including an examination of tax haven uses to facilitate evasion of U.S. taxes and the use of tax treaties to facilitate the use of tax havens, and existing United States information gathering and administrative practices. Options for administrative, legislative and treaty changes are set forth in the report. This article summarizes the material in the report, with particular emphasis on the options it presents for decreasing the use of tax havens by United States and other taxpayers.

II. LEVELS OF USE OF TAX HAVENS

Treasury's concern with the use of tax havens is based, at least in part, on data that activity through tax haven entities is increasing. Internal Revenue Service (IRS) data indicate that in 1976, the total of assets controlled by U.S. corporations and formed in tax havens equalled $55.4 billion (17.6 percent of the world-wide assets of U.S. controlled foreign corporations), up from $11.7 billion (12.1 percent) in 1968. Data from the Department of Commerce indicate a five-fold increase in direct investment levels in U.S. controlled tax haven business in the period from 1968 to 1978 (from $4.7 to $23 billion), and a nine-fold increase in the earnings of tax haven entities (from $0.5 to $4.4 billion). These increases in tax haven related investment outstripped increases in non-tax haven business investment during the same period, which experienced an increase from $57.2 to $145.2 billion, an increase of two and one-half times. Earnings of non-tax haven entities increased from $6.0 billion to $21.3 billion, an increase of three and one-half times. Additional data indicate that tax haven entities are used more in certain industries, such as transportation, contract construction, finance, insurance, real estate and banking, than in other industries.

Though more difficult to measure, foreign investment through tax havens is also increasing. The study cites IRS data on non-resident alien gross income paid by U.S. payors and incomplete data from the Commerce Department on direct investment in the U.S. The figures indicate that the level of foreign investment in the U.S. from tax havens is high. Payments of U.S. gross dividends, interest and other income payments to recipients in havens increased by $1.9 billion in 1978. Expressed as a percentage, this amount equals 42 percent of all payments to non-resident aliens.

The report also notes that, in 1978, nearly 80 percent of U.S. gross income paid to tax havens went to foreign corporations.

The report was also concerned with the levels of use of tax havens to further non-compliance with U.S. tax laws. However, in this area, the lack of information made reliable estimates impossible to develop. Problems in measuring this type of tax haven use include the laundering of money and the protection of anonymity of accounts in tax havens.

III. TYPES OF TAX HAVEN TRANSACTIONS

The study loosely categorizes tax haven use into four groups:

(1) uses that are not tax motivated and may have no United States tax impact (e.g. to avoid currency and control requirements or to minimize the expropriation of business assets);

* Staff member of the International Bureau of Fiscal Documentation.

This valuation will require that costly valuations must be undertaken each year (perhaps more than once a year) by reason of its gain on fair market valuation. The formula will require expensive appraisals from independent parties of the corporation's realty holdings, both domestic and foreign (if any) and of all its other trade or business assets (presumably including goodwill). The burdensome nature of this determination is compounded by the statutory language which indicates that if the corporation meets the RPHC test at any time within the specified five year period, it so qualifies. This rule could virtually require daily calculations and appraisals which would constitute an immense burden in terms of effort and expense. *It is suggested that, by statutory amendment, or by regulation, the determination process should be substantially simplified.*

The additional costs described in this section will put an undue and costly burden on the industrial investments of foreign enterprises in the U.S. and therefore discriminate them in comparison to U.S. owned enterprises. Such a discrimination is clearly contrary to the principle of free trade and equal treatment strongly advocated by the ICC.

III. DETERMINING CONTROL

The legislation contains special rules for the treatment of controlling interests where a RPHC is involved. "Controlling interest" means "50 percent or more of the fair market value of all classes of stock of a corporation". In cases where there is no market quotation, and where the capital of the corporation comprises two or more classes of stock, it may be necessary to arrange for frequent valuations of each class in order to ascertain whether and when a controlling interest existed. Heavy additional costs and compliance requirements would arise and would be increased in those cases where values were challenged by the Internal Revenue Service. *A more workable statutory formula should be devised.*

IV. DEFINITION OF REAL PROPERTY

The concept of real property for the purposes of the Act includes, inter alia, "Other personal property associated with the use of real property." It is the view of the ICC that these terms are much too broad and could lead to the result that assets (such as machinery) situated within land or buildings but purchased for the furtherance of an activity which is not connected with investment in or development of real estate, would contribute towards placing a corporation within the category of a RPHC. *We therefore recommend that such assets should be specifically excluded from the definition of real property.*

Our main recommendation remains however to exclude any real property used in the actual conduct of a trade or business from the definition of a "U.S. real property interest" — See II above.

V. NON-RECOGNITION RULES

The Act provides that (subject to regulations yet to be published) gains covered by the Act can enjoy the benefit of the Non-Recognition Rules, provided that this does not result in their escaping tax at any later stage. It is important to ensure that Non-Recognition should apply in the case of a disposal of the shares of a RPHC by a foreign corporation to a second foreign corporation within the same group, in the course of an internal reorganisation where the shares involved remain within the same ultimate beneficial ownership.

VI. DEFINITION OF A SUBSTANTIAL INVESTOR

The compliance requirements relating to a "substantial investor" are expected to involve major corporate groups in exceptionally heavy compliance responsibilities. They are expected to identify shareholders whose pro-rata share of U.S. real property interests exceeds U.S. $ 50,000 in fair market value. The ICC believes that this requirement will be unworkable in practice because many corporations issue bearer stock, which is transferable on delivery. They cannot maintain records of the holders of this stock and the information is not made available to them. *Even where this serious obstacle does not exist, it is essential to reduce the heavy compliance costs by increasing the above-mentioned prorata share to a fair market value of a minimum of U.S. $ 250,000 per investor.*

VII. RESPECT FOR INTERNATIONAL TREATIES

The ICC believes that the provisions made in the legislation for overriding conflicting international tax treaties are extremely ill-advised. International investment can only take place in a stable legal environment in which enterprises can assume that the "rules of the game" will not be unreasonably changed by the host country. Even though a four year period is provided for renegotiation of conflicting tax treaties prior to the overriding taking effect, experience has shown that there will be many treaties not renegotiated in that time period. Additionally, the negotiators will in effect be presented with an unfair fait accompli by the U.S.

Furthermore, by disallowing a stepped-up basis in respect of a disposition made to a related party which is not taxable under existing treaties, the U.S. is, in effect, unilaterally abrogating those treaties. *The ICC strongly urges that this provision of the Code be amended to accord due respect to international treaty obligations.*

ICC STATEMENT

ON TAXATION OF FOREIGN INVESTMENT IN UNITED STATES REAL PROPERTY TAX ACT OF 1980[1]

Note to National Committees and Members of the Taxation Commission*

Please find enclosed a copy of the ICC's critique of the U.S. Foreign Investment in Real Property Tax Act of 1980 (Doc. No. 180/212 Rev.). The document has been revised in light of comments received by National Committees and Members of the Taxation Commission.

On April 1, 1981, the ICC Executive Board granted advance authorization for the document to be submitted to the appropriate U.S. legislative and administrative officials through the intermediary of the U.S. Council.

The reason for this expedited procedure is that proposed regulations under the Act are expected within the next two to three months and there is normally a sixty day period for comments on the proposed regulations prior to their taking effect. Additionally, it should be forwarded as soon as possible to the legislative authorities who will be considering amending legislation.

Thus, for the information of National Committees, the document as will be forwarded to the U.S. authorities is enclosed.

* Document No. 180/212 Rev. Bis, Original.

ISSUES CALLING FOR FURTHER EXAMINATION AND APPRAISAL[2]

I. INTRODUCTORY

As a matter of principle the ICC does not oppose the main object contained within the legislation in that it seeks to tax capital gains made by certain foreign persons from disposals of U.S. real property. This object is not in conflict with the structure of the O.E.C.D. Model Agreement. *The effects of the legislation do, however, extend much further than this and the compliance requirements can be expected to prove extremely onerous to many of the taxpayers involved and, in some cases, unworkable.* Regulations to the Act have yet to be determined and will need to be closely examined by taxpayers during the exposure period. Amendments to the Act itself will also be essential.

II. DEFINITION AND DETERMINATION OF A UNITED STATES REAL PROPERTY HOLDING CORPORATION (RPHC)

The statutory definition of a RPHC is much too broad, with the result that the scope of the capital gains tax imposed by the new legislation stretches beyond the legislative intention to tax only pure gains from investment in real estate. The following situations can arise:

(A) A U.S. subsidiary of a foreign corporation may own U.S. real estate for use in the actual conduct of that business (e.g. a factory to produce goods for sale, an office building to house the employees of the business, etc.). Depending upon the ratio of the fair market value of the real estate, which forms an integral part of the trade or business, to the fair market value of the subsidiary's total assets held for use in the business, that subsidiary could qualify as a RPHC. *The ICC recommends that the Internal Revenue Code should be amended to provide an exception from the term "U.S. Real Property Interest"* for such real estate, regardless of its value in proportion to the total assets of the enterprise.

(B) If a U.S. subsidiary of a foreign enterprise qualifies as a RPHC, by reason of an investment motivated ownership of U.S. real property, it could meet the test of RPHC status, even though separately engaged in a U.S. trade or business unrelated to its real estate interests, in the event that the value of its real estate equalled 50 percent of the value of all its assets. Accordingly, the entire gain on the shares on the sale of the U.S. subsidiary would be taxable as a gain on the disposition of a U.S. real property interest, despite the fact that as little as half of the gain (or possibly no part of the gain at all) was related to U.S. real property holdings. *It is suggested that the Code be amended to provide that only a portion of the gain or disposition of the shares of a RPHC be taxed, such portion to be calculated by applying the ratio of the subsidiary's real estate assets to its total assets.*

Moreover, the taxation by the U.S. of the capital gain arising out of the disposal of the shares of a U.S. subsidiary engaged in an industrial and/or a commercial activity in the U.S. by its foreign parent company is contrary to the O.E.C.D. Model Convention (Sect. 13).

The statutory formula for making the annual test to determine RPHC status of a U.S. corporation is as follows:

$$\frac{\text{Fair market value of U.S. realty}}{\text{Fair market value of U.S. Realty + Foreign realty + Trade/business assets}}$$

1. In the May 1981 issue we published the article: "Foreign Investment in Real Property Tax Act of 1980" by Messrs. Herbert H. Alpert and Fred Feingold giving an overview of the new legislation subjecting foreigners to U.S. tax with respect to gains from the disposition of interests in U.S. real estate.
We now take pleasure in reproducing Documents No. 180/212 Rev. and 180/212 Rev. Bis, both original versions, in which the International Chamber of Commerce, Paris, sets forth its opinion on the subject.
2. Document No. 180/212 Rev., Original.

— services bancaires, fiduciaires et comptables disponibles
— bonnes communications téléphoniques, télex et aériennes
— anonymat dans les rapports avec les investisseurs pouvant être assuré.

L'existence d'une convention fiscale avec les Etats-Unis constitue un élément favorable bien que dans certains cas l'article se rapportant à l'échange de renseignements entre les deux pays peut faire hésiter certains investisseurs.

L'investisseur devra selon les données économiques de son placement décider si la société étrangère investira directement aux Etats-Unis ou si, par contre, elle constituera une filiale américaine pour entreprendre l'opération en question.

5. CONCLUSIONS

Les placements immobiliers aux Etats-Unis présentent à juste titre un très vif intérêt de la part des investisseurs étrangers. Toutefois, les possibilités pour éviter toute imposition aux Etats-Unis lors de la vente du placement ont diminué suite au FIRPTA. Dans la plupart des cas, cette imposition demeurera modeste et n'influencera pas la décision d'investir aux Etats-Unis. Par contre, la façon dont l'investissement s'effectue pourra être affectée.

Il demeure toujours, jusqu'à présent, deux éléments inconnus. D'une part l'administration fiscale américaine, en l'occurrence le "Internal Revenue Service" (I.R.S.) doit préparer les prescriptions administratives d'application sous forme de règlements (*regulations*). En effet, le législateur a laissé à l'I.R.S. un certain nombre de problèmes à résoudre. Il faudra un certain laps de temps pour que les propositions de la part du fisc soient rendues publiques.

D'autre part, la nouvelle convention fiscale entre les Etats-Unis et les Antilles Néerlandaises influencera certainement la manière d'effectuer les investissements passant par cette juridiction. On connaîtra sans doute prochainement le résultat des négociations.

Les investisseurs devront être fort attentifs aux dispositions concernant les renseignements à déclarer au gouvernement américain non seulement dans le cadre de la législation fiscale mais également en raison des autres lois qui peuvent éventuellement leur être applicables.[50]

50. Deux lois distinctes seront souvent pertinentes: *Agricultural Foreign Investment Disclosure Act of 1978*, 7 U.S.C. 3501-3508 et *International Investment Survey Act of 1976*, 22 U.S.C. 3101-3108. Il est évident que d'autres lois peuvent jouer un rôle selon la nature de l'opération envisagée.

en question a été conservé dans le patrimoine du contribuable pendant moins d'un an il sera considéré comme étant une plus-value à court term (*short-term capital gain*) et imposable au taux ordinaire.

Si le contribuable a des bénéfices mais aussi des pertes, il doit tout d'abord solder ses profits et pertes à long terme et ses profits et pertes à court terme. [40] Le montant net des pertes à court terme peut être déduit des plus-values nettes à long terme. [41] Si les pertes excèdent les bénéfices, des règles particulières sont applicables pour déterminer d'une part leur déductibilité et d'autre part leur report aux années antérieures et postérieures à l'exercice fiscal en cours. [42]

Il faut également savoir que les biens pouvant bénéficier de l'imposition spéciale sont en général limités à ceux qui ne figurent pas dans l'inventaire du contribuable comme biens destinés à la vente à la clientèle. [43] Chaque opération doit être évaluée selon les critères prévus par la loi et par la jurisprudence.

(ii) Taux d'imposition des plus-values

En principe, les personnes physiques calculent le montant de l'impôt sur les plus-values à long terme en appliquant les taux normaux sur quarante pour cent de ces plus-values. [44] Puisque le taux d'imposition le plus élevé est actuellement 70 pour cent, cela implique que le taux maximum sur les plus-values est de 28 pour cent. [45]

En ce qui concerne les sociétés, elles seront généralement imposées au taux de 28 pour cent sur les plus-values à long terme, à moins que les taux ordinaires ne produisent un résultat plus favorable. [46]

(iii) Imposition des plus-values dans le chef des contribuables étrangers disposant d'un intérêt immobilier aux U.S.A.

La nouvelle législation (FIRPTA) établit le principe que toute vente d'un intérêt immobilier, telle qu'elle a été définie par la loi par une personne physique non-résidente ou par une société étrangère est considérée comme étant dans le cadre d'une activité commerciale aux Etats-Unis et ce à partir du 18 juin 1980. Bien que le fisc américain n'ait pas encore émis de dispositions administratives en la matière, plusieurs conclusions peuvent d'ores et déjà être tirées de la nouvelle situation. En supposant que l'investissement a été réalisé par une société étrangère, il ne sera plus possible d'éviter l'imposition américaine par la mise en liquidation de celle-ci, par un simple échange d'un bien immobilier en Amérique pour un bien situé à l'étranger ou par la vente des biens avec paiements différés. Ces trois techniques ont, jusqu'à tout récemment, souvent été employées par des investisseurs étrangers pour éviter l'imposition des plus-values aux U.S.A. [47]

Par contre, la vente de titres d'une société étrangère par des investisseurs non-résidents, ne sera pas soumise à la nouvelle imposition. [48] Cela pourrait être considéré par certains comme une porte échappatoire. Bien entendu, cette exemption n'est applicable que dans le cas de vendeurs, personnes physiques ou morales, étant vraiment des non-résidents du point de vue fiscal américain.

En outre, certaines conventions fiscales permettent aux investisseurs de réaliser leurs objectifs de façon avantageuse pendant la période transitoire prenant fin en principe au 31 décembre 1984. [49] Par exemple, la convention fiscale entre les Etats-Unis et les Pays-Bas prévoit dans son Article XI(1) la non-imposition par les Etats-Unis de la vente de titres dans une société américaine par un ressortissant des Pays-Bas.

Il en résulte qu'un investisseur, résident ou non aux Pays-Bas, pourrait envisager la constitution d'une société néerlandaise qui à son tour serait propriétaire des titres d'une société immobilière américaine. Les avantages fiscaux dont les investisseurs peuvent bénéficier aux Pays-Bas sont bien connus des spécialistes.

4. JURIDICTIONS OU L'INVESTISSEUR ETRANGER AURA INTERET A CONSTITUER SA SOCIETE ETRANGERE

Antilles Néerlandaises

Il est clair que jusqu'à l'année passée, les Antilles Néerlandaises et dans une certaine mesure les Iles Vierges Britanniques offraient les plus grands avantages aux investisseurs étrangers désirant constituer une société pour investir dans l'immobilier aux Etats-Unis. Les avantages étaient attribuables à plusieurs éléments dont le plus important était l'existence de conventions fiscales avec les Etats-Unis contenant des dispositions particulièrement favorables aux investissements immobiliers. Il en résultait que ces deux juridictions n'imposaient pas, ou très peu, les revenus en provenance de biens immeubles aux Etats-Unis ni les distributions aux actionnaires. En plus, il y avait diverses méthodes permettant d'éviter les impôts américains sur les plus-values.

Depuis la nouvelle législation américaine, ces avantages ont fort diminué. En outre, le lecteur se souviendra que les conventions entre les Etats-Unis et les Antilles Néerlandaises et les Iles Vierges Britanniques, sont en train d'être modifiées. [49a]

Il semble toutefois que les Antilles Néerlandaises conserveront certains avantages et par conséquent continueront d'être favorisées par les investisseurs. Ces avantages peuvent être résumés comme suit:

— système fiscal particulièrement favorable
— structure et fonctionnement de sociétés semblables à ceux des Pays-Bas
— stabilité économique et politique

40. I.R.C. Para. 1222.
41. Idem.
42. Voir notamment I.R.C. Paras. 1211 et 1212.
43. I.R.C. Paras. 1221 et 1231.
44. I.R.C. Para. 1202.
45. I.R.C. Para. 1.
46. I.R.C. Para. 1201.
47. Voir Senate Finance Committee Report on H.R. 1212, CCH *Standard Federal Tax Reporter*, Vol. 10 (1980), Para. 6159A.
48. Conference Committee Report à l'égard du FIRPTA, P.L. 96-499, CCH *Standard Federal Tax Reporter*, Vol. 6 (1981), Para. 4199E.
49. Voir note 32 supra.
49a. Voir note 12 supra.

maximum sur les plus-values est actuellement établi à 28 pour cent.

3. Tombent sous le coup des dispositions de la loi, non seulement les biens immobiliers détenus par des personnes et sociétés étrangères, mais aussi les sociétés américaines dont les avoirs en biens immobiliers situés aux Etats-Unis dépassent 50 pour cent de la totalité des biens meubles et immeubles. [24] Il en résulte que la vente par un étranger des titres d'une telle société dénommée "Real Property Holding Corporation" en abrégé "RPHC", est une opération imposable même si le vendeur et l'acheteur sont tous les deux des étrangers non-résidents.
4. Toute distribution effectuée par une société étrangère d'un intérêt dans un bien immobilier aux U.S.A. (*U.S. real property interest*), y compris les distributions faisant suite au rachat de titres ou de la liquidation de la société, est imposable. [25] Cette disposition a pour objet l'élimination de certaines techniques qui auparavant servaient à éviter l'imposition des plus-values même si la société étrangère était considérée comme engagée dans une activité commerciale aux U.S.A.
5. La loi prévoit l'obligation de fournir des déclarations au fisc concernant les investissements immobiliers visés dans plusieurs cas et notamment:
   (a) toute société dénommée RPHC qui a un ou plusieurs actionnaires étrangers. Cette obligation ne s'applique pas aux sociétés dont les actions sont cotées en bourse. La déclaration, à fournir annuellement, indiquera les noms et adresses des actionnaires étrangers; [26]
   (b) toute société étrangère ainsi que les associations (*partnerships*), trusts et successions dont un actionnaire, investisseur ou bénéficiaire a un intérêt indirect dans le bien immobilier américain dépassant $50,000. [27] La déclaration, à fournir annuellement, indiquera les noms et addresses de toute personne ayant un tel intérêt indirect dans un investissement immobilier. Le déclarant en informe les actionnaires, associés ou bénéficiaires. [28] Une exemption est prévue quand la valeur des biens immobiliers en question ne dépasse pas $50,000. [28a]
   (c) toute personne étrangère n'exerçant aucune activité commerciale aux Etats-Unis et propriétaire direct d'un bien immobilier américain non couvert par la disposition précédente, à moins que la valeur du bien ne dépasse pas $50,000. [29]

   Il est à noter que le fisc est autorisé à substituer l'obligation de fournir des garanties appropriées dans le cas où les personnes citées sub 5(b) ne peuvent fournir les renseignements exigés. [30] Les personnes qui ne fournissent pas les déclarations requises par la loi paieront des amendes qui peuvent aller jusqu'à $25,000. [31]
6. En principe et sauf disposition contraire dans une convention fiscale, la loi s'applique à toute disposition ayant lieu après le 18 juin 1980. [32]
7. Après le 1er janvier 1985, la loi prévaudra sur toute convention fiscale en vigueur. [33] Cette date a été choisie afin de permettre au fisc de renégocier les conventions contenant des dispositions en contradiction avec la nouvelle législation. Dans certains cas afin de permettre la réconciliation d'une nouvelle convention fiscale et la loi, le délai peut être porté jusqu'au 1er janvier 1987. [33a]

(c) Revenus effectivement liés à un activité commerciale aux Etats-Unis

Toute société étrangère considérée comme ayant une activité commerciale aux Etats-Unis est imposée sur une base nette en ce qui concerne son revenu provenant de cette activité. [34] Dans ce cas, la société étrangère établit sont revenu imposable de la même manière qu'une société américaine. [35] En outre, les taux d'imposition sont ceux applicables aux sociétés américaines. [36] Il en est de même pour les sociétés étrangères qui ont opté pour cette façon d'imposition selon les principes repris ci-dessus à no. 3(b)(i).

Evidemment, les conventions fiscales peuvent jouer un rôle dans le sens que les sociétés étrangères (à part celles qui ont volontairement opté pour un traitement fiscal sur revenus nets en provenance de biens immobiliers) ne seront imposées aux U.S.A. sur leurs activités commerciales que si elles ont un établissement stable dans ce pays. [37] Tous les revenus attribuables à cet établissement seront imposables aux Etats-Unis.

Puisque toute plus-value réalisée lors d'une disposition de certains intérêts immobiliers américains détenus par des étrangers sera dorénavant imposée comme si la société effectue des opérations commerciales aux Etats-Unis, il faut examiner en premier lieu la définition en droit fiscal américain du terme "plus-value" (*capital gain*) et ensuite déterminer les conséquences qui en découlent.

(i) Définition de "plus-value" (capital gain)

Normalement le bénéfice sur la vente ou l'échange d'un bien est imposable au taux ordinaire. [38] Mais si le bénéfice provient de la vente ou l'échange d'un bien en capital (*capital asset*) qui a été dans le patrimoine du contribuable pendant une période d'au moins un an, il sera imposable au taux réservé aux plus-values à long terme (*long-term capital gains*). [39] Dans la mesure où le bien

24. I.R.C. Para. 897(2).
25. I.R.C. Para. 897(d).
26. I.R.C. Para. 6039C(a).
27. I.R.C. Para. 6039C(b).
28. I.R.C. Para. 6039C(b)(3).
28a. Idem.
29. I.R.C. Para. 6039C(c).
30. I.R.C. Para. 6039C(b)(2).
31. I.R.C. Para. 6039C(g).
32. FIRPTA Sec. 1125(a).
33. FIRPTA Sec. 1125(c).
33a. Idem.
34. I.R.C. Para. 882(a)(1).
35. Idem.
36. Idem; voir I.R.C. Para. 11.
37. I.R.C. Para. 894 établit le principe de l'exonération de revenus pour le calcul des montants imposables dans la mesure où cette exonération est prévue par une convention fiscale avec les Etats-Unis.
38. I.R.C. Para. 61(a)(3).
39. I.R.C. Paras. 1201, 1202 et 1223.

comme constitutives d'une activité commerciale, cette règle générale connait plusieurs exceptions. Par exemple, l'acquisition d'un immeuble bâti dans un but essentiel d'investissement ou l'achat d'un bien immobilier pour le donner en location n'est pas nécessairement constitutif d'une activité commerciale aux U.S.A. [16]

La notion fiscale américaine d'imposition sur une base nette signifie que le contribuable est en droit de déduire de ses revenus bruts les dépenses encourues en vue de produire ou de conserver les revenus concernés, c'est-à-dire, à titre d'indication et non de façon limitative, les intérêts d'emprunts, les frais d'entretien, les taxes immobilières locales et, bien sûr, les amortissements.

(b) Revenus n'étant pas effectivement liés à une activité commerciale aux Etats-Unis

Si les revenus d'un bien immobilier américain ne sont pas effectivement liés à une activité commerciale dans ce pays, ces revenus seront imposés sur une base brute au taux de 30 pour cent, éventuellement réduit en cas d'applicabilité d'une convention fiscale tendant à éviter les doubles impositions. [17] La base brute de taxation signifie que l'imposition américaine s'applique aux recettes sans diminutions pour frais y afférents. Il est à noter que la convention fiscale actuellement en vigueur entre les U.S.A. et les Antilles Néerlandaises ne permet pas la réduction de l'imposition à un taux inférieur à 30 pour cent pour ce genre de revenus.

(i) Imposition des plus-values et revenus ordinaires: Situation avant le 18 juin 1980

Jusqu'à la toute récente législation américaine relative à l'imposition des plus-values réalisées par les étrangers sur la vente de biens immobiliers, le principal avantage pour un investisseur étranger d'avoir recours à une société étrangère qui n'était pas engagée dans des activités commerciales aux U.S.A. résidait dans le fait que les plus-values réalisées par celle-ci à l'occasion de la vente de biens immobiliers situés aux U.S.A. souvent n'y étaient pas imposables. Ce résultat provenait du fait que les personnes non-résidentes y compris les sociétés étrangères n'étaient pas imposables sur les plus-values réalisées aux Etats-Unis dans la mesure où leurs contacts avec ce pays étaient limités. [18]

Suivant les dispositions des Sections 871(d) et 882(d) du I.R.C., une personne physique ou une société étrangère n'exerçant pas d'activités commerciales aux U.S.A. peut en ce qui concerne ses revenus en provenance de biens immobiliers choisir d'être imposée sur une base nette plutôt que brute. Cette disposition permet à la personne étrangère, bien que n'exerçant pas d'activités commerciales aux Etats-Unis, de déduire de ses revenus bruts provenant de biens immobiliers américains toutes les dépenses s'y rapportant. Une fois ce choix effectué, il ne peut être normalement révoqué sans autorisation de l'administration fiscale. [19] Toutefois, plusieurs conventions fiscales conclues par les Etats-Unis, y compris la Convention conclue avec les Antilles Néerlandaises, permettent à la personne étrangère d'effectuer ce choix pour n'importe quel exercice fiscal. [20] L'avantage de cette possibilité et notamment dans le chef d'une société résidant dans un pays conventionnée est évident: à tout moment elle peut souhaiter revenir au statut suivant lequel elle n'est pas considérée comme exerçant un commerce aux Etats-Unis. Dans ce cas, les revenus locatifs de ses biens immobiliers relatifs à l'année pour laquelle il aura été fait recours à cette possibilité seraient imposés au taux de 30 pour cent sur leur base brute. Par contre, toutes les plus-values provenant de la réalisation de biens immobiliers pouvaient échapper aux impôts américains.

(ii) Imposition des plus-values: Situation après le 18 juin 1980

Pendant quelques années plusieurs membres du Congrès Américain se sont plaints du fait que, dans certains cas, des étrangers pouvaient effectuer des opérations immobilières aux Etats-Unis échappant totalement aux impôts, ou tout au moins en partie, dans des conditions où des résidents américains seraient plainement imposés. En 1978 le Congrès a ordonné au Ministère des Finances (*Department of the Treasury*) de préparer un rapport sur les revenus provenant de ventes de biens immobiliers par des étrangers non-résidents et sociétés étrangères. Ce rapports, transmis au Congrès le 4 mai 1979, a conclu que ces personnes "étaient rarement imposables à l'impôt sur les plus-values lors de la disposition de leurs biens immobiliers".

Plusieurs projets de loi ont ensuite été déposés auprès des deux chambres du Congrès. La loi votée à la fin du mois de novembre a été un compromis entre les diverses thèses en présence. [21] Le but poursuivi, l'imposition des plus-values sur la disposition de biens immobiliers par les personnes physiques et sociétés non-résidentes, a été largement réalisé. Les dispositions principales de cette loi peuvent être résumées de la manière suivante:

1. Tous les gains et pertes se rapportant aux dispositions de biens immobiliers américains par des personnes physiques non-résidentes (*non-resident aliens*) et par des sociétés étrangères seront considérés fiscalement "comme si le contribuable avait été engagé dans un commerce (*trade or business*) aux U.S.A. et que ces gains et pertes avaient été effectivement liés à ce commerce". [22]
2. Les personnes physiques étrangères seront imposées à un taux minimum de 20 pour cent. [23] Le taux

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16. I.R.C. Para. 871(a)(1).
17. I.R.C. Para. 1441(a).
18. I.R.C. Paras. 871(a)(2) et 882(a)2.
19. I.R.C. Paras. 871(d)(1) et 882(d)(1).
20. Convention fiscale U.S.A. — Antilles Néerlandaises, Art. X.
21. Voir note 1 supra.
22. I.R.C. Para. 897(a)(1).
23. I.R.C. Para. 897(a)(2). Le taux de 20 pour cent est appliqué sur le moins élevé des trois chiffres suivants:
— le revenu alternatif minimum (*alternative minimum taxable income*) qui représente essentiellement le revenu imposable augmenté de certaines charges personnelles et la déduction de 60 pour cent autorisée pour les plus-values. I.R.C. Para. 55.
— les bénéfices nets sur disposition de biens immobiliers aux Etats-Unis durant l'exercice en question.
— $60,000.

indirectement est constitue uniquement par un bien immobilier situé aux U.S.A. [5]

(b) Les trusts

Du point de vue de l'impôt sur les successions, l'investisseur étranger peut être tenté d'acquérir un bien immobilier en Amérique par l'intermédiaire d'un trust de droit américain ou étranger. [6] Une distinction doit être faite entre un trust qui exclut définitivement le bien immobilier du patrimoine du fondateur de ce trust et un trust qui ne procède pas à l'exclusion de ce bien de son patrimoine.

Lorsque le fondateur maintient une partie substantielle de ses pouvoirs de propriétaire tels que, par exemple, le droit de recouvrir une partie de la propriété des biens composant le trust, [7] la détention à vie de son bien, [8] le pouvoir de modifier la désignation des bénéficiaires du trust, [9] ou le droit de révoquer le trust pendant une période de moins de dix ans à dater de sa fondation, [10] les biens composant le trust continueront à faire partie de la succession du disposant. Un trust constitué à l'étranger serait, à ce point, traité de la même manière qu'un trust américain. [11]

Un trust irrévocable, américain ou de droit étranger, qui ne souffrirait d'aucune des restrictions mentionnées ci-dessus, peut se révéler utile afin d'éviter l'imposition sur les successions et les donations; par contre, son usage entraîne une diminution importante de souplesse et de contrôle et peut également comporter un certain nombre de désavantages en matière d'impôts sur les revenus.

Néanmoins, un trust constitué en dehors des Etats-Unis peut être envisagé par l'investisseur pour la détention des actions d'une société étrangère. S'il est constitué correctement, le trust peut permettre d'éviter les impôts sur le patrimoine ou sur les successions dans la juridiction de l'investisseur et peut également simplifier les questions de dévolution successorale. Il y a lieu cependant d'être prudent dans ce domaine relativement inexploré en matière de conflits de lois.

3. CONSIDERATIONS EN MATIERE D'IMPOTS SUR LES REVENUS DE SOCIETES

Un investisseur étranger préfèrera souvent posséder des biens immobiliers aux Etats-Unis par l'intermédiaire d'une société étrangère investissant directement dans les biens immobiliers sans passer pas une société américaine, celle-ci perdant certains des avantages actuellement accordée à une société étrangère. De plus, les actions d'une société américaine peuvent donner lieu à une imposition sur la succession et sur les libéralités comme cela a été dit précédemment. Dans d'autres cas l'investisseur acquerra ses biens immobiliers américains par le biais d'une société américaine qui à son tour serait détenue par une société constituée à l'étranger.

Le choix de la juridiction étrangère est à déterminer par une étude simultanée couvrant, entre autres, l'imposition sur les revenus en vigueur aux U.S.A. et la législation fiscale en la matière à l'étranger. Actuellement, les Antilles Néerlandaises et jusqu'à présent les Iles Vierges Britanniques paraissent offrir le plus grand échantillonnage d'avantages, bien que d'autre juridictions puissent également en offrir quelques uns. L'atout principal de ces deux juridictions tient au fait qu'elles bénéficient de conventions fiscales favorables avec les Etats-Unis et qu'elles sont elles-mêmes des pays à impôts réduits ou nuls. [12]

(a) Les impôts sur les revenus d'une société étrangère aux U.S.A.: Généralités

Examinons premièrement comment seront imposés les revenus provenant d'un bien immobilier situé aux U.S.A. au cas où l'investissement est effectué par le biais d'une société de droit des Antilles Néerlandaises. On note tout d'abord, à la lecture du traité existant entre les U.S.A. et les Antilles Néerlandaises, que les revenus d'un bien immobilier américain ne sont pas imposables aux Antilles Néerlandaises. [13] Ceci constitue le premier et non l'unique avantage de recourir à une société des Antilles Néerlandaises.

L'imposition américaine d'une société des Antilles Néerlandaises retirant des revenus d'un bien immobilier situé aux U.S.A. dépend du point de savoir si cette société est engagée ou non dans des activités commerciales aux U.S.A. Si cette société y exerce de telles activités, tout revenu qui s'y rattache effectivement est imposable dans le chef de la société, sur une base nette, à l'impôt sur les sociétés s'élevant actuellement à un taux maximum de 46 pour cent. [14] L'expression "être engagé dans des activités commerciales aux U.S.A." ne peut donner lieu à une définition simple. Si la société étrangère dispose d'une succursale aux U.S.A., elle sera considérée comme y exerçant des activités commerciales. Cependant, il est possible qu'une société étrangère soit considérée comme exerçant des activités commerciales aux U.S.A. même si sans y disposer d'une succursale, ses activités aux U.S.A. atteignent une densité de rapports commerciaux qui autoriserait l'imposition de ces activités. [15]

Bien que la plupart des transactions immobilières aux U.S.A. d'une société étrangère y seraient considérées

5. Reg. Para. 20.2105-1(f).
6. Le trust est normalement constitué par un *settlor* ou *grantor* qui transmet un bien à une deuxième personne, le *trustee* qui devient le propriétaire du bien mais qui est obligé de l'administrer pour un ou plusieurs bénéficiaires.
7. I.R.C. Paras. 2033 et 2038.
8. I.R.C. Para. 2030.
9. I.R.C. Para. 2041.
10. I.R.C. Para. 2038.
11. I.R.C. Para. 2103; voir notamment Reg. Para. 20.2103-1.
12. Les deux conventions vont être modifiées prochainement. Le texte de la nouvelle convention avec les Iles Vierges Britanniques a déjà été rendu public; des pourparlers sont toujours en cours avec le gouvernement des Antilles Néerlandaises.
13. Convention, Art. V.
14. I.R.C. Para. 871(b).
15. I.R.C. Para. 864(b); la loi n'étant pas précise, il faut se référer à la jurisprudence; voir Rhoades and Langer, *Income Taxation of Foreign Related Transactions*, Matthew Bender, N.Y., Vol. 1, Para. 2.31(3).

Investissements Immobiliers Réalisés aux U.S.A. par des Etrangers - Certain Aspects Fiscaux

par Eric Osterweil *

1. INTRODUCTION

Une variété de choix est offerte aux étrangers désireux de tirer profit de placements et d'investissements immobiliers aux Etats-Unis d'Amérique. La façon dont ces placements ou investissements seront effectués devra être déterminée par des facteurs à la fois fiscaux et non-fiscaux. D'un point de vue strictement fiscal, l'investisseur étranger sera guidé par un ensemble de considerations comprenant le désir d'éviter l'imposition américaine sur le patrimoine telle que les impôts sur successions et donations et de réduire ou même éliminer les impôts américains et étrangers sur les revenus et les plus-values sur capital.

En outre, l'investisseur recherchera la sécurité juridique et politique et, dans la mesure du possible, un certain anonymat. Il souhaitera également réduire les frais et le temps nécessaire à la gestion de ses avoirs.

Un certain nombre de solutions permettent d'atteindre ces buts dans une large mesure bien que la récente législation fiscale américaine imposant les plus-values réalisées par des étrangers sur leurs ventes de biens immobiliers ait considérablement modifié les possibilités en la matière. Ces investissements sont souvent accomplis par l'intermédiaire d'une société étrangère ressortissant d'une juridiction comme celle des Antilles Néerlandaises ou des Iles Vierges Britanniques.

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Les diverses considérations fiscales américaines dont il faut tenir compte au sujet des impôts sur les successions, les donations et les revenus, de même que les raisons de porter son choix sur l'une ou l'autre juridiction étrangère sont étudiées ici. En outre, cet exposé commentera la récente législation fiscale aux Etats-Unis intitulée Foreign Investment in Real Property Tax Act of 1980 *(FIRPTA) qui aura un impact considérable sur les investissements immobiliers aux Etats-Unis effectués par des étrangers.* [1]

2. CONSIDERATIONS EN MATIERE D'IMPOTS SUR LES SUCCESSIONS ET LES DONATIONS

(a) Généralités

Un bien immobilier détenu aux U.S.A. par une personne physique étrangère peut tomber sous le coup des dispositions de l'*Internal Revenue Code* (I.R.C.) concernant les successions et donations et notamment dans les cas de biens de non-résidents non citoyens des Etats-Unis d'Amérique. [2]

Non seulement un bien immobilier situé aux Etats-Unis est considéré comme inclus dans les biens imposables d'une personne physique étrangère non-résidente, mais également les actions détenues par elle dans des sociétés américaines sont comprises dans ses biens taxables au titre de l'impôt sur les successions. [3] Sur la base de dispositions fiscales analogues, les personnes physiques étrangères non-résidentes peuvent être imposables sur la donation d'un bien situé aux Etats-Unis, y compris les biens immobiliers et les actions de sociétés américaines. [4]

Afin d'éviter cet obstacle, un bien immobilier américain ou éventuellement les titres d'une société américaine, peuvent être détenus par une société étrangère qui sera à son tour directement ou indirectement détenue par une personne physique étrangère non-résidente. En général les actions d'une société étrangère ne sont pas comprises dans les biens soumis à l'impôt sur la succession d'un étranger non-résident et n'entraîneront aucune imposition sur une donation éventuelle même si l'actif de la société dont l'étranger est actionnaire directement ou

* Oppenheimer, Wolff, Foster, Shepard and Donnelly; Bruxelles.

1. Foreign Investment in Real Property Tax Act of 1980, ci-après dénommée FIRPTA, P.L. 96-499, 5 décembre 1980. Cette loi apporte plusieurs nouveaux articles à l'Internal Revenue Code et modifie certaines autres dispositions du Code.
2. I.R.C. Paras. 2103 et 2104.
3. I.R.C. Para. 2104.
4. I.R.C. Para. 2511.

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15th General Assembly of the Inter-American Center of Tax Administration (CIAT):

THE CHALLENGE OF TAX ADMINISTRATION UNTIL THE END OF THE 20TH CENTURY

"The challenge of tax administration until the end of the 20th century" was the main theme at the 15th General Assembly of CIAT held from June 29 – July 3, 1981 in Mexico City. Eighteen of the 26 CIAT Member countries were represented as well as observers from 19 non-member countries. The following 8 subjects were discussed:

I. "The future of the economy and government revenue systems", by Mr. D. Ibarra, Vice-minister of Finance of Mexico.
II. "The evolution of tax administration from 1961 to the present", by Prof. R. Hoyo, General Coordinator with the Mexican Federal Entities.
III. "The optimization of human resources in tax administration", by Dr. D. Barañano, I.L.O.
IV. "Future developments in technology and their impact on tax administration", by Prof. R. Curnow, London University.
V. "The future of important functions in tax administration" which was subdivided into three sub-topics:
  (a) "Collection", by Prof. P. Pavesi, former General Director of Taxes, and Prof. H.B. Wencelblat, both from Argentina;
  (b) "Management information", by Dr. J.B. Hom, Director of the Institute for Tax Administration at the University of Southern Californa, U.S.A.;
  (c) "Audit", by Mr. A. Strassl, Ministry of Finance, German Federal Republic.
VI. "Systems for measuring tax evasion", by Prof. O. Oldman, Harvard University, and Prof. D. Holland, Massachusetts Institute of Technology, U.S.A.
VII. "Harmonization at domestic level of tax administration functions", discussed by Prof. L. Illanes, O.A.S., Washington, U.S.A.
VIII. "Voluntary compliance of the taxpayer: myth or reality?", by Prof. Dr. E. Danzig, Mexico.

The International Bureau of Fiscal Documentation has been given permission to publish the official papers of this Assembly.

From a survey of 18 CIAT member countries it appeared that in 1961 9 of these countries collected more revenue via indirect taxes than through direct taxation while Colombia, Mexico and Venezuela collected more through direct taxes; in Paraguay the revenue from direct and indirect taxes were equal.[1] In 1980, 10 of these countries collected more revenue through indirect taxes, although Colombia, Mexico and Venezuela continue to collect more revenue via direct taxation.

The following tax reforms were foreseen by countries within the next years:

— *Argentina* will reduce the number of taxes and their economical disadvantages.
— *Colombia* will definitely abolish the inheritance tax.
— *Ecuador* will amend the income tax, the sales tax and the tax on services rendered.
— *The U.S.A.* will reduce gradually the tax rates applicable to individuals, by 30 percent for 1984, reducing to 50 percent the marginal rate applicable to the entire income. The distinction among items of income according to source will be also abolished.
— *Mexico* will simplify the tax structure, as well as the scope and form of each one of the taxes currently in force; it will codify the various taxes into a Federal Tax Law which will include the applicable tax rates; it will finally "globalize" the individual income, without making any distinction among the items according to source.
— *Paraguay* will implement an individual income tax that will be global and universal and will transform the sales tax into a VAT.
— *Costa Rica* will shortly implement a structural tax reform.
— *The Dominican Republic* will reform import duties.
— *Venezuela* will establish proportional rates for enterprises; create new taxes on luxury items and capital gains; establish a comprehensive VAT with few tax rates and levy a special tax on rural real property, affecting mainly large and unproductive rural land.

The next CIAT General Assembly will be held in Asuncion (Paraguay) in June 1982, under the presidency of Mr. G. Prieto Fortún, Vice-Minister of Finance of Mexico, newly elected CIAT Chairman. The main theme will be "Tax evasion and tax compliance".

1. Five CIAT members did not participate in the survey.

particularly real estate and shares of private corporations, from a non-resident to ensure that the vendor has obtained a certificate from Revenue Canada, Taxation, before the purchaser acquires the property—failing which the purchaser becomes liable to pay a certain portion of the purchase price as Canadian tax on behalf of the non-resident. To obtain a certificate, the non-resident must pay a certain portion of the price on account of the tax that he will owe or provide security for payment of the tax that is satisfactory to Revenue Canada.

The new rules require certificates to be obtained on a non-resident's disposition of a Canadian resource property and give separate treatment to the disposition of depreciable real property and other depreciable assets used in carrying on a business in Canada. Unlike the existing rules, these rules do not prescribe a percentage of the price, or of the taxable gain, that must be paid to the Canadian tax authorities in order to obtain a certificate that will protect the purchaser: in these cases, the amount that must be paid is in the discretion of the tax authorities — as always has been the case with respect to the alternative of providing adequate security, which is allowed here as well. Presumably the required amount for the non-resident vendor to pay on account of his tax will be measured having regard to the amount of the taxable gain, or recaptured depreciation, that will be realized on the sale and on any other relevant factors. If a certificate is not obtained in these cases, the purchaser may be liable to pay as much as 50 percent of the purchase price on account of the non-resident's tax, whereas the maximum liability of the purchaser in the case of non-depreciable capital property is 15 percent of the purchase price.[15]

These totally discretionary provisions and severe penalties are unfortunate and, in the event of a disagreement with the Canadian tax authorities, may make it difficult for a non-resident to complete a sale of depreciable property in Canada or of a Canadian resource property. In those cases it may become necessary for the non-resident first to roll over the assets in question to a private corporation and then to sell the shares.

IX. FOREIGN TAX CREDIT OR DEDUCTION

The rules relating to foreign taxes have been changed to deny a credit or deduction for any tax relating to income from Canadian sources that is imposed by another country on a taxpayer because he is a citizen of that country.[16] This change will prevent United States citizens who are resident in Canada from claiming credit against their Canadian tax, or a deduction in computing their income under the Canadian Act, for U.S. taxes that they must pay, because of their citizenship, on income arising in Canada.

X. NON-RESIDENT-OWNED INVESTMENT CORPORATIONS

The rules in the Canadian Income Tax Act relating to non-resident-owned investment corporations are designed to equate the Canadian tax burden imposed on a resident investment corporation owned wholly by non-residents and that imposed on non-residents who invest directly in Canada. To help achieve this result, these corporations are entitled to pay special "capital gains dividends" out of their total net capital gains, after tax, from dispositions of Canadian property. The corporation is required to file an election to that effect at or before the time when it pays such a dividend, which is then exempt from Canadian withholding tax. The new rules permit a non-resident-owned investment corporation to file a late election to designate a particular dividend that it has paid as a capital gains dividend, subject to paying a penalty depending on the amount of the delay in filing.[17]

XI. WITHHOLDING TAX

The normal Canadian withholding tax on interest paid by a resident to a non-resident is not imposed on interest payable by a resident corporation on an arm's-length obligation issued after June 23, 1975 and before 1983 if, under the terms of the obligation, the issuer cannot be required to pay more than 25 percent of the principal amount of the debt issue within the first five years that it is outstanding, except in the event of failure or default under the terms of the obligation. The new rules add a further exception if the terms of the obligation or of any related agreement become unlawful or are changed by legislation or by a court, statutory board, or commission. These events, too, may permit the lender to demand early discharge of the obligation without prejudicing the exemption of the interest payments from Canadian withholding tax.[18]

XII. THE BOUNDARIES OF CANADA

The new rules extend the geographic limits of Canada, for purposes of the Canadian Income Tax Act, to include the seas and air space above submarine areas where natural-resource exploration or exploitation is being carried out under license from the federal government or a provincial government.[19] The submarine areas themselves were included in Canada under the Act as it read before the recent amendments. This definition is relevant, for example, in applying the rules in the Act relating to source of income and differentiating exploration and development expenses incurred within and outside Canada.

15. Section 116.
16. Subparagraph 126(7)(c)(iii). See also subsection 20(12).
17. Subsections 133(7.3)—(7.6).
18. Clause 212(1)(b)(vii)(D). See also Paragraph 212(1)(s), subsections 214(3), (3.1), 215(5).
19. Section 255.

Certain technical changes have also been made to the rules applying the branch tax to non-resident insurance corporations.[9]

V. TERMINATION OF NATURAL-RESOURCE BUSINESS

The amendments provide that where a non-resident ceases to carry on the business of producing, refining, or processing natural-resource products at a fixed place of business in Canada and either does not recommence a business of this type at a fixed place of business in Canada within the same taxation year or, before recommencing any such business, disposes of a Canadian resource property, there will be a deemed realization, at fair market value, of the non-resident's Canadian resource properties as of immediately before the cessation of business. For this purpose the non-resident's taxation year is deemed to end at the cessation of business, and a new taxation year commences immediately afterward, at which time he is deemed to have reacquired his Canadian resource properties at a cost equal to their fair market value. Similar provisions apply where a non-resident is a member of a partnership that carried on such a business in Canada.[10]

The term "fixed place of business in Canada" is new to the Income Tax Act, and no definition of it is given. The term has presumably been borrowed from Canada's experience in negotiating tax treaties, particularly with the United States.

The new rules seem intended to ensure that royalties from, and gains on dispositions of, resource properties in Canada, when realized by a non-resident after terminating any business in Canada, will not escape Canadian taxation under an applicable treaty, or be entitled to more favourable taxation, because there is no permanent establishment, or fixed place of business, in Canada at the time that the income in question is considered to be realized.

VI. CORPORATE MIGRATION

For some time, the Canadian tax authorities have been concerned about the possibility that a Canadian corporation can cease to be resident in Canada, or can shift its corporate jurisdiction outside Canada, and thereby, under shelter of an applicable tax treaty, escape Canadian tax on its accrued gains and on the distribution of its retained earnings. Consequently new rules are provided for when a corporation incorporated in Canada (except a corporation that was never resident in Canada) (1) has been continued under a corporate jurisdiction outside Canada or (2) has become resident outside Canada and as a result has become exempt under a Canadian tax treaty from Canadian tax on its business or property or natural-resource income earned outside Canada. Here too there is a deemed realization at fair market value immediately before the corporate migration, but in this case the deemed realization applies to all the corporation's assets. Again the corporation's taxation year is considered to terminate immediately before the migration, and a new taxation year commences at the time of migration, and the corporation is deemed to have reacquired each of its assets immediately afterward at a cost equal to its fair market value. The resulting tax is in lieu of the "departure tax" that normally applies to the capital properties, only, of a person who ceases to be resident in Canada. As well, the corporation will never again be regarded as a "Canadian corporation" and will therefore not qualify for a number of tax preferences that are granted to Canadian corporations, to taxable Canadian corporations, or to Canadian-controlled private corporations.[11]

To deal with the retained earnings of the migrating corporation, the new rules extend the application of the Part XIV tax, which previously had been strictly a "branch tax". A 25 percent tax is imposed on the fair market value (whether realized or deemed realized) of the retained earnings of the migrating corporation as of immediately before the migration. This tax is therefore in substitution for the Canadian withholding tax that would normally have been imposed on distributions of retained earnings if the corporation had not migrated from Canada. Because of the circumstances in which this new Part XIV tax is imposed, it is unlikely that the 25 percent rate will be reduced by any treaty, and it is unlikely that the corporation will be able to claim credit for this tax in computing any tax that it must pay to its new jursidiction.[12]

VII. FOREIGN AFFILIATES

Some further changes have been made to the rules that attempt to impose appropriate levels of tax on Canadian residents with respect to passive income (known as "foreign accrual property income") earned by non-resident corporations that qualify as their "controlled foreign affiliates". Under the new rules, the foreign accrual property income of a controlled foreign affiliate will not include a foreign-exchange gain or loss on the redemption or cancellation of shares of the controlled foreign affiliate or of another foreign affiliate of the Canadian resident or on the non-arm's-length transfer of the shares of another foreign affiliate.[13] The new rules also ensure that the inclusion of the relevant portion of accrued capital gains or capital losses on a foreign affiliate's assets in the computation of foreign accrual property income on the ultimate disposition of those assets is not cut off by a non-arm's length transfer of the shares of the foreign affiliate or by its amalgamation with another corporation.[14]

VIII. NON-RESIDENT'S DISPOSITION OF CANADIAN PROPERTY

Since 1972 the Canadian Income Tax Act has required a purchaser of certain kinds of Canadian property,

9. Subsections 219(4)–(8).
10. Subsection 115(4). See also subsections 66.2(7), 66.4(7).
11. Section 88.1.
12. Section 219.1.
13. Paragraph 95(2)(h).
14. Paragraph 95(2)(f).

III. EMPLOYEE TRUSTS AND EMPLOYEE BENEFIT PLANS

The new amendments attempt to deal with cases where deferred compensation is provided for employees in a form other than a deferred-income plan — such as a registered pension plan or a deferred profit sharing plan — of a type that is specifically recognized in the Income Tax Act. Under an "employee trust", an employer now obtains a current deduction as amounts are contributed to the trust, and the employee-beneficiaries are immediately taxed on those contributions, as well as on investment income currently earned by the trust, even though the employees' enjoyment of these amounts is deferred. Under an "employee benefit plan", the employees are not taxable until they receive benefits from the plan, but the employer is not able to deduct his contributions to the plan until that time. Thus in each case the timing of the employer's deduction is matched to the timing of recognition of benefits as income to the employees.

The rule postponing the deduction of employer contributions to employee benefit plans does not apply, however, where a contribution is made to such a plan in respect of an employee who is not resident in Canada and is regularly employed outside Canada and does not relate to services that the employee has performed, or will perform, while he was or will be resident in Canada. The rule also does not apply if the custodian of the plan is not resident in Canada and the contribution in question is made in respect of an employee who either (1) was not resident in Canada at the time or (2) was resident in Canada for not more than 36 out of the 72 months preceding the date of the contribution and was a beneficiary under the plan before becoming resident in Canada — providing that, in either such case, the contribution does not relate to services that the employee has performed, or will perform, while he was or will be resident in Canada otherwise than during the temporary period just referred to.[2]

As well, the rules requiring a person to include in his employment income any current benefits that he received under an employee benefit plan do not apply to a pension benefit relating to services performed by an employee when he was not resident in Canada.[3] Pension benefits paid by a resident in Canada to a non-resident are not subject to Canadian withholding tax to the extent that they relate to services performed by an individual when he was not resident in Canada and when he was not employed, or was only occasionally employed, in Canada.[4]

Payments by a Canadian resident to a non-resident under an employee benefit plan or an employee trust are not subject to Canadian withholding tax;[5] contributions to, and investment income earned by, an employee trust would already have been taxed to the employee-beneficiaries; and benefits to a non-resident under an employee benefit plan, if not exempt under the rule previously mentioned, would be taxed to him as income from employment in Canada, which would be subject to graduated rates of Canadian income tax in accordance with the same tax rate table that applies to resident individuals, rather than a flat-rate withholding tax.[6]

IV. BRANCH TAX

For some years, what is now Part XIV of the Canadian Income Tax Act has imposed an additional tax at a rate that is now 25 percent (or such lesser rate as is provided for in an applicable tax treaty) on the profits earned by an unincorporated Canadian branch of a non-resident enterprise, to the extent that these profits cannot be regarded as having been reinvested in Canadian business assets. This tax was designed to equate, approximately, the total Canadian tax burden to a foreign enterprise of carrying on business in Canada through a branch with that of carrying on business in Canada through a subsidiary corporation incorporated in Canada; in the latter case, Canadian withholding tax would apply on dividends remitted to the non-resident owner.

The recent amendments address the effect on the branch tax of the subsequent incorporation in Canada of such a branch and the transfer to a new wholly owned subsidiary corporation, on a rollover basis in exchange, or partial exchange, for shares of the corporation, of Canadian business assets (other than real estate) that had been used by the branch. In that case the non-resident parent will be subject to the "branch tax" on any excess of the total fair market value of any "boot" received on the transfer plus the paid-up capital of the shares received on the transfer over the price (probably tax values) that was elected to apply to the transfer of these assets for tax purposes.[7] If unrealized growth in the value of business assets can be repaid to the non-resident owner in the form of "boot" or a return of the paid-up capital of the subsidiary's shares, what otherwise would be subject to branch tax (if the branch had not been incorporated) on realization, or to withholding tax on dividends (if the realization had occurred after incorporation of the branch and if the total of the "boot" and of the paid-up capital of the shares issued in exchange had not exceeded the tax value of the transferred assets) would be transformed into a capital gain on disposition of the redeemed shares, which might escape Canadian tax because of an exemption of capital gains under an applicable tax treaty.

On the other hand, where the total of the "boot" and paid-up capital of shares issued in exchange is less than the elected value of the transferred assets for tax purposes, the deficiency is deducted from what otherwise would be the base for paying branch tax for the year in question and is also deducted from what otherwise would be the cost base of those shares to the non-resident owner. If the non-resident enterprise is subject to Canadian tax on capital gains, the latter deduction will limit the amount of any capital loss, or increase the amount of any capital gain, on the subsequent disposition of the subsidiary's shares.[8]

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2. Subsection 18(10).
3. Subparagraph 6(1)(g)(iii).
4. Paragraph 212(1)(h).
5. Subsection 212(17).
6. Paragraphs 2(3)(a), 6(1)(g).
7. Paragraphs 219(1)(a.4), (k).
8. Subsection 52(7).

Recent Canadian Income Tax Amendments: International Aspects

by Edwin C. Harris *

I. INTRODUCTION

The enactment by the Canadian Parliament early in 1981, of Bill C-54, amending the federal Income Tax Act, finally put into effect the efforts of two successive governments to update and alter the Act. The amendments include, with some important modifications, tax changes proposed by the Progressive Conservative government in its budget of December 1979 as well as by the Liberal government in its budget of October 1980. Depending on when the amendment in question was first announced or was last significantly modified, the effective dates of the changes vary (with some exceptions) between October 1979 and January 1981.

The main thrust of these changes affects the purely domestic aspects of the Canadian income tax system. Nevertheless, there are some significant changes to the rules relating to international transactions, and these changes will be briefly summarized in this article.

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II. EMPLOYMENT OF CANADIANS ABROAD

In recent years the Canadian tax administration has extended its view of the scope of the residence of an individual under the Income Tax Act. When an individual is found to be resident in Canada, he is subject to Canadian tax on his world income. In a revision issued in May 1980 to its Interpretation Bulletin IT-221, "Determination of an Individual's Residence Status", Revenue Canada, Taxation, administratively adopted the view that "[w]here a Canadian resident is absent from Canada (for whatever reason) for less than 2 years, he will be presumed to have retained his residence status while abroad, unless he can clearly establish that he severed all residential ties on leaving Canada." This administrative change meant that many Canadian who moved to other countries for periods of between six months and two years to work on international development contracts would continue to be subject to Canadian tax on their entire income earned during the period of their stay outside Canada. It was claimed that this administrative attitude put Canadian engineers and other consultants at a competitive disadvantage in bidding for contracts of this nature.

The new amendments offer some limited relief. A resident individual who works outside Canada for more than six consecutive months will now be exempt from Canadian tax, in certain cases, on up to $50,000 per annum (reduced proportionately where the qualifying employment is for less than the full calendar year in question) or 50 percent of the qualifying employment income earned in the year while resident in Canada — whichever is less. To qualify for this exemption, an individual must be employed by a Canadian resident, a partnership in which one or more Canadian residents have more than a 10 percent interest, or a non-resident corporation that qualifies as a "foreign affiliate" of a Canadian resident. The contract must relate to exploration of natural resources or a construction, installation, agricultural, or engineering activity or any other activity to be prescribed by Regulation to the Act.[1]

Thus a Canadian resident individual who worked on such a contract for a full calendar year and was paid $100,000 or more for that year would be exempt from Canadian tax on $50,000 of that income. It will still be worthwhile, however, for individuals working on contracts of this type in countries that impose little or no tax on this employment income to attempt to establish that they have ceased to be resident in Canada. In that case the major obstacle will be the new views of Revenue Canada, Taxation, on the scope of the concept of residence in the case of individuals.

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1. Income Tax Act subsections 6(10), (11).

F. The Foreign Tax Law (Aussensteuergesetz)

This law was introduced in 1972 and aims at safeguarding a German tax claim in specific international situations.

It provides for:

- the application of the "dealing at arm's length" principle in the case of internationally affiliated companies;
- the introduction of "extended limited tax liability" for individuals that emigrate from the Federal Republic of Germany to low tax countries but maintain substantial economic interests in the Federal Republic of Germany, i.e. those individuals are subject to a greater tax burden than in the case of "normal" non-residents;
- the taxation of individuals with major stockholdings in German corporations in the event of emigration;
- the taxation of the income of German-dominated foreign-based companies based in low-tax countries; and
- the taxation of the income and net wealth of certain foreign-based family foundations in which German taxpayers have an interest.

FINAL REMARK

The tax system (plus the social security system) of the Federal Republic of Germany is one of the most complex schemes that can be found. But there is substantial ground for doubt whether it actually provides, in all instances, the appropriate tools the Government needs to cope with the economic and social problems the country is facing these days. Indeed, it appears that its complexity and scope constitute major obstacles to achieving the desirable policy goals. It will be necessary in the future to keep the door open to fresh ideas which, although they may lead into areas which were previously taboo (and also outside the scope of the article), will ensure the accessibility of otherwise unavailable reasonable possibilities for solutions.

of the premium ranging from 10 to 40 percent, depending on the kind of investment).

As far as the *individual/corporate income tax is concerned*, a tax rebate of up to 30 percent is available. Employees may claim specific allowances in addition to the rebate.

B. The Border Area Promotion Law (Zonenrandförderungsgesetz)

Investments in commercial activities that are carried on in the area of the Eastern frontier of the Federal Republic of Germany may, for the purpose of taxes on income and profits, benefit from a "special depreciation", the rate of which is 40 or 50 percent depending on the kind of investment (see also C. below).

C. The Investment Premium Law (Investitionszulagengesetz)

Investments in commercial activities may benefit from an investment premium if the investments are made in an area which is defined as a promotion area, and if they are regarded as being beneficial for the national economy. Investment premiums are also available for certain investments in the fields of:
— research and development; or
— energy production or redistribution.

The actual premium amounts to:
— 10 percent for investments in border areas (see B. above);
— 8.75 percent for investments in other promotion areas;
— 20 or 7.5 percent, as the case may be, for investments in the fields of research and development;
— 8.75 percent for investments in the field of diversification of energy production.

D. The Law Promoting Investment Abroad (Auslandsinvestitionsgesetz)

In order to facilitate investments by German enterprises in foreign countries, the Law Promoting Investment Abroad provides a number of relief measures.

The following is a very brief description of some of the major provisions.

(i) Creation of profit-deductible reserves in case of the transfer of certain items

Where a taxpayer transfers items that belong to the fixed assets of this German-based enterprise into a corporation, partnership or permanent establishment abroad, he may create in the year of the transfer a reserve up to the amount that represents the profit resulting from the dissolution of hidden reserves contained in the item being transferred.

After a dissolution free period of five years, the reserve must be dissolved, i.e. added back to the profit in equal annual installments over five years.

(ii) Consideration of losses of foreign-based permanent establishments or partnerships

Where a tax treaty provides for the exemption of the income of a foreign-based permanent establishment or partnership of a German taxpayer from tax, no consideration of its losses (i.e. negative income) would normally be possible in Germany. However, this law enables the German taxpayer to request that such losses be taken into consideration.

(iii) Consideration of losses of foreign-based subsidiary companies

Where a German taxpayer holds a certain percentage of the equity capital of a foreign corporation which suffers losses, a reserve may be created for these losses.

(iv) Transfer of hidden reserves as contained in a shareholding

The Law Promoting Investment Abroad also provides enterprises with the possibility to transfer hidden reserves as contained in their share to the equity capital of a corporation — in the case of disposal — into a newly acquired share in the equity capital of a foreign corporation.

These reliefs are available only if a large number of conditions are satisfied.

E. The Developing Countries Tax Law (Entwicklungsländersteuergesetz)

In order to encourage German enterprises to invest in developing countries, the Developing Countries Tax Law has been introduced offering certain relief measures.

Basically, where a German-based enterprise invests in a developing country, it may create a reserve which is calculated as a percentage of the capital invested. The actual amount of the reserve depends on various factors, including the "status" of the developing country in which the investment takes place. In least developed countries it is calculated as 100 percent of the capital invested; in the remaining developing countries it is 40 to 60 percent.

The law further provides that the reserves must be dissolved, beginning with the sixth year after their creation, in annual installments of generally one-twelfth of the reserve. Since the amount resulting from the dissolution of the reserves must be added to domestic West German income, this measure represents a rather generous tax respite for German enterprises. Moreover, a benefit can be reaped where certain business assets, particularly self-developed intangible assets containing hidden reserves, are being transferred.

As far as the taxes which are unrelated to profits are concerned, the law prescribes that for the net wealth tax (Vermögensteuer) and the relevant part of the business tax (Gewerbekapitalsteuer) the amount of the created reserve may be deducted from the taxable base (net worth).

(iii) Tax rates

The tax rates also depend upon the degree of consanguinity of the heirs/donees, as follows:

Taxable transaction (taxable base)		Applicable rate of tax Category I	II	III	IV
up to	50,000	3	6	11	20
	75,000	3.5	7	12.5	22
	100,000	4	8	14	24
	125,000	4.5	9	15.5	26
	150,000	5	10	17	28
	200,000	5.5	11	18.5	30
	250,000	6	12	20	32
	300,000	6.5	13	21.5	34
	400,000	7	14	23	36
	500,000	7.5	15	24.5	38
	600,000	8	16	26	40
	700,000	8.5	17	27.5	42
	800,000	9	18	29	44
	900,000	9.5	19	30.5	46
	1,000,000	10	20	32	48
	2,000,000	11	22	34	50
	3,000,000	12	24	36	52
	4,000,000	13	26	38	54
	6,000,000	14	28	40	56
	8,000,000	16	30	43	58
	10,000,000	18	33	46	60
	25,000,000	21	36	50	62
	50,000,000	25	40	55	64
	100,000,000	30	45	60	67
above	100,000,000	35	50	65	70

Note: Taxable transactions carried out within 10 years are cumulative.

(3) Capital taxes (Kapitalverkehrsteuern)

(a) Capital duty (Gesellschaftsteuer)

(i) Scope

Subject to this tax are the acquisition of shares in domestic corporations (Kapitalgesellschaften) on the occasion of their creation, or an increase in capital at later stages. Certain exceptions exist, mainly with respect to public companies.

(ii) Taxable base

The taxable base is the consideration paid or the value of the shares acquired.

(iii) Tax rate

The tax rate is 1 percent, reduced in certain specific cases to 0.5 percent.

(b) Stock exchange turnover tax (Börsenumsatzsteuer)

(i) Scope

The transfer of securities, such as shares and debt instruments, is subject to this tax. Certain exceptions exist.

(ii) Taxabe base

The taxable base is the consideration paid or the value (usually fixed at the stock exchange) of the securities transferred.

(iii) Tax rates

The tax rate is 0.1 percent in the case of debt instruments, and 0.25 percent in the case of shares (general rule).

(4) Other registration taxes and license duties

The West German tax system includes a large number of registration taxes and license duties which may be levied at the Federal, State, District or Municipal level. The following is a list of the better known ones, but it must be emphasized that this list is not complete and that these taxes and duties may not be levied in certain states, municipalities, etc. They include:

— motor vehicle tax (KFZ Steuer);
— bill of exchange tax (Wechselsteuer);
— insurance tax (Versicherungsteuer);
— racing and lottery tax (Rennwett- und Lotteriesteuer);
— fire protection tax (Feuerschutszsteuer);
— entertainment tax (Vergnügungsteuer);
— hunting tax (Jagdsteuer);
— dog tax (Hundesteuer).

II. THE "DIVERSIFIED" TAX LAWS

The "ordinary" tax laws described in Section I above are all concerned with the levying of a certain type of tax.

In addition to these laws, the German tax system contains another type of tax law which is referred to here as a "diversified" tax law.

The most significant feature of these laws is that, broadly speaking, they do not constitute a separate liability to tax, but do affect the "ordinary" tax laws in one way or another. In other words, their provisions influence the *tax liability, the taxable base, the tax rate, the amount of tax due, etc.* of the taxes levied under the "ordinary" tax laws.

The following is a very brief description of the most important "diversified" tax laws:

A. The Berlin Promotion Law (Berlinförderungsgesetz)

The Berlin Promotion Law offers a wide range of incentives to Berlin-based enterprises/individuals which affect many "ordinary" taxes. As regards the *turnover tax*, a Berlin-based entrepreneur may claim a reduction in the applicable tax rate for the supply of goods and the rendering of services to entrepreneurs in West Germany. Entrepreneurs based in West Germany may also claim a reduction in turnover tax for items received from a Berlin-based entrepreneur.

As regards *taxes that generally concern income and profits*, a great variety of relief measures is offered. They include, for example, accelerated depreciation for specific fixed assets of an enterprise, accelerated depreciation for the construction of dwellings, a tax rebate for the granting of specified loans to Berlin-based debtors, and an investment premium for certain investments (the rate

Note: It must again be emphasized that this is only a general presentation. In actual fact, the German social security system is extremely sophisticated and littered with exceptions and specific provisions.

B. Indirect taxes

In the Federal Republic of Germany, two categories of indirect taxes are levied: the turnover tax (Value Added Tax) and a great number of excise taxes.

(1) Turnover tax/Value Added Tax (Umsatzsteuer)

Since 1968, the Value Added Tax has been levied as the German turnover tax; the underlying law (Umsatzsteuergesetz) has been adapted in accordance with the various directives of the EC.

(i) Scope

The turnover tax is a non-cumulative tax which is levied whenever a taxable transaction takes place.

An entrepreneur is entitled to a credit for the amount of tax shown in his suppliers' invoices or paid at importation. The tax is levied on the supply of goods, on the rendering of services, on private use, and on importation of goods. Small enterprises may benefit from special treatment.

(ii) Taxable base

The taxable base is the consideration paid (supply of goods; rendering of services), the value of the withdrawal (private use), and the customs value (importation), all excluding the turnover tax.

(iii) Tax rates

Standard rate: 13 percent.
Reduced rate (for essentials): 6.5 percent.

(2) Excise taxes

The West German tax sytem includes a large number of excise taxes. For practical reasons, they are usually levied at the producers' level. The recipient of the revenue from excise taxes is the Federal government (except the beer tax, which is levied by the States). Excise taxes include the following:

— mineral oil tax (Mineralölsteuer);
— tobacco tax (Tabaksteuer);
— coffee tax (Kaffeesteuer);
— tea tax (Teesteuer);
— spirits tax (Alkoholsteuer);
— sparkling wine tax (Schaumweinsteuer);
— bear tax (Biersteuer);
— sugar tax (Zuckersteuer).

C. Registration taxes and license duties

There is a great variety of registration taxes and license duties in the Federal Republic of Germany, which are either levied by the Federal Government, the States or the Municipalities. The following list contains only those levies which are of some significance in terms of their revenue yield.

(1) Real property transfer tax (Grunderwerbsteuer)

(i) Scope

Transactions in real property are subject to the real property transfer tax (Grunderwerbsteuer). It must, however, be noted that there are many exceptions, which differ from State to State.

(ii) Taxable base

The taxable base is the consideration paid for or the value of the real property being transferred.

(iii) Tax rate

The real property transfer tax is generally levied at the rate of 7 percent.

(2) Inheritance and gift tax (Erbschaft- und Schenkungsteuer)

(i) Scope

Transfers (acquisitions) of property by cause of death and inter vivos gifts are subject to inheritance and gift tax (Erbschaft- und Schenkungsteuer). Also, the capital of a family foundation is subject to this tax once every 30 years.

The person liable to the tax is the recipient of the transferred property. A distrinction must be made between *resident* and *non-resident* recipients. For purposes of this law, the term *resident* is more broadly defined than in the individual income tax law. Tax liability arises where either the deceased/donor *or* the recipient is a *resident* at the time the taxable transaction occurs, and the entire property is subject to tax wherever it is situated. *Non-residents* are subject to the tax if the property transferred is situated in Germany (see also "net wealth tax", supra), and the tax is imposed on the share which each recipient receives.

(ii) Taxable base

The taxable base is the value of the property as determined in accordance with the principles of the Valuation Law (see also "net wealth tax", supra).

Debts, etc. are considered in the calculation of the taxable base. Numerous and varying exempt amounts are provided for specific items, such as household items, etc., as well as certain personal exemptions.

The actual exempt amounts depend on the degree of consanguinity of the heirs/donees. In this regard, a distinction is made between the following four categories:

Category	*Consanguinity*	*Exempt amount (DM)*
I	spouses	250,000
	children	90,000
II	grandchildren	50,000
III	parents; brothers/sisters; nephews and nieces; parents-in-law; divorcees, etc.	10,000
IV	others	3,000

(ii) Taxabe base

The trade tax is based upon two factors:
— the business yield (Gewerbeertrag); and
— the business capital (Gewerbekapital).

The business yield is calculated according to the principles of the Individual/Corporate Income Tax Law, subject to certain adjustments. The business capital is calculated according to the principles of the Valuation Law (assessed value), but subject to certain adjustments.

After the adjustments have been made, the "uniform assessment amount" (einheitlicher Steuermessbetrag) is calculated as follows:
— the *adjusted business yield* is multiplied by the assessment rate of 5 percent;
— the *adjusted business capital* is multiplied by the assessment rate of 0.2 percent.

Businesses which are carried on by individuals or partnerships are entitled to an exempt amount of 36,000 DM with respect to the business yield, and 120,000 DM with respect to business capital; the latter exempt amount also applies to corporations. (Until 1979, a third factor had been employed in determining the basis for the trade tax in a number of municipalities, namely, the payroll trade tax. This tax was, however, abolished as of January 1, 1980.)

(iii) Tax rate

Since every municipality is more or less free to determine its own "multiple" (Hebesatz), there is no uniform trade tax burden in the Federal Republic of Germany.

The actual tax rate is arrived at by multiplying the "uniform assessment amount" by the "multiple".

It appears that, generally speaking, the average trade tax burden amounts to about 15-20 percent, depending upon the "multiple" chosen by the municipality.

(5) Real property tax (Grundsteuer)

(i) Scope

Real property (land and buildings) situated in Germany is the subject of the real property tax (Grundsteuer). Certain exemptions are provided, sometimes for a limited period of time only, in the case of real property owned by the public, and of real property that serves specific purposes (dwellings).

This tax is a municipal tax, although it is assessed according to Federal legislation (see, however, "tax rates" below). The amount of tax due is a deductible expense for purposes of the corporate/individual income tax.

(ii) Taxable base

This tax is levied upon the value of real property as determined according to the rules of the Valuation Law. This value is multiplied by the assessment rate (which depends upon the kind of real property; generally between 0.26 percent to 0.6 percent); the result is referred to as the assessment amount (Steuermessbetrag).

(iii) Tax rate

Every municipality is more or less free to determine its own "multiple" (Hebesatz), so the actual tax burden varies from municipality to municipality.

(6) Church tax (Kirchensteuern)

Individuals who are members of an officially recognized religious community are subject to the church tax.

The church tax falls under the legislative competence of the individual States of the Federal Republic of Germany. The taxable base is usually the income of an individual; it is, however, possible that another base can be chosen (e.g. net wealth; real property).

As a general rule, the usual burden of the church tax (on income) is between 8 and 9 percent of the amount of income tax due. Relief is provided for individuals with children.

The church tax is usually levied together with the individual income tax.

(7) Social security contributions (Sozialabgaben)

Although in the Federal Republic of Germany social security contributions are not regarded as taxes, they are very briefly described here since their payment is, in most instances, required by law.

The most important contributions include the payments to the *statutory employee pension insurance* (gesetzliche Rentenversicherung), to the *statutory health insurance* (gesetzliche Krankenversicherung) and to the *statutory unemployment insurance* (gesetzliche Arbeitslosenversicherung).

(i) Common features are as follows:

— generally speaking, all individuals who receive *income from dependent employment* are subject to these contributions;
— the contribution is borne by the employer and the employee equally;
— certain part-time employments and low salary employments are exempt from social security contributions.

(ii) Individual features of the different insurances (rates and figures applicable for 1981, possibly subject to change) are as follows:

— *Statutory employee pension insurance*
The rate is 18.5 percent on gross salary; the maximum amount subject to this contribution is fixed at 4,400 DM per month (52,800 DM per annum).
— *Statutory health insurance*
Since the statutory health insurance is organized regionally, there is no uniform rate. However, it amounts in general to between 10 and 13 percent of gross salary; the maximum amount of income subject to this contribution is fixed at 3,300 DM per month (39,600 DM per annum).
— *Statutory unemployment insurance*
The rate is 3.0 percent on gross salary; the maximum amount of income subject to this contribution is fixed at 4,400 DM per month (52,800 DM per annum).

EXAMPLE ILLUSTRATING THE IMPUTATION SYSTEM OF THE FEDERAL REPUBLIC OF GERMANY

A German-based corporation receives and distributes income
— simplified survey —

(I) Taxation of the German corporation

(a)	*Foreign-source income* (after foreign taxes)		100	
(b)	German corporate tax thereon (assumption made: income is exempt by virtue of a tax treaty, thus no German tax)		—	100
(c)	*German-source income*		100	
(d)	German corporate tax thereon (56 percent of (c))		56	
(e)	German-source income after tax			44
(f)	Distribution of the *maximum amount of income* possible (the tax rate for distributed income amounts to 36 percent):			
(g)	— foreign-source income		100	
(h)	*minus* tax on distribution (36 percent on (g))		36	64
(i)	— German-source income (net of tax)		44	
(k)	*plus* tax refund due to the lowering of the tax from 56 percent down to the 36 percent	56		
	tax on distributions	36	20	64
(l)	*Gross dividend ((h) plus (k))*			128
(m)	Dividend withholding tax (25 percent of (l))			32
(n)	Net dividend ((l) minus (m))			96

(II) Taxation of the shareholder

(A)	*Shareholder is a resident of the Federal Republic of Germany*			
(1)	Net dividend		96	
(2)	*plus* dividend withholding tax (m)		32	
(3)	*plus* imputation credit (i.e. refund of tax on distribution; 9/16 of (l))		72	
(4)	Gross amount of dividend (subject to individual/corporate income tax in the hands of the resident shareholder)			200
(B)	*Shareholder is not a resident of the Federal Republic of Germany* (assumption made: there is a tax treaty between the non-resident's home country and the Federal Republic of Germany)			
(i)	Net dividend		96	
(ii)	*plus* refund of German dividend withholding tax according to the tax treaty * (difference between 25 and 15 percent = 10 percent of (l))		12.8	
(iii)	refund of corporate income tax * (h)	36		
(iv)	*minus* 15 percent dividend withholding tax (from (iii); procedure see (ii))	5.4	30.6	
(v)	Gross amount of dividend (after German taxes)			139.4

* *Note:* The underlying philosophy of West German tax law is that German-source income should be taxed once in the Federal Republic of Germany. Consequently: — the imputation credit is not granted to non-residents for the corporate income tax on German-source income; however, — the German corporate income tax levied on foreign-source income, which is either exempt by virtue of a tax treaty or which has borne a foreign tax burden, that is equivalent to the West German tax burden, is refundable. The refund itself is, however, subject to the dividend withholding tax at the rate of 25 percent, which may be lowered to 15 percent by virtue of a tax treaty. (The assumption that there is such a tax treaty has been made in the example above.)

The address of the competent authority for the refund of both the dividend withholding tax (see (ii) above) and the corporate income tax (see (iii) and (iv) above is:
Bundesamt für Finanzen
Koblenzer Strasse 63-65
D 5300 Bonn 2

(iii) Tax rates

Net wealth tax is levied annually at the following flat rates:
(a) in the case of corporations: 0.7 percent.
(b) in the case of individuals: 0.5 percent.

Non-residents

Non-resident individuals and corporations are subject to "limited tax liability" (i.e. taxation of domestic (German) property). It should be noted that the taxation of "domestic property" in the case of non-residents is not 100 percent identical with that of net wealth in the case of residents. In particular, no exempt amounts are available for non-resident individuals.

Debts may be deducted only if they are directly related to domestic property.

Nevetheless, taxation of a non-resident's domestic property will take place only if it amounts to at least 20,000 DM (for both individuals and corporations). The tax rates are identical to those for residents, i.e. 0.5 percent for individuals and 0.7 percent for corporations.

(4) Trade tax (Gewerbesteuer)

(i) Scope

All domestic establishments, regardless of their legal status, are subject to the trade tax (Gewerbesteuer). This tax is basically a municipal tax, although it is assessed according to the Federal legislation (see, however, "tax rate" below). The amount of trade tax due is a deductible expense for purposes of the corporate/individual income tax.

place of management within the German domestic territory are subject to "unlimited tax liability" (i.e. taxation of world-wide income). The existence of a seat or place of management is determined according to the principles of the Fiscal Code (Abgabenordnung 1977).

(ii) Taxable base

In theory, the income of resident corporations is calculated according to the principles that apply to individuals. In practice, the income of corporations consists basically of income from business (see box "Determination of income"). In addition, the following expenditures may be claimed as business expenses:

- certain costs incurred in the course of an issue of stock to the extent that the expenses exceed the premium;
- expenditures for the advancement of charitable, religious, and scientific purposes or for the general public welfare, up to a maximum of:
  - 10 percent of income for scientific purposes;
  - 5 percent of income for other purposes; or
  - 0.2 percent of total turnover plus wages and salaries paid.

Non-deductible expenditures include:

- payments of corporate income and net wealth tax;
- one-half of any payments made to members of the supervisory board.

(Regarding losses, see box "Determination of income".)

(iii) Tax rates

The general corporate income tax rate is 56 percent. Where profits are distributed, the rate is reduced to 36 percent ("distribution burden"). This rate constitutes — at the same time — the "imputation credit", i.e. it is creditable against the income tax liability of resident shareholders after having been included in their taxable base (see also box "Example"). There are, however, certain exceptions to this rule.

Non-residents

Corporations that have neither their *seat* nor *place of management* within the domestic territory of Germany are subject to "limited tax liability" (i.e. taxation of German-source income). To determine whether or not there is a corporation in the sense of the Corporate Income Tax Law, the criteria of German law must be employed.

As far as the determination of the taxable base is concerned, it must be noted that the classification of income takes place by following the individual income tax rules ("isolating approach"). In other words, a non-resident corporation may have income from the various sources as defined in those rules (see also the sections on the taxation of non-resident individuals).

The applicable tax rates for non-resident corporations are as follows:

- income from a domestic (German) branch: 50 percent;
- income taxed by way of withholding tax: see under individual income tax, subsections (c) and (d) supra;
- income taxed by way of assessment: 56 percent.

It should be noted that non-resident corporations are not entitled to the imputation credit for dividends. Where, however, dividends are fully or partly paid out of profits the origin of which is foreign rather than German, the German corporate income tax levied thereon (i.e. the distribution burden of 36 percent) is refundable (see box "Example").

(3) Net wealth tax (Vermögensteuer)

Similar to the concept of income taxation, West German tax law provides for the separate taxation of the net wealth of individuals and corporations.

The amount of tax due is not a deductible expense for purposes of the corporate/individual income tax.

Residents

(i) Tax liability

Individuals and corporations *resident* in the Federal Republic of Germany are subject to "unlimited tax liability" (i.e. taxation of world-wide net wealth).

The same principles as those established for purposes of the individual and corporate income tax are used to determine the residence of the taxpayer.

(ii) Taxable base

Residents are subject to net wealth tax on their worldwide net wealth as determined in accordance with the rules of the Valuation Law (Bewertungsgesetz).

The valuation law distinguishes four types of property:

- *agricultural and forestry property:* the value is determined by capitalization of the average yearly earnings;
- *real property:* the value is determined on the basis as established for January 1, 1964 plus an additional 40 percent;
- *business property:* the value is determined on the basis of *gross capital* minus debts. A special capital balance sheet must be prepared which is not identical with that for income tax purposes. In certain cases, a relief is granted for business property abroad;
- *other property* (e.g. assets such as shares, bonds, capital claims, etc.): the value is usually determined according to the market price. With respect to a great number of items, exempt amounts are provided for and/or they are taken into consideration only if their value exceeds a certain amount.

Taxation of net wealth will take place only where the calculation of the total net wealth is:

(a) in the case of resident corporations, at least 20,000 DM;
(b) in the case of resident individuals,[1] the remainder after the deduction of exempt amounts. The basic exempt amount is 70,000 DM for a single person, 140,000 DM for married persons and, generally, 70,000 DM for each child under the age of 18. Further exempt amounts are granted in specific cases.

1. With respect to the net wealth tax, "family assessment" is the general rule (as opposed to the individual income tax, where children are taxed separately).

(c) Capital yield tax (Kapitalertragsteuer)

The capital yield tax is a withholding tax levied at source under the individual income tax law rules. Dividends and similar profit distributions made by corporations are subject to this tax. The rate of the tax is 25 percent; where the payor bears the tax, it amounts to 33 1/3 percent.

Resident taxpayers may credit the capital yield tax against their individual or corporate income tax liability, whichever is appropriate. For *non-resident* taxpayers, the levying of this tax constitutes — from the German point of view — a final tax unless a refund may be claimed due to a tax treaty.

(d) Coupon tax (Kuponsteuer)

The coupon tax is a withholding tax levied at source according to the individual income tax law rules. Payments of interest for debentures and loans to *non-residents* from a resident payor (debtor) are subject to this tax. The rate of the tax is 25 percent.

From the German point of view, the levying of this tax constitutes a final tax unless the taxpayer can claim a refund under a tax treaty.

Determination of income

German tax law provides for two methods that may be applied in the determination of income:

(a) The "excess of receipts over expenditures" method, to be applied with respect to income from dependent employment, income from capital, income from rental and leasing, and income from other sources. Income (i.e. excess of receipts over expenditures) is determined by making a comparison of receipts on one side and expenditures (i.e. income-connected expenses, such as maintenance costs, etc.) on the other. However, capital expenditures are not as such deductible, but may be — in cases provided for by the law — amortized by way of depreciation.

(b) The "profit" method, to be applied with respect to income from agriculture and forestry, business, and self-employment. Profit is determined by making a comparison between the capital at the beginning and at the end of the year.

Liberal professions (= self-employment) and certain small businesses may opt for the "excess of receipts over expenditures" method described under (a) above. For businesses that are registered in the German Commercial Register this exception does not apply, since they are required by the Commercial law to keep records and regularly prepare balance sheets.

As regards income from agriculture and forestry, specific rules exist for the computation of income. The rules that are established for the computation of profits from business under the Individual Income Tax Law also apply to corporations, since the Corporate Income Tax Law has adopted these rules.

The following are some basic principles as regards the computation of profits:

- business expenses can only be deducted if they arise in the course of the business;
- every item in the business must be valued separately (certain exceptions exist);
- items acquired must be valued at their acquisition cost (i.e. total costs, including indirect costs);
- the acquisition cost of capital assets forms the basis for the deduction for depreciation; the following are the most important depreciation methods:
  - *straight-line depreciation* (general rule);
  - declining balance depreciation (must not exceed 2.5 times the straight-line method; maximum depreciation rate in any case is 25 percent);

  (Note: Where it is found that the value of any asset is lower than that established in the balance sheet under general rules, depreciation down to the "going concern value" — Teilwertabschreibung — may be claimed.)
- a tax-free reserve may be created for extraordinary price increases or wide price fluctuations on world markets for certain current assets;
- in the course of a business, capital gains are included in ordinary business income, although certain relief measures are provided for in certain cases;
- losses may be carried forward for five years (no limitation with respect to the amount) and carried back for one year (limit 5,000,000 DM).

Note: For specific incentives etc. available, see Sec. II, "The "diversified" tax laws", infra.

(2) Corporate income tax (Körperschaftsteuer)

Although the Federal Republic of Germany has applied a full imputation system since 1977, the corporate income tax (Körperschaftsteuer) is levied independently from the individual income tax on the profits of corporations.

Residents

(i) Seat and tax liability

Corporations (i.e. companies such as stock corporations (AG); partnerships limited by shares (KGaA); limited liability companies (GmbH); as well as various other legal and economic formations) that have their *seat* or

(married persons) are tax exempt (Grundfreibetrag);
- the income exceeding these figures up to 18,000 DM (single persons) and 36,000 DM (married persons) is taxed at a uniform rate of 22 percent;
- the income exceeding 18,000 DM up to 130,000 DM (single persons) and 36,000 DM up to 260,000 DM (married persons) is taxed at a progressive rate that ranges from 22 to 56 percent;
- the income exceeding 130,000 DM (single persons) and 260,000 DM (married persons is taxed at a uniform rate of 56 percent.

Thus the following tax burdens apply to the following amounts:

Taxable amount of income	*Tax due from single persons (basic rate table)*		*Tax due from married persons (split rate table)*	
DM	DM	%	DM	%
5,000	166	3.3	—	—
10,000	1,271	12.7	332	3.3
20,000	3,496	17.5	2,542	12.7
50,000	15,096	30.1	9,748	19.5
100,000	41,236	44.2	30,138	30,1
200,000	97,141	48.61	82,472	44.2
300,000	153,146	51.1	138,278	46.1
400,000	209,150	52.3	194,282	48.6
1,000,000	545,147	54.5	530,310	53.0

It should be noted that a special rate may apply (e.g. for certain kinds of extraordinary income).

Non-residents

Individuals who do not maintain their domicile or habitual place of abode within the domestic territory of Germany are subject to "limited tax liability" (i.e. taxation of German-source income).

It must be noted that the definition of the source of income in the law is not 100 percent identical as far as "unlimited" vis-à-vis "limited" tax liability is concerned.

Business expenses and income-connected expenses may be deducted only if they are directly related to the income in question.

As far as "special expenses" are concerned, non-residents cannot claim the same deductions that residents are entitled to (although certain reliefs are provided for in the case of income from dependent employment; see under wage tax below).

The deduction of "extraordinary expenses" is likewise not possible. Nor are non-residents eligible for the same personal exemptions as residents. They may, however, deduct a special exempt amount of 840 DM, provided that the tax is not paid by way of withholding, but rather by way of assessment at the ordinary rate (i.e. "basic table"). In the case of non-residents, however, the usual method of levying the individual income tax is by way of a flat rate withholding tax which represents, from the German point of view, a final tax (unless a refund may be claimed under a tax treaty).

Some important examples of the flat rates of withholding applied to non-residents are:
- 30 percent on payments to members of a corporate supervisory board (42.85 percent if the payor bears the tax);
- 25 percent on royalty payments (33.5 percent if the payor bears the tax).

For the taxation of dividends and interest, see subsections (c) and (d) infra, respectively.

Note: With the introduction of the "Aussensteuergegesetz" of 1972, a third kind of tax liability has been created; see Sec. II. below.

(b) Wage tax (Lohnsteuer)

The wage tax is actually the individual income tax on income from dependent work. The major difference between the taxation of wages and that of other income items is to be seen in the method of collection, i.e. the wage tax is deducted at source by the employer rather than by assessment.

Residents

Since for many taxpayers income from dependent work constitutes their only source of income, deduction of the wage tax represents a final tax, except where the income exceeds a certain amount (generally, an annual income of 24,000 DM in the case of single persons and 48,000 DM in the case of married persons), or where there is income — other than income from dependent work — which exceeds, as a general rule 800 DM. The — usually — final character of the wage tax means that most of the relevant tax-free amounts, etc. have been included in the tax tables that are used to calculate the deductions. (Note, however, that each resident taxpayer can apply for a special kind of assessment (Lohnsteuerjahresausgleich) if he wishes to do so.) Furthermore, the categorization into wage tax classes also takes into account factors such as e.g. marital status (i.e. basic rate table or split-rate table, etc.). All relevant data concerning an employed individual are included in a "wage tax sheet" (Lohnsteuerkarte) which is issued annually by the municipality in which the individual is resident.

Non-residents

Individuals who do not maintain their domicile or habitual place of abode in the Federal Republic of Germany but obtain income from dependent work there are also subject to the wage tax. They are, however, entitled to a number of personal reliefs (in comparison with non-residents who obtain income from other sources; see above) which include, for instance, the consideration of the old age exemption and of income-connected expenses, as well as certain reliefs that take into consideration the marital status of the individual. In calculating the actual wage tax burden the basic table must be applied.

In any case, a non-resident individual who receives income from dependent work in the Federal Republic of Germany is required to apply on a prescribed form for a "confirmation" (Bescheinigung gem. § 39d Einkommensteuergesetz) at the office of the tax authority which is competent for his employer's area (Betriebstättenfinanzamt). The "confirmation" basically contains the same data as the "wage tax sheet" of a resident individual.

THE TAX LAWS OF THE FEDERAL REPUBLIC OF GERMANY

I. THE "ORDINARY" TAX LAWS

Although there is room for controversy over this kind of classification, the various German taxes are nevertheless categorized in this survey as *direct taxes, indirect taxes* and *registration taxes and license duties*

A. Direct taxes

The most important direct taxes are the individual income tax and the corporate income tax. Although there is a separate law for each of those taxes, there are many provisions in the latter that refer to those in the first, for instance with respect to the computation of taxable income. Furthermore, through the introduction of the full imputation system for dividends in the case of resident recipients as of January 1, 1977, there is necessarily a direct link between both taxes.

The imputation system has not been extended to the net wealth tax; consequently, the capital of a corporation is subject to this tax both as a corporation as such and in the hands of the shareholder.

The major features of the various direct taxes can be summarized as follows:

(1) Individual income tax (Einkommensteuer)

(a) Assessed individual income tax; general principles

The concept of German tax law provides for the separate taxation of the income of individuals vis-à-vis the taxation of legal entities and equivalent bodies (hereinafter referred to as "corporations"). *Partnerships* are not subject to the Corporate Income Tax Law but, instead, their profits are taxed, on a proportional basis, in the hands of the partners according to the rules of the Individual Income Tax Law.

Residents

(i) Domicile and tax liability

Individuals who maintain their *domicile* or *habitual place of abode* within the domestic territory of Germany are subject to "unlimited tax liability" (i.e. taxation of world-wide income). The nationality of the individual is not relevant in this context.

The determination of whether a "domicile" or "habitual place of abode" exists follows the principles of the Fiscal Code (Abgabenordnung of 1977).

(ii) Taxable base

In the case of residents, there are seven sources of income:
- income from agriculture and forestry;
- income from business;
- income from self-employment (mainly from liberal professions);
- income from dependent employment;
- income from capital;
- income from rental and leasing;
- income from other sources insofar as they do not belong to another type of income, including:
  - income of a recurrent nature;
  - income from certain support payments;
  - income from speculative transactions;
  - income from occasional activities;
  - emoluments of members of parliaments.

The calculation for each source of income is made separately. Actual costs (i.e. business expenses in the case of agriculture and forestry, business, and self-employment income; and income-connected expenses (Werbungskosten) in the other cases) are deductible for these calculations. With respect to certain sources of income, lump sum deductions are also provided for.

The total income from all the different sources (less some minor adjustments and reliefs) is referred to as the "*total amount of gross income*" (Gesamtbetrag der Einkünfte). If one source of income yields a loss, this may generally be set off againt income from other sources.

From the total amount of gross income, the following items can be deducted:

- *special expenses* (Sonderausgaben) are expenditures which fall outside the income-producing activity, such as: maintenance payments, premiums for sickness, accident and liability insurance, statutory pensions, unemployment insurance contributions, etc. For some items there is no limit on the deductible amount, whereas for other items maximum amounts or fixed lump sum amounts are provided for, sometimes depending upon marital status and the number of children.
- *extraordinary expenses* (aussergewöhnliche Belastungen) are expenditures which are unavoidably incurred by the taxpayer. Such expenditures may only be deducted insofar as they exceed the burden which the taxpayer is expected to bear himself. For certain commonly occurring situations, lump sum deductions are provided for.
  Further items which are deductible from the total amount of gross income include a tax free amount for liberal professions, and losses carried back or forward (the carry-back is limited to 5,000,000 DM and one year, the carry-forward is limited to five years but there is no limitation with respect to the amount).

The result, after the deduction of these amounts, is called — simply — "income" (Einkommen). From this income, the following personal exemptions can be deducted:
- old age exemption;
- housekeeping exemption for certain single persons.

The figure resulting after all these deductions is the "taxable amount of income" (zu versteuerndes Einkommen).

(iii) Tax rates

Individuals are taxed at rates which are calculated according to the following rules (for taxable year 1981):
- the first 4,212 DM (single persons) and 8,424 DM

The Tax System of the Federal Republic of Germany – A Short Survey

by Eugen Jehle *

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INTRODUCTION

Although the Federal Republic of Germany is a federation in which the legislative institutions of the individual States have their own areas of competence, in the area of taxation the actual practice yields a situation where most of the important taxes are governed by Federal law. However, this situation does not say anything regarding the right to the receipts. *Indeed, the revenue of the major taxes is shared as follows (1980):*

	Federation	*States*	*Municipalities*
(1) Individual income tax:	*42.5 percent*	*42.5 percent*	*15 percent*
(2) Corporate income tax:	*50 percent*	*50 percent*	*——*
(3) Turnover tax:	*67.5 percent*	*32.5 percent*	*——*

The Federation *is also entitled to the receipts derived from excise taxes (with the exception of the beer tax) and customs duties.*

The States' *income consists mainly of receipts from the net wealth tax, the beer tax, and the inheritance and gift tax (apart from the shares mentioned above).*

The Municipalities *are entitled to the receipts from the trade tax (although there is a certain readjustment, referred to as "Umlage", of the total trade tax revenue) and a number of registration and license duties.*

As far as the competence to enter into agreements with other States is concerned (e.g. the right to conclude conventions for the avoidance of double taxation), it is the exclusive right of the Federation to be active in this field. At present (January 1, 1981), there are 48 comprehensive conventions with respect to taxes on income and capital in force.

In addition, there is a number of conventions in existence with respect to inheritance taxes, to taxation of income from shipping and air transport, and to administrative and legal assistance.

The following article is confined to a short description of the national tax laws *of the Federal Republic of Germany.*

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that up to now the Supreme Tax Court has not yet pronounced on problems regarding the Aussensteuergesetz, with the exception of two unpublished decisions, one concerning a provisional directive and one concerning a request to suspend collection of the tax, although the Aussensteuergesetz entered into force on September 13, 1972.

One of the possible reasons may be that that authorities and lower tax courts encounter serious difficulties in evaluating facts abroad. The extension of international administrative assistance could be helpful to expedite the procedures. A particular — and in my opinion promising — form of exchange of information was agreed upon in 1979 between the United States and the Federal Republic. The two countries will carry on coordinated simultaneous audit programs examining the financial records of associated enterprises during which the auditors of the two countries will transmit their conclusions and exchange information on a reciprocal basis.

A fast solution of tax problems may also work in the interest of the taxpayers. In addition, entrepreneurs will only reluctantly start proceedings against the tax authorities since they are aware that the final decision may be arrived at only after many years.

[contined from page 347]

important change in her tax system with the reform of the corporate income tax. Due to the introduction of the full imputation system, the profits of corporations are subjected to a tax on income only once. The corporate income tax amounts to 56 percent of non-distributed profits; this rate is reduced to 36 percent as far as distributed profits are concerned. It is this 36 percent which can be claimed by the shareholder as a credit against his income tax liability.

In order to make sure that profits are taxed at least once, it is necessary to exclude from the imputation system those shareholders whose dividends are not fully subjected to individual or corporate income tax in the Federal Republic of Germany. This type of shareholder includes, in particular, domestic public-law entities, domestic corporations that are exempt from tax, and non-residents.

But the danger exists that exclusion from the imputation system can be avoided by way of using unorthodox legal arrangements. Thus, action has been taken with respect to cases in which shareholders who are not entitled to the imputation credit dispose of their shares to taxpayers who are entitled to this credit and in which the amount to be credited forms part of the consideration for the sale. Another legal provision will prevent taxpayers from avoiding the taxation of a domestic corporation's profits by arranging for the corporation to rely too heavily on borrowing. In specific cases, payments in respect of borrowed funds are to be treated as constructive dividends rather than deductible business expenses and subject to the corporate income tax accordingly.

The problem of the imputation of corporate income tax on an international level can only be satisfactorily solved through the harmonization of the various corporate income tax systems. The commission of the European Community has done some preparatory work in this area. From the German point of view, harmonization ought to take place in such a manner that we do not have to return to the double taxation of distributed corporate profits, but that we can retain our full imputation system.

Our fiscal policy will continue to focus on simplifying our tax system and on decreasing red tape. The Federal Government continues to work towards this goal step by step, since ideas for implementing a comprehensive simplication of the tax system have proved to be unrealistic. The scope of action is rather narrow since any government embarking on a simplication of its tax system must take the following aspects into consideration:

— it is necessary to subject all citizens to taxes that are socially just and equal, and take into account the economic potential of the taxpayers;
— it must be recognized that the tax system also serves non-fiscal purposes that are essential for a modern interventionist state (e.g. social policy, housing, economic policy, influencing the business cycle, energy policy, protection of the environment);
— European law and international economic relations;
— the procedures for tax collection on a broad scale;
— the budgets of the Federal Government, the Laender Governments and the municipalities, as well as the financial adjustments among the various levels of government.

In addition, the competence of the Federal Government in this area is limited since administration and organization of taxation is largely controlled by the Laender. For most tax laws, the assent of the Bundesrat is required.

Nevertheless, we have been able to achieve a number of successes in our efforts, and it is this that encourages us to continue our policies.

sufficient if the base company — without carrying on any other business activities — merely manages *one* subsidiary company or if it merely holds shares of one or more subsidiary company(ies) and if it limits itself to the exercise of the rights embodied in the shares. The Supreme Tax Court believes the resulting difference in taxation between a domestic portfolio holding company which is used as an intermediary for investment in shares and a foreign company used for the same purposes to be justified, since in the former case taxation will in general only be deferred whereas in the latter case the lower foreign tax will result in a definite tax saving.

The question of the appropriate set of circumstances, or, in other words, how tax should by virtue of Section 6(2) of the Steueranpassungsgesetz be imposed in a case of abuse of law, is in the above decision solved by indicating that taxation should be based on the real facts thus disregarding the presentation which is considered to be abusive; i.e. taxation should be based on the whole of the circumstances which the taxpayer attempted to disguise through the abuse of the law. In the case under litigation this meant that the distribution of profits which had been effected by the base company could not be disregarded. However, it was held that German taxes should be levied as if the distribution had taken place, but not through the base company. Thus, when attempting to establish the proper set of circumstances in the sense of Section 6(2) of the Steueranpassungsgesetz it could specifically not be assumed that the domestic company had accumulated income, because it was not the distribution of income as such which was considered to be abusive, but rather the *distribution of income through an intermediary foreign company.*

In all cases in which the Supreme Tax Court assumed an abuse of law in the sense of Section 6(2) of the Steueranpassungsgesetz (currently Section 42 of the Abgabenordnung) there existed between the foreign base company and the domestic taxpayer a "Gesellschaftsrechtlicher Verflechtung", meaning that the domestic taxpayer had ownership rights as a partner or member of the company. A different situation existed in the case decided by the Supreme Tax Court of May 9, 1977.[42] In this case a GmbH (limited liability company) established in Switzerland, whose sole shareholder was a Swiss AG (corporation), acquired a "silent interest" in a German GmbH (plaintiff). The Supreme Tax Court explained that its decisions under which foreign base companies were for tax purposes disregarded do not apply if there is no "Gesellschaftsrechtlicher Verflechtung" as in the case of a "silent interest". In such cases the tax implications of any legal act can only be judged in conformity with the general principles of civil law regarding the abuse of law with a view to tax evasion.

3. Which law is applicable?

In situations with international aspects the question which law — German or foreign — must be applied is often of prime importance. This was made particularly clear in two cases of disguised dividend distributions made to foreign shareholders which the Supreme Tax Court had to decide upon on April 6, 1977.[43]

The facts were: a domestic subsidiary corporation (A) received notice from its foreign parent corporation (B) that another foreign subsidiary (C) had opened a credit in favor of (A) and the latter had entered this credit in its financial records. Shortly after, when the financial director of the parent (B) made an equiry with respect to the tax consequences of the credit, instructions were given to cancel this credit.

The Supreme Tax Court held that the question — whether the service (by granting the credit) rendered by foreign associated corporation (C) to domestic corporation (A) was disguised dividend distribution made by (A) to its foreign parent (B) — had to be decided in accordance with German tax law. For this purpose, the Supreme Tax Court used the so-called "triangle-construction" for disguised dividends in case of associated companies, i.e. it assumed a disguised dividend distribution made by the subsidiary corporation (in this case (A)) to its parent corporation (in this case (B)) and it assumed that the parent (B) made a disguised capital contribution to its other subsidiary corporation (in this case (C)). This rule is also applicable if one of the associated corporations is subject to German tax, whether as a resident corporation (subject to German income tax on world-wide income) or as a non-resident corporation (subject to German tax on German-source income only). German income tax law is therefore also applicable to the foreign parent corporation with respect to its German-source income in the form of a disguised dividend distribution.

However, the preliminary question which had to be solved in the case under litigation was a question of civil law, i.e. whether the opening of the credit by associated corporation (C) in favor of domestic corporation (A) constituted for the latter a legal right to use this credit. The law which governed this question would in this case be either German or English civil law, and which one this should be was decided by international private law.

IV. CONCLUSION

The majority of the recent decisions on international tax problems which are discussed in this article concern taxable years dating more than ten years back. In some cases the adoption of new laws, the amendment of existing laws and the conclusion of new tax treaties have meanwhile changed the situation. It should be noted

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trolling parent corporation and taxed in the hands of the latter, provided that a number of conditions have been met. The parent must, inter alia, exercise financial, economic and organizational control over its subsidiary. The parent corporation, however, must be engaged in business activities. That is to say, it will qualify for the "Organschaft" treatment if it is a holding company carrying on general management functions over a number of subsidiaries by issuing directives, instructions etc. to its subsidiaries. However, a mere token management will not be sufficent.

42. No. I R 126/77 published in BFHE 128,61 and BStBl II (1979) at 586.

43. No. I R 183/75 published in BFHE 122, 102 and BStBl II (1977) at 571. (See for a discussion in the English language: 17 *European Taxation* (1977) at 277; No. I R 184/75 published in BFHE 122, 105 and BStBl II (1977) at 574.)

quired that the hidden reserves also be taxed even if the taxpayer after many years leaves the Federal Republic. However, it should be noted that this landmark decision does not consider the termination of the taxpayer's "unlimited" liability to German income tax [30] to be decisive but rather the earlier contribution of his sole proprietorship for shares, which under the provisions of Section 16(1) of the Einkommensteuergesetz is deemed to be a transfer of a business which may benefit from a tax deferral. The change in the taxpayer's tax status, from "unlimited" to "limited liability" to German income tax, is merely the occasion which makes a further deferral of the realization of the hidden reserves impossible, since a later taxation of such reserves may be frustrated.

This decision has been criticized, inter alia, by Professor Dr. Horst Vogel and Dr. Helmut Krabbe [31] since the Supreme Tax Court computes the taxable transfer profit at the moment that the taxpayer becomes a non-resident and thus has "limited liability" to German income tax. It is true that one may wonder whether it is legitimate to (i) reason that the transfer of a business by way of a contribution for shares is essentially subject to tax and (ii) subsequently use the value of the shares at the moment the taxpayer leaves the country for the computation of the taxable base, in other words, to take into account any increases or decreases of the value of such shares subsequent to the transfer of the business. The former "privilege" which the courts have granted the taxpayer — that he is not required to realize any hidden reserves at the moment of transfer of the business — may turn into a disadvantage if the taxpayer is obliged to pay tax on hidden reserves which have arisen after the transfer. The decision of April 12, 1978 [32] contains a number of important statements with respect to the "emigration taxation". One of its crucial dicta reads: "The procedure under which income, which has been treated as business income, falls into another income category as a result of a change of a taxpayer's tax status under which he has limited liability to German income tax [33] — which is usually caused by the relocation of a business or of a taxpayer's residence abroad — will generally lead to the realization and taxation of hidden reserves as provided for in the termination of a business" (Section 16(3) Einkommensteuergesetz). [34]

This statement of the Supreme Tax Court is based on the decision of its "Great Senate" [35] with respect to the change of the business structure of a market garden (Decision of October 7, 1974),[36] holding that a business is also deemed to be terminated if through any event or legal act, and notwithstanding it remains in existence as an economic entity, its income tax position is altered in such a manner that the taxation of its hidden reserves is no longer guaranteed. This leads — if one disregards the problem of having a domestic permanent representative — to the following chain of reasoning.

The rentals which a lessor of a business having his residence in the Federal Republic of Germany receives are under German income tax law deemed to be business income if the lessor does not notify the tax authorities of the termination of his business. However, the courts have decided that such a lease of business property does not constitute a permanent establishment situated in the Federal Republic of Germany. Therefore, if the lessor moves abroad and thus has "limited liability" for purposes of German income tax [37] the rentals can no longer be taxed as business income since the essential prerequisite for taxing business income of a non-resident — i.e. a permanent establishment — is lacking. They will in such a case be subject to German income tax as "Einkünfte aus Vermietung und Verpachtung" (income from rentals) under Section 49(1) No. 2 of the Einkommensteuergesetz. [38] This change in the status of the taxpayer's rentals means that no German tax can be imposed on any profits derived from the sale or other disposition of the business and, therefore, the change of residence is deemed to result in the simultaneous termination of the taxpayer's business in the sense of Section 16(3) of the Einkommensteuergesetz. However, the primary cause of the taxation of the hidden reserves in such a case is not the change of the taxpayer's residence but rather the termination of the business which is assumed because of the change in status of the income from business income to mere rentals.

2. Base companies

The Supreme Tax Court has in its decisions expounded that it will consider the creation of a base company abroad by a domestic taxpayer as an abuse of law if there are no economic or other important reasons for the creation of such a base company and also if the base company does not carry on proper business activities. The decision of the Supreme Tax Court of December 9, 1980 [39] focussed on the business activities of a base company, In this decision the Supreme Tax Court also had to establish on which fictitious taxable event German taxation should be based if an abuse of law is assumed. [40]

The Supreme Tax Court finds that — similar to its doctrine vis-à-vis the "organschaft" [41] — for the recognition of the existence of qualifying business activities it is not

30. See note 14 above.
31. "Wohnsitzverlegung in die Schweiz und Besteuerung stiller Reserven in Anteilen und Kapitalgesellschaften" by H. Vogel in 50 *Der Betrieb* (1977) at 1717 and "Zur Steuerentstrickung bei Wohnsitzwechsel ins Ausland" by H. Krabbe in 32 *Betriebs-Berater* (1977) at 431.
32. No. I R 136/77 published in BFHE 125,157 and BStBl II (1978) at 494.
33. See note 14 above.
34. The "Einkommensteuergesetz" is the Individual Income Tax Law.
35. The "Great Senate" consists of the presidents of the divisions of the Supreme Tax Court who lay down guiding principles to be observed by the individual court divisions.
36. No. GrS 1/73 published in BFHE 114, 189 and BStBl II (1975) at 168.
37. See note 14 above.
38. See note 34 above.
39. No. VIII R 11/77 published in BFHE 132, 198 and BStBl II (1981) at 339.
40. Cf. Section 6(2) of the Steueranpassungsgesetz.
41. The term "Organschaft" (consolidated balance sheet) describes a situation under which the entire profits and losses of a controlled subsidiary corporation are pooled with those of a con-

facts and circumstances which are of substantial commercial significance and which have a certain practical value. Knowing the names of non-residents having a security deposit with a German bank is not a business secret in this sense.

The significance of the decision lies in its interpretation of the concept of business secret, since the reasoning in this judgement clarifies that this interpretation may also be applied to similar provisions in other agreements for administrative and judicial assistance as well as to the term "commercial, industrial, business or professional secret" in the sense of Section 117(3), fourth sentence, of the Abgabenordnung 1977.

The decision does not constitute a "violation of banking secrecy" since German tax law does not protect such banking secrecy. The tax administration has, however, in the so-called bank ruling imposed a certain restraint on itself with respect to the collection of information in order not to place too heavy a burden on the confidential relationship between credit institutions and their clients. [23] However, the bank ruling expressly permits and permitted the tax administration to carry on specific investigations with banks in particular cases.

2. General rules of international law

There exist very few general rules of international law which affect taxation. One of them is the exemption from direct taxation of diplomatic representatives in the country where they have been accredited, a provision which has been included in the Treaty of Vienna concerning diplomatic relations. This rule was the subject of a decision of April 26, 1978 [24] rendered by the First Division of the Supreme Tax Court.

However, in international tax cases general rules of international law which have no direct tax implications may play a decisive role. An example taken from recent case law is the case of a ship's officer who was employed on board a Liberian ship, which during a long period of time was stationed off the Nigerian coast to take in crude oil. The officer's opinion was that his wages earned during that time were not liable to German income tax, since by virtue of Article 15 of the German-Liberian tax treaty, Liberia—the country where he had performed his duties — had the exclusive right to tax his income. This case was dealt with in the decision of October 15, 1977 [25] of the Supreme Tax Court which applied two general principles of international maritime law:

(i) Ships at sea are deemed to be parts of the State whose flag they are flying.

(ii) Territorial waters are part of the territory of the coastal state bordering on these waters and are subject to its jurisdiction. (The extent of these territorial waters, however, is still an unsolved problem.)

The adjacent area over the Continental Shelf borders on the territorial waters and, by virtue of the Convention of Geneva concerning territorial waters and adjacent areas, a coastal state possesses certain rights with respect to the control and exploitation of such adjacent areas but not full sovereign rights. Ships which are located in such an adjacent area cannot, therefore, according to the opinion of the Supreme Tax Court be deemed to constitute part of the domestic territory of the coastal State but must be considered to be a ship at sea and thus to constitute part of the territory of the state whose flag they fly.

III. DECISIONS ON NATIONAL PROVISIONS DEALING WITH INTERNATIONAL TAX ASPECTS

1. Transfer of current assets to a foreign permanent establishment

The decision of July 16, 1969 [26] of the Supreme Tax Court established the principle that in case of transfer of current business assets from a domestic enterprise to its foreign permanent establishment, any hidden reserves contained in the book values of such assets shall be added to the taxable income of the enterprise if they would otherwise escape German taxation ("Gewinnverwirklichung durch Steuerentstrickung"). In two recent cases, the issue was whether these hidden reserves must also be taxed where the sole proprietor or the person having an interest in an enterprise takes up residence abroad. In one of these cases, i.e. the decision of January 26, 1977, [27] the taxpayer had contributed his sole proprietorship to a corporation receiving shares in the corporation as a consideration. He availed himself of those provisions of German income tax law under which he could transfer the assets of the sole proprietorship at book value, thus deferring income tax at the termination of the business. Fourteen years later — 1968 — the taxpayer moved to Switzerland. In that year neither the provisions of the Umwandlungsteuergesetz 1969 (Company Reorganization Tax Law 1969) nor those of the Aussensteuergesetz were effective.

The Supreme Tax Court held that the taxpayer, by acquiring a residence abroad, had become a non-resident taxpayer with "limited liability" to German individual income tax. [28] In such a case the hidden reserves contained in the shares held by the taxpayer were deemed to be realized by him and therefore subject to German individual income tax. The Supreme Tax Court thus confirmed its earlier decisions regarding the contribution of sole proprietorships to corporations. In its decision of April 30, 1975, [29] the Supreme Tax Court ruled that if the taxpayer is a non-resident the hidden reserves must already be taxed at the moment of contribution. The above decision of January 26, 1977 re-

23. See the Circular Letter of August 31, 1979 No. IV A 7-S 0230 - 11/79 which was then effective and which was published in BStBl (1979) at 590.

24. No. I R 97/76 published in BFHE 125,375 and BStBl (1978) at 628.

25. No. I R 250/75 published in BFHE 123,341 and BStBl II (1978) at 50.

26. No. I 266/65 published in BFHE 97,342 and BStBl II (1970) at 175.

27. No. VIII R 109/75 published in BFHE 121,63 and BStBl II (1970) at 283.

28. See note 14 above.

29. No. I R 41/73 published in BFHE 116, 118 and BStBl II (1975) at 706.

to be found in the treaties concluded with Switzerland and Spain. By virtue of Article 24 of the German-Swiss tax treaty and Article 23 of the German-Spanish tax treaty, a credit for foreign tax imposed in the "situs" country is granted by the country where the taxpayer resides.

In conformity with this last rule the Supreme Tax Court held in its decision of December 4, 1979 [16] regarding the German-Swiss tax treaty that the plaintiff who received rental income from a dwelling house situated in Switzerland had to pay German income tax on this income. The taxpayer had not stated that he paid any income tax in Switzerland.

The decision of January 22, 1980 [17] with respect to the German-Spanish tax treaty states in the first sentence of the summary preceding the decision, and containing the essential arguments on which the decision revolves: "The annual rental value of an owner-occupied dwelling house situated in Spain is subject to domestic income tax." [18] No tax was imposed in Spain.

All recent tax treaties concluded by the Federal Republic of Germany contain — in conformity with Article 9 of the OECD Model Convention — a provision regarding associated enterprises. Under this provision profits derived from commercial or financial relations between associated enterprises established in the two contracting states may (can) be adjusted, if they have been derived under conditions which independent enterprises would not have agreed upon.

The tax treaties concluded by the Federal Republic of Germany with the Netherlands and France prior to publication of the final text of the OECD Model Convention contain in Articles 6 and 5, respectively, a similar provision. With respect to these provisions the Supreme Tax Court pronounced in its decisions of March 12, 1980, [19] and January 31, 1981. [20] These two decisions are significant, since they terminate the controversy which has been aired in various tax journals whether the contracting states "may" or "can" adjust the profits of associated enterprises. The Supreme Tax Court supports those persons who belive that the authority which has been expressed in both terms is not granted to the tax administration but rather to the legislature. Therefore, the provisions in tax treaties for the taxation of associated enterprises do not constitute an independent legal base for the tax authorities under which they may adjust the profits of associated enterprises. The situation is rather that such an adjustment is only possible if the case which is to be decided upon is covered by adjustment provisions existing under German national tax law. Such national adjustment provisions are, in particular, those with respect to disguised profit distributions, disguised capital contributions, abuse of the legal forms governed by the Bundesgesetzbuch (General Law Code) and — as of 1972 — Section 1 of the Aussensteuergesetz (Foreign Tax Law). [21] Of course, for the application of these provisions no authority based upon a treaty provision is required.

b. *Agreements for administrative and judicial assistance*

With the increase of international business, administrative and judicial assistance between the countries also increases in significance.

The Federal Republic of Germany long ago began to conclude agreements for administrative assistance in tax matters with other countries, whether through an administrative assistance or exchange of information clause in a tax treaty or through a separate agreement for administrative and judicial assistance. However, it was not before 1979 that the Supreme Tax Court had to deal with problems of international exchange of information.

A decision whose major significance lies in the fact that it reveals in which manner similar cases may be decided upon in the future is the decision of the Supreme Tax Court of February 20, 1979 [22] on the German-Swedish Agreement on administrative and judicial assistance in tax matters of May 14, 1935 (hereinafter 1935 Agreement). In this case the Court held that a domestic bank requested by the German tax authorities to give information on the identity of certain deposit holders within the framework of the administrative assistance provisions between the Federal Republic of Germany and Sweden, is obliged to render such information. The reasoning of the Supreme Tax Court essentially upheld the opinion of the tax authorities as to the extent and the limits of the supply of information. Its main arguments were:

- The 1935 Agreement is still effective, although the German-Swedish tax treaty of 1959 contains in its Article 24 an exchange of information clause. Since the 1935 Agreement is more extensive it must be assumed that it was the Contracting States' wish that the two treaties should exist independently of each other.
- Business secrets in the sense of the provisions for administrative and judicial assistance are only those

16. No. VIII R 125/78 published in BFHE 125, 165 and in BStBl II (1980) at 97.
17. No. VIII R 134/78 published in BFHE 130,261 and BStBl II (1980) at 447.
18. The Federal Republic of Germany, as well as some other European countries like Belgium, Luxembourg and the Netherlands, subjects a presumptive income from owner-occupied dwelling houses to individual income tax.
19. No. I R 186/76 published in BFHE 130, 296 and BStBl II (1980) at 531.
20. Not yet published.
21. The Aussensteuergesetz (Foreign Tax Law) of 1972 seeks to preserve tax equality in international relationships by measures to eliminate legal international tax avoidance and illegal tax evasion. Articles in the English language which were published in *European Taxation* are, inter alia, "*Foreign Tax Law - Aussensteuergesetz*" by E. Mittendorf-Snaas in 14 *Eur. Tax.* (1974) at 237; "*Foreign Tax Law: Aussensteuergesetz — Change of residence to low tax countries*" by E. Mittendorf-Snaas in 14 *Eur. Tax.* (1974) at 346; "*The foreign base company in the West German tax law*" by E. Jehle in 17 *Eur. Tax.* (1977) at 364, 400 and 18 *Eur. Tax.* (1978) at 22; "*Treatment of major shareholding in the case of emigration — Taxation of the appreciation in the value of stock according to the Aussensteuergesetz*" by E. Jehle in 18 *Eur. Tax.* (1978) at 368.
22. No. VII R 16/78 published in BFHE 127, 104 and in BStBl II (1979) at 268. See for a discussion in English, 19 *European Taxation* (1979) at 189.

that country. These national provisions apply since to date no tax treaty has been concluded between the Federal Republic of Germany and Mexico. The Federal Republic meanwhile concluded tax treaties with Romania and Brazil and under the provisions of these treaties assembling activities also constitute a permanent establishment.

Two recent decisions of the Supreme Tax Court deal with taxation in conformity with the "place of work" criterion which was laid down in Article 4 of the German-Swiss tax treaty of 1959. Article 4(1), first sentence, of this treaty provides that income from personal services shall only be subject to tax in that country where the services are performed. [12]

The decision of October 12, 1978, [13] deals with a person who had carried on a profession in the Federal Republic of Germany and who after selling his business had moved to Switzerland. As had been agreed, his successor remitted part of the fees connected with the cases which had not been completed at the time of the transfer of the business. The German tax authorities of the district where the Swiss resident had carried on his professional activities before moving to Switzerland assessed him to income tax on those deferred payments from independent personal services as having "limited liability" to German income tax. [14] The Supreme Tax Court confirmed that the Federal Republic of Germany is authorized to impose its income tax in such a case. The fact that the taxpayer had in the past performed services through a fixed base located in the Federal Republic and that the payments were directly connected with these services was considered to be decisive. The Supreme Tax Court based its opinion on the use of the word "herrühren" (derived) in Article 4(1), first sentence, of the German-Swiss tax treaty of 1959. Since the Supreme Tax Court found that the deferred payments constituted a consideration for the transfer of the business it denied that these payments were to be considered as support payments. The Final Protocol to the German-Swiss tax treaty supplementing the provisions of Article 4 of this treaty and providing, inter alia, that retirement pensions and other support payments shall only be taxable in the country where the taxpayer resides was, therefore, not applicable in this case.

This situation was not changed by the new German-Swiss tax treaty of 1971. Article 14 of this treaty is also based on the "place of work" criterion and Article 18 gives a different rule only for certain support payments — limited to those connected with dependent work.

Some doubts may exist with respect to the second decision which dates from November 9, 1977 dealing with Article 4 of the German-Swiss tax treaty of 1959. [15] In this case the Supreme Tax Court had to decide on the taxation of payments made by a former employer as compensation for a "waiting period" during which the former employee had committed himself not to carry on any activities competing with his former employer's business activities after leaving the latter's service. The former employee had meanwhile emigrated to Switzerland. The Supreme Tax Court held that such payments were liable to German income tax because the recipient had carried on his former activities in the Federal Republic of Germany. In reaching this decision the Supreme Tax Court's reasoning was again based upon the meaning of the word "herrühren" (derived) in Article 4(1), first sentence, of the German-Swiss tax treaty of 1959. This reasoning also means that mere causality between income and the performance of activities is sufficient for the Federal Republic of Germany to exercise its taxing rights.

However, this decision is therefore problematic since — as the Supreme Tax Court itself states — the payments for the "waiting period" did not constitute a consideration for work performed in the past but rather a compensation for the observance of the "waiting period". The "service" thus rendered by the former employee in the form of abstaining from any activities competing with those of his former employer was, however, performed by the employee in Switzerland. It is, therefore, possible that Switzerland will not agree with the Supreme Tax Court's interpretation of the German-Swiss tax treaty. Any resulting double taxation of this income must in such a case be eliminated in a mutual agreement procedure between the German and Swiss tax authorities.

Irrespective of the philosophy which two countries concluding a tax treaty use as a basis for the attribution of the income which they may subject to tax, regarding income from real property they will always respect the primacy of the "situs" criterion without any restrictions. The tax treaties concluded by the German Federal Republic generally prevent double taxation in such a case through the exemption method, therefore, as it is usually expressed in those treaties, they "shall be excluded from the basis upon which the Federal Republic tax is imposed. . .". Exceptions to this general rule are

12. A non-official translation of this article published in *Supplementary Service to European Taxation* reads:
"1. Income from dependent or independent personal services shall, subject to the provisions of Para. 2 of this article or of Article 5, be taxed only in the State in which the personal services from which the income is derived are carried on. Independent personal service is only deemed to be carried on in either of the two States, if the professional activity is performed through a fixed center in that State. Theatre, radio, motion picture, or television performers, athletes and artists working independently, shall be taxable for income derived from public performances only in the State in which the activities are carried on, irrespective of whether these activities are carried on through a fixed center or not.
2. Income from dependent services carried on by persons who are domiciled in one of the States near the frontier and are employed in the other State near the frontier (frontier workers) shall be taxed only in the State in which the taxpayer is domiciled."
13. No. I R 69/75 published in BFHE 126, 209 and BStBl II (1979) at 64.
14. Residents of the Federal Republic of Germany are subject to income tax on their world-wide income, i.e. they have according to German terminology "unlimited tax liability" (unbeschränkt steuerpflichtig). Non-residents of the Federal Republic, however, have only "limited liability" to tax (beschränkt steuerpflichtig), meaning that they are only subject to German income tax with respect to certain German-source income indicated in German income tax law.
15. No. I R 254/75 published in BHFE 124, 35 and BStBl II (1978) at 195: see also the commentary in *Höchstrichterliche Finanzrechtsprechung* (1978) at 88.

Professor Dr. Heinrich List (61) started his career in taxation in 1949 as an officer in the customs department. In 1955 he became a legal clerk with the Supreme Tax Court and in 1959 was appointed judge on the Lower Tax Court of Munich. On June 1, 1962 he returned to the Supreme Tax Court but now as a judge. Ten years later he became Chairman of a division of the Supreme Tax Court, in 1974 the Court's Vice-President and in 1978 its President. Professor List obtained his doctor's degree in 1960 (thesis: Self-denunciation in criminal law) and in 1964 was offered a position as lecturer in tax law and financial law at the University of Erlangen-Nuremburg where in 1967 he was made adjunct professor (Honorarprofessor).

Professor List has published numerous articles and is co-author of an authoritative handbook on German turnover tax law entitled "Kommentar zum Umsatzsteuergesetz", a handbook on the German Fiscal Code (Abgabenordnung) entitled "Kommentar zur AO" and the famous German tax encyclopedia "Handwörterbuch des deutschen Steuerrechts".

The International Bureau of Fiscal Documentation wishes to thank Professor List, who is a member of its Advisory Council, for contributing to this special issue of the *Bulletin*.

Consequently, the tax authorities held the U.K. company liable for the payment of the wages tax. The Supreme Tax Court upheld the opinion of the tax authorities.

It is true that the obligation to withhold wages tax is only placed on domestic employers, i.e. those employers who are established in the Federal Republic. A domestic employer is defined as any employer who has a permanent establishment in the Federal Republic (this definition is currently also in conformity with the definition in Section 38(1) of the German Einkommensteuergesetz (Individual Income Tax Law) in its amended form of 1975). The Supreme Tax Court considered the office which was used by the U.K. employer's German employee as a permanent establishment of the U.K. company, since by virtue of Section 16(2) of the Steueranpassungsgesetz [7] offices or similar business establishments are deemed to be permanent establishments. The fact that the German-United Kingdom tax treaty gives a more limited definition of the term "permanent establishment" was considered to be immaterial by the Supreme Tax Court, since this definition only applies "for purposes of the tax treaty". The decision of the Supreme Tax Court was further supported by the fact that the German-United Kingdom tax treaty does not contain any provisions with respect to the withholding and payment of the German wages tax by a non-resident employer.

This case is becoming more and more important because of the increasing number of contracts under which employees are placed at the disposal of German enterprises by non-resident employers. When deciding this case the Supreme Tax Court pointed out that such employers should in case of doubt call upon the German tax authorities using the procedure of Section 56 of the Lohnsteuer-Durchführungsverordnung (Wages Tax Implementation Decree) [8] in order to avoid being held responsible for the payment of wages tax at a later moment.

Another case, the decision of March 7, 1979, [9] concerned the taxation of profits which a domestic enterprise made in 1968 through the assembly of machinery in Romania, Mexico and Brazil, i.e. these profits were made before the Federal Republic had concluded tax treaties with Romania and Brazil in 1973 and 1975, respectively, and before the Abgabenordnung 1977 became effective. [10] The Supreme Tax Court held that these profits were not derived through a permanent establishment located abroad so that no unilateral relief for the prevention of double taxation was available. It reached this decision since for the interpretation of the term "Betriebstätte" (permanent establishment) only the rules of the German national law were decisive and not those laid down in tax treaties and the OECD Model Convention. Under the definition of the term "permanent establishment" contained in Section 16 of the Steueranpassungsgesetz [11] which was then applicable, assembly activities could not be deemed to constitute a "feste örtliche Einrichtung" (fixed local establishment) in the sense of Section 16(2) No. 2 of the Steueranpassungsgesetz nor a "Bauausführung" (construction project) in the sense of the same Section of the Steueranpassungsgesetz.

However, Section 12 of the Abgabenordnung 1977, which became effective on January 1, 1977 and which replaced Section 16 of the Steueranpassungsgesetz, mentions in the second sentence, in addition to construction projects, also assembling activities as an example of a permanent establishment. This means that under the current national German legal provisions the taxpayer in the above case would have had a permanent establishment in Mexico as a result of his assembling activities in

7. The term "Steueranpassungsgesetz" literally means "Tax adjustment law". Its function was, inter alia, to give general definitions applicable to a number of tax laws. The Steueranpassungsgesetz was abolished as of January 1, 1977 and the general definitions are currently to be found in the Abgabenordnung (Fiscal Code) 1977. See *"The new fiscal code — First tax reform law of March 16, 1976"* by W.G. Kuiper in 16 *Eur. Tax.* (1976) at 292.

8. This is designated as the "Lohnsteuer-Anrufungsauskunft" procedure meaning that the employer and the employee are entitled to request information from the tax authorities whether the wages tax is due in a particular case. The reply of the tax authorities is not final and may be revoked at any time, but not retroactively.

9. No. I R 145/76 published in BFHE 127, 517 and BStBl II (1979) at 527.

10. See note 7 above.

11. Id.

Recent Cases of the German Supreme Tax Court on International Tax Law

by Prof. Dr. Heinrich List

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I. INTRODUCTION

The concept of international tax law encompasses on the one hand legal rules of international law, which either through "transformation" [1] or in the form of general rules of international treaty law [2] have become part of German law, and on the other hand legal rules embodied in German national tax law which deal with facts having an international character.

German scholars and practitioners often designate the latter aspect of international tax law as "Aussensteuerrecht", i.e. national rules for international tax law as opposed to, for instance, treaty provisions. [3] These two aspects of international tax law are also designated as international tax law in a broad sense.

II. DECISIONS ON TAX TREATY LAW

1. Treaty law

a. Treaties for the prevention of double taxation [4]

The tax policy of the Federal Republic of Germany when concluding tax treaties is — as is the case in most industrial countries — to give primacy to the residence principle over the source principle. However, since the Federal Republic also accepts as a guiding principle that business must be able to compete, it recognizes the source principle as well, although mostly in only a limited form, with respect to income which is derived from direct and permanent participation in business activities.

This is the case for:
- *business income*, with the restriction, however, that the income must be derived through a permanent establishment situated in the source country (i.e. the "permanent establishment"criterion);
- *income from dependent and independent activities*, with the respective requirements, however, that it must not concern temporary activities nor must the activities be carried out through a fixed base (i.e. the "place of work" criterion);
- *income from real property*, generally without any restriction (i.e. the "situs" criterion).

The German Supreme Tax Court must take these three attribution criteria into account in its recent decisions with respect to treaty law. In its decision of October 5, 1977 [5] the concept of permanent establishment was crucial in establishing the liability to tax wages [6] of a non-resident taxpayer acting as an employment agency. The case concerned a company established in the United Kingdom which had contracted with a German enterprise to complete a certain project in the Federal Republic of Germany and which for this purpose placed a number of its employees at the disposal of the German enterprise. The United Kingdom company hired a German employee to assist its British workers in Germany, using an office set up in Germany. This employee, inter alia, paid the wages remitted from the United Kingdom to the British employees. The German tax authorities found that the United Kingdom company should have withheld German wages tax from the wages paid to its employees working in Germany and should have paid this tax over to the German Treasury.

1. Article 59(2) of the German Grundgesetz (Constitution), hereinafter cited as "GG"). This article transforms treaty law into domestic law.
2. GG, Art. 25.
3. See *Prinzipien des internationalen Steuerrechts* by O. Bühler (1964); Vol. III of *Einführung in das besondere Steuerrecht*, entitled *Das internationale Steuerrecht der Bundesrepublik*, by V. Kluge (1976), and recently the article *"Das Völkerrecht in der Rechtsprechung des Bundesfinanzhof"*, by H.W. Bayer in 58 *Steuer und Wirtschaft* (1981) at 61.
4. Hereinafter designated as "tax treaties".
5. No. I R 90/75 published in *Bundesfinanzhof-Entscheidungen* (hereinafter cited as "BFHE") 124, 29 and in *Bundessteuerblatt* (hereinafter "BStBl) II (1978) at 205.
6. Under German law employers are obliged to withhold wages tax (Lohnsteuer) from the wages they pay to their employees. This tax either replaces the income tax (in case of low incomes) or may be credited against the employee's income tax liability. The employee is the taxpayer but the employer is obliged to withhold the tax and to pay the tax over to the Treasury. The employer is severally liable for the payment of the wages tax in case he does not meet his obligation.

HAPPY BIRTHDAY

On September 25, 1981, the last day of our Congress, Mr. Hans Matthöfer will celebrate his birthday.
The Editors of the Bulletin for International Fiscal Documentation wish him many happy returns of the day and will toast to his health at the final banquet.

European Community as a pillar of its foreign policy and, because of this, will make its contribution as the integration process continues. However, it will strive to bring about a fair balancing of interests as well as to avoid situations in which conflicts are "solved" to the unilateral detriment of individual member states.

Cooperation with the member states of EFTA will be expanded continuously. Indeed, the EFTA member states are connected with the European Community by way of a free trade agreement; this relationship has developed into a widely uniform European market that consists of 17 countries with more than 300 million inhabitants.

After many years of huge surpluses, the German current account has moved into the red. One important reason for this is the increased oil bill of the Federal Republic of Germany. Despite lower quantities of imported oil, we have been forced to spend 100 percent more for these imports in 1980 than in 1978. Additional reasons for this deficit include an earlier revaluation of the DM, the effects of which are being felt only now, and the increased deficit in the field of services (e.g. tourism) as well as capital transfers. In the long run, the Federal Republic of Germany must strive to return to a balanced external position. This is to be achieved by lowering the dependency on imported oil, encouraging investment and innovation, as well as strengthening the competitive position of German businesses. In this process, the still rather high degree of price stability in the Federal Republic of Germany in comparison to other countries is one of the most prominent positive features. The earlier there is an improvement of the West German current account situation, the earlier there will be more scope for a monetary policy which is not all that tainted by pressures due to the disequilibrium in our balance of payments. Indeed, this will enable us again to pursue a more domestically oriented monetary policy.

Our fiscal policy is guided by the necessity of permanent adaption and long-term development. The total tax burden must be designed in such a manner that desirable public services can be financed without adversely affecting the individual capacity and motivation of taxpayers. For some 30 years, the so-called taxation ratio has been remarkably stable in the Federal Republic of Germany (approximately 24 percent). According to our estimates, this ratio will be 24.13 percent in 1981 and will amount to 24.16 percent in 1982 and 24.15 percent in 1983. Thus, there will be virtually no change in this ratio, and the Federal Government has no intention to effect any increase in the future.

Although the total tax burden is thus basically stable, there is a built-in tendency towards structural changes within the tax system. The share of direct taxes tends to increase, while that of indirect taxes is decreasing accordingly. This dynamic is particularly manifested with respect to the wage tax, due to the connection between the progressive tax rates and nominal wage increases.

Until the mid-1970s, this tendency continued nearly without restriction. The share of direct taxes increased from 51.6 percent in 1952 to 62.1 percent in 1977. The share of the wage tax in respect of the total tax revenue nearly tripled from 11 to 30.3 percent. As a result, the wage tax ratio (i.e. the relationship of wage tax revenue to total gross wages) increased from 7 percent in 1960 to 15 percent in 1974.

As from 1974, the Federal Government has tried to stop this trend. Through a number of tax relief measures, the government has stabilized the wage tax burden. The wage tax as a percentage of the total tax revenue has since levelled out at about 30 percent. The wage tax ratio has also been stabilized at around 15 percent. Likewise, the ratio between direct and indirect taxes has stabilized at 57.4 : 42.6 percent (1981). One of the contributing factors has been a moderate increase in some excise taxes, such as the mineral oil tax, the spirits tax, the tobacco tax as well as the turnover tax. In the long run, our policy is to maintain a balanced tax pattern and to stabilize the share of direct taxes; it is for this reason that we cannot exclude the possibility that some excise taxes may have to be adjusted in the future.

Further development of the turnover tax will depend on tax harmonization within the European Community. At present, no spectacular progress can be expected that would bring about the abolition of the tax borders between the various member states of the European Community. Instead, we have to expect an extended period of consolidation during which must be solved those problems that remained after the Sixth Directive for the harmonization of turnover taxes of May 17, 1977. One important problem is the question whether specific common procedures should be introduced for second-hand goods (in particular second-hand cars). In addition, there are some 40 transitional regulations contained in the Sixth Directive that have to be eliminated in due course. It is still too early to predict when the harmonization of tax rates (with regard to number, percentages, and classification of transactions) will take place. There are strong signs that this last stage of the turnover tax harmonization will not be achieved in the 1980s.

The turnover tax is the most important indirect tax, contributing slightly more than one quarter of total tax revenue. In the course of time, the share of the turnover tax as a percentage of total tax revenue will diminish slightly if tax rates remain unchanged. If one accepts that the relative importance of this tax within the framework of the entire tax system is to be maintained, an idea that corresponds with the harmonization attempts of the European Community, then one also has to take into account the progressively decreasing incidence of this tax.

In 1977, the Federal Republic of Germany witnessed an

[continued on page 355]

THE OBJECTIVES OF THE FISCAL POLICY OF THE FEDERAL REPUBLIC OF GERMANY IN THE 1980s

by H. Matthöfer

The picture of the world economy shows grey spots: economic growth has been slowing down noticeably; internal and external imbalances of most economies narrow the scope of governmental monetary and fiscal policy; and, despite some hopeful signals of stabilization, inflation remains a serious problem.

What we are experiencing these days is a unique accumulation of world-wide recession, structural crises and high interest rates.

There are nevertheless prospects of a resurgence of international economic activity. The propensity to invest could prove to be relatively constant. The pressure to adapt in a period of scarce and expensive energy produces positive elements in creating a considerable investment potential which should be capable of maintaining growth for an extended time period. The consumption of oil in a number of oil-importing countries has dropped considerably. Nevertheless, periods of relative quiet in the oil market must not lead to a less stringent policy of energy saving or to a slackening of efforts towards developing alternative sources of energy.

At a time when all industrial and developing countries are fighting fiercely to maintain their competitive world position, the rejection of protectionist tendencies is especially important. Free world trade, which alone provides access to economic and social progress to all participants, is not a spectacle for sunny days but rather a crucial test for difficult times.

The economic situation of many oil-importing, developing countries is a matter of concern. Since 1971, their foreign indebtedness has more than quadrupled, their debt service requirements have increased six-fold and their debt structure has deteriorated due to an increase in the share of "hard" commercial loans. The gulf between the poor and rich of this world has become greater.

But one should not be too pessimistic. Not only has the indebtedness of developing countries increased; their economic potential has increased as well. On the other hand, the ability to achieve economic improvements as well as the ability to adapt differ tremendously from country to country. Some 20 developing countries that are statistically recorded as non-oil countries have emerged in the meantime as minor oil-exporting countries (on a net basis) or have become largely self-sufficient as regards their energy consumption.

It is at home that adaptation begins. This is true for industrial as well as for developing countries. Nevertheless, the efforts of developing countries will continue to need the support of outside aid. This is not to say that only development aid to the poorest countries must be increased, but, rather, that there must be free access to the markets of the industrialized countries for the export commodities of developing countries.

The Government of the Federal Republic of Germany devotes great attention to the improvement of its economic relations with the countries of the Third World. On January 1, 1981, the Second Convention of Lomé concluded between 59 African, Caribbean and Pacific states and the European Community entered into force; it provides for a number of improvements as compared with the previous Convention. At about the same time, the system of general preferences in favor of developing countries entered its second decade. Further improvements in the EEC Scheme are being implemented in 1981. The Federal Government will continue to support further material improvement, particularly for the poorest of the developing countries.

Within Europe, international cooperation is manifested in the realization of the customs union. Since the foundation of the European Community slightly less than 25 years ago, a uniform economic area has been created that has opened new dimensions for trade, business and agriculture and that has by now become an established feature in this part of the world. At present, however, the European Community finds itself in a phase where it is more and more difficult to continue the process of integration in a consistent way; this is primarily due to increasing economic difficulties all over the world. Indeed, the Federal Government continues to regard the membership of the Federal Republic of Germany in the

Hans Matthöfer (55), the present Federal Minister of Finance joined the Social Democratic Party (SPD) in 1950. He studied economics and social sciences in Frankfurt/Main, Germany and Madison (Wis.) U.S.A. and graduated in 1953 as "Diplomvolkswirt". In 1953 he entered the employment of the IG Metall (Metal workers' union) as a member of the Economics Department of the Executive Committee where he specialized in problems connected with automation, mechanization, economic growth and employment. From 1957-1960 he served as a member of the O.E.E.C. Mission in Washington and Paris. In 1961 he became head of the Training and Education Department of the Executive Committee of the IG Metal, as well as a Member of Parliament. As a Member of Parliament he served on the Committees for Economic Affairs, Economic Cooperation, Legal Affairs and Foreign Affairs. He became a Vice-President of the German-Latin Group of Parliamentarians. President of the Patronage Committee of the German Section of Amnesty International and Editor of the periodical "Express Español" (until the end of 1972). From 1971-1973 Mr. Matthöfer acted as President of the Board of Trustees of the German Foundation for Developing Countries. In 1971 he was appointed Parliamentary State Secretary in the Federal Ministry for Economic Cooperation. In 1974 he became the Federal Minister for Research and Technology and in 1978 the Federal Minister of Finance. Mr. Matthöfer is a prolific author who wrote a number of books on economic and political problems as well as numerous articles on questions regarding trade unions, development and research policies.

Herzliche Glückwünsche zum Geburtstag

Am 25. September 1981, dem letzten Tag unseres Kongresses, kann Herr Minister Matthöfer seinen Geburtstag feiern.
Die Herausgeber des Bulletin for International Fiscal Documentation möchten es nicht versäumen, ihm dazu die besten Wünsche zu übermitteln und bei der Abschiedsveranstaltung auf sein Wohl anzustossen.

wann mit einer Harmonisierung der Steuersätze (nach Zahl, Höhe und Zuordnung der einzelnen Umsätze) gerechnet werden kann, erscheint derzeit noch verfrüht. Vieles spricht dafür, dass diese letzte Stufe der USt-Harmonisierung in der 80er Jahren nicht erreicht werden kann.

Die Umsatzsteuer ist mit einem Anteil von etwas mehr als einem Viertel am Gesamtsteueraufkommen die wichtigste indirekte Steuer. Der Aufkommensanteil nimmt im Zeitverlauf bei gleichbleibenden Steuersätzen leicht ab. Wenn man — in Übereinstimmung mit dem Harmonisierungsbestreben der EG — als Zielvorgabe anerkennt, dass die relative Bedeutung dieser Steuerart innerhalb des Steuersystems erhalben bleiben soll, muss allerdings auch deren regressive Belastungswirkung beachtet werden.

Eine entscheidende Wende hat die Bundesrepublik 1977 mit der Reform der Körperschaftsteuer vollzogen. Durch die Einführung eines Anrechnungsverfahrens werden die Gewinne von Körperschaften seitdem nur einmal mit einer Steuer vom Einkommen belastet. Die Körperschaftsteuer, die für einbehaltene Gewinne regelmässig 56 v. H. beträgt, ermässigt sich für ausgeschüttete Gewinne auf 36 v. H. Die verbleibenden 36 v. H. werden auf die Einkommensteuer der Anteilseigner angerechnet.

Um die Einmalbesteuerung sicherzustellen, ist es erforderlich, alle Anteilseigner von der Steueranrechnung auszunehmen, deren Dividenden im Inland nicht voll der Einkommensteuer oder der Körperschaftsteuer unterliegen. Zu diesen Anteilseignern gehören insbesondere inländische Körperschaften des öffentlichen Rechts, inländische steuerbefreite Körperschaften sowie Ausländer.

Es besteht allerdings die Gefahr, dass das Anrechnungsverbot durch ungewöhnliche Gestaltungen unterlaufen wird. Deshalb sind Massnahmen dagegen getroffen worden, dass nichtanrechnungsberechtigte Anteilseigner die Beteiligung an einer inländischen Körperschaft an anrechnungsberechtigte Erwerber veräussern und sich das Anrechnungsguthaben im Preis mitbezahlen lassen. Durch eine weitere Gesetzesregelung soll vermieden werden, dass die Gewinne inländischer Körperschaften durch übermässige Fremdfinanzierung der Besteuerung entzogen werden. In bestimmten Fällen sollen Vergütungen für Fremdkapital nicht als abziehbare Betriebsausgaben, sondern als verdeckte Gewinnausschüttungen behandelt und der Körperschaftsteuer unterworfen werden.

Das Problem der Anrechnung von Körperschaftsteuer über die Grenze hinweg lässt sich nur zusammen mit einer Harmonisierung der Körperschaftsteuersysteme zufriedenstellend lösen. Die EG-Kommission hat hierfür bereits Vorarbeiten geleistet. Aus deutscher Sicht sollte die Rechtsangleichung so erfolgen, dass wir nicht zu einer Doppelbelastung der ausgeschütteten Körperschaftsgewinnen zurückkehren müssen, sondern unser Vollanrechnungsverfahren beibehalten können.

Ein Schwerpunkt unserer Steuerpolitik bleibt die Vereinfachung und Entbürokratisierung unseres Steuersystems. Die Bundesregierung führt diese Aufgabe schrittweise fort, weil Vorstellungen vom grossen Wurf einer umfassenden Steuervereinfachung sich als nicht realisierbar erwiesen haben. Der Handlungsspielraum ist leider eng begrenzt, den Steuervereinfachung muss Rücksicht nehmen auf:

- die unverzichtbare sozialgerechte und gleichmässige Besteuerung aller Bürger nach ihrer Leistungsfähigkeit,
- ausserfiskalische Zielsetzungen, ohne die ein moderner Interventionsstaat nicht denkbar ist (z.B. Sozial-, Wohnungsbau-, Wirtschafts-, Konjunktur-, Energie-, Umweltschutzpolitik),
- das europäische Recht und die internationalen Wirtschaftsbeziehungen,
- die Technik der Steuererhebung im Massenverfahren,
- die Haushalte von Bund, Ländern und Gemeinden und den Finanzausgleich unter den Gebietskörperschaften.

Der Bund hat zudem nur begrenzte Zuständigkeiten; Verwaltung und Organisation liegen in erster Linie bei den Ländern. Die meisten Steuergesetze bedürfen der Zustimmung des Bundesrates.

Dennoch haben wir einige Erfolge aufzuweisen, die uns ermutigen, den eingeschlagenen Weg beharrlich weiter zu schreiten.

Die Bundesregierung misst dem Ausbau der Wirtschaftsbeziehungen mit den Ländern der Dritten Welt grosse Bedeutung bei. Am 1. Januar 1981 ist mit einer Reihe von Verbesserungen das zweite Abkommen von Lomé zwischen der Europäischen Gemeinschaft und 59 Staaten des afrikanischen, karibischen und pazifischen Raums in Kraft getreten. Etwa zur gleichen Zeit ging das allgemeine Präferenzsystem zugunsten der Entwicklungsländer in das zweite Jahrzehnt seiner Anwendung. Das Schema der Gemeinschaft für 1981 ist erneut verbessert worden. Auch in Zukunft wird die Bundesregierung für weitere materielle Verbesserungen, insbesondere zugunsten der ärmeren Entwicklungsländer, eintreten.

Im europäischen Raum steht die internationale Zusammenarbeit im Zeichen der Verwirklichung der Zollunion. Seit Gründung der Europäischen Gemeinschaft vor weniger als 25 Jahren ist ein heute nicht mehr wegzudenkendes einheitliches Wirtschaftsgebiet mit neuen Dimensionen für Handel, Gewerbe und Landwirtschaft geschaffen worden. Zur Zeit befindet sich die Gemeinschaft allerdings in einer Phase, in der es angesichts zunehmender weltweiter wirtschaftlicher Probleme immer schwieriger wird, den Integrationsprozess konsequent fortzusetzen. Die Bundesregierung, die in der Mitgliedschaft der Bundesrepublik Deutschland in der EG einen Eckpfeiler ihrer Aussenpolitik sieht, ist auch weiterhin bereit, ihren Beitrag zur Fortsetzung der Integration zu leisten. Sie wird aber darauf drängen, dass ein gerechter Interessenausgleich stattfindet und Konflikte nicht auf Kosten einzelner Mitgliedstaaten ausgetragen werden.

Die Zusammenarbeit mit den EFTA-Staaten, die durch Freihandelsabkommen eng mit der Europäischen Gemeinschaft verbunden sind, wird kontinuierlich ausgebaut werden. Die Staaten der EFTA und der EG bilden inzwischen einen weitgehend einheitlichen europäischen Markt von 17 Ländern mit mehr als 300 Millionen Bewohnern.

Nach vielen Jahren hoher Überschüsse ist auch die deutsche Leistungsbilanz in die roten Zahlen geraten. Eine wesentliche Ursache ist die höhere Öleinfuhrrechnung der Bundesrepublik. Trotz gesunkener Öleinfuhrmengen haben wir 1980 um 100 Prozent mehr für Ölimporte ausgeben müssen als im Jahr 1978. Daneben spielen andere Gründe eine Rolle, z.B. Spätwirkungen der früheren DM-Aufwertung und der Anstieg unseres Defizits bei den Dienstleistungen (Reiseverkehr) und Übertragungen. Auf Dauer muss die Bundesrepublik zu aussenwirtschaftlichem Gleichgewicht zurückfinden. Der Weg dorthin führt auch für die deutsche Wirtschaft über eine Senkung der Öleinfuhrabhängigkeit sowie über Investitionen, Innovation und Stärkung der Wettbewerbsfähigkeit. In diesem Prozess ist die im internationalen Vergleich weiterhin hohe Preisstabilität der Bundesrepublik eines der wichtigsten Aktiva. Je schneller sich eine Besserung der deutschen Leistungsbilanz abzeichnet, um so eher werden sich die aussenwirtschaftlichen Zwänge unserer Geldpolitik lockern und wird sich neuer Spielraum für eine mehr binnenwirtschaftliche Ausrichtung der Geldpolitik ergeben.

Unsere Steuerpolitik steht im Zeichen stetiger Anpassung und langfristiger Entwicklung. Es gilt dabei, die Gesamtsteuerbelastung so zu gestalten, dass die wünschenswerten Staatsaufgaben finanziert werden können, ohne die individuelle Leistungskraft und Leistungsmotivation des Steuerzahlers zu schwächen.

Die sog. volkswirtschaftliche Steuerquote bewegt sich in der Bundesrepublik Deutschland seit 30 Jahren mit bemerkenswerter Stabilität auf dem gleichen Niveau und schwankt nur mit relativ geringen Ausschlägen um 24 v. H. Auch in den nächsten Jahren wird sie nach den Vorausschätzungen mit 24,16 v. H. (1982) und 24,15 v. H. (1983) nach 24,13 v. H. (1981) praktisch unverändert bleiben. Die Bundesregierung strebt eine Anhebung der Steuerquote auch für die Zukunft nicht an.

Bei hiernach insgesamt gleichbleibender Gesamtsteuerbelastung wohnt unserem Steuersystem gleichwohl eine starke Dynamik zur Strukturverschiebung innerhalb der Steuerarten inne. Der Anteil der sog. direkten Steuern nimmt tendenziell laufend zu, der Anteil der indirekten Steuern nimmt dementsprechend ab. Durch das Zusammenwirken des progressiven Steuertarifs mit Nominallohnerhöhungen ist die Dynamik besonders deutlich bei der Lohnsteuer.

Bis Mitte der 70er Jahre lief diese Entwicklung nahezu ungebremst. Der Anteil der direkten Steuern erhöhte sich von 51,6 v. H. (1952) auf 62,1 v.H. (1977). Der Anteil der Lohnsteuer am Gesamtsteueraufkommen verdreifachte sich beinahe von 11,0 v. H. auf 30,3 v. H. Entsprechend stieg die Lohnsteuerquote, das ist das Verhältnis des Lohnsteueraufkommens zur Bruttolohnsumme, von 7 v. H. (1960) auf 15 v. H. (1974).

Ab 1974 hat die Bundesregierung dieser Entwicklung bewusst entgegengesteuert. Sie hat durch eine Reihe von Steuerentlastungsmassnahmen erreicht, dass die massgebenden Schlüsselzahlen für die Belastung der Lohnsteuerzahler nicht mehr weiter angestiegen sind. Der Anteil der Lohnsteuer am Gesamtsteueraufkommen liegt weiterhin bei rd. 30 v. H. Die Lohnsteuerquote wurde bei 15 v. H. stabilisiert. Auch das Verhältnis direkte/indirekte Steuern hat sich mit 57,4 v. H. zu 42,6 v. H. (1981) wieder etwas eingependelt. Dazu beigetragen haben auch mässige Verbrauchsteueranhebungen bei der Mineralölsteuer, Branntweinsteuer, Tabaksteuer und Umsatzsteuer. Wir wollen die Steuerstruktur langfristig im Gleichgewicht halten und die Grenzen der direkten Steuerbelastung nicht weiter hinausschieben; deshalb können Anpassungen der Verbrauchsteuern auch für die Zukunft nicht ausgeschlossen werden.

Die Weiterentwicklung der Umsatzsteuer wird weiterhin von der Steuerharmonisierung in der EG abhängen. Spektakuläre Fortschritte, die eine baldige Aufhebung der sog. Steuergrenzen zwischen den Staaten der EG ermöglichen würden, zeichnen sich dabei zur Stunde nicht ab. Eher ist mit einer längeren Konsolidierungsphase zu rechnen, in der die Probleme gelöst werden müssen, die in der 6. EG-Richtlinie zur Harmonisierung der Umsatzsteuern von 17. Mai 1977 noch offen geblieben sind. Dazu gehört insbesondere die Frage, ob für Gebrauchtgegenstände (vor allem Gebrauchtwagen) eine gemeinschaftliche Sonderregelung vorgesehen werden soll. Ausserdem müssen im Laufe der Zeit mehr als 40 Übergangsregelungen abgebaut werden, die in der 6. Richtlinie enthalten sind. Eine Prognose darüber,

Hans Matthöfer (55), der Bundesminister der Finanzen, trat im Jahre 1950 der SPD bei. Er absolvierte das Studium der Wirtschafts- und Sozialwissenschaften in Frankfurt am Main und in Madison (Wisconsin, U.S.A.) und schloss dieses 1953 als Diplomvolkswirt ab. 1953 nahm er eine Tätigkeit in der Abteilung Wirtschaft beim Vorstand der IG Metall auf; Schwerpunkte seiner Aufgaben stellten gewerkschaftliche und soziale Probleme der Automation und Mechanisierung dar. Von 1957 bis 1960 war er als Mitglied der O.E.E.C.-Mission in Washington wie auch am Sitz der O.E.E.C. in Paris tätig. 1961 wurde er Leiter der Abteilung Bildungswesen beim Vorstand der IG Metall; ferner wurde er zum Mitglied des Deutschen Bundestages gewählt, wo er im Ausschuss für Wirtschaft, im Ausschuss für wirtschaftliche Zusammenarbeit, im Ausschuss für den wirtschaftlichen Besitz des Bundes, im Rechtsausschuss sowie im Auswärtigen Ausschuss tätig war. Ferner war er Vizepräsident der lateinamerikanischen Parlamentariergruppe und Mitglied des Ehrenpräsidiums der deutschen Sektion von Amnesty International. Darüber hinaus war er bis Ende 1972 Herausgeber der Zeitschrift "Exprèss Español". Von 1971 bis 1973 war Herr Matthöfer Präsident des Kuratoriums der Deutschen Stiftung für Entwicklungsländer; 1972 wurde er zum Parlamentarischen Staatssekretär beim Bundesminister für Wirtschaftliche Zusammenarbeit berufen. Im Mai 1974 wurde er Bundesminister für Forschung und Technologie und seit 1978 ist er Bundesminister der Finanzen.

Publikationen:

- *"Der Unterschied zwischen Tariflöhnen und den Effektivverdiensten in der Metallindustrie der Bundesrepublik", Frankfurt/Main 1956,*
- *"Technological change in the Metal Industries" (zwei Teile), Paris 1961/62,*
- *"Der Beitrag politischer Bildung zur Emanzipation der Arbeitnehmer — Materialien zur Frage des Bildungsurlaubs", Frankfurt/Main 1970,*
- *"Streiks und streikähnliche Formen des Kampfes der Arbeitnehmer im Kapitalismus", Frankfurt/Main 1971,*
- *"Für eine menschliche Zukunft. Sozialdemokratische Forschungs- und Technologiepolitik", Düsseldorf/Wien 1976,*
- *"Humanisierung der Arbeit und Produktivität in der Industriegesellschaft", Köln/Frankfurt/Main 1977.*

Ferner zahlreiche Artikel zu Fragen der Gewerkschafts-, Finanz- und Entwicklungspolitik.

Aufgaben der deutschen Finanzpolitik in den 80er Jahren

von Hans Matthöfer — Bundesminister der Finanzen

Das Bild der Weltwirtschaft ist mit Grautönen durchsetzt. Das Wirtschaftswachstum hat sich fühlbar abgeschwächt. Innere und äussere Ungleichgewichte der meisten Volkswirtschaften schränken die Möglichkeiten für staatliche Geld- und Fiskalpolitik ein. Die Inflation bleibt trotz erfreulicher Stabilisierungsansätze ein ernstes Problem.

Wir erleben in dieser Zeit eine bisher einmalige Kumulation weltweiter Rezession, struktureller Krisen und hoher Zinsen.

Aussichten, dass sich die internationale Wirtschaftstätigkeit wiederbelebt, sind aber durchaus vorhanden. Die Investitionsneigung könnte sich als relativ robust erweisen. Der Zwang zur Anpassung an eine Zeit knapper und teurer Energie hat auch eine positive Seite in Gestalt eines erheblichen Investitionsbedarfs, der für längere Zeit ein Wachstum sollte stützen können. Der Ölverbrauch in vielen öleinführenden Ländern ist z.T. bereits deutlich gesunken. Phasen relativer Ruhe am Ölmarkt dürfen keinen Anlass geben, in der konsequenten Politik der Energieeinsparung und des "Weg vom Öl" nachzulassen.

Gerade in einer Zeit, da alle Industrie- und Entwicklungsländer schwer um ihre Behauptung im weltwirtschaftlichen Wettbewerb ringen, ist es wichtig, protektionistischen Tendenzen entgegenzutreten. Der freie Welthandel, der allein eine Teilnahme aller am wirtschaftlichen und sozialen Fortschritt ermöglicht, ist keine Schönwetterveranstaltung, sondern muss sich gerade auch in schwierigen Zeiten bewähren.

Sorge bereitet die wirtschaftliche Lage vieler öleinführender Entwicklungsländer. Ihre Auslandsverschuldung hat sich seit 1973 mehr als vervierfacht, der Schuldendienst versechsfacht, und die Schuldenstruktur hat sich durch einen höheren Anteil harter kommerzieller Kredite verschlechtert. Die Kluft zwischen Arm und Reich in dieser Welt ist grösser geworden.

Vor verallgemeinerndem Pessimismus ist jedoch zu warnen. Nicht nur die Verschuldung der Entwicklungsländer, auch ihre wirtschaftliche Leistungskraft ist gestiegen. Andererseits sind Ausgangslage und Anpassungspotential von Land zu Land sehr unterschiedlich. Etwa 20 statistisch als Nicht-Öl-Entwicklungsländer bezeichnete Länder sind inzwischen kleinere Netto-Ölexporteure oder weitgehend Energieselbstversorger geworden.

Anpassung beginnt zu Hause. Dies gilt für Industrie- wie für Entwicklungsländer. Die Eigenanstrengungen der Entwicklungsländer bedürfen jedoch weiterhin der Hilfe von aussen. Das bedeutet nicht nur ein Mehr an Entwicklungshilfe besonders für die ärmsten dieser Länder. Offener Marktzugang für die Ausfuhren der Entwicklungsländer auf den Industrieländer-Märkten ist noch wichtiger.

There are two seminars scheduled for Berlin, the first on "Taxation of income arising from the international sea-bed". In view of the controversy which has bogged down progress on the proposition for a Law on the international sea-bed, it will be interesting to see how the seminar develops. The second seminar is on "Principles of German tax law", which should attract the same considerable interest as seminars on the domestic tax laws of the host country always have in the past.

The nature of the two subjects for discussion at Berlin, and the high level of the two Cahiers on the subjects will, I hope, lead to an equally high level of discussion at the working sessions. In the recent past, the level of discussion at Congress has not nearly matched the quality of the prepared papers.

This number of the Bulletin contains articles on some interesting areas in the German tax system, as well as a range of other erudite contributions. May I suggest that members of IFA who are participants in the Berlin Congress, and who will receive an advance copy of this Bulletin as part of their Congress kit should, if they are not already subscribers to the Bulletin, become subscribers to what is one of the important tax journals of the world, and is incidentally the official organ of the International Fiscal Association. It should be in the library of every member.

I hope that the Berlin Congress will be very successful at the working and professional level. I wish participants a happy time in Berlin and hope they will be able to renew professional and personal friendships. At the end of the Berlin Congress I will end my period of office as your President. It has been an interesting four years, during which we have voyaged to Sydney, Copenhagen, Paris and Berlin. The support of the Secretary-General and the General Treasurer, and the small but dedicated staff of central IFA has ensured efficiency in the conduct of the affairs of IFA. Both the Executive Committee and the Permanent Scientific Committee have been assiduous in their work between Congresses, and our warm thanks are due to all members who have given their time and their energies to the work of IFA, not only at the centre, but in the national branches, from which IFA draws its energy and its vigour for a prosperous future.

IFA NEWS

FEDERAL REPUBLIC OF GERMANY

The German Branch of IFA announces that it will organise on September 17 - 20, 1981 a joint German-United States Tax Seminar in Rothenburg o.d.T. (Bavaria) immediately preceding the Annual IFA Congress which will be held September 21 - 25 in West Berlin. The German Branch urges its members to join the U.S. IFA members who will proceed by train from Rothenburg to West Berlin.

Subjects which will be discussed include:

- the principal differences between the German and United States tax systems;
- loan financing of corporations by foreign shareholders;
- the inheritance tax treaty between the Federal Republic of Germany and the United States;
- rulings for transfer pricing between associated enterprises;
- the repercussions of the differing concepts of income in the Federal Republic of Germany and the United States;
- limits of the exchange of information including those imposed by accounting practice;
- tax treatment of investment, inter alia, in oil and natural gas resource and real property.

SWITZERLAND

The Swiss Branch of IFA sent us a report on its activities during 1980.

Its first 1980 meeting was held on February 8, 1980 in Basle. Dr. Max Widmer, who has been the Director of the International Tax Division of the Swiss tax administration for many years, talked on the development of international taxation and its prospects for the future. Dr. Widmer who has often been a member of Swiss delegations negotiating tax treaties and who has been the Chairman of the OECD Working Group for Double Taxation in Paris gave a survey of the problems which the Swiss economy with its manifold international connections has to solve.

The next meeting was held on June 20, 1980 in Zurich. All members of the Swiss Branch's Board of Directors were reelected. Dr. Heinz Weidman submitted a paper on the taxation of the annual rental value of owner-occupied dwellings and the furthering of the construction of such dwellings.

The fall meeting was held on October 31, 1980 in Neuchâtel where Dr. Kurt Stocker reported on the proceedings of the Paris Congress of IFA 1980. The members of the Swiss Branch found that those persons who chair the IFA meetings should be better prepared and should apply the rules adopted more strictly. A suggestion to this effect was sent to the Secretary-General of IFA.

At the fall meeting the reports for the Berlin Congress of IFA (1981) were submitted and discussed. The reporter on the subject "Mutual agreement procedure and practice" is Mr. Daniel Lüthi, notary public, and Dr. Charles Constantin reported on "The unilateral measures to prevent double taxation". Mr. Jacques Bégulin reported on the situation with respect to Swiss federal finance.

The Congress of Berlin

ALUN G. DAVIES
President of IFA.

The Congress of 1981 will be held at the International Congress Centre in West Berlin. This is a custom-built complex with every conceivable facility. Our host will be the city of West Berlin, separated territorially from the Federal Republic of Germany, but tied to it by every bond except the legal one. West Berlin, isolated in the midst of East Germany, and separated from East Berlin by the formidable Wall, will be a fascinating place to visit. The city seems almost shy and introverted compared with the Berlin which was the capital of pre-war Germany, but its spirit, bold, stubborn and courageous, also has its appeal.

During the Congress week in Berlin, we shall be discussing two subjects which are very central to the international tax problems which IFA is dedicated to study. The first subject has the rather dull title "Mutual agreement — procedure and practice". Behind this unexciting exterior lies one of the most important and problematical of the question which the huge network of bilateral treaties for the avoidance of double taxation has left unsolved. What happens in the still unresolved areas of these treaties which still leave the taxpayer without any remedy for double taxation? In these areas, the taxpayer may still find himself in the jaws of the nutcracker between two competing tax jurisdictions.

There is considerable ignorance, even amongst tax specialists, of this relatively new area of controversy. It is uncharted and unmapped, and there is very little published material or precedent. It has even been suggested that there is a conspiracy of silence in governmental circles, and certainly a lack of encouragement to the taxpayer to exercise such rights as he may have. As an example of the paucity of information on the subject, the only source of information in the United Kingdom on how to commence mutual agreement procedures is published in the United States. The fact that no formal procedure exists in the United Kingdom should surely be a matter of record.

It is certainly true that the use of mutual agreement procedure in double tax agreements is increasing, and is bound to increase further, as governments give more and more attention to the problem of transfer pricing between associated companies in the field of international trade and commerce. The choice of this subject for the Berlin Congress is timely.

The General Report of Dr. Karl Koch and his 17 collaborators in the national reports, is a substantial and valuable contribution to the sparse professional literature on the subject of mutual agreement procedure. The Cahier on this subject will form the basis for most interesting discussions in the working sessions of Congress. It provides evidence that the present mutual agreement procedure is protracted and unwieldy, and that they give taxpayers very little protection. Procedures which do not allow taxpayers the right to initiate proceedings, which do not give taxpayers the right to require the elimination of taxation contrary to the treaty, and which refuse taxpayers the right to obtain details of the progress of discussions between governments on a specific issue, are clearly unsatisfactory. Governments may not be hostile to the implementation of mutual agreement procedures, but there are few governments who show any enthusiasm to help the taxpayer achieve some helpful answer to his problems. The fate of the EEC proposal for a Council directive (dated 29 November 1976) — it seems to be moribund — shows that in this area of mutual agreement procedures, governments are markedly unenthusiastic.

The second subject to be discussed at the Berlin Congress is also closely connected with treaties for the avoidance of double taxation, or rather with the need for the supplementation of tax relief where such treaties are not available, or whether their scope is less than total. The general report of Dr. D. Juch, supplemented by 20 national reports, shows that international double taxation is only partially prevented by bilateral treaties, most of which have been concluded between developed countries. There is still a great need for unilateral relief measures to deal with relationships between developed and developing countries and also between the developing countries. As the network of double tax treaties expands, the need for unilateral measures may well decrease, although they will always be necessary for situations not wholly covered by treaty arrangements.

Throughout the Cahier on unilateral tax measures, there is evidence of the considerable variety that exists in the kinds of unilateral relief granted in the various countries. The general reporter suggests that as the U.N. and the O.E.C.D. have now succeeded in producing draft conventions for bilateral relationships, they might now consider the production of draft documents for unilateral tax measures, especially vis-à-vis the Third World. He makes the point that while such drafts would not intégrate the basic and conficting principles of exemption and credit, they might provide a bridge between them. Dr. Juch modestly disclaims any aim to produce such a model, but then goes on to do so, at least in outline.

Y.C. Jao:

Steueränderungen und Reformen in Hong Kong 401
Untersuchung der Änderungen des Steuerrechts seit 1976. Die dabei eingeführten Vereinfachungen und Rationalisierungen resultierten in einer niedrigeren Belastungsquote bei den Personalsteuern, einem höheren Steueraufkommen und folglich einem grösseren Finanzüberschuss. Diese bemerkenswerten Ergebnisse verdienen es, dass ihnen über den lokalen Bereich hinaus Beachtung geschenkt wird.

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Die Struktur der Einkommensbesteuerung nach dem Schedulen- und dem Globalsystem — die internationale Dimension 409
Untersuchung des Schedulen- und des Globalsystems der Besteuerung sowie die Auswirkungen auf unilaterale und bilaterale Massnahmen zur Vermeidung der Doppelbesteuerung im internationalen Rahmen. Weitere Themen, die hier behandelt werden, sind die Besteuerung von Körperschaften vis-à-vis natürlichen Personen sowie eine mögliche Alternative zur Besteuerung der multinationalen Unternehmen.

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Catherine S. Salomons und Leesa M. Stern:

Bericht über das britisch/niederländische Steuerseminar (7.-8. Mai 1981) 417
Bericht über das Steuerseminar der britischen und der niederländischen IFA-Gruppe, das sich insbesondere mit komplexen Fragen der Dividendenbesteuerung unter dem Doppelbesteuerungsabkommen zwischen Grossbritannien und den Niederlanden befasste. Weitere Diskussionspunkte betrafen den Informationsaustausch sowie Fragen der "Ansässigkeit" bei natürlichen Personen und Körperschaften.

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Sylvain R.F. Plasschaert:

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Catherine S. Salomons et Leesa M. Stern:

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Some problems of tax policy in developing countries
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Eugen Jehle:

Das Steuersystem der Bundesrepublik Deutschland 357
Gesamtdarstellung des deutschen Steuersystems. Behandelt werden u.a. die Einkommensteuer, Körperschaftsteuer, Umsatzsteuer sowie eine Reihe von "speziellen" Steuergesetzen, die grösstenteils steuerliche Anreize für bestimmte Investitionen vorsehen, z.B. in Berlin (West), im Zonenrandgebiet sowie im Ausland. Es wird auch kurz auf das Aussensteuergesetz eingegangen, dessen hauptsächlicher Zweck in der Bekämpfung der Steuerumgehung zu sehen ist.

Edwin C. Harris:

Kürzliche Änderungen im kanadischen Steuerrecht; internationale Aspekte 368
Der Gesetzentwurf C-54, der Anfang 1981 Gesetzeskraft erlangte, enthält eine Reihe von wichtigen Änderungen, die sich mit internationalen Transaktionen beschäftigen. Dieser Artikel untersucht die Auswirkungen, die diese Änderungen haben, und zwar für im Ausland lebende Kanadier, für Mitarbeitertrusts, für Mitarbeiterfonds, für die Erhebung der Zweigstellensteuer, für die Beendigung von Rohstofförderungsunternehmen, für die Verlegung des Sitzes und der Geschäftsleitung einer Körperschaft, für ausländische Tochtergesellschaften, für die Veräusserung kanadischer Vermögenswerte durch Ausländer, für die Anrechnung ausländischer Steuern oder deren Abzug von der Bemessungsgrundlage, für Investmentgesellschaften in ausländischem Besitz, für die Quellensteuer sowie für die Besteuerung durch die Festlegung der Grenzen Kanadas.

XV. Generalversammlung des Interamerikanischen Zentrums der Steuerverwaltungen (C.I.A.T.):

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Die Kritik der Internationalen Handelskammer am "U.S. Foreign Investment in Real Property Tax Act 1980" richtet sich hauptsächlich gegen die Begriffe "United States Real Property Holding Corporation", "controlling interest", "real property" sowie "substantial investors". Ferner bringt die Internationale Handelskammer ihre Missbilligung darüber zum Ausdruck, das Vorschriften dieses Gesetzes Vorrang vor Bestimmungen der Doppelbesteuerungsabkommen haben sollen.

V. Tkachenko:

Schwerpunkte des Berichts des U.S.-Schatzamtes zu Steueroasen und deren Nutzung durch U.S.-Steuerzahler 381
Dieser Artikel fasst die Schwerpunkte des Berichts des U.S.-Schatzamtes zu Steueroasen und deren Nutzung durch U.S.-Steuerzahler zusammen. Dieser Bericht basiert auf einer Studie über Transaktionen mit Steueroasen, den relevanten Bestimmungen des nationalen U.S.-Steuerrechts, den von den U.S.A. abgeschlossenen Doppelbesteuerungsabkommen und den Versuchen der U.S.-Steuerbehörden, diese Transaktionen in den Griff zu bekommen.

Pedro Massone:

Entwicklungen in Lateinamerika – Das Mexikanische Einkommensteuergesetz 1980 389
Ende 1980 trat in Mexiko eine Reihe von Gesetzen in Kraft, die Veränderungen bei den direkten und indirekten Steuern zum Inhalt haben. Die wichtigste Änderung stellt die Einführung eines neuen Einkommensteuergesetzes dar, das seit dem 1. Januar 1981 anzuwenden ist. Dieser Artikel beschäftigt sich mit den wichtigsten Merkmalen des neuen gesetzes, insbesondere mit den Vorschriften, die für Unternehmen, Investoren und Nichtansässige Bedeutung haben.

Eugen Jehle:

Le système fiscal applicable en République Fédérale d'Allemagne 357
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Edwin C. Harris:

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La loi C-54, promulguée au début de 1981, contient un certain nombre de modifications importantes aux règles portant sur les transactions internationales, modifications étudiées dans cet article. Ces modifications affectent l'imposition des Canadiens à l'étranger, les structures sociales en faveur des employés, l'introduction d'un impôt sur les filiales, la cessation d'entreprises d'exploitation de ressources naturelles, l'émigration des sociétés, les affiliés étrangers, une disposition applicable aux non-résidents en matière de propriété canadienne, crédit fiscal étranger ou déduction, des sociétés d'investissement détenus par des non-résidents, la retenue à la source et les frontières du Canada en matière fiscale.

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Le défi de l'administration fiscale jusqu'à la fin du XXe siecle. Rapport de la dernière conférence du C.I.A.T. qui a eu lieu du 29 juin au 3 juillet 1981.

Eric Osterweil:

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La critique de la C.C.I. sur la loi fiscale américaine de 1980 sur les investissements étrangers dans l'immobilier porte essentiellement sur la définition de "United States Real Property Holding Corporation", "controlling interest", "real property" et "substantial investors". Le dépassement des conventions fiscales par la nouvelle loi est également désapprouvé par la C.C.I.

V. Tkachenko:

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Pedro Massone:

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Fin 1980 le Mexique a introduit un certain nombre de lois modifiant les impôts directs et indirects. Le plus important de ces amendements a été l'introduction d'une nouvelle loi sur l'impôt sur le revenu applicable à partir du 1er janvier 1981. L'article insiste sur les points les plus importants de la loi et en particulier dans les domaines où des modifications importantes ont été introduites ou qui présentent un intérêt spécial pour les entreprises, les investisseurs et les non-résidents.

Pedro Massone:

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Y.C. Jao:

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Zu den Zielen der Regierung der Bundesrepublik Deutschland im Bereich der Finanzpolitik gehört u.a. die Erweiterung der internationalen Zusammenarbeit auf der Basis verschiedener Verträge, insbesondere des Vertrages von Rom, auf den die Europäische Gemeinschaft begründet ist. Die Finanzpolitik im nationalen Rahmen reflektiert die Notwendigkeit ständiger Anpassung sowie die Bestimmung langfristiger Entwicklungen. Eine wichtige Entwicklung stellt z.B. die Einführung des Vollanrechnungssystems im Bereich der Körperschaft-/Einkommensteuer dar. Die Bundesregierung ist indes nicht bereit, einen Missbrauch dieses Systems zwecks Steuervermeidung hinzunehmen. Eine schrittweise Vereinfachung des Steuersystems gehört ebenfalls zu den Zielen der Bundesregierung.

Heinrich List:

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Prof. Dr. List, der Präsident des Bundesfinanzhofs, untersucht eine Reihe von neueren Entscheidungen zu Doppelbesteuerungsabkommen sowie zum Aussensteuerrecht der Bundesrepublik Deutschland. Allerdings betreffen die meisten der zitierten Entscheidungen Fälle, die mehr als 10 Jahre zurückliegen; der Bundesfinanzhof hatte bislang keine Gelegenheit, sich mit Problemen, die nach dem Inkrafttreten des Aussensteuergesetzes im Jahre 1972 aufgetaucht sind, zu beschäftigen. Einer der Gründe dafür könnte in den Schwierigkeiten gesehen werden, mit denen die Finanzämter und Finanzgerichte bei der Aufklärung von Sachverhalten, die z.T. im Ausland spielen, zu kämpfen haben.

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Heinrich List:

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Monsieur le Professeur Dr. List, Président de la Cour Suprême Fiscale allemande, étudie un certain nombre d'arrêts récents portant sur les conventions fiscales et les dispositions nationales se rapportant aux aspects fiscaux internationaux. Néanmoins, la plupart de ces arrêts concernent des années fiscales remontant à plus de 10 ans lorsque de la Cour Suprême Fiscale ne s'était pas encore prononcée sur les problèmes liés au droit fiscal international, prise de position qui a eu lieu en 1972. Cette situation peut être due, entre autre, au fait que les autorités fiscales et les cours de justice rencontrèrent de nombreuses difficultés dans l'évaluation des biens à l'étranger.

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SEPTEMBER 1981

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OCTOBER 1981

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EUROPEAN REGIONAL INCENTIVES: 1980

A survey of regional incentives in the countries of the European Community. Edited by Douglas Yuill and Kevin Allen. Glasgow, Centre for the Study of Public Policy, University of Strathclyde, 1980. 382 pp., £ 17.50.
Study on past changes, the current position and future trends and issues in regional incentives granted in European countries, viz., Belgium, Denmark, France, German Federal Republic, Ireland, Italy, Luxembourg, the Netherlands, United Kingdom.
(B. 103.165)

TAX SAVINGS FOR THE EXPATRIATE EXECUTIVE AND MANAGER IN WESTERN EUROPE

By David Phillips. London, The Economist Intelligence Unit, Ltd., 1981. EIU Special Report, No. 92, 94 pp., £40.
Report explaining to the layman the various systems in Belgium, France, German Federal Republic, Italy and the Netherlands with respect to individual income tax for expatriate executives and managers. (B. 103.166)

FRANCE

DROIT FISCAL

Troisième édition. By Gilbert Tixier and Guy Gest. Paris, Librairie Générale de Droit et de Jurisprudence, 1981. 557 pp.
Third revised edition of introductory textbook on general features of tax laws in the world as viewed from various angles. (B. 103.173)

DROIT PENAL FISCAL

By Gilbert Tixier and Jean-Marie Robert. Paris, Dalloz, 1980. 136 pp.
Monograph on the penal law on taxes emphasizing tax fraud, with reference to case law on the issue. (B. 103.170)

LAMY FISCAL

Tome I: taxes sur le chiffre d'affaires; enregistrement et timbre; fiscalité immobilière; impôts directs locaux. Tome II: impôts directs d'Etat;contrôle, contentieux, pénalités. Paris, Lamy S.A., 1981. 804 + 1058pp.
Annual publication in two volumes containing an explanation of French tax legislation. Supplements are issued regularly in order to keep the two volumes up to date. (B. 103.214)

LA TAXATION D'OFFICE A L'IMPOT SUR LE REVENU

(Actes des Journées d'Etudes organisées par la Société Française de Droit Fiscal à Strasbourg les 3 et 4 mai 1979). Paris, R. Pichon, R. Durand-Auzias, 1980. 165 pp., 60 Fr.Frs.
Text of the proceedings of a study conference convened by the "Société Française de Droit Fiscal" in Strasbourg, 3-4 May 1979 on the work of the control office on income tax returns.
(B. 103.174)

LES TAXES D'URBANISME

By Pierre-Jean Ciaudo. Paris, Editions Sirey, 1981. 144 pp.
Monograph designed as a guide to and study of the levy and administration of taxes for purposes of urban areas. (B. 103.163)

INTERNATIONAL

CUSTOMS VALUATION

Convention, recommendations, opinions, notes and studies. Fourth impression (October 1980). Brussels, Customs Co-operation Council, 1980.
Loose-leaf publication of compendium containing the convention on the valuation of goods for customs purposes, recommendations, opinions, notes and studies. The material is updated by supplements. (B. 103.154)

CUSTOMS VALUATION

Examples illustrating the Explanatory Notes to the Brussels

9. Influence of the tax law on general law (September 9, 1980; speaker Dr. Alcides Jorge Costa).
10. Competence conflicts between the ICM and the ISS [2] (October 21, 1980; speaker Dr. Geraldo Ataliba).
11. Consolidation of the rules of the ICM of the State of Rio de Janeiro — controversial aspects (December 2, 1981; speaker Dr. João Gabriel de Mello Brandão, superintendent of the State Tax Service).
12. Aspects of the implementation of tax rules (December 9, 1981; speaker Dr. Gilberto de Ulhôa Canto).
13. Economic aspects of the computation of social security contributions (December 19, 1980; speaker Prof. Fernando Atonio Rezende da Silva).

The Brazilian Branch co-sponsored the First International Congress for the Study of Taxation (I Congresso Internacional de Estudos Tributarios) as well as the Fourth Inter-American Tax Congress (IV Congresso Interamericano de Tributação) which were held in 1980. In 1980, 39 new members were admitted so that the total number of Brazilian IFA members is currently 271.

BRITISH BRANCH

The British Branch held its Annual General Meeting on May 28, 1981. The Chairman's report for that meeting shows that the number of members is currently 478 (a net increase of 25) made up of 387 individuals and 91 corporate members. The Manchester sub-branch has 56 members.

During 1980-81 eight discussion meetings and a wine-tasting evening were organized. In addition, the Manchester sub-branch organized five technical meetings. On May 7-8, 1981, a joint Anglo-Dutch tax seminar was held in Amsterdam. [3]

London Congress 1985

The British Branch has been selected to host the 1985 IFA Congress and arrangements have been made to hold this at the Barbican Centre.

2. Imposto sobre Serviços (Tax on services).
3. See the next issue for a report on this meeting.

COLOMBIAN BRANCH

On April 7, 1981 the Colombian Branch held a luncheon meeting in honor of Dr. Alba Lucia Orozco de Triana who has recently been appointed a director of the national tax service. During the lunch Dr. Luis Ignacio Becerra Fadul talked on the tax aspects of technical services and their international repercussions.

On May 22, 1981 a seminar was organized during which papers on the following subjects were presented:

(i) Tax incentives in developed and developing countries, by Dr. Carlos Ramirez Guerrero and by Dr. Eduardo Laverde Toscano.
(ii) Inflation and taxation: international experiences, by Dr. Armando Parra Escobar and by Dr. Alfredo Lewin Figueroa.
(iii) Provisions regarding branch offices of foreign companies, by Dr. Luis Ignacio Becerra Fadul and Dr. Gabriel Sarria Olcos.

A circular letter was distributed inviting members of the Colombian Branch to contribute to a series of articles under the heading "Letters from IFA" (Carta de la IFA) which will deal with international aspects of taxation. The list of subjects to be discussed is as follows:

1. Income tax treatment of technical services and technical assistance.
2. Structure of the tax on remittances and reform of this structure with respect to new projects.
3. Refundable costs and fees with respect to technical service contracts and technical assistance contracts.
4. The tax treatment and the provisions with respect to commercial law and exchange control regulations applicable to branches of foreign service companies set up in Colombia.
5. Taxation in the countries of the Andean Pact.
6. Double taxation treaties.
7. The tax treatment and the accountancy and exchange control regulations applicable to the "liquidation" of Colombian branches of foreign companies;
8. Tax treatment of leasing.

It is possible to add to this list within the framework of the general theme. Articles submitted should number between 4 to 10 pages.

Dealing at Arm's Length under Danish Income Tax Law

Decision of the Special Tax Tribunal of December 15, 1980 re: A/S Dansk Esso. [1]

The August/September 1979 issue of the *Bulletin* contained an article by *Mr. J. Mazanti-Andersen, M.C.J.* dealing with the arm's length provisions in Danish income tax law which were enacted in 1960. [2] It may be recalled that 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...."*

Until 1978 the Danish tax authorities applied this provision only to a limited extent. However, in 1978 the taxable income of a number of companies which were or had been resident in Denmark and which were or had been controlled by foreign oil companies was arbitrarily increased by the Danish tax authorities.

One of these cases was brought before the Special Tax Tribunal which held in that case that the tax authorities were not entitled to apply Section 12(1). Mr. Mazanti-Andersen kindly sent us a translation of the ruling of the Special Tax Tribunal which is reproduced in the adjacent column.

> *"The Special Tax Tribunal considers that where the greater share of the market in question is controlled by multi-national groups and where there are no independent enterprises of importance with which a comparison can be made, there may be such circumstancial evidence that an estimated assessment is considered warranted under section 12 of the Company Tax Act, although there are no demonstrable facts. On the basis of the information presented, including information on the amount of gross profit shown in the financial statements published, on the adjustment to be made when compared with the gross profit of other companies, and on the uncertainty attending the calculation of the gross profit estimated by the Inland Revenue Department, the Special Tax Tribunal considers, however, that the basis for applying section 12 of the Company Tax Act has not been proved to be sufficiently clear in the present case.*
>
> *The assessment complained of shall therefore be reduced to the amount filed with the tax authorities.*
>
> **It is ruled**
>
> *that the assessment of the taxable income for A/S Dansk Esso (with jointly taxed subsidiaries) made by the Special Commissioners of Direct Taxes in the amount of Dkr. 18,749,000 shall be reduced to Dkr. 1,749,594."*

1. File No. 4-76-971/3-000/73.
2. "Danish rules for dealing at arm's length" in 33 *Bulletin for International Fiscal Documentation* (1979) at 347.

IFA NEWS

BRAZILIAN BRANCH

In 1980 the Brazilian Branch continued its tradition of organizing luncheon meetings during which a paper was read by a distinguished tax expert followed by lively discussions. These papers dealt with the following subjects:

1. Changes in the law on Federal tax collection (January 15, 1980; speaker Prof. Francisco Neves Dornelles, secretary of the Federal tax collection department).
2. The tax system and fiscal federalism (March 17, 1980; speaker Prof. João Luiz da Silva Junior, secretary of General Planning and Coordination of the State of Minais Gerais).
3. The ICM, [1] its administrative difficulties and the resulting economic distortions (April 30, 1980; speaker Dr. Heitor Brandon Schiller, Finance Secretary of the State of Rio de Janeiro).
4. The decree-law and legislative power of the executive (May 29, 1980; speaker Dr. Mairo Caldeira de Andrada).
5. The constitutionality of compulsory loans (June 30, 1980; speaker Dr. Hamilton Dias de Souza).
6. Accountancy and the lawyer (July 8, 1980; speaker Dr. Carlos Alberto Alvahydo de Ulhôa Canto).
7. The compulsory loan: procedure and calculation (August 4, 1980; speaker Dr. Fernando Cicero).
8. Collection of the outstanding debts of the Federation — Bill for an Act (August 26, 1980; speaker Dr. Ives Gandra de Silva Martins).

1. Imposto sobre Circulação de Mercadorias (Tax on merchandise traffic).

ANNEX (7)

COMPARISON OF TAX PAYABLE AND EFFECTIVE TAX RATE OF TAXPAYERS OF SIMILAR CIRCUMSTANCES AND INCOME LEVELS UNDER TAX LAWS OF FOUR DIFFERENT ADMINISTRATIONS *

Tax payable in:

Status / Income	Hong Kong (**) ($)	Singapore (HK$2.50 = S$1) ($)	Malaysia (HK$2.30 = R1) ($)	U.K. (HK$12.50 = £1) ($)
Single person (annual income) ($)				
36,000	850 (2.4%)	2,427 (6.7%)	3,037 (8.4%)	5,644 (15.7%)
60,000	4,500 (7.5%)	6,337 (10.6%)	8,892 (14.8%)	12,843 (21.4%)
120,000	18,000 (15.0%)	22,937 (19,1%)	31,072 (25.9%)	30,844 (25.7%)
Married person, with no children (annual income) ($)				
48,000	150 (0.3%)	3,772 (7.9%)	4,517 (9.4%)	6,356 (13.2%)
72,000	2,550 (3.5%)	8,332 (11.6%)	11,147 (15.5%)	13,556 (18.8%)
120.000	13,750 (11.5%)	22,137 (18.4%)	29,232 (24.4%)	27,956 (23.3%)
162,500	24,375 (15.0%)	36,287 (22.3%)	47,917 (29.5%)	40,706 (25.1%)

Note: *) Not including such other compulsory levies as the U.K. national insurance contribution, payroll tax in Singapore, and capital gains taxes in the U.K. and Malaysia.

**) After proposed increases in personal allowances.

Percentage figures in brackets are the effective rates of tax.

ANNEX (8)

PROPOSED ANNUAL DEPRECIATION ALLOWANCES

Rate of 10 percent

1. Air-conditioning plant excluding room air conditioning units.
2. Bank safe deposit boxes, doors and grills.
3. Broadcasting transmitters.
4. Cables (electric).
5. Lamp standards (street) — gas or electric.
6. Lifts and escalators (electric).
7. Mains (gas or water).
8. Oil tanks.
9. Shipping — Ships, junks and sampans. Lighters. Tugs.
10. Sprinklers.

Rate of 20 percent

11. Domestic appliances.
12. Furniture (excluding soft furnishings).
13. Room air-conditioning units.
14. Shipping — Launches and ferry vessels. Hydrofoils.
15. Taxi meters.
16. Type and blocks (if not dealt with on renewals basis).

Rate of 30 percent

17. Aircraft (including engines).
18. Bar syphon apparatus.
19. Bicycles.
20. Bleaching and finishing machinery and plant.
21. Concrete pipe moulds.
22. Electric cookers and kettles.
23. Electronic data processing equipment.
24. Electronics manufacturing machinery and plant.
25. Motor vehicles.
26. Plastic manufacturing machinery and plant including moulds.
27. Shipping — Outboard motors.
28. Silk manufacturing machinery and plant.
29. Sulphuric and nitric acid plant.
30. Tank lorries.
31. Textile and clothing manufacturing machinery and plant.
32. Tractor — bull dozers and graders.
33. Weaving, spinning, knitting and sewing machinery.

Rate of 10 percent

34. Machinery or plant, not specified in items 1 to 33, and used for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephone or public telegraphic service.

Rate of 20 percent

35. Any other machinery or plant, not specified in items 1 to 34.

Note: The effect of these proposals is thus:

to increase from 5 to 10 percent the annual depreciation allowance for items 4, 5, 7 and 8;

to increase from 15 to 20 percent the annual depreciation allowance for items 11, 12, 13, 14, 15, 16 and 35;

to increase from 25 to 30 percent the annual depreciation allowance for items 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 31, 32 and 33.

TABLE (13)

GENERAL REVENUE BY MAIN SOURCES 1971-72 TO 1981-82
(Adjusted for analytical purposes)

	1971-72 ($mn)	1972-73 ($mn)	1973-74 ($mn)	1974-75 ($mn)	1975-76 ($mn)	1976-77 ($mn)	1977-78 ($mn)	1978-79 ($mn)	1979-80 ($mn)	1980-81 (Revised Estimates) ($mn)	1981-82 (Draft Estimates) ($mn)	1981-82 (After revenue proposals) ($mn)
Recurrent Account:												
DIRECT TAXES												
Earnings and profits tax	929	1,083	1,680	2,144	2,234	2,699	3,357	4,115	5,724	8,035	10,005	8,923
INDIRECT TAXES												
Duties	451	472	442	473	558	681	734	830	883	908	943	943
General rates	314	291	369	408	534	618	723	807	890	985	1,061	1,061
Internal revenue:												
Bets and sweeps tax	51	53	62	96	161	265	336	509	658	840	1,020	1,020
Entertainment tax	32	34	4	4	19	23	27	29	37	44	50	50
Hotel accommodation tax	4	5	6	6	9	15	20	24	33	42	51	51
Stamp duties	214	713	463	303	382	428	490	762	934	1,925	1,300	1,145
Motor vehicles taxes	44	57	46	32	49	102	148	259	360	395	435	435
Franchises	26	35	34	40	51	51	63	74	83	106	117	117
OTHER REVENUE	968	1,167	1,444	1,650	1,846	1,968	2,253	2,737	3,871	5,094	6,860	6,860
Total Recurrent	3,033	3,910	4,550	5,156	5,843	6,850	8,151	10,146	13,473	18,374	21,842	20,605
Capital Account:												
DIRECT TAXES												
Estate duty	27	40	50	42	64	85	110	128	200	245	250	237
INDIRECT TAXES												
Taxi concessions	–	39	85	–	–	–	112	250	266	288	86	86
OTHER REVENUE												
Land Sales	269	669	318	287	346	557	1,008	1,893	2,845	10,077	11,498	11,498
Others	19	13	13	108	2	2	2	25	12	16	98	98
Total Capital	315	761	466	437	412	644	1,232	2,296	3,323	10,626	11,832	11,919
Total Revenue	3,348	4,671	5,016	5,593	6,255	7,494	9,383	12,442	16,796	29,000	33,774	32,524

TABLE (16)

BALANCE OF THE FISCAL SYSTEM 1971-72 TO 1981-82

	Guideline Ratio	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81 (Revised Estimates)	1981-82 (After revenue proposals)
Direct taxes / Indirect taxes	55:45	45:55	39:61	54:46	61:39	56:44	55:45	57:43	56:44	60:40	61:39	65:35
Direct and indirect taxes / All other recurrent revenue	70:30	68:32	70:30	68:32	68:32	68:32	71:29	72:28	73:27	71:29	72:28	67:33

TABLE (9)

GROWTH RATES OF CONSOLIDATED ACCOUNT EXPENDITURE (ADJUSTED) AND THE RELATIVE SIZE OF THE PUBLIC SECTOR 1970-71 TO 1981-82

	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	Revised Estimate 1980-81	Estimate 1981-82
Consolidated Account Expenditure (Adjusted), at Current Prices ($mn):												
Recurrent	1,914.5	2,163.7	2,718.7	3,547.2	4,647.4	4,934.1	5,786.4	6,933.8	8,183.7	9,969.9	13,346.8	16,941.1
(a)	1,790.4	1,986.1	2,472.1	3,273.6	4,320.1	4,583.0	5,407.7	6,366.3	7,623.6	9,232.9	12,380.0	15,779.1
(b)	124.1	177.6	246.6	273.6	327.3	351.1	378.7	567.5	560.1	737.0	966.8	1,162.0
Capital	588.5	788.4	1,156.1	1,513.8	2,044.9	1,642.3	1,568.7	2,234.4	3,937.9	5,649.2	9,170.3	11,326.7
(c)	508.3	703.8	941.1	1,378.6	1,897.1	1,477.0	1,411.1	2,061.8	3,666.6	5,230.0	7,797.7	10,539.4
(d)	42.5	48.1	58.5	57.7	98.7	105.0	92.7	94.5	195.5	219.7	998.6	541.2
(e)	37.7	36.5	156.5	77.5	49.1	60.3	64.9	78.1	75.8	199.5	374.0	246.1
Total	2,503.0	2,952.1	3,874.8	5,061.0	6,692.3	6,576.4	7,355.1	9,168.2	12,121.6	15,619.1	22,517.1	28,267.8
Gross Domestic Product at Current Prices ($mn) *	19,214.0	21,873.0	25,854.0	33,964.0	38,786.0	40,574.0	51,973.0	59,615.0	69,491.0	86,113.0	106,088.0	126,430.0
Relative Size of the Public Sector (%)	13.0	13.6	15.0	15.0	17.3	16.2	14.2	15.4	17.4	18.1	21.2	22.4
Consolidated Account Expenditure (Adjusted), at Constant (1973) Prices ($mn):												
Recurrent	2,614.4	2,779.1	3,053.2	3,547.2	4,024.5	4,155.2	4,569.8	5,071.1	5,532.3	5,937.3	6,611.8	7,621.0
(a)	2,393.6	2,536.5	2,749.8	3,273.6	3,730.7	3,831.9	4,244.7	4,660.5	5,189.7	5,572.1	6,193.1	7,175.6
(b)	220.8	242.8	285.4	273.6	293.8	323.3	325.1	410.6	342.6	365.2	418.7	445.4
Capital	870.9	1,018.5	1,329.3	1,513.8	1,742.0	1,490.6	1,368.3	1,789.6	2,768.3	2,948.4	4,180.1	4,549.3
(c)	771.3	921.2	1,095.6	1,378.6	1,618.7	1,360.0	1,251.0	1,668.1	2,593.1	2,701.4	3,451.8	4,165.8
(d)	49.2	50.7	59.6	57.7	80.9	80.2	66.2	64.3	123.6	126.6	541.2	271.6
(e)	50.4	46.6	174.1	77.5	42.4	50.4	50.9	57.2	51.6	120.4	187.1	111.9
Total	3,485.3	3,797.6	4,364.5	5,061.0	5,766.5	5,645.8	5,937.9	6,860.7	8,300.6	8,885.7	10,791.9	12,170.3
Growth rates of Consolidated Account Expenditure (Adjusted) (%):												
In money terms:												
Recurrent	–	13.0	25.7	30.5	31.0	6.2	17.3	19.8	18.0	21.8	33.9	26.9
Capital	–	34.0	46.6	30.9	35.1	–19.7	–4.5	42.4	76.2	43.5	62.3	26.6
Total	–	17.9	31.3	30.6	32.2	–1.7	11.8	24.7	32.2	28.9	44.2	26.8
In real terms:												
Recurrent	–	6.3	9.2	16.9	13.5	3.2	10.0	11.0	9.1	7.3	11.4	15.3
Capital	–	16.9	30.5	13.9	15.1	–14.4	–8.2	30.8	54.7	6.5	41.8	11.9
Total	–	9.0	14.9	16.0	13.9	–2.1	5.2	15.5	21.0	7.0	21.4	12.8

Notes: *) Calendar year figures. The figure for 1979 is provisional, that for 1980 is preliminary and that for 1981 is a forecast.

Legend:
(a) Salaries and other recurrent.
(b) Maintenance.
(c) Major capital works and land acquisition.
(d) Purchase of plant and equipment and major capital works.
(e) Other non-recurrent.

excess of the guideline of 15 percent of expenditure in 1982-83; and probably even more so than at 1st April 1981 when our "free" reserves will stand at about 42 percent of budgetted for expenditure in 1981-82.[264]

(b) Budgetary guidelines

251. An analysis of the Draft Estimates of Expenditure and the Revenue Estimates (amended to allow for the cost of the five tax concessions) in terms of our budgetary guidelines[265] dramatically illustrates the effect of the enormous increase in capital expenditure on Guideline (3), which requires that the surplus on recurrent account should be sufficient to meet 60 percent of capital expenditure; and on Guideline (1), which requires that at least 88 percent of total expenditure should be financed by recurrent revenue. Both guidelines will be breached but, fortunately, this does not matter because capital revenue is no less than 126 percent of capital expenditure. In other words, the financing of the capital account in 1981-82 is in no way dependent on the surplus on recurrent account (a repeat of our experience in 1980-81); and, therefore, the fact that recurrent revenue is meeting too small a proportion of total expenditure is acceptable. The obvious conclusion to be drawn is that the original purpose of the guidelines, namely, to secure the financing of the capital account has been, at least for the time being, overtaken by events. I shall return to this subject shortly.

(c) Balance of the fiscal system

252. As regards the balance of the fiscal system,[266] although the cost of my five tax concessions largely affects the yield from direct taxes, the ratio of direct to indirect taxation will further deteriorate to 65:35 in 1981-82 from 61:39 in 1980-81, which is some distance away from the guideline ratio of 55:45. The ratio of direct and indirect taxation taken together to all other recurrent revenue will be 67:33 in 1981-82, compared with 72:28 in 1980-81, the guideline ratio being 70:30; but this improvement is much more apparent than real inasmuch as the contribution of interest earnings on the General Revenue Balance to all other (non-tax) recurrent revenue will be as high as 45 percent in 1981-82, compared with 33 percent in 1980-81.

(d) Steady progression guideline

253. As regards the steady progression guideline of 10 percent, the (adjusted) provision in the Draft Estimates of Expenditure implies a growth rate in real terms of 12.5 percent, compared with 20.1 percent in 1980-81 and an average annual growth rate for the five post-recession years of 12.7 percent.

8. THE PUBLIC SECTOR AND THE ECONOMY

254. Finally, I must assess the likely impact of the public sector, defined in terms of the Consolidated Account, on the economy, which I argued earlier would enjoy growth with a fair measure of stability in 1981.[267]

(a) Growth and the relative size of the public sector[268]

255. The average annual growth rate of expenditure on Consolidated Account, in real terms for the five post-recession years was 13.8 percent, which exceeded the growth rate of G.D.P. at 11.3 percent over the same period. After accelerating from 5.2 percent in 1976-77 to 15.5 percent in 1977-78 and to 21 percent in 1978-79, the growth rate of expenditure was slowed down to 7 percent in 1979-80. It then accelerated again to 21.4 percent in 1980-81 (not entirely by design) and, although it will slow down to 12.8 percent in 1981-82, it will be well in excess of the forecast growth rate of G.D.P. in 1981 of 8 percent. Thus the relative size of the public sector will further increase from its historical high of 21.2 percent in 1980-81 to 22.4 percent in 1981-82,[269] reflecting the fact that the growth rate of expenditure on Consolidated Account is higher than the growth rate of the economy, rather than a serious slow down in the latter. An increase in the relative size of the public sector of this order in 1981-82 is, I think, just about acceptable on macro-economic grounds. Although the public sector surplus will be smaller than in 1980-81, it will still be substantial, representing a further net draining off of spending power. Further, my forecast of the state of the economy, which incorporates this increase in public sector expenditure, is for a growth rate of total final demand which does not exceed that of the G.D.P. (excluding the effect of re-exports) and a rate of unemployment at least as high as in 1980, suggesting that there is room for the growth rate of public sector expenditure proposed. However, the scope for further enlargement of the public sector is very limited indeed.

(b) Net balance of the public sector

256. On General Revenue Account the budgetted for surplus is $7,881 million and on Consolidated Account it is $7,381 million.[270] As in the last two years, to ensure that the surplus on General Revenue Account has a constraining effect on domestic demand by the private sector, and hence on total domestic demand, the increase in the Government's Hong Kong dollar balances will be invested so as to prevent it feeding back into the financial sector's credit base, with unwanted consequences for inflation. That is to say, the increased balances[271] will be either placed by the Exchange Fund short term (on demand, at call or at short notice) thus attracting the 100 percent liquid assets requirement, or switched by the Exchange Fund into foreign currencies when suitable opportunities occur.

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264. See Statistical Appendix, Table (15). [Not included — Ed.]

265.

		($mn)	(%)	Ratio
(1)	Recurrent revenue / Total expenditure	= 20,605 / 24,643	= 84	At least 88%
(2)	Recurrent expenditure / Recurrent revenue	= 15,188 / 20,605	= 74	No more than 80%
(3)	Surplus on recurrent account / Capital expenditure	= 5,417 / 9,455	= 57	At least 60%
(4)	Recurrent expenditure / Total expenditure	= 15,188 / 24,643	= 62	No more than 70%
(5)	Capital revenue / Capital expenditure	= 11,919 / 9,455	= 126	At least 20%

266. See Statistical Appendix, Table (16).

267. See Paras. 151-159 above. [Not included — Ed.]

268. See Statistical Appendix, Table (9).

269. ($mn)

Consolidated Account expenditure at current prices $= \frac{28,268}{126,430} \times 100 = 22.4$

270.

	($mn)
Revenue	35,649
Expenditure	28,268
Surplus	7,381 *

Note: *) The difference of $500 million between this surplus and the surplus on General Revenue Account of $7,901 million is made up as follows:

	($mn)
Urban Council	— 39
Housing Authority	—169
Development Loan Fund	—135
Lotteries Fund	— 30
Home Ownership Fund	—112
Student Loan Fund	— 15
	—500

271. But the present ceiling of $20,000 million on borrowings by the Exchange Fund will have to be increased shortly.

241. But I think this is an opportune time to remove the half percentage point loading levied with effect from the year of assessment 1976-77, thus returning the effective rate to 16.5 percent. The cost to the revenue in 1981-82 will be $206 million, or 3.5 percent of estimated revenue from corporation profits tax as reflected in the printed Revenue Estimates for 1981-82 of $5,900 million.[255] In 1981-82, both final profits tax assessments for 1980-81 and provisional profits tax for 1981-82 will be affected and the calculation of the cost to the revenue allows for the two instalment system for the payment of provisional profits tax. The cost in a "full" (i.e. an ordinary) year will be $139 million. Lest it be thought that this proposal will only benefit a few large corporations, may I remind Members that the number of limited liability companies paying corporation profits tax is presently of the order of 18,000, may of which are small family-owned businesses.

(iii) Depreciation allowances

242. My *third* concession is designed to offer encouragement to manufacturers and others to re-equip and upgrade their plant and equipment as our economy faces up to the challenges of a changing world trading environment. The average annual growth rate of private sector expenditure on the plant, machinery and equipment component of gross domestic fixed capital formation was 30 percent in money terms and 22 percent in real terms for the five post-recession years. As a proportion of G.D.P., private sector expenditure on plant, machinery and equipment increased steadily from 10 percent in 1975 to 14 percent in 1980. I would like to see both the growth rate of such expenditure and its relative importance even higher.

243. As a result of a new Table made by the Board of Inland Revenue under the Inland Revenue Rules on 9th April 1979, the existing 20 percent annual rate of depreciation allowance was absorbed into the 25 percent rate and this now applies to 15 out of 33 heads, the other 18 heads attracting rates of 5, 10, 15 and 30 percent. More recently, a "pooling" system for capital expenditure on two or more assets ranking for the same rate of annual allowance was introduced. I now propose that the 33 heads be re-grouped under three rates of annual allowance of 10, 20 and 30 percent.[256] Additionally, by way of offering further encouragement, I also propose that he initial allowance should be increased from 25 to 35 percent.[257] Thus, for example, for an item of equipment ranking for the annual rate of allowance of 30 percent, the write-off allowed for profits tax purposes in the year of purchase will be 54.5 percent. The cost to the revenue of these more generous allowances will be $203 million in 1981-82, after allowing for the two instalment system for the payment of provisional profits tax. Again, both final profits tax assessments for 1980-81 and provisional profits tax for 1981-82 will be affected. The cost will be $119 million in a "full" (i.e. ordinary) year.[258]

(iv) Estate duty

244. My *fourth* concession concerns estate duty: in response to rising asset values I have, on three occasions, increased the limit below which duty on the estates of deceased persons is not payable, from $200,000, the limit prevailing between 1970 and 1974, to $600,000 for the estates of persons dying after 11th July 1980. On reflection, and with the benefit of hindsight, I do not think I went far enough last year. So, I now propose the limit should be raised to $1 million for persons dying after the enactment of the necessary legislation. The cost to the revenue will be approximately $13 million in 1981-82 and perhaps $17 million in 1982-83.

(v) Stamp duty on conveyances of low value properties

245. Last year, a new platform was introduced for the concessionary rate of ad valorem duty on conveyances of low value properties provided for under Head 19(1) of the Schedule to the Stamp Ordinance. While the limit for the fixed concessionary rate of $20 remained at $100,000, the limit for the concessionary ad valorem rate of duty of 1 percent was raised by $75,000 to $250,000. Thus, the full ad valorem rate of duty of 2.75 percent became payable on properties above $250,000, compared with $175,000 previously.

246. In recognition of the even higher level of prices of domestic flats now prevailing, I propose that the limit for the fixed concessionary rate of $20 be raised to $250,000 and for the concessionary ad valorem rate of duty of 1 percent to $500,000. The cost to the revenue of raising these limits will be no less than $155 million in 1981-82, or about 22 percent of estimated revenue from stamp duty on asignments reflected in the printed Revenue Estimates for 1981-82. The usual marginal relief arrangements will, of course, continue to apply to these new limits. About 48,000 purchasers of flats will benefit from these higher limits (and, remember, it is the *purchaser* who, in practice, pays the duty on the assignment).

247. The new platforms of $250,000 and $500,000 will have to be extended also to Head 53(1) voluntary dispositions inter vivos.

(vi) Implementation

248. As Your Excellency this morning signed the necessary Order under the Public Revenue Protection Ordinance, the new limits for the concessionary rates of stamp duty on conveyances of low value properties will be effective from the opening of business tomorrow morning. Bills to amend the Inland Revenue Ordinance to provide for my proposals in respect of personal taxation, corporation profits tax, the initial depreciation allowance for plant and machinery and estate duty will be introduced into this Council as soon as possible.

7. OUTTURN AND ASSESSMENT

(a) Outturn and state of fiscal reserves

249. The cost to the revenue of my five tax concessions is $1,250 million[259] and thus my estimate of total revenue becomes $32,524 million. The difference between this figure and the estimate of total expenditure of $24,643 million, namely, $7,881 million, is the surplus I am budgetting for on General Revenue Account in 1981-82.[260] This represents 24 percent of revenue as now estimated and, whilst it is about twice the relative size of the surplus in the first three years of the post-recession period, it is below the relative size of the expected surplus for 1980-81 of 32 percent.[261] The reason is, of course, that the increase in expenditure in 1981-82 on 1980-81 is 25 percent, but the increase in revenue is only 12 percent, compared with the increase in expenditure in 1980-81 on 1979-80 of 42 percent and the increase in revenue of 73 percent.[262]

250. Should this budgetted for surplus materialise our "free" fiscal reserves at 1st April 1982 will be of the order of $18,100 million.[263] Obviously, therefore, at that date we shall be well in

255. See also f.n. 206. above.
256. The Board of Inland Revenue will, accordingly, be invited to make a new Table under Rule 2 of the Inland Revenue Rules, but Annex (8) is indicative of what the new Table will look like.
257. This proposal will require an amendment to the Inland Revenue Ordinance itself.
258. In the long term, the cost will be nil for the effect of increased depreciation allowances is simply to accelerate the rate at which allowances are granted, although the beneficial cash flow effect is important to the business community.
259. Classifying the five tax concessions in terms of our tax requirements (see Paras. 94-99 above):

Proposal	*Requirement*
Personal taxation	Fifth (& converse of First)
C.P.T.	Fifth (& converse of First)
Depreciation	Sixth
Estate duty	Fifth
Stamp duty on conveyances of low value properties	Fifth & Sixth

260.

	$mn	$mn
Revenue:		
Recurrent	20,605	–
Capital	11,919	32,524
Expenditure:		
Recurrent	15,188	–
Capital	9,455	24,643
Surplus on recurrent account	–	5,417
Surplus on capital account	–	2,464
Overall surplus	–	7,881

261. See f.n. 77. above. [Editor's note: this f.n., inter alia, states that in year 1980-81 total revenue was $mn 29,000 and the surplus $mn 9,323.]
262. See Statistical Appendix, Table (11). [Not included — Ed.]
263. That is, $10,300 million being our "free" fiscal reserves at 1st April 1981 (see Paragraph 112 above) *plus* $7,826 million (i.e. the expected cash book balance at 31st March 1982 without the adjustments made for analytical purposes) = say, $18,100 million.

allowance from $5,000 to $7,000 (or by 40 percent). The criteria for the granting of this allowance, now claimed by some 65,000 taxpayers in respect of some 80,000 dependent parents, will continue to apply;[247] although this will mean that, in certain circumstances, a taxpayer contributing only the minimum qualifying annual contribution of $1,200 to a dependent parent will enjoy tax relief in excess of this figure.

231. This package of proposals will be effective for final salaries tax assessments for 1980-81 (and for personal assessments also) and provisional salaries tax for 1981-82. The cost to the revenue in 1981-82, after allowing for the two instalment system for the payment of provisional salaries tax,[248] will be $673 million[249] or no less than 32 percent of estimated revenue from personal taxation (salaries tax and personal assessment) as reflected in the printed Revenue Estimates for 1981-82 of $2,090 million.[250] The cost in a "full" (i.e. an ordinary) year will be around $408 million at present levels of chargeable incomes.

232. The effect of this package of proposals will be to exempt 85,000 persons previously liable to salaries tax, and a further 55,000, who would have become liable in 1981-82, will remain out of the tax net. Thus the number of salaries taxpayers for the year of assessment 1982-82 will be 255,000, as opposed to the 395,000 presently envisaged in the net without this package of concessions. Additionally, 237,000 of these taxpayers will benefit by way of reduced liability. The remaining 18,000 or 7 percent of the total number of taxpayers left in the net will not benefit for they will remain on the standard rate of 15 percent and this group will continue to contribute well over half of the total yield from salaries tax. So much for the claim that the less well paid subsidise the better off.

233. For the record, a further 45,000 persons who elect for the advantages available under personal assessment will benefit from this package of concessions.

234. Examples of the effects of the new allowances on persons at various income levels and in various personal circumstances appear at Annex (4) *(not included — Ed.)* to the printed version of this speech. A table showing the present and future effective rates of tax at different income levels for persons in various personal circumstances is at Annex (5) *(not included — Ed.)*. And I have set out at Annex (6) *(not included — Ed.)* the income levels at which persons in various personal circumstances will become liable at the standard rate in future.

235. I would plead that these annexes be examined with care, For example, just consider the very considerable relief which persons in various personal circumstances at different income levels will enjoy if my package of proposals is implemented: a single person on an annual income of $23,500 will pay $50, a reduction of $375 on his present liability of (only) $425. A married person on an annual income of $46,000 will pay $50, a reduction of $1,050 on his present liability of (only) $1,100; a married person with two children on an annual income of $58,000 will pay $50, a reduction of $1,350 on his present liability of (only) $1,400; while a married person with two children and two dependent parents on an annual income of $72,000 will pay $50, a reduction of $1,900 on his present liability of (only) $1,950.

236. At the same time, a single person will now pay at the standard rate of 15 percent on an annual income of $106,250, compared with $87,500 at present. A married person will now pay at the standard rate of 15 percent on an annual income of $162,500, compared with $125,000 at present; a married person with two children will now pay at the standard rate of 15 percent on an annual income of $192,500, compared with $147,500 at present; and a married person with two children and two dependent parents will now pay at the standard rate of 15 percent on an annual income of $227,500, compared with $172,500 at present.

237. I would earnestly suggest, Sir, that this package of proposals will meet the claims of those who argue that the low income earner is in dire need of relief from his tax "burden", although I would deny that the low income earner is significantly affected by our salaries tax system *at all*. The package will also afford considerable relief for those who claim to belong to the "sandwiched" society; and to middle income earners as well for, even their tax liability is, in percentage terms, very modest compared with their other personal liabilities.

238. At the same time, to those Members and taxpayers and potential taxpayers who keep arguing that allowances under our system of personal taxation have not kept pace with inflation and who fail to remember that elsewhere in the world the real burden of taxation has steadily increased,[251] and who choose to ignore that in Hong Kong we have a fiscal system designed to do no more than produce sufficient revenue for our growing needs, without recourse to debt, I would say this: between the years of assessment 1973-74 and 1979-80, the personal allowance for a single person increased from $10,000 to $15,000 (personal allowance of $12,500 and supplementary allowance of $2,500) and the personal allowance for a married man from $20,000 to $30,000 (personal allowance of $25,000 and supplementary allowance of $5,000), that is to say, an increase of 50 percent in each case. Without conceding, *for one moment*, that there is a need to fine tune allowances in accordance with changes in the purchasing power of money incomes generally, this 50 percent increase in personal allowances almost exactly offset the effects of the increase in prices over the period as measured by the C.P.I. Yet this year's proposals alone lift personal allowances by yet *another* 50 percent, or by more than three times the rate of inflation, in 1980. So, *obviously*, I do not believe in fine tuning!

239. Before leaving personal taxation I feel bound to comment on the somewhat vociferous claims heard recently to the effect that our direct tax system is one wherein the "rich" are subsidised by the "poor". The respective contributions to the revenue of salaries tax and profits tax just do not support such claims. On the contrary, over the years, the contribution from profits tax has consistently, and significantly, outstripped that from salaries tax. Thus, in 1979-80, for example, the contribution from profits tax amounted to 67 percent of total collections of earnings and profits taxes compared with only 22 percent from salaries tax; in 1980-81, the contribution from profits tax is no less than 69 percent, while that from salaries tax, *despite* fiscal drag, has declined to 18 percent. If the package of concessions I have just proposed is approved by this Council, the contribution from profits tax will increase to 70 percent of the estimated total collections from earnings and profits taxes in 1981-82, whilst that from salaries tax will further decline to no more than 15 percent.

(ii) Business taxation

240. Against this background, I come to my second and third concessions which relate to business taxation: my *second* concession will benefit all corporate businesses. When I was seeking out ways and means of raising extra revenue in 1976 (unnecessarily as it turned out[252]), I proposed,[253] and it was subsequently agreed, that a temporary loading of an extra half percentage point should be added on to the 1.5 percentage points (or 10 percent) surcharge on the standard rate of corporation profits tax. The surcharge concept itself was introduced in 1975 as a device pending the introduction of a dividend withholding tax:[254] that idea came to an untimely end and so the surcharge concept has remained with us.

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247. B.S., 1979, Annex (10).
248. Provisional tax and, therefore, the two instalment system, does not apply to personal assessment.
249.

	1981-82 ($mn)	"Full" year ($mn)
Under salaries tax:		
Personal allowances and supplementary allowances	536	298
Child allowances	44	25
Dependent parent allowances	18	10
Under personal assessment:		
Allowances	75	75
Total	673	408

250. See also f.n. 206. above.
251. For a variety of budgetary and *non*-budgetary reasons: for a comparative analysis of personal taxation in Hong Kong, Singapore, Malaysia and the United Kingdom, see Annex (7).
252. For the budgetted for deficit of $491 million (or $355 million after taking out various revenue proposals) turned into a surplus of $917 million.
253. B.S., 1976, Paragraph 177.
254. B.S., 1975, Paras. 90-94.

public finances generally, even though it *could* be argued that, to do so, would be justified on macro-economic policy grounds.

(c) Management of public utility-type undertakings

220. But, in the case of our six public utility-type undertakings the importance of observing the no-subsidy principle cannot be overlooked, that is to say, the charges set must cover the full costs of operation and earn a required return on capital employed. It is clear from the latest operating accounts of our several undertakings[236] that only in the case of the airport and the Post Office[237] is the return on average net fixed assets satisfactory.

221. I should just mention here that the Postmaster-General intends to make certain adjustments to postal charges during the coming year. Essentially these adjustments will be designed to meet international obligations and to rationalise part of the system of postal rates and fees. A few services will become more expensive and a few slightly cheaper. I expect the consequences will be neutral in terms of the revenue and thus will result in no change in the profitability of the Post Office.[238]

222. But it is equally clear that the Kowloon-Canton Railway and waterworks undertakings are making losses and over the next four years, 1981-82 to 1984-85, the position of each will worsen, particularly as further substantial capital investment is being made in both undertakings. I fear, therefore, that their fare/tariff structures will have to be looked at again closely before very long (but this will be coupled with a re-examination of the assumptions underlying their operating accounts).

(d) Tax concessions proposed for 1981-82

(i) Personal taxation (i.e. salaries tax and personal assessment)

223. So I come to my five tax concessions for 1981-82: my *first* concession, and it is really a package of concessions, stems from my oft-repeated, but generally ignored, undertaking to review the system of personal taxation periodically, having regard to our current budgetary situation, and to the need to maintain equity as between different income groups[239] at a time when the growth of money incomes is leading to fiscal drag.[240]

224. As regards our current budgetary situation: it is no part of this Government's policy to contemplate, let alone plan for, a growth rate of total revenue in excess of budgetary requirements unless considerations of macro-economic policy apply[241] as they do this year.[242] But I accept that the level of our "free" fiscal reserves, at $10,300 million or 42 percent of budgetted for expenditure in 1981-82 of $24,670 million,[243] is well in excess of the guideline of 15 percent, and estimated revenue in 1981-82 is no less than 137 percent of estimated expenditure. Yet the difference between the Draft Estimates of Expenditure and the Revenue Estimates of $9,131 million is largely due to the absence of a deficit on capital account — indeed a surplus has emerged — and it would be clearly imprudent, despite the healthy state of our "free" fiscal reserves, to dissipate this overall surplus on tax concessions which are, by their very nature, recurring.

225. As regards the implications of fiscal drag for equity: money incomes per capita increased by 19 percent in 1980. Taxpayers are thus being pushed up the scale of effective rates of tax[244] and this means that their tax liability in relative terms is tending to increase; although, let me hasten to add, this does not mean they cannot afford any additional burden at all, if necessary, for real incomes per capita have increased also, albeit at a slower rate (at 5.5 percent and this is an *average* measure only). But, in present circumstances, there is no *need* for the tax burden to be increased.

226. Further, the growth of money incomes per capita over time means that the tax net tends to embrace an ever growing number of economically active persons. Given the Government's revenue requirements, this is not necessarily unreasonable to the extent that the growth of money incomes per capita is associated with improvements in real terms. But it has always been our policy to pitch the levels of the entry points into the tax net, the so-called thresholds, high and to keep out of the tax net those who might otherwise be brought to charge solely because of the effects of inflation on money incomes.

227. So, notwithstanding the complete failure of most commentators to look at the actual tax liability of persons in various circumstances, I need no persuading, *first*, that the thresholds are now too low; *secondly*, that the impact of effective rates of tax needs to be stretched out over a broader spectrum of incomes; and, *thirdly*, that the levels of gross income at which the standard rate of 15 percent is applicable need to be lifted.

228. Any adjustments to our system of personal taxation involve technical difficulties, to a greater or lesser extent, and have financial implications for taxpayers and the revenue, which are acceptable to a greater or lesser extent. But, after examining various options with the Commissioner of Inland Revenue over the past four months, may package of proposals is as follows: *first*, I propose an increase in the level of personal allowances from $12,500 to $15,000 for single persons and from $25,000 to $30,000 for married persons. At the same time, I propose an increase in the present supplementary personal allowances from $2,500 to $7,500 for single persons and from $5,000 to $15,000 for married persons; and I further propose that the claw-back[245] continue to be zero rated, meaning that taxpayers at all levels of income will enjoy the full benefit of the supplementary personal allowances, save those on high incomes to which the standard rate applies. Thus, if my proposals are agreed, the personal allowance and supplementary allowance for single persons will together become $22,500, compared with $15,000 at present, a very substantial increase of no less than 50 percent; and for married persons they will become $45,000, compared with $30,000 at present, again an increase of 50 percent.

229. *Secondly*, I propose an increase in child allowances from $5,000 to $7,000 for the first child (or by 40 percent) and from $4,000 to $5,000 for the second child (or by 25 percent). A two-child family is fairly typical nowadays[246] and, as I regard the present allowances of $3,000 for the third child, $2,000 for the fourth to the sixth child and $1,000 for the seventh to the ninth child as adequate, for various reasons, I do not propose they be changed.

230. *Thirdly*, I propose an increase in the dependent parent

236. See Annex (3). [Not included — Ed.]

237. The return on average net fixed assets was 31.2 percent in 1979-80. It will be around: 16.5 percent in 1980-81, *but* will fall to 1 percent at today's prices in 1981-82. In other words, if there are no changes to postal rates further to those mentioned here, the rate of return could well become negative during 1981-82. The profitability of the Post Office in terms of individual services is variable. Losses are particularly marked for the local inland services and the rates for these services cannot remain at their present low levels for much longer.

238. As regards the main *privately* owned public utility-type undertakings the Government exercises a degree of control over their charges to ensure that they do not make excessive profits as a result of their monopolistic position in the market. At the same time, they are allowed to make profits sufficient to encourage their shareholders to remain in that business and to expand sufficiently to keep up with demand. Within this constraint, and provided the Government is satisfied the undertaking is run efficiently, charges sufficient to recover costs and to earn an acceptable rate of return are — for they must be — permitted. Incidentally, increases in charges raised by all public utility undertakings (public as well as private) account for a *very* much smaller proportion of the increase in the cost of living as measured by the C.P.I. than generally imagined:

Year	Rate of increase in C.P.I. (A)	Rate of increase due to increase in price of public utilities
	(%)	(%)
1976	3.4	-
1977	5.8	0.1
1978	5.9	0.1
1979	11.6	0.5
1980	15.5	1.4

239. In accordance with the fifth requirement of the tax system: see Paragraph 98 above.

240. See Paras. 224-226 below.

241. As envisaged in the sixth requirement of the tax system: see Paragraph 99 above.

242. See Paras. 254-256 below.

243. See Paragraph 112 above.

244. Tax payable as a percentage of gross chargeable income minus expenses, but before the deduction of any eligible allowances.

245. The device whereby the supplementary allowance is, by the application of a percentage reduction, progressively withdrawn and eventually eliminated when assessable incomes exceed a specified limit (see Section 42B (1)(aa) and (bb) of the Inland Revenue Ordinance and B.S., 1977, Paras. 211-212).

246. In 1978-79 there were 291,000 salaries taxpayers of whom 170,000 were single, 26,000 were married with no children, 55,000 were married with one or two children and 20,000 were married with three or more children (and there were 20,000 persons on the standard rate).

because our excise duties are specific and not ad valorem and rates have not been updated to maintain incidence. The contribution of *bets and sweeps taxes* to total recurrent revenue, after peaking at 5 percent in 1977-78, has steadily declined since then to 4.6 percent in 1980-81 and to an estimated 4.1 percent in 1981-82.

215. Finally, of the other indirect taxes, the only one that is worth worrying about in terms of equity between classes of taxpayers is *First Registration Tax* on motor vehicles[223] which is estimated to contribute 2 percent to total recurrent revenue in 1981-82, compared with 2.2 percent in 1980-81, having peaked at 2.6 percent in each of the two previous years 1978-79 and 1979-80. Whether this represents a reasonable contribution to the revenue is debatable. I do not wish to be drawn into arguments about which of the three imposts borne by private motorists,[224] namely, First Registration Tax, annual licence fees for vehicles and drivers and excise duty on hydrocarbon oils, would be the weapon most likely to be effective in any attempt to ensure that available road space is used as effectively as possible as our public transport services are diversified and improved or, indeed, into an argument as to whether *any* of these weapons should be used.[225] But it is also debatable whether the total contribution of road users to total recurrent revenue is as high as it should be, having fallen from an average of 6.8 percent in the first four post-recession years to 5.3 percent in 1980-81 and being estimated at only 4.8 percent in 1981-82.[226]

(b) Sources of additional revenue

216. Now, because I have five tax concessions to propose at a substantial cost to the revenue, I had to consider not only tapping the reserves of taxable capacity indicated in the present inequitable distribution of the burden of taxation between different classes of taxpayers, but also restoring the loadings on royalty-loaded fees[227] and tax-loaded fees and charges[228] to the extent that they have been eroded by inflation and updating cost-related charges including those raised by our various public utility-type undertakings.[229]

217. As regards our reserves of taxable capacity: I warned last year that, in the absence of a revaluation of rateable values the General Rate percentage could be — and in terms of equity between different classes of taxpayers should be — raised to increase revenue from *rates. Stamp duties* on contract notes and assignments of property could be raised, I think, without discouraging commercial transactions and, therefore, breaching the neutrality principle.[230] Without necessarily arguing that declining incidence means that the point of diminishing returns has not yet been reached, some adjustments to some rates of duty on *dutiable commodities* ought to be productive of more revenue, albeit carrying a possible risk of adding to inflationary pressures (but wholesalers' and retailers' absolute profit margins must have widened).[231] Certainly, there is scope for raising extra revenue from *bets and sweeps taxes* because I cannot believe that punters as a class of taxpayer should be contributing less than, say 5 percent, to total recurrent revenue[232] particularly when totalisator turnover has increased from $2,580 million in the (financial year) 1976-77, to well in excess of $8,200 million in 1980-81 and is predicted to be about $10,500 million in 1981-82. Finally, there is scope for some innovations in the *taxation of motorists* — F.R.T.,[233] annual licence fees for vehicles and drivers[234] and duty on hydrocarbon oils — again on the grounds of equity between classes of taxpayers and likely price elasticities.

218. As regards royalty-loaded fees and tax-loaded fees and charges: many of these fees and charges should be increased by up to 100 percent and more to restore the original loadings; and, as regards cost-related charges, many of these are, for one reason or another, up to five years or more out of date. Phase III of the Financial Information System means that we shall have available, in due course, up-to-date information on costs, thereby enabling us to make adjustments to all fees and charges on a routine basis any time during a year as a purely management exercise. I emphasise on a routine basis, because not to keep them up to date means that users are cross-subsidised from General Revenue or cross-subsidised to a greater extent than intended (and this is particularly objectionable in principle in the case of fees and charges payable by business enterprises).[235]

219. So, even ignoring the possibility of increasing some tax rates (as opposed, for example, to simply restoring the incidence in the case of excise duties) or widening the ambit of some of our revenue laws (as opposed, for example, to reform measures designed to reinstate an original intention or to respond to changing commercial practices), it is apparent that we have various options at our disposal to finance any necessary and desirable tax concessions and to correct the falling trend of recurrent revenue to total expenditure. However, I do not intend to invoke any of these options at this time in view of the present state of our

223. Levied on all motor vehicles other than enfranchised public omnibuses.
224. Just for the record, the number of private cars increased by 68 percent to 175,000 between 1976-77 and 1980-81, whereas goods vehicles and all other vehicles increased by only 37 and 26 percent respectively (to 51,000 and 40,000).
225. Particularly when account is taken of the recent increases in the before-tax prices of petrol and automotive diesel oil.
226.

Year	Hydrocarbon oils	Vehicles and drivers' licences	F.R.T.	Total	Total as % of recurrent revenue
	($mn)	($mn)	($mn)	($mn)	
1976-77	188	168	102	458	6.7
1977-78	212	183	148	543	6.7
1978-79	242	218	259	719	7.1
1979-80	261	265	360	886	6.6
1980-81	288	298	395	981	5.3
1981-82	311	300	435	1,046	4.8

227. Royalty-loaded fees are payments for permission to engage in certain activities and trades, viz.: licences required for various regulated activities and trades (e.g. bank licences). The level of fees imposed is not directly related to any costs which may be incurred in their regulation.
228. Tax-loaded fees and charges are levied for services rendered or permissions given. They are set above the level necessary to recover full costs specifically for the purpose of raising revenue.
229. Cost-related charges fall into three groups:
(a) those which do not cover the full cost (including the cost of capital) of the services provided, because there is a case on policy grounds for part of the cost of the services concerned being borne by General Revenue;
(b) those which are designed to cover the full cost (including the cost of capital) of the services provided. These charges may, from time to time, be set at a level above that necessary to recover full cost to deter usage for policy reasons;
(c) those which are set for the public utility-type undertakings operated by the Government and which are designed to recover the full costs of operation and to earn a required return on capital employed.
230. That is, the second requirement of the tax system referred to at Paragraph 95 above.
231. Incidence of duties (examples only):

	Effective date of last duty change	Incidence immediately thereafter	Present incidence (January 1981)
		(%)	(%)
Liquor:			
Brandy (V.S.O.P.)	3rd December 1975	40	26
Whisky (Ordinary)	ditto	58	41
Gin ditto	ditto	59	45
Beer: imported	24th July 1980	14	14
local	ditto	14	14
Chinese type spirit:			
imported	3rd December 1975	28	25
local	ditto	26	20
Tobacco:			
Cigarettes:			
imported (U.K.)	1st March 1978	34	24
imported (U.S.)	ditto	30	21
local	3rd December 1975	37	25
Hydrocarbon oils:			
Motor spirit *	25th February 1976	35	20
Diesel oil for road vehicles *	ditto	34	16

Note: *) Metrication was introduced on 1st January 1981, but this was not considered a duty change. The calculations here are inclusive of the increase in prices announced by the oil companies in January 1981.
232. A new rate of tax of 11 percent for exotic bets was introduced in 1975 (see C.S., 1975, Paras. 41-42), but the rate for traditonal bets has remained unchanged at 7.5 percent since 1931. The average on-course bet per punter per daytime race meeting has increased from $570 in the (financial year) 1976-77 to an estimated $1,174 in 1980-81 and is predicted to be well over $1,400 in 1981-82. Even having regard to the importance of discouraging illegal off-course bookmakers, there is obviously scope for increasing the yield from betting taxes by reducing the Jockey Club's commission (at present 9.25 percent) and, perhaps, even the proportion available for prize money (83.25 percent).
233. Rates of F.R.T. were last raised on 1st March 1979 (see B.S. 1979, Paras. 193-197).
234. Licence fees for vehicles were last raised on 1st March 1979 (see B.S., 1979, Paras. 202-210). Fees for drivers' licences have remained unchanged since 1st March 1974 (see B.S., 1974, Paras. 168-169).
235. For example, the present fee payable for textile export licences now covers only 50 percent of the cost of issuing quotas.

been substantial out of hours trading as well) and to the fact that the consideration on assignments of property, at some $2,800 million per month, has exceeded original expectations.

204. The estimate of $1,061 million for *rates* (up by 8 percent on the revised estimate for 1980-81) assumes that interim valuations of new premises will be about the same as this year, and takes into account the completion in 1980-81 of the rating of all rateable premises in the developed and developing areas of the New Territories and allows for the phased increases in the percentage rates charged.[210]

205. I have assumed that the yield from *bets and sweeps taxes* will be $1,020 million, or 21 percent up on the revised estimate for 1980-81, which is 17 percent up on the original estimate.

206. The estimate of $943 million for *dutiable commodities* is nearly 4 percent up on the revised estimate for 1980-81 which is, however, *down* by 3.6 percent on the original estimate.

207. As regards all other recurrent revenue at $6,860 million: of this, no less than 45 percent, or nearly $3,100 million, is estimated to be interest earnings on the General Revenue Balance and on the balance in the Mass Transit Fund which, remember, also accrues to General Revenue until equity in the Mass Transit Railway Corporation is bought and paid for.

(c) Capital

208. My estimate of capital revenue in 1981-82 is $11,932 million, which is an increase of $1,306 million, or 12.3 percent, on the revised estimate for 1980-81 of $10,626 million.

209. Within this estimate of $11,932 million, land transactions are expected to bring in $11,498 million[211] (as opposed to the revised estimate for 1980-81 of $10,077 million), taxi concessions a modest $86 million[212] and estate duty a not uphelpful $250 million.

210. Within the estimate of $11,498 million for land transactions, *land sales* by public auction and tender[213] are expected to yield $9,855 million from the sale of 196 acres, compared with the revised estimate for 1980-81 of $8,777 million from the sale of 156 acres;[214] *private treaty grants* are expected to yield $1,087 million,[215] compared with the revised estimate for 1980-81 of $876 million; and *modifications and regrants* are expected to yield $556 million, compared with the revised estimate for 1980-81 of $424 million.

211. In the five post-recession years, land sales by public auction and tender have been 38 acres, 34 acres, 58 acres, 76 acres and 156 acres respectively. The fact that, in 1981-82, a further substantial area will be sold, namely, 196 acres, is a reflection of the build up of expenditure on development works recently.[216]

212. I gave earlier a forecast of land production in the new three year forecast period, 1982-83 to 1984-85.[217] The outlook for land *sales* should, therefore, be mentioned here: the forecast is for about 300 acres to be sold in each of these three years.[218] Together with private treaty grants and modifications and regrants, the revenue yields implied in these figures are such as to suggest that the financing of the capital account in the forecast period will continue to be much less dependent on the surplus on recurrent account than hitherto.

6. FISCAL POLICY

(a) Equity of the tax system

213. I said earlier that our tax system is no longer as equitable between different *classes* of taxpayers as it should be and I implied, accordingly, that it needed to be improved.[219] I am afraid that, according to the Revenue Estimates as printed, the equity of the system will further deteriorate with one exception: revenue from property tax in 1981-82 is estimated to double compared with 1980-81, partly as a result of the addition of new buildings, but mainly as a result of the reassessment of assessable values now in train.[220] Thus the contribution of property tax to total collections of earnings and profits taxes will increase to 6.4 percent in 1981-82 from 4 percent in 1980-81 and may be compared with 9.4 percent in 1976-77, the year of assessment in which the list of assessable values was established as a by-product of the 1976 revaluation of rateable values.[221]

214. As regards indirect taxes: *rates* are estimated to contribute only 4.9 percent to total recurrent revenue in 1981-82, compared with 5.4 percent in 1980-81 and 8.9 percent in 1977-78, when the new lists of rateable values come into effect. The only way that this trend can be reversed is by an increase in the General Rate percentage, because a revaluation of rateable values is not possible so long as rent controls extend to all residential premises.[222] Apart from 1980-81, when they will contribute a remarkable 10.5 percent to total recurrent revenue, *stamp duties* contributed between 6 percent and 7.5 percent (an average of 6.8 percent) in the first four post-recession years and are estimated to contribute 6 percent in 1981-82. *Dutiable commodities* are estimated to contribute only 4.3 percent to total recurrent revenue in 1981-82, compared with 4.9 percent in 1980-81. The contribution of dutiable commodities has, in fact, been declining steadily since 1976-77, when it was 10 percent, partly because earnings and profits taxes are so income sensitive and partly

210.

	Year in which area became rateable	Rates charge for 1981-82
		(%)
Tshing Yi	1974-75	11
Yuen Long	1976-77	11
Tai Po	1976-77	11
Sha Tin	1976-77	11
Tuen Mun	1976-77	11
Clearwater Bay Road	1976-77	11
Luen Wo Market	1976-77	11
Shek Wu Hui	1976-77	11
Sai Kung	1977-78	10
Cheung Chau	1980-81	7
Peng Chau	1980-81	7
Lantau	1980-81	7
Lamma	1980-81	7

Note: The total rateable value of rated premises in the New Territories will have increased from $390 million at 1st April 1975, to an estimated $1,911 million at 1st April 1981, while the number of rated premises will have increased from 20,748 to about 86,000 over the same period.

211. The estimate of $11,498 million is based on an assessment of the prices likely to be realised for the individual lots making up the land sales programme for 1981-82. That is to say, a view has been taken of the premia likely to be realised — and this view is, of necessity, subjective — and takes account of the change in the terms of sale for industrial purposes which requires payment of the full premium in a single lump sum. The estimate also includes instalments of premia payable to the Treasury in respect of commercial/residential and industrial lots sold in previous years. For sales in the New Territories, a provisional assessment has been made of the number of lots to be sold by auction and by Letters A/B tender, the revenue from the latter being particularly difficult to assess as it depends on the age of the Letters A/B offered by successful tenderers.

212. For 331 licences only which will bring the total number of taxi licences in the urban areas up to the limit imposed under present policy of 10,000.

213. Land sales being defined so as to include land disposed of by tender in exchange for Letters A/B, the lots themselves being either drawn from newly formed and serviced land or from areas released from other uses (e.g. open storage let on short term tenancies).

214.

	Industrial		*Non-industrial*		*Total*	
	1980-81	*1981-82*	*1980-81*	*1981-82*	*1980-81*	*1981-82*
	(Acres)		(Acres)		(Acres)	
Urban areas	25.3	34.9	47.2	46.4*	72.5	81.3
New Territories	14.3	40.3	69.2	74.8	83.5	115.1
Total	39.6	75.2	116.4	121.2	156.0	196.4

Note: *) This estimate *could* be on the low side for there are several large sites in the Victoria Barracks area which *may* be sold in 1981-82 pending on when planning processes can be brought to finality.

215. It has been assumed that only one site of 12 possible sites will be ready to be granted in 1981-82 to the M.T.R.C. for joint development with property developers.

216. The gross figures for land *production* in f.n. 109. and Paragraph 190 above are, of course, *inclusive* of large areas appropriated for public housing, Government, institutional and community use, open space and roads. [Editor's note: f.n. 109., inter alia, states that gross areas of land formed and serviced in 1980-81 amount to 1,264 acres. Para. 190, inter alia, states that land production in 1981-82 is expected to amount to 1,562 acres.]

217. See Paragraph 191 above. [Editor's note: Para. 191 states that over the forecast period 1982-83 to 1984-85 land production will be about 1,400 acres per annum.]

218. A Land Disposal Sub-Committee of the Special Committee on Land Production was set up during 1980 to monitor the six-monthly land sales programmes and to forecast likely sales eighteen months ahead. This arrangement is designed to provide early warning of any difficulties which may prejudice the fulfilment of the land sales programmes.

219. See Paragraph 100 above.

220. See Paragraph 202 above.

221. Contribution of property tax to total recurrent revenue:

	(%)
1976-77	3.7
1980-81	1.7
1981-82	2.9*

Note: *) On the basis of the Revenue Estimates as printed.

222. B.S., 1980, Paras. 262-266.

will enable us to blend grants from General Revenue with debt finance for such large, lumpy and expensive works projects as a new airport or fixed harbour crossings which we may eventually decide to embark upon in the 1980s outside the Public Works Programme itself.

112. Our (total) fiscal reserves at 1st April 1976 represented 39 percent of budgetted for expenditure in 1976-77.[129] A year later, I decided that we had to make specific provision to secure our significantly larger contingent liabilities,[130] on the basis of a gearing of three. So our "free" fiscal reserves at 1st April 1977 were reckoned to be $1,213 million,[131] or nearly 15 percent of budgetted for expenditure in 1977-78 of $8,143 million. This was equal to the guideline ratio I then selected. By 1st April 1980, the position had improved to $5,716 million,[132] or 31 percent of budgetted for expenditure in 1980-81 of $18,332 million; and the position will show a further improvement at 1st April 1981 to $10,300 million,[133] the equivalent of 42 percent of the expenditure I am budgetting for in 1981-82 of $24,670 million.[134] This is distinctly better than the guideline of 15 percent.[135]

...

5. REVENUE ESTIMATES[204]

(a) Total revenue

195. Total revenue in 1976-77 was only $7,494 million. The revised estimate of revenue in 1980-81 is $29,000 million.

196. The Revenue Estimates as printed anticipate that total revenue collections will be $34,138 million but, on an adjusted basis, this figure becomes $33,774 million,[205] which is an increase of $4,774 million, or 16.5 percent, on the revised estimate for 1980-81.

(b) Recurrent

197. My estimate of recurrent revenue in 1981-82 is $21,842 million, an increase of $3,468 million, or 19 percent, on the revised estimate for 1980-81 of $18,374 million. Within this estimate, direct taxes are estimated to contribute $10,005 million, or 46 percent, of total recurrent revenue, indirect taxes $4,977 million, or 23 percent, and all other recurrent revenue $6,860 million, or 31 percent.

198. As regards direct taxes: at $10,005 million, the estimate is an increase of $1,970 million, or 24.5 percent, on the revised estimate for 1980-81 of $8,035 million, which was $2,311 million, or 40 percent, up on actual collections in 1979-80 of $5,724 million,[206] such has been the growth rate of money incomes in recent years, particularly in the financial and related business services and property sectors.[207]

199. The assumptions made in calculating the estimate of $6,675 million for *profits tax* in 1981-82 (up by 20 percent on the revised estimate for 1980-81) is that total profits assessable to tax in 1981-82[208] will be around 25 percent higher than profits assessed to tax in 1980-81; and that there will be an increase in hold-over orders from 12.5 percent in 1980-81 to 15 percent in 1981-82. However, if there were to be a *sharp* downturn in the economy, the effect on profitability of businesses could lead to the hold-over provisions of the provisional tax system being invoked on a larger scale than this and actual collections in 1981-82 being down on the estimate. Furthermore, in a situation in which the growth rate of profits eases back, the difference between final tax and provisional tax diminishes and so does the balance collectible in the following year.

200. The estimate of $1,950 million for *salaries tax* (up by 32 percent on the revised estimate for 1980-81) allows for the fact that provisional tax in 1980-81, being based on 1979-80 assessable incomes, will be less (probably much less) than 1980-81 final tax collectible in 1981-82. This is because money incomes in 1980-81 were on a fast rising trend and, therefore, there will be substantial balances to be collected in 1981-82. The estimate envisages that the number of salaries taxpayers in the net will be around 395,000 in 1981-82, as opposed to 340,000 in 1980-81.

201. The estimate of $600 million for *interest tax* (up by 9 percent on the revised estimate for 1980-81) assumes double-digit interest rates for some time to come and some diversion of funds out of equity investments into deposits with banks and deposit-taking companies.

202. The estimate of $640 million for *property tax* (up by 100 percent on the revised estimate for 1980-81) reflects the higher assessable values likely to be established by the reassessment exercise now in hand;[209] and the application of these higher assessable values will go some way towards correcting the present inequity of treatment between non-corporate and corporate property owners (including, in effect, non-corporate business proprietors), the latters' actual income from property being brought into profits tax charge.

203. As regards indirect taxes: I have assumed that the yield from *stamp duties* will be $1,300 million, which is $625 million less than the revised estimate for 1980-81 of $1,925 million. This latter figure is, in turn, almost three times the original estimate, thanks to the fact that turnover recorded on the stock exchanges averaged nearly $8,000 million per month in 1980 (and there has

129.

Year	Fiscal reserves *	Budgetted expenditure **	(1) as % of (2)
	($mn) (1)	($mn) (2)	
1st April 1976/1976-77	2,810	7,212	39
1st April 1977/1977-78	3,713	8,143	46
1st April 1978/1978-79	4,949	10,144	49
1st April 1979/1979-80	6,416	12,446	52
1st April 1980/1980-81	8,916	18,332	49

Notes: *) From 1st April 1976 the General Revenue Account's foreign currency assets were transferred to the Exchange Fund against interest bearing debt certificates thus insulating the Government's fiscal reserves from differences in exchange values and in the book values of fixed interest bearing assets: see B.S., 1976, Paras. 75-84. As explained in Paragraph 110 and f.n. 125. above, the Hong Kong dollar balances of the General Revenue Account over and above the Treasury's current cash requirements are also now held in the Exchange Fund against the issue of interest bearing debt certificates in accordance with the concept of the Exchange Fund being effectively banker to the Government.

**) *Including*, for this purpose, debt repayments.

130. B.S., 1977, Paragraph 106.

131. Fiscal reserves at 1st April 1977 = $3,713 million, minus $2,500 million being one third of contingent liabilities at 31st March 1981 (i.e. the end of the then forecast period) = "free" fiscal reserves of $1,213 million.

132. Fiscal reserves at 1st April 1980 = $8,916 million, minus $3,200 million being one third of contingent liabilities at 31 March 1984 (i.e. the end of the then forecast period) = "free" fiscal reserves of $5,716 million.

133. Fiscal reserves at 1st April 1981 = $15,339 million, minus $5,000 million being one third of contingent liabilities at 31st March 1985 (i.e. the end of the next forecast period) = "free" fiscal reserves of, say, $10,300 million.

134. *Inclusive*, for this purpose, of public debt repayments of $27 million.

135. In fact, the relative size of our "free" fiscal reserves is now nearly three times what it was in 1977-78.

204. See Statistical Appendix, Table (13).

205. That is comprising $21,842 on recurrent account and $12,296 on capital account. All the adjustments are on capital account. Thus the unadjusted estimate of capital revenue of $12,296 may be reconciled with the adjusted estimate referred to in Paragraph 208 below as follows: $12,296 million minus $332 million, being payments for land premia from the Home Ownership Fund minus $32 million, being a reimbursement from the Special Coin Suspense Account for the Jubilee Sports Centre = $11,932 million.

206.

	1979-80 Actual	1980-81 Revised Estimates	1981-82 Estimates
	($mn)	($mn)	($mn)
Profits tax	3,832	5,565	6,675
Salaries tax	1,275	1,480	1,950
Personal assessment	103	120	140
Interest tax	216	550	600
Property tax	298	320	640
Total	5,724	8,035	10,005
[Profits tax:			
Corporations	3,364	4,935	5,900
Other Businesses	468	630	775]

207. These now contribute around 45 percent to total collections of profits tax (c.f. 15 percent for the manufacturing sector).

208. Tax *payable* in 1981-82 *equals* final tax for 1980-81 in respect of profits in 1980-81 minus provisional tax already paid plus provisional tax for 1981-82 based on profits in 1980-81 plus second instalment of 1980-81 provisional tax payable in 1981-82 minus second instalment of provisional tax for 1981-82 payable in 1982-83.

209. As explained in B.S., 1980, Paras. 268-276. Property tax at the standard rate of 15 percent is levied on all non-corporate property owners, other than owner-occupiers and other special categories such as charitable institutions and clubs, on assessable values, less 20 percent for repairs and outgoings. Assessable values are, essentially, hypothetical figures, estimated in the same way as rateable values, except where the rent is controlled when assessable values are equal to the permitted rent or authorised rent under the Landlord and Tenant (Consolidated) Ordinance.

ty and share transactions.[117] The new ordinance will, both in language and in intent, reflect the realities and practices of present day commercial life.

(e) Management of the General Revenue Account

(i) Budgetary guidelines

102. So much for the relationship between the public sector and the economy, trends in the pattern of cash disbursements on Consolidated Account and fiscal policy in the five post-recession years. I turn now to an assessment of the management of the General Revenue Account, the underlying theory of which is that, taking one year with another, we should achieve at least a balance between revenue and expenditure, having regard to the need to make additions to our fiscal reserves in line with the growth of expenditure and our contingent liabilities.

103. To begin with, an appropriate relationship had to be determined between the recurrent and capital accounts, because the rate at which our recurrent commitments grow in relation to recurrent revenue must be limited in order to secure the financing of the capital account; and we must not delude ourselves into believing that this is not true, simply because it is not the case just now.

104. The guidelines adopted in the 1970s were that recurrent revenue should meet at least 88 percent of total expenditure, that recurrent expenditure should absorb no more than 80 percent of recurrent revenue, and that at least 60 percent of capital expenditure should be financed by the surplus on recurrent account and at least 20 percent by capital revenue.[118] In addition, an upper limit was set to recurrent expenditure of 70 percent of total expenditure.[119]

105. Taking each of the five guidelines in turn:[120] the ratio of recurrent revenue to total expenditure (Guideline (1)) fell from 104 percent in 1976-77 to an average of 95 percent in the next four post-recession years, because the growth rate of total expenditure exceeded the growth rate of recurrent revenue, except in 1979-80;[121] but the ratio nevertheless remained well above the guideline of at least 88 percent.

106. Throughout the five post-recession years the ratio of recurrent expenditure to recurrent revenue (Guideline (2)) never exceeded the guideline of 80 percent. Indeed, it has been *well* below it in the last two years at 66 percent. The fact is that the prolonged post-recession upswing of our economy has meant that, in no year, did the growth rate of recurrent expenditure exceed the growth rate of recurrent revenue, which was influenced by the growth rate of G.D.P. in money terms after allowing for leads and lags.[121]

107. Again, throughout the period, the ratio of the surplus on recurrent account to capital expenditure (Guideline (3)) exceeded the guideline of at least 60 percent: it recorded an average of 108 percent in the first two years of the period and 85 percent in the last three. The surplus on recurrent account and flushing capital revenues (Guideline (5)),[122] combined in 1976-77 with under-spending on capital account,[123] resulted in overall surpluses on General Revenue Account.

108. Finally, the success with which the growth rate of recurrent expenditure has been contained in relation to recurrent revenue, combined with a new and, in my view, very appropriate, emphasis on capital expenditure, has meant that the balance between recurrent expenditure and capital expenditure (Guideline (4)) shifted over the period: in the two years 1976-77 and 1977-78, the average ratio of recurrent expenditure to total expenditure at 78 percent exceeded the guideline of no more than 70 percent but, in the last three years, the ratio fell steadily from 67 percent in 1978-79 to 61 percent in 1980-81.

(ii) Fiscal reserves

109. So much for the management system devised to force us to think through the consequences of particular courses of action by reference to certain guidelines.

110. In support of this management system are our fiscal reserves. These fiscal reserves, together with the balances in various funds[124] and the Exchange Fund's surplus, represent the net financial assets of the Hong Kong Government. Apart from the Treasury's current cash requirements, the bulk of the financial assets are held in the Exchange Fund, and placed by the Fund in bank deposits in Hong Kong dollars and foreign currencies and in various interest bearing instruments in foreign currencies.[125] The Fund transacts its business through 87 banking, safe custody and security accounts located in 13 countries,[126] reflecting the extensive programme of diversification, in terms of both currencies and management, of our financial assets over the past seven years since the end of 1974.

111. Our fiscal reserves have several roles:[127] *first*, provision must be made for cover for our contingent liabilities, which also secures, of course, our credit rating in international capital markets. *Secondly*, unexpected and unavoidable commitments and situations involving a short lived tendency for expenditure to exceed revenue, or for revenue yields to fall below expectations, should not affect the implemention of the Government's on-going policies and programmes or involve adjustment to tax rates and charges.[128] Such situations are best dealt with by having available adequate "free" fiscal reserves; and, happily, they are adequate. *Thirdly*, to the extent that our "free" fiscal reserves exceed the minimum guideline ratio of 15 percent of budgetted for expenditure in the following year, they are available for such purposes as the purchase of equity in trading enterprises (such as the M.T.R.C.) and the placing of statutory funds, such as the Development Loan Fund, in a position to meet their commitments, for there is no reason why annual revenues should necessarily have to meet these particular calls. In addition, they

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117. B.S., 1978, Paras. 214-218.
118. In other words, the view was taken that net capital expenditure, after applying the surplus on recurrent account, should be financed in a certain way, that is to say, at least half by capital revenue and no more than half by debt.
119. In summary:

Guideline		*Ratio*
(1)	$\frac{\text{Recurrent revenue}}{\text{Total expenditure}}$	At least 88% (*)
(2)	$\frac{\text{Recurrent expenditure}}{\text{Recurrent revenue}}$	No more than 80%
(3)	$\frac{\text{Surplus on recurrent account}}{\text{Capital expenditure}}$	At least 60%
(4)	$\frac{\text{Recurrent expenditure}}{\text{Total expenditure}}$	No more than 70%
(5)	$\frac{\text{Capital revenue}}{\text{Capital expenditure}}$	At least 20%

Note: (*) This ratio is derived from Guidelines (4) and (2), viz.: $70\% \div 80\% = 88\%$.

120. See Statistical Appendix, Table (15). [Not included — Ed.]
121. *Growth rates of:*

Year	Total expenditure (%)	Recurrent expenditure (%)	Recurrent revenue (%)	G.D.P. in money terms (%)
1976-77/1976	9	17	17	28
1977-78/1977	24	19	19	15
1978-79/1978	34	18	24	17
1979-80/1979	26	21	33	24
1980-81/1980	42	35	36	23

122. In 1977-78, 1978-79 and 1979-80 capital revenue financed, on average, 65 percent of capital expenditure and in 1980-81 was sufficient to finance all of it (being 138 percent of expenditure).
123. In relation both to the Approved Estimates and actual expenditure in 1975-76.
124. For example, the Development Loan Fund, the Special Coin Suspense Account and the Mass Transit Fund.
125. The Exchange Fund's liabilities are the sum of the value of non-interest bearing Certificates of Indebtedness issued to the two note issuing banks, coins in circulation and interest-bearing debt certificates issued to the Treasury in respect of sums deposited with the Fund on behalf of the General Revenue Account.
126. The 87 accounts include 5 accounts with central banks and 16 accounts with various financial institutions managed on a discretionary basis within guidelines laid down by the Secretary for Monetary Affairs who is also the Secretary (and a member) of the Exchange Fund Advisory Committee.
127. Quite apart from providing such cover as is necessary for seasonal deficits. In the past, these have peaked in October after which E.P.T. receipts began to flow in; and, simply because capital revenue has distorted this pattern recently, there is no reason to suppose that this will be the case indefinitely.
128. Of course, a sudden change of pace is inevitable in a situation in which the world trading environment shifts adversely; *or* when, perhaps through failure to exercise proper control over expenditure, a risk of persistent deficit emerges; *or* when the growth rate of expenditure has been accelerating and a period of consolidation is desirable (for instance, on administrative grounds); *or* when a persistent situation of demand-pull inflation threatens the ability of the economy to maintain internal and external equilibrium.

HONG KONG: Budget 1981/82

Extracts from the Budget Speech which was pronounced on February 25, 1981 by the Financial Secretary, Sir Philip Haddon-Cave.

See for a detailed discussion of the Hong Kong tax system the Bureau's publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

...

(d) Fiscal policy

(i) Balance of the fiscal system[111]

92. I turn now to the subject of fiscal policy. In our externally-oriented economic circumstances, there is no alternative to a relatively high dependence on direct taxation[112] for the financing of recurrent services within the General Revenue Account and to help finance the deficit on capital account. However, as the yields from earnings and profits taxes are related to the growth rate of the economy in *money* terms, if that rate is sustained at, say, 20 percent as it has been recently, then high yields will be enjoyed. The yield from earnings and profits taxes increased by 3.5 times over the five post-recession years[112] whereas the G.D.P. (at current prices, of course) increased by 2.5 times only. But yields from indirect taxes[113] (excise duties, for example) are more closely related to the growth rate of the economy in *real* terms.

93. The thesis that there will be a tendency for the relative importance of earnings and profits taxes to increase is borne out by our experience during the five post-recession years as seen in the context of the guideline ratios I bear in mind when assessing the balance of the fiscal system, namely, that the ratio of direct to indirect taxation should be 55:45 and the ratio of direct and indirect taxation taken together to all other recurrent revenue should be 70:30. The average ratio for direct to indirect taxation shifted from 56:44 in the first three years of the period to 60:40 in the last two; and the ratio of direct and indirect taxation taken together to all other recurrent revenue averaged 72:28 over the five years. But the fact that we are not adhering to these ratios does not mean that they no longer serve a purpose, which is to remind us of the importance of trying to maintain the yield from indirect taxes and fees and charges.[114]

(ii) Requirements of the tax system

94. At the same time, our tax system has been designed to meet six requirements all of which I believe to be compatible with our externally-oriented circumstances and our free enterprise economy: the *first* requirement is to help to generate sufficient recurrent revenue to finance a major proportion of a given level of total expenditure[115] and to maintain our fiscal reserves at a satisfactory level.

95. The *second* requirement is that the tax system is as neutral as possible as regards the internal cost/price structure, the supply of human effort and private investment decisions (and this means, inter alia, that apart from a degree of progressivity for personal taxation, the emphasis should be on proportionality).

96. The *third* requirement is that the laws governing the tax system are adapted from time to time to make them compatible with changing commercial practices.

97. The *fourth* requirement is that each and every levy — be it direct or indirect — is simple and easy (and, therefore, inexpensive) to administer for both the Government and the taxpayer and does not encourage evasion, for a narrowly based tax system with low rates of charge cannot afford to finance costly overheads (and, in this situation, arguments about equity being sacrificed for simplicity have a very doctrinaire ring to them).

98. The *fifth* requirement is that the tax system is equitable as between different classes of taxpayers or potential taxpayers and between different income groups (and this means, inter alia, setting relatively high thresholds for personal taxation and generally ensuring that the system rests as lightly as possible on the disposable incomes of those at the lower end of the income spectrum, or leaves them untouched).

99. Exceptionally, and this is the *sixth* requirement, the tax system must be capable of being used to achieve non-fiscal (that is to say, economic and social policy) objectives when necessary. I stress the word *exceptionally*, because I believe that such policy objectives should be pursued directly through public expenditure programmes and by appropriate legislative measures, and not indirectly by adjustments to tax rates and amendments to tax laws. Once a government starts to tread that path the consequences are unpredictable, and probably irreversible, and the economic costs unquantifiable.

100. The tax changes introduced in the past five years have all been consistent with one or more of these requirements. But, as I said last year, I am none too happy with the present distribution of the tax burden as between some *classes* of taxpayers and there is evidence that some correction needs to be made again for fiscal drag.[116]

(iii) Tax reforms implemented recently and in hand

101. I should record here the state of play on several reform measures put forward in previous years and which are still in hand: a bill was published on 20th February last to grant relief to trustees who become liable to withholding tax on interest which they receive and are thereafter obliged to deduct interest tax a second time from interest paid to beneficiaries of the trust fund. The bill also makes provision to bring to charge surpluses thrown up on the redemption or realisation of certificates of deposit and similar entitlements to stated sums of money which, under the present law, escape liability to tax. Another bill will be published on 27th February next to replace the existing Stamp Ordinance now that the ambit of the charge is limited to transfers of proper-

111. See Statistical Appendix, Table (16).
112. There were *no* major tax increases during these years and the system of personal taxation was adjusted on three occasions to allow for fiscal drag. Several reform measures, such as the bringing into charge of profits earned in Hong Kong from offshore borrowing and lending transactions arranged by banks and other financial institutions in Hong Kong, and improved administrative efficiency, have also increased the productivity of the system. But the income sensitivity of our direct tax system is self-evident.
113. *Direct* taxes are defined as earnings and profits taxes. (Estate duty is regarded as capital revenue.) *Indirect* taxes are defined as excise duties, General Rates, bets and sweeps taxes, entertainment tax, hotel accommodation tax, stamp duties, motor vehicle taxes and franchises. (Premia paid for taxi concessions are regarded as capital revenue.)
114. In a low tax environment, and particularly one which is characterised by high thresholds, public services which can be related to individual needs must be charged for in full, provided adequate remission arrangements are available when required, except where, as is frequently the case, a policy decision has decreed that the cost of those services should be borne, in whole or in part, by General Revenue. In some instances, charges may be pitched *above* the level necessary to recover full costs, for the purpose of raising revenue or for deterring usage; and fees which are set for permission to engage in certain activities are not cost-related at all. See further f.n. 229. below.
115. That is, Guideline (1): recurrent revenue should finance at least 88 percent of total expenditure.
116. For a summary of the corrections made since 1976-77, see B.S., 1980, f.n. 264. and Paras. 281-288. [These Paras. have not been included — Ed.]

strictly controlled. His need for protection from unfair treatment and all the related questions are not enough appreciated in this part of the UN reports. Such an international tax atmosphere created by mistrust involves the risk of gross injustice.

In short, the ICC would have preferred a much more balanced presentation of the whole subject.

To sum up:

The UN Model Treaty and Manual show promise but also give rise to some regrets. Despite all the good intentions and search for common interests, it becomes evident that there is an overemphasis on taxation at source and that the Model Treaty is aligned too much with the fiscal interests of the states and not with the needs for investment. The ICC expects governments to keep a better sense of proportion. If, instead, States become involved in an even more detailed struggle over the distribution of total tax revenue, all participants, including the States and their economies, would suffer. The ICC therefore urges governments to negotiate efficient and reasonable treaties for the avoidance of double taxation between developed and developing countries, treaties which serve as a prerequisite for the desired international investment and economic growth.

In next issues:

The design of schedular and global systems of income taxation: the international dimension
— by *Sylvain Plasschaert*

Tax changes and reforms in Hong Kong
— by *Y.C. Jao*

The Mexican income tax
— by *Pedro Massone*

Attempts to restructure the Philippine income tax and recent developments
— by *Angel Q. Yoingco*

Taxation of individuals in the People's Republic of Yemen
— by *Ahmed Abdulla Al-kadi*

Some problems of tax policy in developing countries
— by *Nizar Jetha*

Recent Canadian income tax amendments
— by *Edwin C. Harris*

International tax avoidance; the impact of legal systems
— by *Nathan Boidman*

Report on the Anglo-Dutch tax seminar (May 7-8, 1981)
— by *C.S. Salomons and L.M. Stern*

The tax system of the Federal Republic of Germany
— by *E. Jehle*

circumstances of the individual case and, thus, produce a totally arbitrary allocation of profits among the affiliates in the group.

The real dangers of double or even multiple taxation and heavy administrative burdens which would arise from such taxation methods would be substantial deterrents to international trade and investment which any double taxation convention seeks to foster.

The ICC, as well as other International Organisations, has taken a firm stand against any such global or unitary methods in its Document No. 180/195 Rev., to which the reader is referred.

5. LEGAL CERTAINTY

Investments are the result of long term planning processes. Within an enterprise, plans to invest in developing countries have to compete with investment projects in other developing countries and in industrialised countries including the home country of the investor. Since the resources available for investment are restricted by the economic success of the enterprise and its financial resources, only the best and most promising investment plans are put in hand.

Evaluation of an investment and its likely success demand that reliable figures be used, including the taxes in the host country. This can only occur when there is clarity and stability of national policies, laws, regulations, and administrative practices. Consequently, when investments are being planned, legal certainty, dependable tax forecasts and reasonably stable tax terms for investors rank high in importance. Accordingly, enterprises prefer to invest in a country with which a treaty exists with clear provisions for the avoidance of double taxation. Thus, the ICC feels that in the Model Convention and Manual, the idea of legal certainty and of whether the tax burden that might actually be expected by investors can be calculated in advance, has been pushed too far into the background. This is especially true as a result of the many far-reaching deviations from the traditional principle of only taxing business profits in the country of source where they are clearly attributable to an effectively existing permanent establishment. Governments should give this point further thought.

6. REASONABLE FISCAL COMPENSATION

Negotiations on the conclusion of a double taxation treaty are and remain negotiations within the context of the natural desire of states to insure their "fair" share of the total taxes levied upon the investing enterprises. Naturally, contracting states may have very different ideas about this. The difference of opinion between the developed and developing countries is unfortunately especially great.

Whether tax in the home country of the enterprise or tax in the source country of income should take priority is an ancient issue. Rather naturally, developing countries have come out as strong supporters of taxation at source. However, as stated by the Secretary General's report (p. 9), such countries should be aware of the "need to strike a balance between the preservation of the developing countries' taxing rights (source taxation) and the measures required to attract foreign investment". States need to realize that (1) a treaty cannot come into existence unless both states are willing to compromise and (2) even if a treaty is concluded, if it results in an unreasonable tax burden as perceived by potential investors, the treaty will be of little aid to fostering the economic progress of developing countries, nor in increasing their tax revenue from foreign enterprises.

7. INTERNATIONAL COOPERATION BETWEEN TAX AUTHORITIES

Treaties for the avoidance of double taxation always contain provisions on cooperation between the fiscal authorities, most notably:

- the mutual agreement procedure, and
- the exchange of information on taxation.

Under the mutual agreement procedure, the two fiscal authorities are able to contact each other directly and without complications. Thus they are able to resolve cases of double taxation, doubt, or differences of opinions. It is then often possible to work out a reasonable solution. This, of course, is also greatly to the advantage of investors. Over the years the fiscal authorities frequently acquire a better understanding of the economic processes which it is their job to tax. However, the ICC feels that the UN Model on mutual agreement is deficient in the following respects, in order to arrive at a fair and equitable procedure:

(i) the taxpayer should be allowed to participate in the process;
(ii) the taxpayer should be allowed to approach both the governments involved in the process;
(iii) the two governments concerned should be required to arrive at an agreed solution;
(iv) the taxpayer should have facilities to appeal against the agreed solution, if it is unacceptable to him.

The exchange of information on taxation under the treaties assists the Contracting States' efforts against tax evasion and indeed tax fraud.

However, the UN Manual and Commentaries lack a balanced perspective on this point. Once again — though it is not expressed in these terms — the question is treated on the assumption, which is as common as it is wrong, that international operations and international tax evasion are synonymous. The ICC agrees with governmental efforts to combat fiscal fraud and tax evasion. However, it believes the extent of such fraud and tax evasion to be greatly and often willingly exaggerated. As recognized in the UN ECOSOC Secretary General's Report (p. 17), reliable estimates are scarce and the so-called evidence is "impressionistic". Furthermore, home countries of investors normally already have efficient tax legislation and administrations dealing with this problem, as do many developing countries. The investor, whose contribution to the economy is what after all makes taxation possible, should not be regarded only as one who needs to be permanently and for assessing the withholding tax and for the crediting of this tax in the country of residence of the investor. If this is accepted, it will ensure the avoidance of double taxation.

However, it is to be considered as a major failure that the UN Model Convention contains no limits on the withholding rate of tax on dividends, interest and royalties. The ICC fears that future treaty negotiations will give rise to even more disputes concerning these amounts than in the past. The final effect might well be a failure to conclude any treaties or simply an excessive rate of withholding tax at the source. The ICC believes that States engaged in negotiations should give more thought to the consequences of excessive tax expectations and to the impediment to desired investment resulting therefrom.

The ICC also does not share the opinion that gains from the alienation of a substantial participation should be taxed in the host country. This could result in double taxation as the host country could not take into account losses and depreciation on related transactions.

3. CHANNELLING OF TAX INCENTIVES

Incentives to investment based on tax concessions, offered by a developing country to assist its economy, often run the risk of benefiting the wrong party. Countries in which the investing enterprises have their headquarters often apply credit methods under which only the taxes actually paid are available for credit so that the host countries are in effect subsidising the treasuries of the industrialised countries and not the investing enterprise. In certain countries, the national legislation already contains certain provisions for channelling at least some of the tax concessions back to the investor, but these provisions are not sufficient. A coordinated taxation procedure which gives priority to the effective channelling of the developing country's tax incentives can be achieved only through a treaty.

Two methods are available:
- exemption of the investing enterprise from tax in its home country, and
- tax sparing credit in the home country of the investing enterprise for the taxes which the host country has foregone in order to encourage investment.

The tax exemption method which many countries apply especially to business profits from permanent establishments and dividends from direct investment is one good and advisable method. It is based on the assumption that the investor should be enabled to oeprate in the developing country under the tax system prevailing in that country. It is therefore considered the prerogative of the developing country to fix the terms of tax advantages under which the enterprise may operate. Whether it is a good idea to offer these incentives to investment should not be a matter for the judgment of the industrialised country, but should be left to the host country's policy. Therefore, as far as business profits are concerned, governments should give the exemption method priority in treaties with developing countries.

Tax exemption generally is not applied in the case of revenues such as portfolio dividends, interest or royalties, the taxes on which are normally shared between the States. This is true in particular where the withholding tax in the host country is limited to a certain level. There exists the alternative method, already incorporated into many treaties, of the tax sparing credit, a method which the ICC would like to see improved and much more widely applied.

Despite the discussions in the UN Group of Experts, unfortunately a considerable amount of elucidation is still required on the subject. Governments of developed countries which take economic cooperation with developing countries seriously should resolve to devote careful thought to a better channelling of such incentives.

4. NON-DISCRIMINATION BETWEEN DOMESTIC AND FOREIGN ENTERPRISES

It is a generally accepted and firm principle of international treaty policy that any double taxation treaty should guarantee the investing enterprise equal tax treatment with enterprises in the country where it is investing. Today provisions in this sense are an established feature of any treaty on double taxation and every state acknowledges the principle of non-discrimination. But, if a closer look is taken at the treaties, it is soon discovered that some treaties with developing countries provide specific clauses which perpetuate discrimination between domestic and foreign enterprises. The result, then, is not parity but disparity of treatment, guaranteed by treaty. One example is the practice of making the "arm's length" principle inoperative if a foreign investor holds 50 percent of more of the shares of an enterprise in a developing country. In such a case, certain developing countries refuse to allow deduction of interest, licence fees and other expenses from taxable income. No enquiry is even made to ascertain whether these expenses are economically reasonable.

This practice is indefensible, at least when there is a treaty presenting all possibilities for bilateral cooperation between the fiscal authorities. For the investor such a treatment represents a heavy and unfair burden. In many cases it has the effect of halting the investments and the associated transfer of technology, so vital to developing countries. It is therefore extremely disappointing that the UN comments concentrate on taxpayers' possible abuses of transfer pricing policies, but do not provide for the firm application of the arm's length principle by the States themselves to all foreign investors, merely leaving the question open to bilateral negotiations. This situation must change if parity of tax treatment and the encouragement of investment are not to remain mere phrases.

The ICC understands that some governments may be considering the application of various so-called "global" or "unitary" methods of determing an enterprise's local tax base. Such methods reject the long approved arm's length approach to intra-group transfer pricing, which is also strongly advocated by the UN Model Treaty. They disregard market conditions as well as the particular

As a result, and in recognition of the principle of international comity, countries accept the necessity for an agreed procedure for dealings between them on tax matters. The most common method for achieving this is through treatment for the avoidance of double taxation. These treaties have already progressed far beyond providing mere technical measures for the avoidance of double taxation and have become an instrument for the improvement of international economic relations. Evidence of this fact is the large number of tax treaties which contain specific provisions to foster foreign investment by the removal of tax curbs on such investment by the channelling of tax incentives for investment granted by one state, usually a developing country, back to the investor and by reducing the risks of such investment and insuring certainty in the legal environment.

Because treaties for the avoidance of double taxation are an important means for fostering international economic investment and development the ICC appreciates the efforts of the United Nations' preparation of a Model Double Taxation Convention between Developed and Developing Countries and its associated Manual for Negotiations. The ICC is also aware of the enormous amount of deliberations and compromise which went into the UN Model and the Manual.

Given its importance upon the negotiations of future bilateral double taxation treaties, it is imperative that governments of both developed and developing countries judge the Model Convention, like any other bilateral tax treaty, in terms of how well it encourages international economic investment and development and at the same time extracts a reasonable, but not excessive, amount of taxation revenue from foreign investors in each State. More specifically, the ICC believes that governments should judge double tax treaties by the extent to which they achieve the following objectives:

1. EFFECTIVE AVOIDANCE OF DOUBLE TAXATION IN INTERNATIONAL OPERATIONS

National legislation normally includes provisions for the avoidance of double taxation. However, the limit of such provisions is always set by the tax on foreign income levied for itself by the State concerned. The provisions therefore necessarily fail if one country taxes an investor in a way or at a level which the investor's home country considers unjustified.

Thus under national law a double burden may continue, since

- the taxation in the host country is not recognised as tax on income in the home country of the investor, or
- the income taxed in a developing country is not regarded as a foreign one, e.g. profits from deliveries, in the respective developed country, or
- the host country imputes profits to a permanent establishment or affiliated company, which have not been made by it.

The effective avoidance of double taxation in international operations therefore requires the tax systems of the States concerned to be so adapted that it is always possible to avoid double taxation. In this respect a treaty can be most useful.

One significant example is the taxation of business profits attributable to a permanent establishment. It is with concern that the ICC notes that the UN Model Convention advocates a marked extension of the concept of permanent establishment, most notably in the treatment of the furnishing of services and in the extent to which an independent representative can be considered as a permanent establishment. Furthermore, in the case of insurance companies, shipping, certain assembly deliveries or services — the undermining by various means of the established criteria of a permanent establishment will give rise to extraordinary difficulties and heavy double taxation. Moreover, the envisaged return to the "force of attraction" of a permanent establishment can only be regarded, from the tax viewpoint, as a regression to outdated practices. Further, it is completely unacceptable to treat the mere purchase of goods as a permanent establishment as it is impossible to establish the profit which should be imputed to such a purchase.

The ICC is aware that some existing bilateral treaties between developed and developing countries may contain one or more of the above-mentioned provisions dealt with in the UN Model Convention or the Commentaries; however, the ICC also notes that many of these provisions have appeared only sporadically in a few treaties and are now taken out of the context of the total framework in which such treaties were negotiated. They are not commonly accepted principles in double taxation treaties. The accumulation of such provisions in the UN Model Treaty is effectively to dilute and ultimately abandon the concept of permanent establishment.

2. REMOVAL OF TAX CURBS ON INVESTMENT

Among the generally accepted purposes of a treaty today is the removal of tax curbs on investment, mainly in the growing field of withholding taxes levied on gross payments. Any double taxation treaty must therefore ensure that such taxation is reduced to a scale which at least makes excessive taxation impossible.

On this subject some of the Commentaries to the UN Model Convention contain interesting proposals. For example, as regards interest and royalties, they stress the necessity of basing the source tax on actual net returns and on the normal tax rates applied in the host country. The Commentaries give informative explanations of the very high expenses connected with such income. These high expenses must be taken into account when determining the withholding tax. Otherwise tax will be levied on gross receipts, not net income.

Another idea which deserves to be welcomed is the proposal that the home country of the investor, in assessing taxes, should for the purposes of the application of a tax credit, deduct at least not more expenditure than the host country. This should be effected so that the same expenses have to be taken as a basis both

THE INTERNATIONAL CHAMBER OF COMMERCE

Comments on the U.N. Model Tax Convention between Developed and Developing Countries*

The ICC has followed with great interest the activities of the UN Group of Experts in their deliberations on the preparation of a Model Tax Convention between Developed and Developing Countries and its related commentaries and manual over the last several years. Now that the proposed Model Convention has been adopted by ECOSOC and published, the ICC wishes to present its views to governments concerning the Model Convention in the context of future negotiations of bilateral double taxation treaties.

In giving its views the ICC emphasizes that it is considering this matter from the point of view of fostering international trade and investment. The ICC does not take any position on the appropriate apportionment of the tax "take" between the States concerned. However, in the ICC's view, the sharing of tax revenues should always be resolved in a manner so that both excessive and double taxation are avoided and the development of international investment is encouraged.

As a starting point, the ICC wishes to express its conviction that the progress of the world economy depends on the evolution of the national economies and the relations between them. Enterprises in both developed and developing countries are dependent upon each other for markets, financial and material resources, and commercial and technical how-how. Cooperation at international level between nations and enterprises is therefore a vital requirement for a flourishing world economy.

Among the important determinants of the level and directions of international investment is the taxation legislation of the respective States. Each state, exercising its sovereignty, levies taxes in accordance with its own criteria, and the resulting taxation system, being national in scope, often clashes with the tax systems of other nations.

These differences in taxation legislation among States are generally recognized to be a great impediment to international investment and thus come at the expense of economic progress of both developed and developing countries. As stated in the Report of the Secretary General of the UN Economic and Social Council of 12 February 1980 (UN Doc. No. E/1980/11, p. 5):

"The growth of investment flows from developed to developing countries depends to a large extent on what has been referred to as the international investment climate. The prevention or elimination of international double taxation, i.e. the imposition of similar taxes in two or more States on the same taxpayer in respect of the same base, whose effects are harmful to the exchange of goods and services and to the movement of capital and persons constitutes a significant component of such a climate."

The ad hoc Group of Experts on Tax Treaties between Developed and Developing Countries of the Economic and Social Council of the United Nations (ECOSOC) approved the United Nations Model Double Taxation Convention between Developed and Developing Countries in its meeting from December 10 to 21, 1979 and the Convention was subsequently approved by ECOSOC on April 22, 1980. It was published in a book entitled "United Nations Model Double Taxation Convention between Developed and Developing Countries" (1980) (ST/ESA/102).

This Convention is also the subject of a book published jointly by the Harvard Law School International Tax Program and the International Bureau of Fiscal Documentation entitled "United Nations Model Convention for Tax Treaties between Developed and Developing Countries" by Professor Stanley Surrey (1980).

The International Bureau of Fiscal Documentation is proud to publish in this issue of the *Bulletin* the opinion of the International Chamber of Commerce on this important subject. The Executive Board of the ICC gave its approval for distribution on April 1, 1981.

* Doc. No. 180/206 Rev. 2 — Original.

finished products and includes the assembling of inputs into finished or semi-finished products but does not include mining or the recovery of minerals.

Under Section 18(1) of Part IV of the Industrial Development Act, the following will be the criteria by which an enterprise may be classified as a "priority enterprise":

(a) Maximum utilisation of domestic raw materials;
(b) Production of intermediate goods which are used by other industries;
(c) Diversification of its industrial structure;
(d) Creation of substantial opportunities for permanent employment;
(e) Improvement of domestic industrial skills or fostering the development of domestic technology;
(f) Promoting industrial development in rural areas.

Section 18(3) of the Industrial Development Act states that an enterprise which in the opinion of the Minister satisfies any two of the criteria described in the first three paragraphs and any two of the criteria described in the last three paragraphs may be classified as a "priority enterprise".

An application has to be made to the "Minister" in writing stating the criteria and the particulars on which such an application is made. The Act does not specify the ministry to which application should be made but we presume it to be the Ministry of Commerce and Trade.

GUIDANCE CONCERNING JOB CREDITS 1979/80

Section 9 of the Income Tax Amendment Act of 1979 introduced a new Section 90A to the Income Tax Act to provide for job credits to Limited Companies, partnerships or individuals engaged in "manufacturing" activities (see definition below). To qualify for job credits, the claimant should be a "manufacturer" and the business should have been in operation for two years at least prior to 31 March 1980. For 1979/80 a credit of K500.00 will be allowed against the tax of a qualifying employer ie a manufacturer for each "qualifying employee" (see definition below). In other words, employees in respect of whom job credits are being claimed for 1979/80 must be those only in excess of the total number of "qualifying employees" at 31 March 1979. A job credit cannot be claimed in respect of a director of a company who is not a whole time service director (see definition below).

Job credits are allowable against the tax charged on the qualifying employer for the charge year 1979/80 only to the extent of the tax charged. Where there is no chargeable income for 1979/80 and the job credits cannot be used up, they may not be carried forward and allowed in a subsequent year.

Where the business is a partnership the credits will be allowed against the tax charged on each partner in proportion to such partner's income from the partnership.

"Manufacturing" means subjecting any physical matter to any processs which materially changes such matter in substance, character or appearance thereby making it an article after such process but excludes the assembly of vehicles.

"Whole time service director" means a director of a company who is required to devote substantially the whole of his time to the service of such company in a managerial or technical capacity and is not the beneficial owner or able to control alone or with his nominee five percentum or more of the issued share capital or voting powers in such company.

"Qualifying employee" means each individual *full time employee* employed by the business for the *whole* of the charge year who was not employed by it for the whole of the previous charge year.

The Department of Taxes has already commenced to issue forms ITF90A for job credit claims for 1979/80. These forms are issued in duplicate, one to list all persons employed during the year ended 31 March 1980 and the other to supply details of all persons employed during the year ended 31 March 1979. The forms are in four parts but the three important parts are as follows:

Part I — Employees under the normal P.A.Y.E. Scheme.
Part II — Employees within the "N" or non-chargeable scheme.
Part III — Employees earning K42.00 or less per month.

Part IV is a summary of gross pay. These forms ITF90A should be sent together with all forms P20 A prepared in respect of employees listed in Part II.

These regulations and notes apply to 1979/80 only since for 1980/81 this Section has been substantially changed.

ITALY:

Post-graduate program in international and comparative tax law (research)

The Law of July 11, 1980 created the possibility of instituting a post-graduate program at universities in Italy for the acquisition of a doctorate in research in the various academic disciplines. Acting upon proposals by Professors V. Uckmar, S. Carbone and G. Marongiu, the University of Genoa has decided to institute such a three-year post-graduate program in international and comparative tax law, which will be established within the university's law faculty.

The program will be administered in close cooperation with the law faculties of principal Italian universities, with the Universities of Ghent, Nice and Munich, and with the International Bureau of Fiscal Documentation.

During its first year, Prof. V. Uckmar will act as the coordinator of the program.

Inquiries for additional information regarding the University of Genoa post-graduate program in international and comparative tax law should be directed to: Prof. Avv. Victor Uckmar, Università degli Studi di Genova, Faccoltà di Giurusprudenza, Via Balbi 5, 16126 Genoa, Italy.

4. *Subsidies*

There will be a very big cut in subsidies which categories have not been named. The cut will be from K208 million to K125 million.

5. *Increase in game fees*

(i) Natural game licence to cover one animal only. The fee remains at K50.00.

(ii) The district licence goes up from K7.50 to K10.00.

(iii) Fee for elephant goes up from K150.00 to K300.00 for Zambians and K1,000.00 for non-Zambians.

(iv) Bird licence goes up from K15.00 to K30.00.

(v) Hunting safari companies to pay K500.00 area fee per annum.

6. *Exchange control*

No changes have been proposed.

IV. INCENTIVES

A. Agricultural sector

The following are the incentives proposed which affect the agricultural sector:

1. *Farming income tax rates*

(a) Companies:
Companies carrying on farming activities will be taxed at a flat rate of 25 percent.

(b) Individuals:
Farming income received by individuals will be taxed at the normal rates for individuals but the maximum rate applicable will be 25 percent.

2. *Depreciation*

Farming machinery, equipment and implements will be allowed to be depreciated at 50 percent per annum of the cost of the asset on a straight-line basis. This accelerated rate of depreciation is an incentive to farmers to utilise agricultural machinery etc. with a view to improving farming on modern lines.

3. *Development allowance*

A "Development allowance" of 10 percent of the total expenditure incurred in a charge year by a grower for planting cash crops such as tea, coffee, bananas, citrus fruits will be given as an incentive to encourage such cash crops. This proposal takes into account the gestation period of about three years before the trees bear fruit. For a new grower the allowances can be carried forward up to the first year of production.

4. *Suspension of duties*

(See notes on Incentives to industrial sector, Para. 7.)

Notes

According to the Income Tax Act, a "farmer" means any person who, with a view to profit engages in husbandry, or pastoral, or agricultural activities or in forestry, or in the raising of plantations or who lets any property for any such purposes.

B. Industrial sector

When the Industrial Development Act was passed on 30 August 1977 to supersede the Pioneer Industries Act, the prime idea was to encourage the establishment of new industries, to diversify the economy of the country, provide new avenues for employment and act as an incentive for the investment of capital. However the regulations needed to provide clear guide lines for investors have not yet been issued. The Honourable Minister has proposed a few selected incentives as an encouragement to the business community. These incentives will be administered under the Industrial Development Act. They are:

1. A "Priority enterprise" will be exempt from income tax, initially for five years, after which a further period of relief will be considered depending on its performance and fulfilment of the conditions which in the first place gave it "priority enterprise" status;

2. Dividends declared and distributed or distributable during the tax relief period will be exempt from tax in the hands of the recipients;

3. Capital expenditure incurred during the tax relief period by an approved "priority enterprise" on any asset which continues to be used for the purpose of that same trade or business after the end of the tax relief period shall be deemed, for depreciation purposes, to have been incurred on the day following that on which the tax relief period ends;

4. Losses incurred by a "priority enterprise" in the course of carrying on its trade or business during the tax relief period shall be deemed as having been incurred, for income tax purposes, in the charge year following that in which the tax relief period ends; and

5. The "priority enterprise" will be exempt from selective employment tax during the period of the tax holiday.

6. *Depreciation*

In the cases where a tax holiday may *not* apply, the Minister has made provision for accelerated depreciation:

(a) Assets of up to the acquisition cost of K500 may be expensed fully in the year of acquisition instead of being depreciated regardless of whether their useful lives extend beyond the year of acquisition;

(b) Accelerated depreciation on a straight-line method over a period of three to ten years may be allowed in respect of specified assets to enable a "priority enterprise" to completely depreciate its assets before the end of their useful lives;

(c) The carry-over of any unutilised depreciation allowances may be allowed to be set-off against future income when the profits of a "priority enterprise" are insufficient to absorb them during a given charge year; and

(d) An initial investment allowance of say (sic) 15 percent of the cost of machinery and plant used by selected industries may be allowed over and above the normal depreciation allowance. This will be a once only allowance.

7. *Suspension of import duties*

Duty on the following items has been suspended:
(a) Barbed wire, bulldozers, field movers, including spares, tractor engines (diesel) including spares, as well as aluminium couplings and fittings.

(b) The 30 percent duty on fertilisers.

8. *Research costs*

(a) Expenses incurred in the conduct of scientific research will be fully deductible, for tax purposes of a "priority enterprise", provided such research relates directly to its business; and

(b) Capital expenditure incurred in the provision of scientific research facilities for a "priority enterprise", including capital expenditure, incurred two years prior to the commencement of its business, will be deductible in the first year of commencement as an expense instead of being written off over a number of years. The unabsorbed balance, if any, will be written off in the normal way.

9. *Location of new industries in rural areas*

A credit of 10 percent of net profit will be allowed in computing the taxable income, for a period of five years, of new industries that are opened in rural areas. This applies to hotels, lodges, and motels as well.

Notes

Under the provisions of Section 2 Part I of the Industrial Development Act, an "enterprise" means a manufacturing industry.

"Manufacture" means the commercial transformation of raw materials or semi-processed raw materials into finished or semi-

HIGHLIGHTS OF THE 1981 BUDGET

I. PERSONAL INCOME TAX

Personal allowances:

Single allowance increased from K500 to K600. Married allowance increased from K1,000 to K1,500. Life Insurance Premium Relief increased from K300 to K400.

Personal tax rates:

Although the maximum rate has been raised to 80 percent, the tax slabs have been so distributed as to give relief to the low and middle income tax payer. Below we give details of the old and new tax rates:

1980/1981

	Chargeable income	Rate	Tax	Cumulative chargeable income	Cumulative tax
		%	K	K	K
First	1000	5	50	1,000	50
Next	1000	10	150	2,000	150
Next	2000	20	400	4,000	550
Next	2000	30	600	6,000	1,150
Next	2000	45	900	8,000	2,050
Next	2000	55	1,100	10,000	3,150
Next	2000	65	1,300	12,000	4,450
Excess		70			

Proposed 1981/82

First	1000	5	50	1,000	50
Next	1500	10	150	2,500	200
Next	1500	15	225	4,000	425
Next	2500	20	500	6,500	925
Next	2500	30	750	9,000	1,675
Next	3000	45	1,350	12,000	3,025
Next	3000	60	1,800	15,000	4,825
Next	5000	70	3,500	20,000	8,325
Next	5000	75	3,750	25,000	12,075
Excess		80			

Under the old rates any taxpayer who had a chargeable income of K12,000 per annum paid K4,450 as tax, whereas under the proposed rates he would pay K3,025, a reduction of K1,425, in addition to the extra relief on the personal allowances.

A person who earns a chargeable income of K25,000 at present, pays K13,550 as tax, whereas under the proposed new rates he will pay only K12,075. There is therefore an equitable distribution of the tax burden on the low and middle income groups.

II. CORPORATE INCOME TAX

(1) Company tax:

The rate has been increased from 48 to 50 percent.

(2) Education levy:

This levy which is imposed on companies incorporated or registered in Zambia carrying on business or deemed to have a source of income in Zambia, has been increased from K120 to K200 per annum and will no longer be allowed as a deduction for tax purposes.

(3) Selective employment tax:

The rate remains at 20 percent but S.E.T. will not be allowed as a deduction for tax purposes. (This is a tax on the salary bills of non-Zambian employees.)

(4) Losses:

The Minister intends to amend Section 30 of the Income Tax Act, so as to make the 'Same Source Rule' apply right from the first year in which a loss is incurred.

At present a loss incurred *in a year* is allowable against *any* income of the *same year* but a loss carried forward or back is allowable only against the income from the *same source* as that in which the loss was incurred in the first place. It may be noted that "source" is not defined in the Income Tax Act. We will have to await further details and clarification of this amendment.

(5) Taxation of branches of multi-national corporations:

Foreign companies having a branch in Zambia at present pay only company tax on profits and the after-tax profits are not subject to withholding tax as they do not declare dividends. The Honourable Minister of Finance proposes to deem a presumptive dividend available for withholding tax purposes.

As this proposal is vague and fairly broad it is not possible to make any definite suggestions. However it may be noted that the withholding tax on dividends is 20 percent. There is however relief available under the provisions of the respective Double Tax Agreements provided certain conditions stipulated there are fulfilled.

Under the provisions of the Income Tax Act, the Commissioner of Taxes has the authority to "deem a dividend". He is given the authority to use his discretion keeping in mind the welfare and growth of the company concerned. He will have to await further regulations to see how the Commissioner of Taxes will quantify the "deemed dividend" and the rate of withholdigng tax.

(6) Capital allowances:

The deemed cost of motor vehicles for the purpose of wear and tear allowance will be raised from K6,000 to K9,000.

It is not known from which charge year the above proposals will take effect but it is probable that they will come into force on 1 April 1981.

III. OTHER FISCAL MEASURES

1. Excise duty

(i) *Clear beer:*
Zambia Breweries to pay an extra 2ngwee per bottle in excise to the Government.

A price increase to the consumer of 1ngwee per bottle.

(ii) *Tobacco:*
Increase of 2ngwee to 5 ngwee per packet of 20 cigarettes.

(iii) *Petroleum products:*
Increase of 3ngwee per litre for premium and 0.8 ngwee for diesel.

(iv) *Sugar:*
Increased by 6 ngwee per kilo.

2. Sales tax

(i) Dutiable imports raised from 10 to 12 percent.

(ii) Locally produced domestic products up between 2.5 to 5 percent with the exemption of:
Tyres and tubes
Blankets
Electricity
Footwear
Furniture
Paints
Car batteries
Clothing
Sales tax of 20 percent on baby napkins now removed.
All these increases are effective from midnight 30 January 1981.

3. Parastatal organisations

Those parastatals which make profit but are not subject to tax will now be liable to tax.

(c) The carry-over of any unutilised depreciation allowances be allowed to be set-off against future income where the profits of a priority enterprise are insufficient to absorb them during a given charge year; and
(d) An initial investment allowance of, say, 15 percent of the cost of machinery and plant used by selected industries be allowed over and above the normal depreciation allowance. This, therefore, would be a once and for all allowance and will not affect the depreciable amount but it will be some form of credit.

(c) General

(i) Research incentives

99. Mr. Speaker, Sir, in order to encourage research for improving technical know-how or invention, the following incentives are proposed:
(a) Expense incurred in the conduct of scientific research be fully deductible, for tax purposes, of a priority enterprise provided such research relates directly to its business; and
(b) Capital expenditure incurred in the provision of scientific research facilities for a priority enterprise, including capital expenditure, incurred two years prior to the commencement of its business, be deductible in the first year of commencement as an expense instead of being depreciated. The unabsorbed balance, if any, should be depreciated in the normal way.

(ii) Location of new industries in rural areas

100. Mr. Speaker, Sir, in order to attract the location of new industries in rural areas, including hotels, motels and lodges, a credit of 10 percent of net profit be allowed in computing their taxable income for a period of five years. This facility should be extended to other priority industries regardless of location.

(iii) Capital allowance — Motor vehicles

101. Mr. Speaker, Sir, I recognise the fact that motor vehicles have become very costly in Zambia. For this reason, I propose that the deemed cost of motor vehicles for depreciation purposes be raised from K6,000 to K9,000.

102. Sir, I have outlined some of the incentives given to farmers. Some of these relate to income tax. In order, therefore, to provide relief to categories other than farmers, I have decided to suspend duty on the following items: barbed wire; bulldozers; field mowers including spares; tractor engines (diesel) including spare parts; as well as aluminium couplings and fittings. In addition, I have also decided to suspend duty on those types of fertilisers which are put up for retail which, hitherto, are dutiable at 30 percent. Mr. Speaker, Sir, I expect our farmers to avail themselves of this generous incentive to agriculture.

103. Mr. Speaker, Sir, the incentives I have just announced are intended to spur the business and agricultural community into greater effort and production. I have done so in full recognition of the high priority accorded to the agricultural sector by the Party and its Government. In particular, the pivotal role of agriculture in Zambia's future and self-reliant development demands and deserves practical and progressive incentives. Mr. Speaker, Sir, I should like to believe that this package of incentives will serve to maintain the momentum and to provide additional impetus in our efforts to create firm foundations for the sustained and endogenous development of our country.

(iv) Personal allowances

104. Mr. Speaker, Sir, for some time now I have given serious consideration to representations relating to the incidence of tax on personal incomes, particularly of those in the low- and medium-income groups. I have given sympathetic consideration to these submissions and have, accordingly decided to make modifications in the personal tax system as follows:
(i) Married allowance should be raised from K1,000 to K1,500;
(ii) Single allowance should be raised from K500 to K600;
(iii) In order to encourage savings the ceiling on life insurance premiums should be raised from K300 to K400.

(v) Personal tax rates

105. Mr. Speaker, Sir, the present personal tax structure is characterised by the rather narrow bands and a steep progression of marginal rates. In order to ease the burden of taxpayers, particularly, those in the low- and middle-income brackets and ensure an equitable distribution of the tax burden while minimising loss to tax revenue to Government, I propose that personal earnings be taxed at the following rates:

Chargeable income K	*Percent tax rate*
First 1,000	5
Next 1,500	10
Next 1,500	15
Next 2,500	20
Next 2,500	30
Next 3,000	45
Next 3,000	60
Next 5,000	70
Next 5,000	75
Excess	80

106. Mr. Speaker, Sir, under the proposed tax structure the objective is to reduce the effective tax rates. For instance, in the case of a taxpayer whose chargeable income attracts tax at the high rate of 75 percent, his effective tax rate would, in fact, be only 48.3 percent.

(vi) Pensions

107. Mr. Speaker, Sir, in order to provide relief to persons in receipt of fixed incomes I have decided that all the handicapped, and also pensioners, aged 60 or more, ordinarily resident in Zambia, should receive their pensions tax free.

CONCLUSION

108. Mr. Speaker, Sir, this afternoon, I have tried to review progress achieved in 1980 and the prospects for 1981. I have done so against the grim background and appraisal of the prevailing international economic situation, particularly those aspects which have, in one way or another, conditioned or are likely to influence the performance of our economy. I hope that I have succeeded in drawing due attention to the continued impact of external forces on Zambia's development efforts and achievements. At the same time, I expect Honourable Members and the nation at large to draw the necessary lessons in terms of strengthening the spirit of self-reliance in order to minimise the degree of dependence on exogenous factors.

109. It is evident from my Address that while the nation may have cause to be proud of some progress, however modest, during a most difficult year, much more remains to be accomplished. Indeed, the turnaround from the economic decline of 8 percent in 1979 to a positive growth rate of 0.8 percent in 1980, is quite encouraging. However, there are still serious problems confronting us, more formidable obstacles in our path towards progress which are capable of dissipating even those gains we have made in the recent past.

110. Mr. Speaker, Sir, I need not stress that the price of inaction or half-hearted measures in the face of serious problems is, ultimately, too high for the nation to afford. On the other hand, the cost of bold decisions and decisive measures commensurate with the situation is, in the long run, minimal. I believe that the choice for the nation is clear and that the nation is ready to adhere religiously to the regime of discipline, dedication, hard work, and a heightened sense of unity and patriotism. These attributes, in an atmosphere of peace and stability, are indispensable to the success of our efforts to achieve a decent standard of living of our people.

undertaking and where losses in one can be written off against profits of another. This arrangement has still left a loophole for tax avoidance. Mr. Speaker, Sir, I propose sealing this loophole by amending Section 30 of the Income Tax Act so as to make the 'Same Source Rule' applicable right from the first year in which a loss is incurred. Mr. Speaker, Sir, it is not easy to estimate the amount of additional revenue to be earned as a result of sealing this loophole.

(d) Taxation of branches of multi-national corporations

89. Mr. Speaker, Sir, at present, foreign companies having a branch in Zambia pay only company tax on profits and the after-tax profits are not subject to withholding tax as they do not declare a dividend like a subsidiary company. I propose therefore that a presumptive dividend be deemed to be available for withholding tax purposes.

(e) Game licence fees

90. Mr. Speaker, Sir, Zambia is endowed with plentiful natural resources. However, our own policies and actions can either destroy or conserve our valuable natural heritage. Zambia has copper and other minerals — a non-renewable resource — we have land which we utilise for agriculture; abundant supplies from which we can tap hydro-electricity for irrigation, lighting and industrial purposes. We have forests for timber and, above all, wildlife resources for some of our basic needs and recreation. Sir, wildlife is now in danger and we need bold policies and effective measures to safeguard wildlife. In consultation with my colleague in the Ministry of Lands and Natural Resources it has been agreed to introduce measures to protect wildlife. In order to conserve certain animal species I have decided to effect certain changes and propose as follows:

(i) That the practice of selling several animals on one licence be abolished. Instead only one animal will be shown on a game licence;
(ii) That the cost of a District Game Licence presently at K7.50 be raised to K10.0;
(iii) That the Bird Licence be increased from K15 to K30;
(iv) That the basic fee of K50.0 per annum for the National Game Licence be retained, but each licence will be issued in respect of one animal only;
(v) That separate Supplementary Game Licences issued to both Zambians and non-Zambians will cover one single animal per licence;
(vi) That the fee for an elephant be raised from K150 to K300 for Zambians and K1,000 for non-Zambians; and
(vii) That the hunting safari companies pay an area fee of K500 per annum.

91. Mr. Speaker, Sir, I seek the indulgence of the House as the comprehensive scope of the changes proposed do not permit me to delve into greater detail at this stage. Sir, the changes proposed take effect from midnight tonight.

(f) Contribution to government revenue— Parastatal organisations

92. Mr. Speaker, Sir, the parastatal sector's contribution to the economy over the years has been negligible. The parastatal organisations have increasingly depended on the Government to bail them out of financial problems. It was in an attempt to stem frequent demands for financial assistance that the Government introduced a guarantee fee of 1 percent and increased rates of interest chargeable on new loans to parastatal organisations. Although many of them are making losses attributable to a number of and varied reasons there are, however, a few that are viable and ought to contribute to Government revenue. Certain parastatal organisations which make profits but, for one reason or another, are not subject to tax as other companies should be liable to tax. This should be so, particularly, now that they have been allowed to charge economic prices.

INCENTIVES

(a) Agricultural sector

93. Mr. Speaker, Sir, from time to time, the Party and its Government has emphasised the importance of the agricultural sector in the nation's development efforts. The importance of this sector has been boosted by the launching of the Ten-Year Food Production Programme by His Excellency the President, Dr. K.D. Kaunda. Sir, in the middle of last year, I also issued a Press release outlining incentives to the agricultural sector. Mr. Speaker, Sir, I now wish to give the contents of my Press release the force of law in the following areas:

(i) Depreciation

94. I propose that farming machinery, equipment and implements be depreciated at 50 percent of the cost of the asset on a straight-line basis, that is, over two years.

(ii) Farming income tax rate

95. Mr. Speaker, Sir, I propose that for companies carrying on farming activities, their income should be taxed at a flat rate of 25 percent. I further propose that farming income received by individuals be taxed at normal rates except that the maximum rate applicable should be 25 percent. For example, in the case of a farmer whose chargeable income is, say, K9,000 per annum, his tax will be computed as follows:

1st K1,000 at 5 percent
Next K1,000 at 10 percent
Next K2,000 at 20 percent
Balance at 25 percent.

Mr. Speaker, Sir, the loss to Government revenue will certainly be compensated by the benefits the nation is likely to gain in terms of increased food production.

(iii) Development Allowance

96. Mr. Speaker, Sir, I propose that those who grow cash crops such as tea, coffee, bananas and citrus fruits be granted an incentive known as a 'Development Allowance' to encourage the planting of such trees. Sir, this proposal takes into account the gestation period of about three years before they bear fruit. For this purpose, Mr. Speaker, Sir, I propose a 10 percent allowance of the total expenditure incurred in the charge year. For a new planter, the allowance can be carried forward up to the first year of production.

(b) Industrial sector

(i) Income tax incentives for priority industry

97. Mr. Speaker, Sir, Honourable Members are aware that regulations under the Industrial Development Act are still under preparation. However, pending the finalisation of these regulations, I propose to offer the business community a few selected incentives to be administered under the Industrial Development Act. These represent part of the package to be announced subsequently. I therefore propose as follows:

(a) An approved enterprise should be exempt from income tax, initially for five years, after which a further period of relief should be approved depending on its performance and fulfilment of the conditions which in the first place made it approvable as a priority enterprise;
(b) Dividends declared and distributed or distributable during the tax relief period be exempt from tax in the hands of the recipients;
(c) Capital expenditure incurred during the tax relief period by an approved priority enterprise on any asset which continues to be used for the purpose of that same trade or business after the end of the tax relief period be deemed as having been incurred on the day following that on which the tax relief period ends for depreciation purposes; in other words, the allowable recovery of the cost not utilised during the relief period should be postponed until the end of the tax holiday;
(d) Losses incurred by a priority enterprise in the course of carrying on its trade or business during the tax relief period be deemed as having been incurred, for income tax purposes, in the charge year following that in which the tax relief period ends; and
(e) The priority enterprise should be exempt from selective employment tax during the period of the tax holiday.

98. Mr. Speaker, Sir, in order to provide for accelerated depreciation in cases where the tax holiday may not apply, I propose the following:

(a) Assets of up to the acquisition cost of say, K500, be expensed fully in the year of acquisition instead of being depreciated regardless of whether their useful life extends beyond the year of acquisition;
(b) Accelerated depreciation on a straight line method over a period of three to ten years be allowed in respect of specified assets to enable a priority enterprise to completely depreciate its assets before the end of its useful life;

Zambia and the mining companies, respectively. In addition, capitalisation was undertaken in Indeco Milling and National Milling companies amounting to K5.6 million and K13.0 million, respectively.

60. Mr. Speaker, Sir, the estimated deficit for 1980 amounted to K224.2 million as compared to K100.4 million in 1979. This deficit was met by short-term borrowing from the banking system.

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REVENUE MEASURES

76. Mr. Speaker, Sir, in my earlier remarks, I have discussed the difficulties the economy has gone through and the likely out-turn for 1981. Sir, I have also indicated that total expenditure should be fixed at K1,184.7 million, while the recurrent revenue likely to be available is set at K887.0 million.

77. Mr. Speaker, Sir, the recurrent revenue figure of K887.0 million includes about K49.8 million which I hope to raise through new revenue measures. Sir, Honourable Members would have wished this figure to be slightly higher, but due to the constraints facing the economy, the scope for a widened taxation base is very limited. Mr. Speaker, Sir, I now wish to elaborate these new measures which, in my view, are aimed more at discouraging consumption of luxury goods, preserving the scarce foreign exchange we so badly need for our development and also conserving our natural resources for posterity while at the same time raising the revenue necessary for the accomplishment of this objective.

(a) Excise duty

(i) Clear beer

78. Mr. Speaker, Sir, the House will recall that in my previous budget address I increased excise duty on clear beer by 2 ngwee per bottle which I subsequently suspended in order to ease the financial problems which the Zambia Breweries were experiencing at the time. Since then, the company has made a modest profit. It is therefore my intention, Mr. Speaker, Sir, to lift suspension so that Government can once again avail itself of part of these resources. Sir, this action will not affect their profitability as arrangements will be made to award them an appropriate price increase of one ngwee. Mr. Speaker, Sir, I expect to raise from this source additional revenue of K2.6 million. This measure will take effect from midnight tonight.

(ii) Cigarettes

79. Mr. Speaker, Sir, Honourable Members of this House will agree with me that cigarettes in Zambia are still lowly priced compared to other countries. In certain countries cigarette manufacturers are required by law to advise the public of the dangers of smoking. In these countries, the duty charged acts as a deterrent. In Zambia we have as yet to enact such laws.

However, I propose a modest increase in duty of 5 ngwee on the most expensive brands, 3 ngwee on the middle brands and 2 ngwee on the lowest brands, per packet of 20 cigarettes. I estimate that the revenue yield will be about K2.4 million. These measures will take effect from midnight tonight.

(iii) Petroleum, oils and motor spirits

80. Sir, petroleum, oils and motor spirits imports claim a sizeable portion of the country's foreign exchange earnings. In 1979 the country spent about K97.1 million and it is expected that the bill for 1980 might reach K130.0 million. One disturbing factor is that the producers of this commodity constantly increase prices. As a result, it is difficult to estimate accurately the amount to be spent each year. These constant price increases exert pressures on our balance of payments. Sir, in the face of soaring oil prices it is incumbent upon the nation to explore alternative and cheaper energy sources. This, however, is a long-term strategy. Meanwhile the nation needs to adopt measures aimed at conserving energy and eliminating consumption. In view of the foregoing, I propose to increase excise duty on this commodity as follows:

Premium	21n to 24n per litre
Regular	20n to 23n per litre
Diesel	12.2n to 13n per litre

I estimate to raise additional revenue of K7.0 million. The United Bus Company of Zambia (UBZ) will continue to receive supplies of diesel at concessionary rates. These measures will take effect from midnight tonight.

(iv) Sugar

81. Mr. Speaker, Sir, in 1979 the Government decided to suspend Excise Duty on sugar to assist Zambia Sugar Company (ZCS) in resolving their liquidity problems. Sir, Government has foregone this source for too long and I have now decided to revoke this suspension so that the effective rate of duty becomes 6 ngwee per kilo. It should further be noted that this is the very rate which was being charged by Government prior to the suspension. As in the case of Zambia Breweries, arrangements have been made for an appropriate price increase. I expect to collect about K5.0 million in revenue. This measure will take effect from midnight tonight.

(b) Sales tax

(i) Imports

82. Mr. Speaker, Sir, in 1972, the Government introduced a surtax on dutiable imports at the rate of 5 percent. This was subsequently repealed and substituted by sales tax in 1975. The rate at which taxable goods were levied was also raised from 5 percent to 10 percent. The rate has remained unchanged over the past five years. It is, therefore, desirable to increase the rate by 2.5 percent. In view of the large volume of dutiable imports. I estimate to raise additional revenue of K10.0 million from this source. This measure becomes effective from midnight tonight.

(ii) Domestic products

83. Mr. Speaker, Sir, Government feels that certain locally produced goods should attract a slightly higher rate of sales tax in order to finance the services it provides to its citizens. I have accordingly decided to increase sales tax on such local products by between 2.5 percent and 5 percent. Sir, I should like to inform the nation through this House that I have not increased tax on the following items: tyres and tubes, blankets, electricity, footwear, furniture, cement, paints, car batteries and clothing.

Sir, the House will be pleased to know that baby napkins which in the past were liable to 20 percent sales tax have now been completely exempted from sales tax. I wish to emphasise that manufacturers of these items shouls pass on this benefit to the nursing mothers.

(c) Income tax

84. Mr. Speaker, Sir, I now wish to elaborate on the new revenue measures I intend to take in the income tax area.

(i) Education levy

85. Mr. Speaker, Sir, presently, this levy is payable only by incorporated or registered companies carrying on business or deemed to have a source of income in Zambia. I propose to increase the levy from K120.00 to K200.00 and disallow it as a deduction for income tax purpose. I hope to raise K180,000 in additional revenue.

(ii) Company tax

86. Sir, under the present tax system, individuals in employment bear a relatively heavier tax burden than companies in business. Due to effects of inflation on real personal incomes, it is desirable to readjust the spread of tax burden between individual tax earners and companies in business. Secondly, in light of the various incentives to companies given elsewhere, there is a case for an increase in company tax. I therefore propose that the rate be increased from 48 percent to 50 percent. I expect to collect additional revenue of K5.5 million.

(iii) Selective employment tax

87. Mr. Speaker, Sir, at the time when this tax was introduced the underlying objective was to encourage employers to train Zambians in order to facilitate effective Zambianisation. The tax is borne by employers who engage non-Zambians, and is allowed as a deduction for income tax purposes. It has been proved that this arrangement does not, in fact, effectively encourage training for Zambianisation. It actually removes the tax burden so that an income supposed to be taxed at 48 percent is taxed only at 20 percent. Sir, in order to seal this loophole, I propose that the tax be disallowed as a deduction for income tax purposes so as to remove this unintended tax reduction aspect and make job-related training of Zambians be taken seriously by employers. Sir, I also propose that the tax rate be set at 20 percent. This measure will raise an additional revenue of K9.0 million.

(iv) Source rule—losses

88. Mr. Speaker, Sir, this rule applies in situations where there are more than one

The growth in the industrial sector had been disappointing. The manufacturing industry showed hardly any increase in 1980, the construction industry showed a steady decline rather than progress. Much of this was due to the lack of foreign exchange on which many industries depended for their sustenance. Added to all these was the fact that the Government expenditure on capital projects had been restricted. However, for the year 1981, the Government has decided to increase its capital expenditure from K191.3 million to K225.8 million. Out of these K98.7 million is expected to be from foreign loans.

A very large percentage of the industrial activity of the country is run by the parastatals which are state controlled. Their contribution to the economy of the country has been negligible. Many of them are running huge losses and have become increasingly dependent on the Government to pull them out of their financial difficulties. There are allegations of waste, inefficiency, bad management and bad planning. Whatever the causes may be they have become a liability to the country. Most of them do not pay tax due to the heavy losses, the few others who make some profit too do not pay for some reason or other. The Government has decided to tax those who make a profit and reorganise the others in such a way as to cut down waste and inefficiency.

The prices of various commodities have been kept down by the Government by granting subsidies. These have become a very heavy burden on the economy of the country and the Government has now decided to cut down on these subsidies. In 1969 they totalled K20.9 million, in 1975 they were K82.8 million, in 1980 they rose to K208 million. For 1981, the Government will cut the subsidy bill to K124.7 million so that certain categories of subsidies will be withdrawn and the full price of the commodities will be met by the consumers. The parastatals have now been given the green light to charge economic prices and requested to reorganise themselves to reduce waste, inefficiency and bad management so that not only would they be self sufficient but also deliver the goods to the consumers at a reasonable price.

Conclusion:
The budget is looked at by some as hopeful and encouraging, while others look at it as a "wait and see budget". While there is encouragement given to the agricultural and industrial sector, yet subsidies have been withdrawn and now everyone wonders how much the commodity prices will go up. Prices of milk, bread, meat, to name a few have already gone up. Will the incentives offered by the Government increase the output in the agricultural and industrial sector so as to offset the loss in revenue, and will the expansion be such as to bring down the prices of foodstuffs which have hitherto been heavily subsidised? We will have to "wait and see".

ZAMBIA: BUDGET 1981

On January 30, 1981 Zambia's Finance Minister, Mr. K.S.K. Musokotwane pronounced his Budget Address. We publish below those parts of his speech which have a direct bearing on taxation.

See for a detailed discussion of taxation in Zambia our publication *African Tax Systems* (also in French: *Systèmes Fiscaux Africains*)

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GOVERNMENT FINANCIAL OPERATIONS

53. Mr. Speaker, Sir, I now wish to discuss the financial operations of the Government for the year ended 31st December, 1980. Some of the figures I will be quoting are provisional and, therefore, subject to revision when the accounts are finalised.

(a) Revenue

54. Sir, the revised total recurrent revenue was K766.7 million as compared to the Budget estimate of K758.0 million. This represented a modest increase of 1.2 percent or K2.7 million over the estimate.

55. Receipts from income tax accounted for K271.1 million with a large portion coming from PAYE and company tax. The revenue from this source was originally estimated at K237.5 million, an improvement of K33.6 million over the budget estimate. The large increase in PAYE is accounted for by the salary and wage increases awarded to the public and parastatal sectors during the year under review. On the other hand, the improved collection under company tax is attributable to the enhanced performance of companies in general.

56. For three years up to 1979, no mineral revenue was received from the mining companies due mainly to accumulated losses which had to be written off in 1980. The revenue collected from this source in 1980 amounted to K41.7 million. In 1981, the mining industry's contribution to Government revenue is estimated only at K2 million. The industry is not expected to make much profit in 1981.

(b) Financing

57. Mr. Speaker, Sir, the non-banking institutions provided K52.0 million and K25.0 million in long- and short-term loans, respectively. Total internal borrowing, therefore, amounted to K77.0 million. On the other hand, external borrowing totalled K289.2 million as against the budget estimate of K144.6 million. The increase in external financing is represented, in part, by Government's assumption from Indeco of loan obligations amounting to K161.0 million in respect of the expansion of Nitrogen Chemicals of Zambia Limited.

(c) Expenditure

58. Mr. Speaker, Sir, total recurrent expenditure authorised by the House for 1980 was K1,107.5 million of which supplementary estimates accounted for K269.2 million. The actual recurrent expenditure in 1979 was K791.2 million. The higher level of expenditure in 1980 as against that of 1979 was due to a number of factors, such as the cost of importation of maize in the sum of K35.2 million, subsidies amounting to K208 million as well as salary and wage awards. Subsidies showed a sharp increase over the budgeted figure of K90.6 million.

(d) Capital Budget

59. Sir, the House approved capital expenditure of K649.5 million of which K458.2 million was by way of supplementary estimates. According to preliminary estimates, capital expenditure in 1980 by ministries and departments was K249.6 million. Part of the balance was used to meet the Government take-over of K161.0 million and K178.0 million loan obligations on behalf of Nitrogen Chemicals of

ZAMBIA'S 1981 BUDGET

by A.B.C. Emmanuel *

The Budget was received with considerable relief by the people who, in view of the serious economic situation in Zambia, caused primarily by the liberation wars, expected a harsher one. The depressed price of copper, the increasing balance of payment deficits, the growing inflation rate and unemployment had brought a general idea that a tough budget with further belt-tightening was forthcoming. Although there were slight increases in the price of beer, cigarettes, petrol etc. by a few ngwee (100 ngwee = 1 kwacha) yet they were not prohibitive and on the other hand, the lower and middle income groups received considerable tax relief. On the whole the Budget was an encouraging one granting incentives to agriculture and industry and aimed at cutting down waste and inefficiency in the parastatals (semi-governmental bodies).

To understand this attitude in the Budget one has to look into the economic background of the country. This has been aptly summed up by His Excellency the President Dr. Kenneth Kaunda when he addressed the National Assembly at its opening on 16 January 1981: "*We have depended a lot on copper and other minerals, we have now to diversify and move away from this dependence to the most viable alternative, which is our land. We must turn to land for our survival. We must aim at land to produce abundance of food not only for consumption but also for export and get the much needed foreign exchange. A country that has no food cannot hope to progress satisfactorily in industrialisation let alone be respected.*"

His Excellency the President had even earlier stressed on the need for self-sufficiency when he opened the Operation Food Production on 23 May 1980, "*We have to feed ourselves and also become the grainery of Africa and the World.*" To this end there were to be large state run farms in each Province covering an average of 20,000 hectares. Each farm would be technically equipped in terms of organisation, planning, farming methods and machinery. There would also be cooperative society farms and peasant and family farms cooperating through common funds, common marketing facilities, common water tanks and common machine centres. The private commercial farmers who were well established and contributed a lot to the agricultural economy were to impart more agricultural know-how to the cooperatives and peasant farmers.

Although this operation Food Drive and other food drives like the Lima food campaign were at work, yet the output in the agricultural sector did not increase. Maize production hardly showed an increase, in fact maize had to be imported during the year. This was partly due to the poor rainfall in the year. Tobacco output had declined and the output in sugarcane, sunflower and seed cotton showed slight increases. On the whole the performance in the agricultural sector was unsatisfactory. To give effect to the emphasis placed on the importance of agriculture in the nation's development efforts the Honourable Minister of Finance in his Budget proposals offered incentives to the agricultural sector.

The incentives offered have been set forth in the extract of the Budget Speech, below.

As regards industrialisation His Exellency the President Dr. Kenneth Kaunda said:
"*While the emphasis is on agriculture, nevertheless increasing agricultural production alone will not be sufficient. Care must be taken of the need for industrial development. It is well known that our industrial development has been lopsided, most of the industries that have been set up are heavily dependant on the importation of raw materials and other essential production inputs. The industries are also highly consumption oriented. There are very few industries that produce capital goods. As soon as there is a shortage of foreign exchange these industries are affected. We must set up industries which will use local raw materials. We must also diversify the location of industries by identifying industrial projects that will be appropriate to the rural environment.*"

The progress in the industrial sector had been slow. The capital expenditure by Government had decreased and it had slowed down investment in the private sector as well. Added to this, the lack of foreign exchange affected the industrial sector that needed foreign exchange for their very existence let alone expansion. The Industrial Development Act was passed on 30 August 1977 to encourage the establishment of new industries, to diversify the economy of the country, provide new avenues for employment and act as an incentive for the investment of capital. Except for a few industries there was no significant growth at all. Although the regulations did exist in the Industrial Development Act, there were no positive incentives or reliefs that attracted investors. So the Honourable Minister of Finance in his Budget speech offered tax reliefs and other incentives with a vew to attracting local and foreign investors to invest in various sectors in the Zambian economy. See the extract of the Budget Speech, below.

In addition to these incentives, there was an incentive offered to employers for each additional job created in the manufacturing industry. This "job credit" facility was introduced in the 1979 budget and modified in the 1980 budget. In short, for every new job created the qualifying employer was to receive a credit of K500.00 against his tax for the year 1979.

For the year 1980 this relief has been modified, granting credits of certain percentages of the basic salaries of the qualifying employees. The method of claiming this relief for 1980 onwards is being worked out by the Revenue Authorities (see note on job credits, below).

* Tax Manager, Price Waterhouse & Co., Lusaka.

justment no distinction should be made as to the origin of credit claims and debts since they do not lose their main character for such adjustment and are totally interchangeable.

Therefore, the Tax Court was *correct* in deciding that the liability consisting of the directors' fees to be paid is not a liability for purposes of inflation adjustment, because it is not a debt entered at the end of the accounting year, although as an expense it is deductible from the income of that year. And it may further be concluded that the law is *wrong* where it denies the deduction in connection with assets representing future non-deductible expenses and also when restricting the deduction to receivables connected with deductible expenses.

VII. CORRECTIONS CONNECTED WITH VERTICAL EQUITY RULES

The preceding sections discussed the very important subject of the adjustment of profits shown by conventional accounting methods, designated under the assumption of a stable price level but which lead to incorrect results under inflationary circumstances. However, inflation also introduces changes which affect "vertical equity" as it has been expressed in the law as being the will of the community.

For instance, it changes the real value of basic deductions and exemptions to which taxpayers are entitled but which are expressed in the national currency and which as inflation progresses become less and less significant. Moreover, under Argentine tax law — as is the case in tax laws in other countries — there exist several formulae expressed in the national currency which lead to the same result.

On the other hand, as income normally increases in nominal terms — even if it remains equal in real terms — due to progressive taxation the average tax rates constantly increase and thus conflict with vertical equity expressed by the tax laws.

In order to remedy this situation the Argentine tax law has introduced a system under which — either annually or monthly — practically all amounts stated in nominal terms are increased as well as the breadth of the tax brackets of its progressive income taxes.

VIII. INDEXATION OF PAYMENTS

Argentine laws also provide for a system under which taxpayments are indexed. The purpose of indexing is to introduce coefficients based upon the price index changing the nominal amount of each payment in order to restate the original value.
For instance, there is a method of indexing advance tax payments based upon the tax debts of the preceding year with results similar to the United States "pay as you go" system. Also there is a system indexing late payments, where the delay is more than two months. This measure has contributed to the reduction of tax evasion based on taxpayers' speculations that payments at a later date using "cheaper" money would eventually be profitable.

IX. SUMMARY

Due to persistent inflation, the Argentine tax system has adopted, especially in the field of income tax, but not exclusively so, a complex system of inflation corrections. In doing so it was realized that traditional tax systems are based on the implicit assumption that price levels are stable, an assumption, however, which would be absurd for countries situated in the South Cone, i.e. Argentina, Brazil, Chile and Uruguay, which have been more concerned with inflation than other countries.

The method which was adopted — established for the Argentine tax system as a whole and not only for the income tax — tried to solve three different kinds of problems:

(1) Distortion of horizontal equity with respect to taxes on income and capital based on the fact that conventional accounting does not correctly value the assets of enterprises and does not correctly establish their income. Thus there is a substantial divergence between profits and capital computed according to conventional accounting methods and real accretion of wealth and real wealth itself.
(2) Methods of correction of amounts expressed in national currency and the range of the tax brackets of progressive income tax in order to maintain vertical equity as the underlying principle of the tax laws.
(3) A system of correction with respect to late payments of tax and to advance payments of tax in such a manner that the taxpayer is paying the real amount due.

However, there is still an area of doubt since the interpretation of the law is to date not very clear. Also, the law leads in a number of cases to unintended results caused by exceptions, loopholes and deficiencies of the law itself.

An example is the case of fees paid to members of a company's Board of Directors. According to Argentine commercial law and the usage in the country, the annual fees to which the members of the Board of Directors are entitled do not appear as debt in the balance sheet, since their amount is decided upon at a later moment when the assembly of shareholders considers the balance sheet and the results of the preceding accounting year. However, although these fees do not appear on the balance sheet they are a liability of the company. Some distinguished authors state that they must be considered a liability to be entered into the balance sheet. This question is undoubtedly significant, since in conformity with the *working capital system* adopted, the inclusion of this liability in the balance sheet implies a substantial increase of taxable profit.

The view that these fees are not a liability appearing in the balance sheet is based on the fact that at the end of the accounting year the fees were not yet established so that there is no debt yet. Other persons feel that, notwithstanding this situation under the law, the fees can be deducted from the income of the year to which they pertain and this is the reason why they should be considered to be a liability.

The first decision rendered by the Tax Court adopted the first point of view, i.e. that directors' fees are not a liability and that they therefore, do not lead to an increase of income through inflation adjustment.

The problem connected with directors' fees is not only interesting in itself but also because it seems to be one case out of a more general "family" of problems. For instance, assume that an enterprise buys shares issued by a corporation with the purpose of selling these at a later date. Earnings from the sale of shares are exempt from income tax under Argentine tax law and they are excluded from the assets qualifying for inflation adjustment. Thus no income tax is assessed on these earnings and the shares do not give rise to any further adjustment so that the whole operation can be carried out unaffected by income tax as is the purpose of the law.

However, the situation will be different if it is assumed that the enterprise contracts a loan to buy the shares. In that case the debt is included in the liabilities and it will, through the inflation adjustment procedure, result in an increase of taxable income and thus the operation is indirectly taxed.

The situation will again be difficult if the enterprise sells the shares with a view to cashing in the proceeds in the future. The credit claim originating from this sale will be listed as an asset and thus will result in a deduction from profits.

Both cases seem to violate the horizontal equity principle and they are in particular under discussion because they lead to two more general problems, i.e.:

(1) Must credit claims be included to be adjusted so that they result in a deduction from profits when they are connected with exempt income or exempt operations?
(2) Must debts originating from non-deductible expenses and from exempt operations be considered as liabilities and thus result in an increase of income?

If the problem is phrased in a somewhat different way the questions can be formulated in the following manner:

(1) Must all taxed income have its counterpart in assets to be adjusted?
(2) Must all deductible expenses have their counterpart in liabilities to be adjusted?

The decision of the Tax Court concerning directors' fees seems to indicate that the answer is negative because the Court decided that these expenses do not imply a liability even when they are deductible, mainly because they are not a debt at the balance sheet date. Also, if the Court were consistent, it should rule that credit claims and debts, irrespective of their connection with exempt income or non-deductible expenses, should affect taxable income.

However, the law is not consistent with this view, since it provides that advance payments of expenses when they are not deductible should not be entered as an asset in the balance sheet. This inevitably leads to a discussion of the advance payment of income tax, which is not a deductible item, and, because according to this rule it is excluded from the assets, it will not lead to a reduction of taxable income.

The law, however, has followed a different approach with respect to debts which must always be entered as a liability but a similar approach for accruals (i.e. estimates of unpaid expenses) which may only be entered as a liability if the corresponding expenses are deductible.

In the author's view, for purposes of inflation adjustments, it is immaterial whether a distinction can be made between assets and liabilities which are connected with expenses which can be deducted or not or with income whether exempt or not. The very purpose of these adjustments is to include profits originating from the loss of purchasing power of the currency when it concerns liabilities — e.g. loans — and to deduct losses resulting from such loss of purchasing power when it concerns cash and credit claims, because loans will be repaid with money which has a quite different value in terms of purchasing power than the money originally borrowed. Ultimately the horizontal equity principle underlies the theory of the inflation adjustment which is meant to include those earnings and losses which constitute real accretions and reductions of wealth. Income tax provisions may exempt certain earnings or not permit certain deductions with a view other than that of horizontal equity but this should not result in an exclusion of profits or losses originating from the application of the inflation adjustment on credit claims and debts. Such income — whether positive or negative — is of a different kind and must be included in income if horizontal equity is to be respected. The connection between exempt transactions and the resulting credit claims is only incidental. For purposes of inflation ad-thus $\quad r = \Sigma (I_i - 1)(A_i - C_i)$ [8]

or $\quad r = \Sigma (I_i - 1)(P_i - M_i)$ [9]

r is the result of inflation which must be added or deducted from earnings computed on the basis of conventional accounting methods

$(I_i - 1)$ represents the *increase* of the price index.

$\Sigma (I_i - 1)(P_i - M_i)$ reflects that the results of inflation — whether benefits or losses — are a result of transfer of wealth from the enterprise creditors to its debtors; it reflects a benefit when $P < M$.

$\Sigma (I_i - 1)(A_i - C_i)$ reflects the method of balance sheet adjustments used by accountants in price level accounting.

When assumption (ii) is abandoned the problem arises of selecting the proper price index.[5] This will not be further discussed in this article since it is not essential for an understanding of the basics of the price level accounting system.

When assumption (i) is abandoned this merely implies that the adjustment must be made starting from the adjusted figures of the preceding balance sheet — properly adjusted — instead of the first balance sheet.

IV. THE ADOPTION OF THE WORKING CAPITAL APPROACH

Upon being confronted with increasing rates of inflation and with a clear need of some kind of adjustment system, the Argentine tax authorities dismissed the draft bill based on price level accounting on the grounds that it was too complicated and that it required a fundamental reform of Argentine income tax. This would be a time consuming and risky task since it implies that almost fifty years experience in applying the tax would be abandoned.

Although this argument has some merits, it is the author's opinion that it is highly exaggerated. However, on these grounds the so-called *working capital* approach was enacted, an accounting procedure which had been used for internal purposes by a number of important enterprises in Argentina and which has for several years been used in the Brazilian tax system.

The fundamentals of this system are:

(1) To continue the use of the *capital goods approach* as it was enacted in 1971.
(2) To aggregate the values of inventories, credit claims, bank deposits and cash at the beginning of the year and to establish the amount representing the increase of the price level during the year. The result must be deducted from profits.
(3) To treat debts owed by the enterprise in a similar manner but increasing, instead of reducing, the amount of profits.

In algebraical terms the system works in the following way:

$$r = (I - 1)\left(\frac{A_f}{n} + A_j + M - P\right) \quad [10]$$

Where:

r is the amount to be deducted from, if positive, or added to, if negative, the profit computed according to the conventional accounting method.
I is the price index based on the beginning of the accounting year.
A_f represents the fixed assets.
n is the useful life of the assets.
A_j represents inventories.
M represents monetary assets as defined earlier in this article.
P represents monetary liabilities as defined earlier in this article.

A number of enterprises with large amounts of liabilities objected to this approach because taxable income was radically increased and it was, therefore, decided to make the system optional during the first year after the legal provisions became effective. In fact, such an option is — curiously enough — a permanent feature of Brazilian law. Of course, the option means that the system will only work when it reduces taxable income and not when it would increase such income. It obviously reduces the amount of tax collected but it is now impossible to ascertain whether any reduction in revenue is caused by the option or by the working capital system itself.

V. ASSESSMENT

There is little doubt that the *capital goods approach* does not solve the problem of horizontal equity since it does not restate profits computed through conventional accounting methods into real accretion terms. Also, there is little doubt that the price level accounting method does obtain such results.

However, with respect to the *working capital approach* there are among experts some doubts as to the equivalence of its results and those of the *price level accounting method.* In other words, do the corrections applied under the *working capital approach* show the real accretion of wealth? It is beyond doubt that the optional character during the first year is a clear violation of the horizontal equity rules. However, doubts remain for the future application of the law and this subject will require extensive further research.

VI. SOME PRACTICAL PROBLEMS INHERENT IN THE ADOPTED SYSTEM[6]

The *working capital system* has achieved its purpose of not fundamentally changing Argentine income tax, since it was only enacted as a new appendix to the law providing for a new correction among existing ones to be applied when filing the annual income tax return.

5. As staticians state, if there were no changes in relative prices, the increase in the price of any single good would represent the index and no weighing problem would exist.

6. The author is indebted to Dr. Isaac Rechter and Dr. Angel Schindel for providing him with cases analyzed in this article. However, he carries the sole responsibility for any mistakes in providing solutions for these cases.

that the owners of the enterprise are entitled to preserve the same amount of purchasing power as they invested before they can be considered to have made a profit. Preserving the nominal value of the capital only would lead to a continuous reduction of the initial and later investments. Liabilities in foreign currencies can also be included in *"adjustable liabilities"*.

Following the same logic as for the distinction of assets it is also possible to distinguish *"monetary liabilities"* which consist of debts and accrued interest in national currency owed by the enterprise.

The price level accounting system in its most simple form consists of two components. In the first place the value of *adjustable assets* is increased for inflation with the use of the price level index, thus reflecting price increases at the end of the accounting year and thus increasing the profits by the same amount. Secondly, *adjustable liabilities* must also be increased with use of the price level index, thus reducing the profits by the same amount.[3]

There are a great many problems connected with the application of the price level accounting system, too complex and too technical to be discussed in this article, but two important conclusions may be drawn.

In the first place, this system also covers the capital goods approach since fixed assets would be valued at their present value and the depreciation reserve would be sufficient to cover the financing of goods to be replaced. The price level accounting system would also solve the problems connected with inventories which would be particularly important to trading enterprises.

Secondly, the fact that profits computed in conformity with the conventional accounting system must be increased by increasing the value of the *adjustable assets* shows there is a possibility that the real accretion of wealth may exceed the results under the capital goods approach, a result which is clearly in conflict with the principles on which the capital goods approach is based.

In order to apply the price level accounting approach, the Argentine tax authorities towards the end of 1975, prepared a draft bill which was presented to Parliament but which never passed the committee stage. In the author's opinion, the draft bill would have important advantages although it would require several corrections. Surprisingly, the general public — not even the members of the accounting profession — had not become acquainted with the importance of this draft bill.

Its main characteristics can be described as follows:

(1) It establishes new adjusted values of every tangible asset by the end of the accounting year using coefficients based on price indexes, increasing the profits by the difference between nominal and adjusted values of the assets at the beginning and at the end of the accounting year.

(2) It increases the values of the net wealth accounts, also by using price index coefficients, adjusting the nominal values at the beginning of the accounting year to adjusted values at the end of the accounting year thus reducing the amount of profits by the difference between the nominal and adjusted values.

According to the accounting profession the price level accounting system is clearly the best system in that it offers results under inflationary circumstances which are similar to those of conventional accounting systems at stable price levels. For this reason — although perhaps at the risk of some repetition — the price level accounting system is also presented in algebraic terms. The basic equation underlying any accounting system and in particular an enterprise's balance sheet can be expressed as:

$$A + M + C + P \qquad [1]$$

Where
A is adjustable assets
M is monetary assets
C is adjustable liabilities
P is monetary liabilities

In order to group the monetary and adjustable items together it is permisseble to write this formula as follows:

$$A - C = P - M \qquad [2]$$

Let us further assume that:
(i) the above symbols refer to the first balance sheet;
(ii) relative prices do not change;
(iii) debts are paid back with the same purchasing power as at the moment of concluding the loan contract (as would be logical in economic terms although not in civil law terms).

Then the formula underlying the balance sheet would be:

$$\Sigma I_i (A_i - C_i) = \Sigma I_i (P_i - M_i) \qquad [3]$$

Where:
i is the date when an asset or liability was entered in the balance sheet
I_i is the price index on a unity basis. It is possible to use one single price level coefficient since we assumed that there would be no relative price changes; the price index is based on "i" and established at the date of the balance sheet.

If we now drop assumption (iii), i.e. if it is now assumed that debts are *not* repaid with the same purchasing power as they had at the moment of contracting the loan but at their nominal value, as civil law demands, the equation would read:

$$\Sigma I_i (A_i - C_i) = \Sigma (P_i - M_i) + \Sigma (I_i - 1)(P_i - M_i) \qquad [4]^4$$

The residue "$\Sigma (I_i - 1)(P_i - M_i)$" represents the *results of inflation* — profits or losses — and can be expressed in the symbol "r". A rewrite of the above formula results in:

$$\Sigma I_i (A_i - C_i) = \Sigma (P_i - M_i) + r \qquad [5]^4$$

$$\text{or } r = \Sigma I_i (A_i - C_i) - \Sigma (P_i - M_i) \qquad [6]^4$$

and because of formula [2] $(P - M) = (A - C)$ [7]

3. For a detailed analysis of this system see: Jorge Macón, *Nivel de precios y equidad en impuestos sobre ingresos netos* (Price level and equity in taxes on income (doctoral thesis, 1971).

4. In fact "P" and "M" can lose here their subscripts "i" and sigma signs because there is no need of them; "i" means the date when the item was entered in the accounting system and its importance is based on the fact that it determines the size of the index "I_i". When "P" and "M" are not indexed the date of origin looses its meaning. However they can be kept for the sake of formal rigour and brevity.

Of course, it is possible to introduce provisions adjusting the values of inventories to solve the particular problem of traders. But, if this is done, a third problem remains to be solved, i.e. that of the holders of credits. For a credit holder inflation during a certain period of time means a loss, since the currency loses its purchasing power. This also holds true for cash. On the other hand, for a debtor inflation means an effective earning since the real value to be paid back diminishes. To use Musgrave's terminology, the problem really is one of "horizontal equity", meaning that equals are not treated as equals. Price level accountancy methods reveal that conventional accounting shows profits which are sometimes higher and sometimes lower than real accretions of wealth. In addition, in those cases where the result is a higher profit amount, the magnitude of the differences shows a wide variation. Thus if the tax rate is applied to profits computed in conformity with conventional accounting methods the amount of tax due related to real accretion of wealth will show different effective rates which also have a large variation, thus clearly violating horizontal equity principles. An extreme example is the situation where there is an effective reduction of wealth but where conventional accounting leads to the assessment of income tax.

II. THE CAPITAL GOODS APPROACH

In the first development period Argentine tax laws followed a course probably inspired by the French laws prior to the 1960s, based on the assumption that conventional accounting methods invariably lead to profit figures which exceed real accretion of wealth. In addition, it was believed that the problem exclusively — or at least mainly — was rooted in the valuation of capital goods. These ideas were in conformity with prevailing theory in the United States where the Government — although experiencing a lower rate of inflation — introduced accelerated depreciation.

As a result, in 1960 and 1967 two so-called revaluation laws were promulgated. The main characteristic of these laws was that they authorized business to adjust the value of — mainly — capital goods with the use of coefficients based on the price level index. This revaluation — which was optional — was only made for income tax purposes and had no consequences for accounting methods.

From a tax point of view these revaluation laws offered enterprises a higher depreciation deduction to be taken against taxable profits, thus reducing the overall tax burden. On the other hand, they were obliged to pay a special tax on the revalued amount but its reate was rather low in comparison to the advantages to be gained through the increased depreciation deductions so that almost every taxpayer opted for revaluation.

In 1971 this system was permanently incorporated in income tax law, without, however, the imposition of any special tax on revalued amounts. Under this system taxpayers were permitted to take depreciation deductions based on historical prices increased by coefficients based on a price level index. As indicated above, this system discriminated clearly between various categories of taxpayers, since it favoured only those who possessed substantial investments in depreciable capital goods. In other words, this system was very favourable for industry. It should be noted, however, that by 1971 technical literature on price level accounting adopting a more complete and non-discriminatory view was well developed.

III. THE PRICE LEVEL ACCOUNTING APPROACH

During the early 1960s the accounting profession in the United States began to develop systematic methods of price level accounting. Almost at the same time research in Argentina developed similar methods under the name of "inflation accounting".[2] This system of inflation adjustment starts from the presumption that there are two kinds of assets and two kinds of liabilities if considered from a point of view of general price level changes.

The first kind of asset is designated "*adjustable*" and comprises, generally, tangible goods, such as capital goods (fixed assets), inventories and similar assets as well as credit claims in foreign currencies. The main characteristic of this category of assets, if viewed from the conventional accounting method, is that if assets are acquired some time before the closing of the accounting year they will probably be entered at a lower value than their market value at the end of the accounting year, which is why its value must be adjusted at the end of the accounting year.

The second kind of asset is the "*monetary assets*", such as credit claims, bank deposits and cash in national currency, whose main characteristic is that they are expressed in their values at the end of the accounting year. However, it is noted that under inflationary conditions they will most probably have lost some of their purchasing power from the date they were registered.

Liabilities are also split in two categories.

The first group is the "*adjustable liabilities*" which in effect are not liabilities at all but are those entries in the balance sheet which are normally called "net wealth" or "capital" comprising statutory capital, reserves and accumulated earnings reflecting the accounts of the owners of the enterprise. These "liabilities" must also be adjusted for inflation in accordance with the price level increase from the date the money was invested in the enterprise to the end of the pertinent accounting year. The reason for this adjustment is that when owners invested their capital in the enterprise the value of the money in the sense of its purchasing power was higher. Indeed, this adjustment is at the very core of the price level accounting method since its basic principle is

2. One of the first studies published on the subject was: *The Financial Effects of Price Level Changes* (American Institute of Certified Public Accountants, New York, 1963). However, there exists an earlier publication on this subject, strangely enough ignored for almost 30 years: *Stabilized Accounting* by Henry W. Sweeney (Harper, New York, 1936). Among the first Argentine works on the subject are: *Contabilidad e Inflación* by Lazzati Santiago (Edicon, Buenos Aires, 1969) and *La Contabilidad y la Inflación* by Arturo Lisdero and Luis E. Outeiral (Buenos Aires, 1968).

ARGENTINA:
Adjustment for Inflation in Argentine Income Tax Law

by Dr. Jorge Macón *

I. INTRODUCTION

Argentina, like its neighbour countries Brazil, Chile and Uruguay[1], can boast of a long experience coping with inflation; not so long as Brazil and Chile, but longer than Uruguay.

Starting in the 1940s, Argentine inflation — with very few exceptions — has run into two digit figures, and more recently inflation has risen to even three digit figures.

Given this extensive experience, it is small wonder that in Argentina and in its neighbour countries with similar problems, the governments have become aware that conventional accounting only offers acceptable results for purposes of income tax where prices are stable. They have also realized that inflation must be taken into account so that earnings or losses computed in conformity with conventional accounting methods must be corrected in order to approximate the real accretion or reduction of wealth.

Until recently, with the systematic development of methods of price level accounting, conventional accounting was considered to show higher profits (or smaller losses) than the real ones so that there was a general consensus that business profits were overtaxed. The main reason for this conclusion was that depreciation methods based on the historical prices of assets do not result in sufficient funds to replace the assets when they have become obsolete, since under conventional accounting methods depreciation reserves are smaller than they should be and consequently profits are too high.

However, it has become clear that the conclusion that conventional accounting methods lead to a general overtaxation is incorrect. It is true that inadequate depreciation practices based on historical prices do create a problem but this is only part of the truth. Should overtaxation be the only cause of problems arising under the conventional accounting methods, the best and simplest policy measure would be to decrease the general rates of the tax and thus put taxation at its proper level. Unfortunately, things are much more complicated.

The problem is that if proper legal measures are provided which adjust depreciation, they reduce the amount of income tax due by, for instance, manufacturers, because a large part of their capital is invested in fixed depreciable assets. However, it would leave practically unchanged the income tax assessments of traders because their assets consist mainly of inventories. The turnover rate of inventories is much higher than that of fixed assets and under a situation of increasing prices they appear in the balance sheet at more updated prices. However, the problem remains essentially the same: the financial result of every sale of a trader is composed of the trader's real profit margin and the difference in cost due to inflation. This cost difference must be taken into account exactly as manufacturers do with the cost which is also a cost element entering the cost price of products sold by them. In the latter case the cost differences tend to be much more spectacular because the price increases for fixed assets are much higher than for inventory, but the som total of price increases for fixed assets and inventory tends to be the same. However, in the latter case they are disguised by the much higher turnover rate of inventory.

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IX. Summary

* Doctor en sciencias económicas.

1. These countries are internationally known as the "South Cone".

provides a 6 percent subsidy rate. However, Table 5 shows that enactment of the Reagan Administration proposal would raise the U.S. subsidy rate above the corresponding rate of any industrial country for each asset group, except buildings where it would be a close second to the Italian rate.

TABLE 4

Tax subsidy rates on non-residential fixed investment by asset group, 1980[1]

(As percentage of asset price)

Country	Non-residential buildings	Other construction	Transport equipment	Non-electrical machinery	Electrical machinery	Other producer durables
Belgium	–7.0	–4.9	0.6	1.7	4.2	2.4
France	–5.1	3.3	0.7	2.4	2.8	–0.9
Germany, Federal Republic	–16.8	–1.3	1.1	1.1	–0.3	1.9
Italy	5.8	12.6	4.8	4.9	7.4	5.6
Japan	–11.3	–7.5	–1.8	0.8	1.1	–0.1
Netherlands	1.7	0.8	–0.2	2.6	–0.1	2.8
United Kingdom	–2.8	13.6	5.4	11.2	11.8	12.4
United States	–8.4	9.7	5.3	8.4	8.7	10.7

1. A positive value indicates a subsidy; a negative value represents a tax. It is assumed that the income tax rate is 46 percent, the nominal discount rate is 10 percent, and the inflation-adjusted discount rate is 5 percent.

TABLE 5

Tax subsidy rates by asset group, 1981[1]

(As percentage of asset price)

Country	Non-residential buildings	Other construction	Transport equipment	Non-electrical machinery	Electrical machinery	Other producer durables
Belgium	–7.0	–4.9	0.6	1.7	4.2	2.4
France	–4.9	3.3	5.1	6.8	7.2	1.8
Germany, Federal Republic	–16.8	–1.3	1.1	1.1	–0.3	1.9
Italy	5.8	12.6	4.8	4.9	7.4	5.6
Japan	–11.3	–7.5	–1.8	0.8	1.1	–0.1
Netherlands	3.3	3.5	1.5	5.6	2.9	5.8
United Kingdom[2]	0.9	15.9	5.4	11.2	12.8	12.4
United States[2]	5.6	17.6	12.5	13.8	15.6	16.0

1. A positive value indicates a subsidy; a negative value represents a tax. It is assumed that the income tax rate is 46 percent, the nominal discount rate is 10 percent, and the inflation-adjusted discount rate is 5 percent.
2. Calculated on the basis of legislative proposal.

In view of the variety of determinants of each country's tax subsidy rate, to highlight the quantitative importance of fiscal incentives, all elements other than the investment credit and depreciation allowances must remain constant. Thus, the tax subsidy rate was recalculated for selected years, assuming the existing 46 percent U.S. income tax rate (which is about the average of the eight countries' rates), a 10 percent nominal discount rate, and a 5 percent inflation-adjusted discount rate for all countries. The 1981 estimates for the United Kingdom and the United States are based on the legislative proposals discussed above.

According to Table 2, between 1973 and 1980 capital cost recovery allowances have been liberalized in five countries — most markedly in the Netherlands — and have remained unchanged in the others. In 1980 the most generous treatment was provided in the United Kingdom, followed by Italy and the United States, with 7 percent, 5 percent, and 4 percent subsidy rates, respectively. Meanwhile, the least advantageous systems are found in Japan and the Federal Republic of Germany, showing 5 percent and 4 percent tax rates, respectively. This year the relative position of some countries is expected to change significantly. Notably, the United States (assuming full implementation of the 10-5-3 system) would move to the top of the list among the industrial countries with a 12 percent subsidy, ahead of the United Kingdom and Italy. In France and the Netherlands, the subsidy rates increase from zero by about 3 percentage points.

TABLE 2

Tax subsidy rate on non-residential fixed investment[1]

(As percentage of asset price)

Country	1973	1980	1981
Belgium	–2.5	–2.5	–2.5
France	–0.1	–0.1	2.9
Germany, Federal Republic	–6.1	–4.2	–4.2
Italy	4.6	5.2	5.2
Japan	–4.6	4.6	–4.6
Netherlands	–5.2	0.2	2.7
United Kingdom[2]	6.5	6.9	7.8
United States[2]	1.1	3.9	11.8

1. A positive value indicates a subsidy; a negative value represents a tax. It is assumed that the income tax rate is 46 percent, the nominal discount rate is 10 percent, and the inflation-adjusted discount rate is 5 percent.
2. The 1981 rate is calculated on the basis of legislative proposal.

V. DISAGGREGATED RESULTS

Table 3 lists the tax subsidy rates on fixed assets used predominantly in manufacturing (industrial buildings, metal-working machinery, other special industry machinery, and general industry machinery), weighted by the share of each asset category within total investment in these assets for each country. As presumably these assets enter more directly in the production of tradable goods, the resulting tax subsidy rates should have a more direct influence on the relative international competitiveness of these countries. The ranking of several countries is affected by the concentration of fiscal incentives in the manufacturing sector. Upon enactment of legislative proposals, in both the United Kingdom and the United States the subsidy rate would climb to 13 percent, while the French, Italian, and the Netherlands rates are clustered around 5 percent. At the other extrme, the German tax rate remains at more than 5 percent. Interestingly, the tax subsidy rates on manufacturing assets exhibit wider variation across countries and a larger average increase between 1973 and 1981 than the rates on all non-residential fixed assets.

TABLE 3

Tax subsidy rate on manufacturing fixed investment[1]

(As percentage of asset price)

Country	1973	1980	1981
Belgium	–2.4	–2.4	–2.4
France	1.2	1.2	4.4
Germany, Federal Republic	–6.7	–5.5	–5.5
Italy	4.1	5.0	5.0
Japan	–3.4	–3.4	–3.4
Netherlands	–4.3	4.2	6.2
United Kingdom[2]	9.8	10.9	13.1
United States[2]	1.3	3.3	12.8

1. A positive value indicates a subsidy; a negative value represents a tax. It is assumed that the income tax rate is 46 percent, the nominal discount rate is 10 percent, and the inflation-adjusted discount rate is 5 percent.
2. The 1981 rate is calculated on the basis of legislative proposal.

Tables 4 and 5 present a more detailed measure of tax subsidy rates across countries by group of assets. Although it appears that capital cost recovery rules are generally biased in favor of machinery and equipment, reflected in 1980 by subsidy rates of up to 13 percent in the United Kingdom, and against non-residential buildings, with a maximum subsidy rate of 6 percent in Italy, comparisons among asset groups within each country may be distorted by the assumed rates of economic depreciation for particular types of assets. Thus, it is appropriate to observe cross-country variations for given asset groups, rather than to consider only the summary comparisons in Table 2.

It is worth noting in Table 4, for example, that until this year for transportation equipment both the United Kingdom and the United States, and now France, offer the highest subsidy rate of 5 percent, as gainst Japan's 2 percent tax rate. As for buildings, the Federal Republic of Germany imposes the heaviest tax rate of 17 percent, followed by 11 percent and 8 percent rates in Japan and the United States, respectively, while Italy price, yields the tax subsidy rate on the asset.[1]

The average tax subsidy as a percentage of the market price of non-residential fixed assets for eight major industrial countries in 1973 and 1978 (which reflects present tax treatment) is shown in Table 1. Tax subsidy rates were actually calculated for each of 29 major asset categories that account for non-residential fixed capital formation in each country.[2] For any given asset category, the basis of the calculation was information on the rate of investment credit, the stream of tax depreciation deductions, the stream of economic depreciation, and relevant financial data (proportion of debt and equity in the capital structure of nonfinancial corporations, yields on corporate bonds and equity, income tax rate, and price indices). Further, the tax subsidy rates thus obtained were aggregated into groups of asset categories or into country totals by taking the weighted arithmetic mean of those rates, where each weight is the share of a given asset category in the country's gross non-residential fixed capital formation (by asset group or total). The corporation income tax rate used in the calculations is the tax rate averaged over retained and distributed earnings, assuming a before-tax dividend payout ratio of one half. The principal data source is a study by G.F. Kopits,[3] revised, updated and complemented with additional information from various IMF, OECD, and UN sources. As for economic depreciation, the commonly made assumption of a geometrically declining pattern is adopted here.[4]

TABLE 1

Tax subsidy rate on non-residential fixed investment[1]

(As percentage of asset price)

Country	1973	1978
Belgium	–0.6	–5.9
France	–1.1	–7.6
Germany, Federal Republic	–5.9	–4.0
Italy	–12.8	–18.4
Japan	–1.4	–1.4
Netherlands	–5.0	–7.7
United Kingdom	2.4	4.4
United States	3.0	0.6

1. A positive value indicates a subsidy; a negative value represents a tax.

IV. OVERALL COUNTRY RESULTS

Table 1 indicates that in 1973 tax subsidy on non-residential fixed investment ranged from a tax rate of 13 percent for Italy to a subsidy rate of 3 percent for the United States, while a number of countries (Belgium, France, Japan) were surprisingly close to neutrality, indicated by a zero tax subsidy. In 1978, a much larger variance was reflected by such extreme values as an 18 percent tax rate for Italy and a 4 percent subsidy rate for the United Kingdom, although one half of the countries had tax rates between 4 and 8 percent. Notwithstanding the trend toward more liberal capital cost recovery allowances, taken as a whole, investors in the eight countries experienced over this period a doubling in the tax rate from an average of about 3 percent in 1973, mainly because of the rise in the expected rate of inflation, accompanied by an increase in the nominal cost of finance. In more precise terms, the present value of economic depreciation (calculated with an inflation-adjusted discount rate) rose faster than the present value of tax depreciation (discounted at the nominal cost of finance), as illustrated particularly by the dramatic rise in the estimate of the Italian tax rate.

An additional factor that tends to accentuate the value of the tax or the subsidy under a given tax depreciation system is an increase in the income tax rate, which occurred in Belgium, the Federal Republic of Germany, Japan, and the United Kingdom. The U.K. case shows that when tax depreciation is faster than economic depreciation, a rise in the income tax rate raises the value of the subsidy on fixed assets to the investor. In contrast, the income tax increase in the other three countries had the effect of raising the tax on assets.

1. The tax subsidy rate on an asset is given by

$$s = k + u \sum_{t=0}^{\infty} x_t (1+r)^{-t} - u \sum_{t=0}^{\infty} \partial(1-\partial)^t (1+r^*)^{-t}$$

where k is the investment credit or grant (as a percent of the asset's value), u is the marginal corporation income tax rate, x_t is the depreciation deduction (as a percent of value) in year t discounted by r, the nominal discount rate, over the asset's life, and ∂ is the declining balance rate of economic depreciation subject to r*, the inflation-adjusted discount rate. For corporations, r can be defined as

$$r = (1-f)r_e + f(1-u)r_d$$

where f/(1-f) is the debt-equity ratio, r_e is the nominal rate of return on equity (dividend plus anticipated capital gain), and r_d is the nominal interest rate on debt. Under a tax system that is neutral under inflationary conditions, the taxpayer would be allowed to deduct economic depreciation indexed each year by the rate of inflation, and interest payments net of inflation, so that the stream of depreciation is discounted by the inflation-adjusted rate

$$r^* = r + fui - i$$

where i is the expected rate of increase in the price of the asset. The conditions for neutrality are discussed by T.N. Tideman, "Measuring the Cost of Capital Services," OTA Paper No. 4, U.S. Treasury Department (April 1975).

2. The following buildings and construction are excluded: educational and hospital buildings; buildings for cultural, religious, sports and social purposes; roads, streets and highways; and land improvement and plantation, and orchard developments.

3. *International Comparison of Tax Depreciation Practices/ Comparaison Internationale des Méthodes d'Amortissement Fiscal* (Organization for Economic Cooperation and Development, Paris 1975).

4. See, for example, the method of computing the rate of replacement of fixed assets used in L.R. Christensen and D.W. Jorgenson, "The Measurement of U.S. Real Capital Input, 1929-67," *Review of Income Wealth* (December 1969), pp. 294-97. The underlying service lives are taken from H.A. Young and J.C. Musgrave, "Estimation of Capital Stock in the United Sates," *The Measurement of Capital*, ed. by D. Usher (University of Chicago Press, 1980), pp. 25-26.

FISCAL INCENTIVES FOR INVESTMENT IN INDUSTRIAL COUNTRIES

by George F. Kopits*

I. INTRODUCTION: BACKGROUND

For more than a decade, several industrial countries have been increasingly concerned about the sagging growth in productivity of labor and the concomitant decline in competitiveness of their products in world markets. Insufficient productivity gains are at least in part attributed to the shortage and obsolescence of capital. Following this reasoning, it is almost routinely recommended that capital accumulation be encouraged by providing subsidies through the tax system, and tax preferences offered to investors in trading partner countries are cited as an argument for introducing tax subsidies.

Indeed, on the basis of the general fiscal measures (as distinguished from those for particular regions, economic activities, or enterprises, or on a temporary basis) affecting private capital formation adopted since the early 1970s in major industrial countries — virtually all of them favorable to investment — there is an implication that some of these countries may be engaged in competitive use of such policy instruments. However, this implication can have only limited validity, as governments have sought to offset the impact of high rates of inflation on investment through liberalized capital cost recovery allowances, quite independently of similar measures introduced in other countries.

In 1971, the United States reinstated the investment tax credit and allowed a 20 percent shorter tax depreciation period for machinery and equipment than had been required previously. In 1972, the Untied Kingdom adopted the current deduction of most machinery and equipment purchases from taxable income, while Canada introduced a two-year writeoff on manufacturing equipment. In 1974, Italy raised the additional depreciation granted over the first three years of an asset's life from 40 to 45 percent. In 1975, the United States increased the basic rate of investment credit from 7 to 10 percent. Since 1977, the Federal Republic of Germany has provided a declining-balance depreciation rate on all machinery and equipment to two and one half times the straight-line rate (subject to a 25 percent ceiling), replacing the former rate of twice the straight-line rate (subject to a 20 percent ceiling) permitted previously. In 1978, the Netherlands replaced a number of specialized subsidies with a general investment tax credit (or cash grant in the event of a loss), ranging from 7 to 18 percent according to the type of asset purchased.

II. CURRENT POLICY CHANGES

The present inflationary environment, coupled with the slowdown in economic activity, has generated renewed pressures in industrial nations for stepping up the subsidization of investment this year. This policy effort involves mainly the introduction of various forms of accelerated tax depreciation and increases in investment tax credits or cash grants, thus sustaining the trend toward further liberalization of capital cost recovery.

France has adopted a 10 percent additional first-year tax deduction for investment undertaken since October 1980 in new assets depreciable under the declining balance method. The Netherlands has raised permanently the basic rate of cash grant (refundable investment tax credit) provided for most machinery and equipment purchases from 7 to 10 percent, following temporary increases to 10 percent in June 1980 and to 12 percent between October 1980 and June 1981. In February, as part of its Social and Economic Recovery Program, Belgium introduced an exemption of up to 5 percent of taxable corporate income for reinvested earnings. In the United Kingdom, the budget submitted to Parliament in March contains a proposal to raise from 50 percent to 75 percent the initial deduction for industrial buildings purchased since then.

However, the most far-reaching change has been proposed in the United States under the Program for Economic Recovery, unveiled by the Reagan Administration in February. In broad terms, the proposal envisages replacing the existing asset lives by the so-called 10-5-3 accelerated cost recovery system and applying a combination of double-declining-balance and sum-of-the-year-digits methods of depreciation over the new lives. These lives are three years for motor vehicles, five years for other machinery and equipment, and ten years for most industrial buildings. The proposal also provides for an extension of the 10 percent investment tax credit to some structures and to all equipment except motor vehicles, which would qualify for a 6 percent credit.

III. MEASUREMENT OF TAX SUBSIDIES

A relatively simple and objective assessment of the quantitative importance of capital cost recovery provisions for the investor in each country may be obtained by comparing the actual tax reduction resulting from the purchase of a plant or a piece of equipment under the country's tax system, with the tax reduction under a truly neutral system. Specifically, actual tax saving is comprised of the investment credit, or cash grant, plus the present value of depreciation deductions over the asset's life multiplied by the income tax rates, whereas neutral tax saving is equivalent to the product of the tax rate and the present value of economic depreciation. The difference, expressed as a proportion of the asset

* Senior Economist, European Department, International Monetary Fund. This paper draws heavily on material published in the *IMF Survey* (October 27, 1980 and April 20, 1981). The views expressed do not necessarily reflect those of the Fund.

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APPENDIX III

Withholding tax rates on Indian-source royalties and fees for technical services paid to non-residents
(including those of tax treaties countries not in connection with a permanent establishment in India) in percentage

	Royalties	*Fees for technical services*
National Law of India	20[2]-40[1]	40[1]
Austria	20[2]-40	0[3]-40
Belgium	20[2]-40	0[3]-40
Denmark	20[2]-40	40
Egypt	20[2]-40	40
Finland	20[2]-40	0[3]-40
France	20[2]-40	40
German Federal Republic	20[2]-40	40
Greece	20[2]-40	40
Japan	20[2]-40	40
Malaysia	20[2]-40	40
Norway	20[2]-40	40
Sierra Leone	20[2]-40	40
Sri Lanka	20[2]-40	40
Sweden	20[2]-40	40

1. Income by way of royalties and fees for technical services shall be deemed to accrue or arise in India if it is payable by:
   (a) the Government; or
   (b) a person who is resident in India, except where the royalties are payable for the purposes of business carried on outside India or of earning any income from any source outside India; or
   (c) a person who is a non-resident, where the royalties are payable for the purpose of business carried on in India or of earning any income from any source in India;

   and the rates for deduction of tax at source would be 40 percent on the gross amount.
2. On so much of the amount of such income as consist of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of any data, documentation drawing or specification relating to any patent, invention, model, design, secret formula or process, or trade mark or similar property, the rates for deduction of tax at source would be 20 percent on the gross amount.
3. If the contract for such fees for technical services is entered into outside India and the payment is received outside India it is not taxable in India except in so far as such amounts are attributable to activities performed in India. In computing the income so subject to tax, there shall be allowed as deduction the expenses incurred in India in connection with the activities performed in India.

Note: The Finance Bill, 1981 has proposed a change in the rate of surcharge in the case of companies from 7.5 to 2.5 percent and the non-corporate rate schedule has been restructured. The readers may refer to the proposed changes in the report on the Indian Budget in 35 Bulletin for International Fiscal Documenation at 215 et seq.

APPENDIX I

Rates of income tax
(Assessment year 1981–82)

Income slabs				*Rates*
	Rs.			%
Up to	8,000			nil
	8,001	–	15,000	15
	15,001	–	20,000	18
	20,001	–	25,000	25
	25,001	–	30,000	30
	30,001	–	50,000	40
	50,001	–	70,000	50
	70,001	–	100,000	55
Over	100,000			60

Provided that (i) no income tax shall be payable on a total income not exceeding Rs. 12,000; (ii) where the total income exceeds Rs. 12,000 but does not exceed Rs. 16,250, the income tax payable thereon shall not exceed 30 percent of the amount by which total income exceeds Rs. 12,000.

Surcharge on income tax	10% of such income tax

APPENDIX II

Schedule for withholding tax rates on royalties and fees for technical services
(Financial year 1980–81)

	Income tax	
	Rate of income tax %	*Rate of surcharge* %
1. Foreign company		
(i) on income by way of royalties payable by an Indian concern in pursuance of an agreement made by it with the Indian concern after March 31, 1976, where such royalty is in consideration for the transfer of all or any rights (including the granting of a licence) in respect of copyright in any book on a subject referred to in the proviso to Sub-section (1A) of Section 115A of the Income Tax Act, to the Indian concern	40	nil
(ii) on income by way of royalties (not being royalty of the nature referred to in (i) above) payable by an Indian concern in pursuance of any agreement made by it with the Indian concern and which has been approved by the Central Government:		
(a) where the agreement is made after March 31, 1961, but before April 1, 1976	50	3.75
(b) where the agreement is made after March 31, 1976:		
(1) on so much of the amount of such income as consists of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation drawing or specification, relating to any patent, invention, model, design, secret formula or process, trade mark or similar property.	20	nil
(2) on the balance, if any, of such income	40	nil
(iii) on income by way of fees for technical services payable by an Indian concern in pursuance of an agreement made by it with the Indian concern and which has been approved by the Central Government:		
(a) where the agreement is made after February 29, 1964, but before the April 1, 1976	50	3.75
(b) where the agreement is made after March 31, 1976	40	nil
(iv) on income by way of royalties or fees for technical services if the agreement is not approved by the Central Government	70	5.25
2. Non-resident person other than a foreign company		
On the whole of such income	income tax at 30 percent and surcharge at 3 percent of the amount of such income, or income tax and surcharge on income tax in respect of the income at the rates prescribed in Sub-Paragraph I of Paragraph A of Part III of the Schedule (i.e. Appendix I as given above), if such income had been the total income, whichever is higher.	

ance for deduction of expenses. If, however, the agreement was made after March 31, 1961 but approved before April 1, 1976, the deductions admissible would be limited to 20 percent of the royalties and the taxable income would be taxed at 53.75 percent.

Further, a lump sum consideration would not necessarily mean payment made once and for all. Any consideration decided in the beginning, even though if it is a payment made annually over a period of years, would also amount to a lump sum consideration. The Finance Act, 1976 has provided such a benefit because the Government seeks to encourage the transfer of technology. The rate of tax in such cases would be 20 percent only on the gross amount as compared to 40 percent in other cases.

III. INCOME BY WAY OF FEES FOR TECHNICAL SERVICES

According to Section 9(1)(vii) of the Income Tax Act, 1961, income by way of fees for technical services will be deemed to accrue or arise in India if it is payable by:

(a) the Government; or

(b) a person who is resident in India, except where the fees are payable for the purposes of business carried on outside India or of earning any income from any source outside India; or

(c) a person who is a non-resident, where the fees are payable for the purposes of business carried on in India or of earning any income from any source in India.

The Explanation to Section 9(1)(vii) states that, for the purposes of this clause, the term "fees for technical services" means any consideration (including any lump sum consideration) for the rendering of any managerial technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "Salaries".

Agreement entered into and payment received outside India

If it is assumed that (i) the recipient is a non-resident foreign company, (ii) the agreement is approved by the Central Government, (iii) it is entered into outside India and (iv) payment is received outside India, fees for technical services would be deemed to accrue or arise in India under Section 9(1)(vii) and would be taxable at the rate of 40 percent of the gross receipts as provided under Section 115A without deduction of expenses.

If the recipient is a non-resident non-corporate taxpayer, whether the agreement is approved by the Central Government or not, the fees for technical services would be taxable at progressive rates as applicable to individuals as given in Appendix I, below and after allowing deduction in respect of the expenditure admissible under the appropriate head of income applicable to the assessee.

If the recipient is a foreign company and the agreement is not approved by the Central Government, it would be taxable at 75.25 percent and there would be no allowance for deduction of expenses. If, however, the agreement was made after February 29, 1964 but approved before April 1, 1976, the deduction admissible would be limited to 20 percent of such fees and the taxable income would be taxed at 53.75 percent.

Treatment of payment for technical knowhow by Indian assessee

Broadly speaking, the payment for technical knowhow is classified as revenue or capital expenditure. Any expenditure made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business is properly attributable to capital and is of the nature of capital expenditure. If, on the other hand, it is not made for the purpose of bringing into existence any asset of enduring advantage but for running the business or working it with a view to producing profits, it is a revenue expenditure.

Further, if it is a capital expenditure, it is considered whether depreciation is permissible or not. If the expenditure can be described as "plant", it would be entitled to depreciation and investment allowance. If, however, it does not fall in the category of plant or any other depreciable asset, it would neither be allowed as revenue expenditure nor will any depreciation be permissible. In that case it would be a dead capital loss. Care must, therefore, be taken to draft the agreement in such a manner that the relevant expenditure can be claimed as revenue expenditure, but if it is treated as capital expenditure it should be attributable to plant so that over a period of years the amount is charged to the profit and loss account and, in some cases, investment allowance over and above the cost of the asset is also claimed.

IV. COUNTRIES WITH WHICH AGREEMENT FOR AVOIDANCE OF DOUBLE TAXATION EXISTS

The above provisions are applicable to those countries with which India has no agreement for avoidance of double taxation in respect of income by way of royalties and income by way of fees for technical services. However, India has comprehensive agreements for avoidance of double taxation on income with Austria, Belgium, Denmark, Egypt, Finland, France, German Federal Republic, Greece, Japan, Malaysia, Norway, Sierra Leone, Sri Lanka, and Sweden. [1] In all such cases, tax liability of the non-resident is determined in accordance with the relevant provisions of the agreement and the aforesaid provisions of the Income Tax Act stand suspended by such agreements.

1. The full text of the comprehensive double taxation agreements on income have been printed in: *Taxes and Investment in Asia and the Pacific*, Part Treaties.

In brief, a business connection involves a relation between business carried on by a non-resident which yields profits or gains and some activity or operation in India which contributes directly or indirectly to the earning of those profits or gains. It predicates an element of continuity between the business of the non-resident and the activity in India.

The concept of income by way of royalties or by way of fees for technical services as introduced by the Finance Act, 1976 is of particular importance to non-residents because income accruing or arising outside India is fictionally deemed to accrue or arise in India and the non-resident would become chargeable in respect thereof, by virtue of Section 5(2)(b) read with Section 9(1), which otherwise would not have been included in his total income.

II. INCOME BY WAY OF ROYALTIES

Income by way of royalties will be deemed to accrue or arise in India by virtue of Section 9(1)(vi) if they are payable by:

(a) the Government; or
(b) a person who is resident in India, except where the royalties are payable for the purposes of business carried on outside India or of earning any income from any source outside India; or
(c) a person who is a non-resident, where the royalties are payable for the purpose of business carried on in India or of earning any income from any source in India.

Explanation 2 to Section 9(1)(vi) defines the term royalty and states that, for the purposes of this clause, "royalty" means any consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital Gains") for:

(1) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
(2) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;
(3) the use of any patent, invention, model, design, or secret formula or process or trade mark or similar property;
(4) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
(5) the transfer of all or any rights (including the granting of a licence) in respect of any copyright in literary, artistic or scientific work including films or video tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or
(6) the rendering of any services in connection with the activities referred to in (1) to (5) above.

On analysing the above provision, it is clear that in cases where royalties do not actually accrue or arise, they will be deemed to accrue or arise by virtue of these provisions. Thus any payment made by the Government as royalties would be taxable under the Indian Income Tax Act, 1961. Royalty payments made by a resident would be taxable in all cases except where they are for the purposes of a business or profession outside India or for the purpose of making or earning any income from any source outside India. Where the royalties are payable by a person who is a non-resident, they would be income by way of royalties if used for the purpose of business or for earning any income from any source in India.

Further, if the consideration for the royalty represents consideration which is of a capital nature in the hands of the recipient it would not be taxed as income by way of royalties nor as capital gains under certain circumstances. Circular No. 21 of 1969, dated July 9, 1969, for Foreign Technical Collaboration clarifies whether the amount received is a capital receipt or a revenue receipt, referring to the case of *Evan Medical Supplies Ltd. v. Moriarty 35 ITR 707.* In the United Kingdom, it has been held by the Courts that a receipt from the sale of knowhow would be a capital receipt only when the sale of technical knowhow or the imparting of technical knowledge and information results in the transferor parting with the property or asset or any special knowledge which would ripen into a form of property and that after such transfer the transferor is deprived of using the asset. In other cases, where no capital asset or property is parted with and the transaction is merely a method of trading by which the recipient acquires the particular sum of money as profits and gains of that trade, the consideration received for the sale of technical knowhow will be on revenue account.

Agreement entered into and payment received outside India

If it is assumed that (i) the recipient is a non-resident foreign company, (ii) the agreement is approved by the Central Government, (iii) it is entered into outside India and (iv) payment is received outside India, income by way of royalties would be deemed to accrue or arise in India under Section 9(1)(vi) and this would be taxable at the rate of 40 percent of the gross receipts; but if the income by way of royalties consists of lump sum consideration for the transfer of technology outside India it would be taxable at the rate of 20 percent of the gross receipt (Section 115A).

If the recipient is a non-resident *non-corporate* taxpayer, whether the agreement is approved by the Central Government or not, income by way of royalties would be taxable at progressive rates as applicable to individuals as given in Appendix I, below and after allowing deduction in respect of the expenditure admissible under the appropriate head of income applicable to the assessee.

If the recipient is a foreign company and the agreement is not approved by the Central Government, it would be taxable at 75.25 percent and there would be no allow-

Taxation of Non-Residents in India for Royalties and Fees for Technical Services

by Dharmendra Bhandari*

I. INTRODUCTION

When an entrepreneur decides to take a plunge into a commercial or industrial venture operating in two or more countries, he must know the vortex of tax risks to which he is exposing himself; otherwise, what could have been lawfully retained as profits would be unknowingly swallowed up by tax imposts in several countries. Each country has a legal system, including taxation laws, as sophisticated and worldly wise as that of any one else and tax planning is as important as business planning, perhaps even more important.

The basic rule of taxation of non-residents in India is that they are liable to tax on income which:
(a) accrues or arises or is deemed to accrue or arise in India during such year, or
(b) is received or is deemed to be received in India by or on behalf of such person.

The Finance Act, 1976 brought about a few fundamental changes in the relevant provisions of Sections 9(1), 44C, 44D and 115A of the Income Tax Act, 1961. The fundamental changes may be summed up as follows:
(1) extension of the ambit of the source rule in India (Section 5(2)(b) juncto 9(1));
(2) introduction of certain provisions which provide certain limits in respect of a claim for deduction of head office expenditure in the case of non-residents (Section 44C);
(3) special provisions for computing income by way of royalties and fees for technical services in the case of foreign companies (Section 44D);
(4) special income tax rates on royalties and fees for technical services in the case of foreign companies (Section 115A).

Prior to amendment by the Finance Act, 1976, income of a non-resident consisting of royalties and fees for technical services was not taxed in India unless the income accrued, arose or was received in India or was caught in the terminology of business connection in India under Section 9(1)(i) of the Income Tax Act, 1961. The income accrued, arose or was received in India if the agreement was made in India or the payment was received in India. Further, according to Section 9(1)(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any asset or source of income in India shall be income deemed to accrue or arise in India. The Income Tax Act, 1961 has not defined business connection, but the courts have given various interpretations to this term in a large number of cases and Circular No. 23 of 1969 (F. No. 7A/38/69—IT (A—II)) dated 23 July 1969 illustrates instances of business connection in India.

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Once a loan is treated as having been made directly to the shareholder, the regulations treat the proceeds in the hands of the corporation as a contribution to capital from the shareholder without considering whether the deemed transfer of the funds might be viewed as a loan from the shareholder to the corporation.

Example 14

On September 25, 1982, J, the sole shareholder of corporation N, guarantees a note for $600,000 issued by N. Assuming that under the principles set forth above the note is properly treated as an obligation of J, J will be treated as making a $600,000 contribution to the capital of N.

If N later pays $33,000 in interest and $100,000 in principal on the note, the total $133,000 in payments is treated as a dividend from N to J to the extent of N's earnings and profits. Thus, N would not be allowed an interest deduction, but J would be entitled to deduct the $33,000 as interest paid.

Assuming N subsequently defaults and J is required to pay $500,000 in principal on the note, because J is treated as the primary obligor on the note (and not merely as a guarantor), the $500,000 payment will in no circumstances be treated as a loss from a loan or as a contribution to the capital of N.

Example 15

Assume the same facts as in Example 14 except that J does not guarantee the note issued by N until September 25, 1983. If the note is properly treated as an obligation of J under the principles set forth above, and on the date of the guarantee a principal balance of $400,000 is due on the note, J will be treated as making a $400,000 contribution to the capital of N on that date.

IX. CERTAIN PREFERRED STOCK

The regulations also prescribe rules under which certain preferred stock with traditional debt features (such as a fixed term and mandatory payment schedule) will be classified as debt for tax purposes. In general, if the preferred stock provides for fixed payments in the nature of principal or interest, its status as debt or stock will be tested under the rules applicable to hybrid instruments discussed earlier. For this purpose, conventional preferred stock whose dividends and redemption payments are payable only out of earnings or in the discretion of the board of directors are not considered to provide for fixed payments in the nature of principal or interest and are treated as stock under the regulations.

Example 16

On August 8, 1985, corporation D issues 500 shares of $100 par value, 6 percent preferred stock. Dividends on the preferred stock are cumulative, and D may not pay dividends on its common stock or repurchase shares of common stock so long as dividends on the preferred stock are in arrears. However, dividends on the preferred stock are payable only if declared by D's board of directors. In addition, the preferred stock is callable after August 8, 1990 for $100 a share at the discretion of D's board of directors. Thus, the holders of the preferred stock cannot compel D to redeem or purchase the stock. Based on these facts, the preferred stock does not provide for fixed payments in the nature of principal or interest. Therefore, the preferred stock is treated as stock.

Example 17

F is a large, stable, and consistently profitable corporation. On March 21, 1985, F issues 50,000 shares of $100 par value, 9 percent sinking fund preferred stock. Dividends and sinking fund payments, which begin five years after issuance, are mandatory to the extent of retained earnings. In addition, dividends are cumulative, but they are payable only out of retained earnings. Based on these facts, the preferred stock does not provide for fixed payments in the nature of either principal or interest. Therefore, the preferred stock is treated as stock.

Example 18

H, a closely-held corporation, issues 1,000 shares of $100 par value, 12 percent preferred stock on January 1, 1984. Dividends are cumulative but are payable only out of earned surplus. The preferred stock is subject to mandatory redemption after 9 years at a redemption price of $100 per share plus accrued but unpaid dividends. However, the accrued but unpaid dividends are payable, upon redemption, only out of earned surplus plus unrealized application of H's assets (but not out of capital or capital surplus). Based on these facts, the preferred stock does not provide for fixed payments in the nature of interest but does provide for fixed payments in the nature of principal. Therefore, the preferred stock is treated as an instrument.

X. CONCLUSION

The foregoing was intended merely to highlight the major provisions of the regulations. Many of the rules are subject to a number of exceptions and modifications depending on the circumstances. In addition, there are other provisions dealing with "locked interests" (e.g. a bond with a non-detachable warrant).

The regulations appear to take into account to a limited degree only the special problems that can arise where the shareholder or the corporation is foreign. The heavy emphasis placed on original issue discount, for instance, may provide planning opportunities where funds are loaned by, for example, a foreign parent to a U.S. subsidiary under a note or other debt instrument, since such discount gives rise to an interest deduction by the subsidiary. Where the 3:1 maximum inside debt-equity ratio limits the amount of indebtedness that can be incurred for this purpose and U.S. withholding tax may ultimately be imposed, there still would likely be a timing benefit of substantial value.

Example 19

Foreign parent corporation P pays $40,000 to its U.S. subsidiary (S) in consideration for a non-interest bearing promissory note in the face amount of $100,000, payable in ten years. Assume that the fair market value of such note is $40,000 and that the debt is within the 3:1 "inside" debt-equity ratio. In such case, the note would carry with it original issue discount of $60,000, entitling S to a $6,000 per annum deduction. For U.S. purposes, however, P would not be taxed on the discount until it was paid, in this case at the expiration of ten years, at which time U.S. tax withholding would likely be required on the discount, assuming that an exemption for interest is not provided by treaty.

Assume that the fair market value of the 6 percent subordinated income debentures is $1,000 each. The debentures without their equity features would provide for the payment of $4,000 (total principal and interest) on March 1, 2038 and would be $265 each. Based on these facts, the income debentures are treated as stock because the fair market value of each income debenture without its equity features (i.e. $265) is less than 50 percent of its actual fair market value (i.e. $1,000/2 = $500).

Example 11

On August 1, 1983, Corporation U issues debentures in the principal amount of $1,000 each. The debentures pay interest at a fixed rate of 8 percent, are due on August 1, 1993, and provide for the payment of principal and interest in German marks. Based on these facts, the debentures provide for fixed payments of both principal and interest.

The debentures are treated as indebtedness because they are straight debt instruments.

Example 12

On September 1, 1984, corporation W issues floating rate notes in the principal amount of $100,000. The notes pay interest at 3 percentage points above the prime rate and are due on September 1, 1994. Under the regulations, a variable rate of interest, which is determined according to an external standard that is not subject to the borrower's control and that is not related to the success or failure of the borrower's business or activities, is treated as a fixed rate of interest. Therefore, because the notes provide for fixed payments of both principal and interest, they are considered straight debt instruments and classified as indebtedness.

V. ADVANCES

The regulations provide special rules for cash advances to a corporation (other than one made by an independent creditor and other than those repaid within six months and not exceeding $25,000) where the obligation is not reduced to writing. Unless the corporation has excessive debt, cash advances will be treated as debt so long as they bear interest at a rate close to one which would be paid to an unrelated lender on a similar type of indebtedness. An equally acceptable rate for corporations whose debt-equity ratio does not exceed 1:1 is a rate within a prescribed range which includes the rate of interest payable on tax deficiencies (currently 12 percent), the local prime rate, a rate determined by the Secretary of the Treasury, or any intermediate rate. The local prime rate includes the rate charged at any bank (including any non-U.S. banks) where the corporation ordinarily does business. If for any year the corporation fails to pay interest within this range, the advance will be reclassified as stock beginning in that year.

VI. DEMAND OBLIGATIONS

As in the case of advances, the rules for classifying obligations payable on demand are largely a function of the rate of interest charged.[3] In general, unless the issuing company has excessive debt, a demand obligation that is held in substantially the same proportion as the holdings of stock will be regarded as debt so long as it bears a rate of interest described earlier in connection with advances. However, like advances, demand obligations will be reclassified as stock if the corporation fails to pay interest at that rate.

VII. INSTRUMENTS ISSUED FOR PROPERTY

As noted above, where the consideration paid for a straight debt instrument is not equal to its fair market value, the regulations treat the difference as a distribution or capital contribution, depending on whether the consideration is adequate or excessive. The rules under which original issue discount and amortizable premium are imputed, however, generally do not apply to instruments issued for the purchase of property.

Thus, to ensure that such instruments bear interest at the market rate, the regulations generally treat an instrument issued in exchange for property as stock if there is a substantial identity of interest between the owners of these instruments and the holders of the corporation's shares, unless the instrument bears interest at a rate that would be paid to an unrelated seller, or, for corporations whose debt-equity ratio does not exceed 1:1, at a rate coming within the range applicable to advances.

Example 13

On January 1, 1987, individuals A, B, and C transfer a tract of undeveloped land and $4,500 in cash to a newly formed Corporation X. In exchange, each receives 100 shares of stock and a two-year, 10 percent promissory note for $110,000. Assume that 10 percent is not an acceptable rate of interest.

Based on these facts, the promissory notes are treated as preferred stock for all purposes of the Code. In particular, all payments of "interest" on the instrument are treated as dividends to the extent of the corporation's earnings and profits, and all payments of "principal" are treated as distributions in redemption of stock.

VIII. GUARANTEED LOANS

One problem that has long existed in the area of classifying instruments as debt or equity has been the difficulty in determining under what circumstances a loan to a corporation guaranteed by its shareholder would be viewed as a loan from the creditor to the shareholder followed by a contribution to the capital of the corporation. The regulations do nothing to resolve the problem but make it clear that the rules established under existing case law will continue to govern. In this regard, the courts have focused primarily on the question of whether, at the time the loan was consummated, the creditor essentially was looking to the guarantor for payment. Some of the factors considered by the courts in answering this question include: (1) whether, at the time of the loan, there was a reasonable expectation that the business would succeed on its own; (2) whether the issuing company was adequately capitalized; (3) subordination of the instrument; (4) the ability of the corporation to obtain the loan in the absence of the guarantee; and (5) whether the loan proceeds are expended for capital assets.

3. The rules do not apply to obligations that are repaid within six months if their total amount, when added to the amount of outstanding advances, does not exceed $25,000.

Example 6

Corporation N, a corporation organized under the laws of country Q, owns all the stock of W, a U.S. company. On January 1, 1987, W issues a $100,000, 28 percent debenture to N in exchange for $100,000. Under provision P of the debenture, an action to enforce the terms of the debenture can be maintained only in the village court of village V in country Q. Assuming that the principal purpose of the inclusion of provision P is to reduce the fair market value of the debenture, the IRS may disregard the term in determining the debenture's fair market value.

Straight debt instruments (other than those issued for property or payable on demand) ordinarily are classified as debt if the corporation's capital is more than nominal. For this purpose, a corporation's capital is considered nominal only if there exists a substantial identity between the owners of these instruments and the holders of the company's shares, and the corporation is regarded as having an "excessive" amount of debt. A corporation's debt will not be considered excessive if, after taking into account the corporation's financial strength, the terms of the instrument would be satisfactory to a bank, insurance company, or similar lending institution making ordinary commercial loans. In addition, the regulations create a safe harbor under which a corporation's debt will not be considered excessive if: (i) its debt-equity ratio is less than or equal to 10:1, its equity being determined by the adjusted basis of its assets (at the end of the year), and (ii) the corporation's "inside" debt-equity ratio is less than or equal to 3:1, computed in the same manner as the 10:1 ratio, but including liabilities to independent creditors only for purposes of computing the company's equity. The use of the inside ratio is intended to discourage foreign shareholders from issuing themselves large amounts of debt at high, non-commercial interest rates, thereby generating large deductions for interest at the corporate level which is not taxed to the shareholders at the full U.S. rate.

A straight debt instrument issued substantially in proportion to a shareholder's stock holdings that is initially classified as debt will be reclassified as stock upon the issuing company's non-payment of interest when due and, in many instances, upon the non-payment of principal when due, where the shareholder fails to pursue available remedies with the same diligence as an ordinary creditor. In those instances where a reclassification occurs, the instrument is treated as stock as of the beginning of the year during which a failure to pay occurs. In addition, where there is a substantial change in the terms of an instrument that is held in substantial proportion to the holdings of stock, the instrument will be treated as newly issued in exchange for property, and its status as debt or equity will be governed by the rules applicable to such instruments discussed below.

Example 7

M is the sole shareholder of X, a corporation that uses the calendar year as the taxable year. On January 1, 1985, X issues $100,000 of ten-year, 9 percent debentures. Of these debentures, $10,000 are issued to M and are treated as indebtedness. The remaining debentures are issued to independent creditors.

X pays all interest accrued on the debentures semiannually until 1990. Because of adverse business conditions, X does not pay the interest accrued in 1990 on the debentures held by M. X continued to pay interest on the debentures held by the independent creditors, but M does not bring suit against X for non-payment of interest.

Under the regulations, the debentures held by M are treated as stock beginning on January 1, 1990, whereas the debentures held by independent creditors are not affected. It is conceivable that this adverse result could be mitigated if X paid the interest to M who then contributed the same to the capital of X.

Example 8

The facts are the same as in Example 7 except that X does not pay interest to either M or the other debenture holders. Additionally, the debenture holders as a group decide not to bring suit against X in the hope that business conditions will improve, and that X will be able to meet its obligations. The debentures held by M continue to be treated as indebtedness because M has not failed to pursue available remedies with the ordinary diligence of an independent creditor.

Example 9

On January 1, 1985, Z Corporation issues $200,000 of ten-year, 10 percent unsecured notes to L, its 80 percent shareholder. Z pays all interest accrued on the notes semiannually until 1990, when, because of adverse business conditions, Z stops paying interest on the notes. On February 1, 1991, L agrees to postpone $10,000 of the accrued interest in 1990 until the notes mature on January 1, 1995. In addition, Z agrees to pledge certain collateral as security for the debentures. Taking into account Z's prior record of paying all interest accrued until 1990 and the pledge of collateral, it is assumed that L has exercised the ordinary diligence of an independent creditor, and therefore the notes will continue to be treated as indebtedness.

There is a seeming inconsistency in the approach the regulations take to straight debt instruments where no interest is provided for and to those where it is stated but not paid. In the former case, where no interest payments are actually made, the regulations will impute interest and treat the instrument as debt. In the latter instance, where interest is stated but not paid, instead of imputing interest, the regulations reclassify the instrument as stock.

IV. HYBRID INSTRUMENTS

Hybrid instruments are treated as stock if their equity features account for more than 50 percent of their fair market value on the date they are issued. In addition, hybrid instruments automatically are treated as stock if there is a substantial identity of interest between the owners of these instruments and the holders of the corporation's shares. Otherwise, the rules for classifying these instruments as debt rather than equity are much the same as those for straight debt instruments.

Example 10

On March 1, 1988, Corporation M issues 6 percent subordinated income debentures in the principal amount of $1,000 due on March 1, 2038. Annual payment of interest is mandatory if net income is available and optional otherwise. Accumulated interest must be paid in all events at maturity.

Based on these facts, each debenture provides for fixed payments of $1,000 in principal and $3,000 in simple interest on March 1, 2038.

A straight debt instrument is a debt instrument other than a hybrid instrument, and a hybrid instrument is one containing an equity feature, such as a conversion privilege or a right to contingent payments. Whether a creditor is independent is determined by looking at all the relevant facts, with a presumption of independence if: (i) the creditor owns, actually and by attribution, less than 5 percent of the corporation's outstanding stock, and (ii) the creditor's holding of stock and debt are not substantially proportionate. The classification of an instrument as stock or indebtedness is made at the time it is issued. In certain cases, however, an instrument initially classified as debt may be reclassified as stock at a later date. But once an instrument is classified as stock, it may not thereafter be reclassified as indebtedness. In most cases, the ultimate determination will depend on whether the holdings of stock and debt of the issuing company are substantially proportionate taking into account all relevant facts and circumstances, including holdings by certain family members and other entities. Proportionality will not exist, however, if the company's stock and debt instruments are widely held and the instruments are separately traded and readily marketable.

Example 1 [2]

A, B, and C each own 100 shares of common stock in corporation Y. Y has no other stock of any class outstanding. However, Y does have outstanding subordinated 8 percent debentures in the principal amount of $100,000. A owns $40,000 of the debentures, B owns $30,000, C owns $20,000, and an independent creditor owns the remaining $10,000. Under the regulations, holdings of the debentures and holdings of stock in Y are substantially proportionate. The result would be the same if the debentures owned by B were owned by B's spouse. Note that the substantially proportionate holdings of stock and debentures do not affect the treatment of the debentures held by the independent creditor.

Example 2

The facts are the same as in Example 1, except that A, B, and C each own $10,000 of debentures, and the independent creditor owns $70,000. Based on these facts, the holdings of stock and debentures are not substantially proportionate.

Example 3

A and B each own 50 percent of the common stock of corporation W. In addition, W has outstanding $100,000 of 6 percent debentures owned entirely by A. Here, the holdings of stock and debentures would not be substantially proportionate.

Example 4

Corporation P owns all the stock of corporations S and T. In addition, S owns 85 percent of a class of debentures issued by T. Based on these facts, holdings of the T stock and debentures are substantially proportionate.

III. STRAIGHT DEBT INSTRUMENTS

Where a straight debt instrument is issued to a shareholder for money, the market value of that instrument first must be determined. Where the amount of money paid for the instruments exceeds its fair market value, the excess is treated as a contribution to capital. On the other hand, where the fair market value of the instrument exceeds the money paid for it, the difference is regarded as a distribution of either cash or stock depending upon whether the instrument is treated as debt or equity. There is a limited safe-harbor rule under which an instrument's face amount will be considered to equal its value if the instrument bears a rate of interest described below in connection with advances, and the instrument is issued for consideration equal to its face. In other cases, troublesome issues of valuation may be encountered.

If the instrument is classified as debt and its face amount is greater than its value, the excess will constitute original issue discount and will be deductible ratably by the corporation over the term of the loan and correspondingly includable in income by the holder much like interest. If the face amount is less than the value of the instrument, the difference will constitute amortizable premium and essentially will be accorded converse treatment.

Example 5

Corporation S is organized in 1985 for the purpose of constructing, owning, and operating an office building. Fifteen Canadian residents (ten of whom are U.S. persons) subscribe for the capital stock of Corporation S at $100 a share. On January 1, 1988, the shareholders agree to loan $400 to Corporation S for each share of stock subscribed. These loans are represented by 19-year, 7 percent debentures in the principal amount of $400 each.

Assume that the debentures are treated as indebtedness and that the fair market value of each debenture is $328. Based on these facts, $72 of each $400 advance is treated as a contribution to capital. Therefore, the shareholder's basis in each debenture is $328 and there is an original issue discount of $72 on each debenture. This discount is deductible ratably by Corporation S over the term of the loan. Each shareholder who is a U.S. person is required to include the discount in income as interest ratably over the term of the loan. The other shareholders would generally not be subject to U.S. tax on the discount until paid.

In each year there would be $28 of interest paid on each debenture upon which, with respect to the debentures owned by Canadian residents who are non-U.S. persons, there would be a 15 percent withholding tax due. In addition, the Canadian resident would be deemed to have received discount of $3.79 (i.e. 72 ÷ 19) upon which a further withholding tax of $.56 would be due (i.e. $3.79 x 15 percent). Thus, the Canadian residents who are not U.S. persons would receive annually $23.24 net of U.S. withholding tax. Compare the result in Example 19, below.

It should be noted that in determining an instrument's fair market value or the reasonableness of an interest rate, the IRS has the authority to disregard a non-commercial term of an instrument where the principal purpose of the inclusion of the term is to increase or decrease the fair market value of an instrument.

2. The examples contained herein are based on those set forth in the final regulations.

Summary of Final Regulations on Treatment of Certain Interests in Corporations as Stock or Debt

by Stanley Weiss and Phillip A. McCarthy *

> *"There is a certain irreducible core of difficulty in making the debt-equity distinction, and some exercise of judgment is ultimately required. The final regulations present this judgment as a relatively straightforward exercise in valuation, and this is quite possibly the most that can be done." —Preamble to Final Regulations, Federal Register, December 31, 1980.*

I. INTRODUCTION

Under Code §385, the Secretary of the Treasury is authorized to prescribe regulations setting forth the factors to be taken into consideration in classifying corporate instruments as debt or equity. The recharacterization of a debt instrument as equity may have significant tax consequences, the most important of which are that the corporate obligor is not allowed a deduction for interest paid, but interest and principal payments made by it are treated as distributions to the recipient and taxable as dividends to him to the extent of the corporation's earnings and profits. The recasting of a loan as equity could create special problems where the issuing corporation has foreign shareholders, since the issuing corporation would be required to withhold at the dividend rate on payments of both interest and principal. While the regulations primarily are concerned with the treatment of debt as equity, rules also are provided for recharacterizing preferred stock as indebtedness under certain circumstances.

On March 24, 1980, the Treasury issued proposed regulations under Code §385 that contained a detailed set of rules for distinguishing between corporate debt and equity. Thereafter, in response to comments it received from the public, the Treasury made a number of ameliorating changes to the proposed rules, and, on December 31, 1980, published the regulations in final form. The final regulations have an effective date of April 30, 1981 and generally will apply only to preferred stock, bonds, notes, or similar evidences of indebtedness issued, and certain cash advances and guaranteed loans made, after that date. [1] All other interests (such as trade accounts payable, claims for wages, bank deposits, etc.) are outside the scope of the regulations and their status as stock or debt will continue to be governed by existing law.

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II. IN GENERAL

The regulations prescribe different rules for the characterization of a straight debt instrument and a hybrid instrument; debt instruments which are held in substantially the same proportion as stock holdings and debt instruments issued to independent creditors; debt instruments issued for money and those issued for other property; and demand obligations, advances, and shareholder guarantees.

* Roberts and Holland, New York City, Washington, D.C. and Miami, Florida.

1. An exception is made for interests created pursuant to a pre-existing commitment in effect on December 29, 1980, and at all times thereafter.

tion with the individual income tax is no doubt a relevant variable in designing tax policy for development. But the rate level of such taxes — which by the nature of our enquiry is not extensively covered here — is of even more fundamental relevance. Amongst other things, governments must decide whether they want to stimulate the adoption of the corporate vehicle and whether, in order to foster business savings, tax rates at the corporate level should be set at a rather low level. The answer to these two questions, in the view of this writer, is, as a matter of principle, an affirmative one. The practice of several developing countries, as Colombia, for example, consists in taxing the corporation at harsher rates than partnerships and unincorporated business units. This implies a hidden subsidy to forms of business which are less sophisticated and which, because of loose accounting standards, already tend to be less effectively assessed. This writer also supports the view of several well-known tax eperts [21] that it appears appropriate to keep the tax burden at the corporate level comparatively low and to accentuate the tax bite when profits are distributed. As a matter of fact, the chances are that the dividends thus received will largely spill over into consumption instead of being recycled through (undeveloped) capital market channels. Ploughed-back profits sustain a high investment ratio, which is a major engine of economic growth. The risk that profits may be retained to shelter high-bracket shareholders from the comparatively higher personal taxes and would not give rise to investment outlays can be countered by measures against the "personal holding type" corporation, discussed above, and by granting some preferential treatment to the act of actual investment instead of to crediting profits to reserves.

21. See, for example, *Richard M. Bird, Taxation and Development: Lessons from Colombian Experience* (Cambridge, Mass., Harvard University Press, 1970).

Conference Diary

JULY 1981

Management Centre Europe: Taxation of International Group Companies and Branches (Seminar) (including: taxation of branches; home jurisdiction; taxation of subsidiaries; taxation of shareholders), Brussels (Belgium), July 6-7 (English).

AUGUST 1981

Management Centre Europe: Leasing Seminar (including: tax aspects of leasing), Brussels (Belgium), August 26-28 (English).

SEPTEMBER 1981

35th Annual Congress of I.F.A.: I. Mutual agreement procedure and practice: II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FEBRUARY 1982

Business Perspectives Ltd.: 7th International Tax Conference (including: developments in legislation and practice in U.S.A., U.K., Canada, Australia and the Far East as they affect companies and individuals with world wide interests; and tax problems involved in investment in Mexico and the Caribbean area). Mexico City (Mexico), February 1-5 (English).

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

tively large, open companies, and to differentiate somewhat amongst various forms of business organisations.

Third, impersonal corporate taxes are rather incongruous in personalized global type systems. The steps taken to remedy this basic incompability contribute towards better adapting tax form to economic substance, but they remain somewhat patchy.

Fourth, the answer to the vexing policy question whether dividends should be taxed once or twice is not given by the inner logic of either the schedular or the global paradigm, but by policy-maker's views about economic and distributional effects. As a matter of fact, formulas of single and of dual taxation of dividends can be operated within systems that are either schedular or global.

And, finally, we noticed some broad shifts over time in the structural design of corporation taxes. This suggests that the rational choice of alternative formulas for corporate taxation may be shaped, to an extent, by the characteristics of different stages of economic development. We turn to this interesting query in the next section, in which the problems of developing countries will hold pride of place.

IV. SPECIFIC PROBLEMS OF BUSINESS TAXATION IN DEVELOPING COUNTRIES

On a priori grounds, one would expect that the use of the corporate legal vehicle will spread as development proceeds. This sequence has occurred in Western Europe and in the United States since the second half of the 19th century. Amongst other factors, the relative shift of economic activity from agriculture to industry greatly contributed to that phenomenon. An empirical study by Ernst-Albrecht Conrad supports that hypothesis. Interestingly, he found in a cross-section exercise that the ratio of corporate tax revenue to GNP was higher in the 1965-67 period in 35 developing countries covered than in 12 industrial ones. This higher level, however, was substantially influenced by a few mineral-exporting countries. Time series also displayed a higher elasticity of corporate tax revenue to GNP for the set of developing counties than for developped ones. The corporate sector and the associated tax revenues are expanding particularly rapidly in countries with high growth ratios. In developed countries, the relative role of the corporate vehicle within the business sector may also be somewhat growing. [20]

Definitive answers would require more extensive data and a further differentiation between domestic and foreign owned enterprises; it is also unclear whether Conrad's concept of corporate taxes also encompasses partnerships and individual businesses; this would be a highly advisable procedure if the data cover countries which apply what we have called the "enterprise tax".

Although, relative to GDP, and especially in mineral-based economies, the corporate sector may be larger than in industrialized countries, there can be no doubt that, on the whole, business units in low-income countries are smaller, in absolute terms, than in industrial countries. Many "business units" are poorly equipped, do not employ modern management and accounting techniques and have a small turnover; their reach is often restricted to the local market. The artisanal sector and petty commerce are still sizeable in number and even in economic significance in many developing countries, whereas in developed economies they have almost disappeared.

The above-mentioned features of the typical socio-economic environment in developing countries throw light on some actual tax practices in those countries. The "enterprise tax" appears fairly well suited to the country's needs, as long as the *modern* corporate sector has not expanded substantially. One must recall that, in many cases, developing countries have forcibly or freely taken over the main lines of the tax systems of an industrial country, most often the metropolis. Thus, the "enterprise tax" was part and parcel of the traditional French schedular system. Spurred by the advance of global systems in many countries, personalizing tax parameters, included graduated rates, were also introduced in developing countries. Since most business units still have a family profile, such parameters were justified on distributional grounds. Progressive rates, however, inhibit the growth of modern enterprises and of the corporate business form.

In other words, the uncritical transplantation of tax models of industrial countries is not at all warranted. This is particularly true of the American corporate tax which is based on the "separate entity" philosophy. In this respect, it is interesting to note that, in the corporate tax field, developing countries often deviate from the technical features that are implied in the architecture of the income tax in the industrial country. Colombia, for example, although it has a global personal tax, features a sort of business tax which differentiates between various legal forms of doing business. Neither would it be wise to experiment with, say, the dividend-received "integrative" methods in the absence of a well-developed capital market. Less sophisticated methods will do as well. Moreover, as suggested by the survey of alternative formulas in III, it would be mistaken to posit that only one single scheme is acceptable. For example, whether or not dividends to resident shareholders should be taxed twice appears to be a decision which largely trancends the postulates of a schedular or global prototype.

But as a country develops, modern domestic businesses will spread and many amongst them will adopt the corporate form. As suggested in the previous section, special provisions for corprate bodies which become open to widespread shareholding would have to be devised. Within the schedular system, the undifferentiated enterprise tax may have to be abandoned as regards incorporated businesses. Where global tax principles already govern the individual income tax, the introduction of some form of separate, impersonal corporate tax would also become desirable.

Finally, another important consideration is in order. The structural form of corporate taxation and its rela-

20. *Ernst-Albrecht Conrad*, "Trends in the level of Corporate Taxation", paper, Fiscal Affairs Department, International Monetary Fund, November 1972.

resources. Admittedly, these can be mitigated to quite some extent by the "integrative" schemes discussed above. But, even then, the separate imposition of retained profits is inevitable, as, in large corporations, the attribution of non-distributed profits to the underlying shareholders is administratively almost unachievable — as discussed above.

In other words, whatever technical arrangements are adopted, impersonal taxes on the corporation cannot qualify as a congenital ingredient in the essentially person-centered global tax architecture. In fact, when corporate-source profits are singled out for separate treatment, they introduce a schedular component in a tax which should be based on total income from whatever source derived.

In this connection, the contention that the "capacity to pay" principle, which is the time-honored justification for progressive taxation and which is predicated on the declining marginal utility of income, also applies to large corporations is not at all convincing. But if the same expression is vested with a different meaning, whereby emphasis is laid upon the corporate economic life proper, it could be solidly asserted that such companies do have the capacity to pay taxes, in their own right. Anyhow, politicians have come to treat corporations as a convenient target for mobilizing revenue.

In one category of corporate units, impersonal features have become even more prevalent. Most large companies, headquartered in the United States, European Market economies or Japan, have nowadays largely become multinationalized in the sense that they perform productive activities in subsidiaries located abroad. These subsidiaries in the host countries are even less related to individual shareholders. They are wholly or partially owned by a foreign corporation, which usually itself is a large and open company.In other words, taxes on the subsidiaries of foreign companies are bound to be designed in an impersonal fashion. [18]

The corporate legal cloth is availed of not only by large enterprises, but also by the numerous *small, closed companies.* Entrepreneurs and businessmen may want to adopt the corporate vehicle for various reasons. First and foremost, the limited liability feature greatly reduces the risk factor. Second, the conversion of an individual unit into a corporate body allows businessmen to obtain a formal wage for their labor inputs, thus making them more fully eligible for social security benefits. And finally, high-income recipients may use the corporate construct to avail themselves of tax savings which result from the twin facts of (a) a lower rate on retained earnings at the company level than the applicable marginal rates in the individual tax, and (b) the widespread exemption or preferential treatment of capital gains.

The economic role of closed companies, particularly in industrial countries, does not match that of large, open corporations. But their number is much larger. They also raise a difficult problem for the policy-maker. Formally, the organisational pattern of the closed company is similar to that of open companies, but their economic reality is clearly different. The closed company is characterized by shareholders who are actively running the business. To treat them fiscally in the same way as one does open companies (i.e. with a separate tax on corporate profits, possibly amended by partial integration schemes — see the previous section), has definite drawbacks. It opens avenues for tax minimisation, to the benefit of top-bracket shareholders, over the profit-retention route. It follows that the symbiosis between the closed company and its shareholders warrants the adoption of tax formulas that would achieve full integration.

This has prompted many countries with global type systems to take some steps to redress those anomalies. Several legislations allow the possibility for specified, closed companies to opt for the tax treatment applicable to partnerships. Elsewhere, tax avoiding mavouvers are combatted by enabling the fisc to pierce throug the corporate veil of so-called director-controlled companies and to allocate the retained profits over the shareholders. Such companies, typically, are of the holding-type variety and are not directly engaged in industrial or commercial activities. One must add that commercial legislation in many countries, such as Germany and France, contains a legal form which is a hybrid between the "sociétés de personnes" and the "sociétés de capitaux". [19] The legal statute for businesses can thus be better adjusted to the economic characteristics of the business units. But such wider options as regards the legal form for doing business do not, as such, solve the fiscal problem, as one must still determine which tax arrangement should apply to the hybrid.

Such measures facilitate the adjustment of formal tax statutes to economic reality, but this welcome flexibility occurs as the cost of a more complex tax legislation; and furthermore, corporate tax legislation cannot adequately accommodate the tremendous variety in size, sector of activity and motivations in setting up corporate units. Only the smaller corporations, which clearly display a family profile, can be segregated into a separate tax category in which the impersonal corporate approach is amended or replaced by the partnership method.

This section, in our view, leads to several interesting conclusions.

First, the application of the same formal tax statute to all corporate bodies is inappropriate, considering the wide variety in the size of corporations and in the involvement of their shareholders in management decisions.

Second, an impersonal tax with flat rates appears suited to the large, open company; yet, in view of undesirable allocational and distributional effects, procedures for alleviating the double taxation of dividends appear justified. Although schedular systems, in accordance with their underlying logic, would postulate an "enterprise tax" applicable to all forms of doing business, they also have been led to recognize the emergence of compara-

18. The impersonal nature of the tax on the subsidiary in the host country does not eliminate the need to reconcile the claims of the host and of the home countries, through unilateral rules and bilateral agreements.

19. Such as the French "société de personnes à responsabilité limitée" and the German "Gesellschaft mit beschränkter Haftung".

not quite complete and open to additional variants, is impressive and filled with much technical detail. But, beyond the thick wood of technicalities, one discovers alternative pathways for tax policy and is faced with options about important matters of substance.

In this connection, and without repeating the extensive literature on the subject, a few important remarks are worth making. First, as already stressed, it is misleading to look only at the level at which profit or income taxes are formally applied. The relevant consideration is whether the taxes levied are meant to burden the corporation or the shareholders. Thus, the use of the withholding technique, while applied by the corporation, hits the shareholder. Second, for purposes of exposition we have, in the preceding section, gauged the "combined tax" burden that results when in several of the abovementioned formulas taxes are formally operating at the two levels. Such an approach presumes that the company has no economic life or substance apart from its shareholders and that, accordingly, the taxes levied on the corporation should be viewed as burdening only the shareholders.

Such symbiosis, which provides the backdrop for the "conduit" or "corporate veil" theory, however, must be seriously questioned with respect to *modern, large corporations.* Although far less numerous than tiny corporate bodies, large corporations account for the lion's share of profits in the corporate sector. The major decisions in most large companies are taken by professional managers, whose possession of shares of the corporation which employs them is most often quite limited. Most of the world's giant corporations were started by daring entrepreneurs as family businesses. Their rapid expansion necessitated tapping the capital market so that, typically the founding family eventually retained only a small part of the outstanding shares. The main exception, which is more prevalent in Europe, consists of the "holding company" situation, in which families or financial groups are in a position to control the company with a comparatively small portion of the shares issued (e.g. only 20 percent), as the other stocks are scattered over a very large number of shareholders who view their capital contribution as a reversible investment, subject to arbitrage against a more promising financial asset. Most individual shareholders also tend to be apathetic with respect to the exercise of the rights of ownership and control that are attached to their shares. In other words, the bulk of the shareholders in such "open" companies does not view itself as intimately wedded to the corporation. As contrasted with partnerships and closed corporations, the shareholders in open companies only contribute capital, not labor services. Today, and especially in the United States, a large part of shares is held by institutional investors, such as private pension funds, acting on behalf of their members. This results in even more tenuous allegiance of individuals with the corporations. The ownership attributes of shareholders are also constrained by the action of other groups, such as unionized workers. It is fair to say that, at present, large companies can no longer be viewed as contractual constructs in which shareholders enjoy sovereign powers of decision, but rather as living organisms acting in their own right, and often with considerable power to affect the economy in which not only shareholders but also other groupings of people hold a stake.

The large, open corporation acts as an impersonal entity in the sense that, usually, and despite the formal attribute of ownership attached to shareholdings, the decision-making organs of the corporation largely act independently from the shareholders. Hence personalization of profit taxes on large companies would not make any sense; neither would graduated rates: to penalize the size of corporate bodies (as measured in terms of taxable profits) is a questionable policy. In sum, the personal nature of the large, open corporation calls for it to be taxed in an impersonal or objective way.

The object-centered features of a *schedular* tax system suit this prescription. But such systems, if consistently structured, do not discriminate between incorporated and other legal forms of business. Such uniform treatment is rationalized by reference to the qualitative discrimination theory, in which all business profits, as they stem from the combination of labor and capital, should be located in the schedule of mixed income. One may wonder, however, whether such principle can be upheld with respect to large corporations to which capital and labor are contributed by different persons.

Hence, it comes as no surprise that, in a large number of historical schedular tax systems, the originally intended uniform treatment of all types of business has fallen apart. We mentioned already that some countries have added a flat-rate schedular tax on dividends as received by shareholders, thus instituting a dual-level, un-integrated tax on dividends. Elsewhere, business units could not be shielded from personalizing features, such as allowances for dependents; the pull of the "ability to pay" principle and the associated tendency to tailor tax liabilities according to the economic circumstances of individual taxpayers have been powerful. As already noticed, in several countries, and especially in Latin America, progressive rate formulas have been introduced, sometimes even on corporations. In other cases, tax rate differentiations according to the form of business have been adopted, with "limited liability" enterprises being more severely taxed. One might add that, almost unavoidably, the severity of the assessment process also tends to diverge: compliance obligations often are more stringent, in fact if not in law, for corporations than for unincorporated units, since the former involve a more sophisticated form of business organisation and are, on the average, larger. As the number of large-sized and open companies in a growing economy increases, the tendency towards a more impersonal form of taxing them and towards severing the links with the tax treatment of the individual shareholders has also gathered strength.

This impersonal mode of taxing profits, however, is ill suited to the *global system,* which aims essentially at apportioning tax burdens in accordance with the comparative capacity to pay of individuals. As illustrated in the preceding section, this almost unavoidable juxtaposition of a tax at the corporate level as distinct from that on individuals creates distortions in the vertical tax burden distribution and in the allocation of investible of firms and of income originating within them.[13] This persistent preference given to the corporate vehicle suggests that tax drawbacks may well be offset by advantages, such as the limited liability. And finally and obviously, one should expect that the absolute level of tax rates exerts a deeper impact on the ability and the propensity to save of companies and shareholders than the structural characteristics of corporate tax designs.

F. Integrative schemes to mitigate the double taxation of dividends

In recent years, a significant number of highly industrialized countries have adopted corporate tax formulas in which the double taxation of dividends is alleviated or even eliminated. As mentioned in a survey by the OECD, the governments have been motivated much more by the adverse allocational effects just mentioned and by the need to arrive at a system which better fits the needs for international coordination of tax claims — in a world in which business is increasingly internationally involved — than by the distortions in interpersonal income tax burden distribution analyzed above.[14] Yet, although the desire to soften the fiscal burden on the shareholders on account of tax already discharged by the corporate body apparently has not been the decisive consideration, these schemes have become known as those seeking "integration" between the two levels of tax. Upon inspection, however, the (re)integration achieved remains incomplete, on two counts. Contrary to the full integration, which is inherent in the partnership approach, only the distributed part of profits is affected by the moves towards integration. And besides, only partial removal of the "double tax" on distributed profits has been granted.

Today, out of nine member states, seven countries in the EEC have adopted such "integrative" schemes. The EEC Commission itself has come out in favor of tax harmonisation on the basis of the French method of relief for dividends received.[15] Only the Netherlands and the Grand Duchy of Luxembourg, as yet, stick to the classic system. As already mentioned, the issue is under active discussion in the United States.

Two main schemes have been adopted to this effect, although various technicalities make for variants. A first approach, the *split-rate* system, reduces the rate applicable at the corporate level on the distributed portion of taxable profits. The system otherwise functions as in the classic model. The difference is that the lower rate on the dividends paid out is not offset by a commensurate upwards adjustment of the tax on the undistributed portion of corporate profits; hence, the actual flow of dividends to the shareholder is enlarged. Whether the "combined" burden of the two-level taxes is lower or higher than under the classic system depends on the marginal rate applicable in the individual tax; at given pay-out ratios, the split-rate system becomes more burdensome for shareholders in the upper-income branches.

West Germany installed such a two-rate system in 1953. A major objective consisted in reactivating stock market activity. In 1977 West Germany moved towards completely eliminating the double fiscal attack on dividends with a complex combination of the dual-rate formula and the dividend-received deduction. The latter is granted to the shareholder and amounts to the second main integrationist formula.

In the *dividend-received* formula, corporate profits are taxed in full and a flat rate is withheld by the company on the gross amount of dividends. This scheme differs from the classic system in that the shareholder benefits from a credit against his liability on his global income for part (typically, one half) of the corporation tax paid on distributed profits. In France, this relief is called the "avoir fiscal". To benefit from it, the shareholder, when submitting his income tax declaration, must augment the dividends received[16] with the amount of the "avoir fiscal". France adopted the "avoir fiscal" formula in 1965; similar tax relief on dividends received was enacted in Belgium (1963) and Great Britain (1973) (where, as mentioned earlier, the classic method had been introduced as recently as in 1965).

One should mention that, at the limit, the dual or split-rate system will merge into undistributed profits tax whenever at the corporate level distributed profits remain exempted, i.e. carry a zero rate. Contrary to the split-rate system, the tax relief alleviation is granted to the shareholder, not to the company.

Depending on the variables in use (rates, pay-out ratio, marginal rates on individuals, etc.) there are bound to be variations in the "combined" tax burden and in the distribution of that burden when the two formulas of dividend relief and the classic system are compared. But a discussion of those complex matters would stretch this chapter beyond what is needed for our specific enquiry.[17]

III. SOME UNDERLYING SUBSTANTIVE ISSUES

The previous section surveyed alternative patterns for designing the tax treatment of corporate bodies — and, more generally, of multiple-owner enterprises — and their links with personal income taxation. The list, while

13. See *William E. Cullison,* "Trends in Federal Taxation since 1950", *Economic Review,* Federal Reserve Bank of Richmond, May, June, 1980, p. 16.
14. "Company Tax Systems in OECD Member Countries", *Organisation for Economic Co-operation and Development,* (Paris, 1973), pp. 13-4.
15. The EEC submitted its directive in 1975. See also the study commissioned by the EEC by *A.J. van den Tempel,* which expressed a slight preference for the classic system.
16. France does not apply a withholding tax on dividends paid to residents.
17. For an excellent comparison in algebraic terms of the integrative and of the classic schemes, see *The Structure and Reform of Direct Taxation (The Meade Report)* (The Institute for Fiscal Studies, London, 1977), pp. 265-8. It can also be shown that, under the assumption of equal revenue yield and of unaffected pay-out ratios, the split-rate and the dividend received are equivalent in terms of relief for corporate distribution. See, *Mitsuo Saito* and *Richard M. Bird,* "International Aspects of the Taxation of Corporations and Shareholders", *IMF Staff Papers,* Vol. XXII, no. 2, July 1975, pp. 392-3.

TABLE II

Comparison of the tax burden under the "classic" and the "partnership" systems

Marginal rate	*Partnership system*	*No distribution of dividends*			*Classic system 50% pay-out rates of dividends*			*Full distribution of dividends*		
	Tax	*Tax*	*Absolute difference with II*	*Percentage difference with II*	*Tax*	*Absolute difference with II*	*Percentage difference with II*	*Tax*	*Absolute difference with II*	*Percentage difference with II*
I	*II*	*III*	*IV*	*V*	*VI*	*VII*	*VIII*	*IX*	*X*	*XI*
10%	10	50	+40	+300 %	52.5	+42.5	+325 %	55	+45	+350 %
30%	30	50	+20	+ 66.7%	57.5	+27.5	+ 91.7%	65	+35	+116.7%
50%	50	50	–	–	62.5	+12.5	+ 25 %	75	+25	+ 50 %
70%	70	50	–20	– 40 %	67.5	– 2.5	– 3.7%	85	+15	+ 21.4%
90%	90	50	–40	– 80 %	72.5	–17.5	– 24.1%	95	+ 5	+ 5.6%

Source: Author's computations.

shown in the second column of Table I. This comparison is rendered in Table II, which shows the "extra burden" due to the corporation tax, both in absolute and in percentage terms. To ensure continuity in the examples, we assume, as in the upper panel of Table I, a corporate tax rate of 50 percent. Within a given column, the "extra burden" is quite high at low levels of overall individual income but declines as we move up the income scale. At some point in the upper income brackets, the classic system becomes more favorable than the hypothetical partnership approach. Rich taxpayers, provided they control the profit allocation policies of the corporate body, could minimize their tax liabilities by increasing profit retention and benefiting from the capital gains on the outstanding shares that result from the profit retention. As share ownership is highly concentrated in the high income brackets, sheltering by way of driving up the retention ratios threatens to undermine the intended progressive distribution of tax burdens.

It also follows that the overall progressivity of the income tax system would be enhanced if the classic system were replaced by the partnership approach and if the intermediate corporate level between the tax authorities and the shareholders were bypassed. As just mentioned, the classic system distorts the intended progressive distribution of inter-personal burdens, which is an essential ingredient of a global income tax on individuals.

In itself, the very formula of the classic system entails some biases with respect to the allocation of resources. Under the assumption made earlier that taxes levied at the corporate level are to be viewed as taxes on the shareholders themselves, and are not shifted to consumers or employees, this system discriminates in favor of retained as against distributed profits. It follows that the tax differential may be expected to induce corporations to operate a lower pay-out ratio of dividends than otherwise would be the case. The system also discriminates against equity financing as compared to debt financing. Whereas interest on bonds and other borrowings can be deducted by the corporation, dividends are not deductible; furthermore, they are tapped a second time in the hands of the shareholders. At a 50 percent corporate tax rate, the corporation must secure US $ 2 of earnings for every US $ 1 of dividends, whereas US $ 1 of interest paid only requires US $ 1 of earnings. Hence, the "separate entity" system involves an incentive for corporations to raise the debt/equity ratio in their financing policies. At a time when, in most highly industrialized countries, the part of national income accruing to profits has been dangerously declining, this fiscal discrimination has become the object of more stringent criticism. It also claimed that the double taxation of dividends, by lowering the return on investments in equities, adversely affects the stock market and the issuing of new equity capital.

That the very structure of the classic system exerts some influence in the directions just mentioned is highly plausible on a priori grounds. Quantitative evidence on this issue, however, is scarce and not impressive. The tax variable is only one, albeit an important, consideration in shaping financial ratios. Thus, many corporations adopt a policy of dividend stabilization over lean and fat years. Growth companies, in need of large investible funds, typically plough back the lion's share of their earnings, whereas more mature companies cater more to the desire of their shareholders for cash dividends. The "combined" load on dividends reduces the shareholder's return and, on this count, his propensity to buy shares. As against this, however, as Charles McLure and Stanley Surrey notice, shareholders benefit from the fact that capital gains are nurtured by the retention of profits and are taxed quite leniently, if at all.[12] In a similar vein, it is also noteworthy that, despite the higher overall burden inherent in this system, the corporate sector has continued to grow, faster than the non-corporate sector, as evidenced by data for the United States, in terms of total receipts, of the number

12. *Charles E. Mc Lure*, Jr., and *Stanley S. Surrey*, "Integration of Income Taxes: Issues for Debate", *Harvard Business Review.*

ed to the shareholder are chargeable to the latter's tax on global income. For collection purposes, the corporation usually withholds a flat tax on the profits made available for distribution.

When we look at the *distributional* effects of this scheme, a two-step analysis is in order. First, we investigate which factors determine the resulting tax burden on taxpayers at different levels of overall income. In a second stage, we examine to what extent the combined tax liability in the classic system compares with the one that would result from the application of the partnership approach. (In both cases, it is assumed that the "combined" burden resulting from the taxes levied at the corporate and at the individual level can properly be viewed as borne by the shareholders. The validity of this assumption will be questioned later.)

The aggregate tax burden resulting from the combination of the corporate and of the individual income taxes under the classic approach depends on three factors — under otherwise equal assumptions as to the prevailing distribution of income amongst persons and households and the scope for shifting the corporate tax, etc.

Obviously, the combined tax burden on the shareholder is higher than if only the corporate profits tax were in operation. (Admittedly, if profits were entirely retained, shareholders would not be liable to tax on any dividends; but, in the longer run, the hypothesis of no distribution whatsoever is unrealistic.)

The "combined" tax burden rises, in absolute terms, as:

(a) the flat corporate tax-rate rises;
(b) the pay-out ratio of dividends out of earnings increases;
(c) the (marginal) tax rate to which the shareholder is submitted on his total income rises.

Table I illustrates the impact of the first two factors. The upper section assumes a 50 percent flat rate on corporate profits. In other words, out of 100 (monetary units) realized by the corporation, the corporate tax only leaves 50 available for distribution and/or retention. The data clearly show that the combined tax load in absolute terms increases, in each *row*, as one moves from full retention to full distribution of profits. Besides, the combined tax burden rises as one ascends, in each *column*, from the lower to the upper brackets of individual tax, with the notable exception of the cases in which no dividends whatsoever are paid out.

We have added a second section to Table I which features a 30 percent corporate tax. When compared with the corresponding entries in the columns and rows of the upper section, one readily concludes that, as already mentioned, the combined tax liability increases as the corporate tax is higher. As a matter of fact, the extra burden on dividends, on account of the higher corporate tax rate, is the algebraic sum of (a) the additional liability at the corporate level and (b) the tax "saving" at the individual's level, resulting from the fact that the higher corporate tax narrows the flow of distributable profits and, accordingly, on this count, reduces the shareholder's liability on the dividends received. The two parts of the sum would only be equal and wash out if the profits were fully distributed and subjected to a 100 percent marginal rate.

We also investigate whether and to what extent the corporate tax affects the distribution of the income tax burden amongst the various layers of the income pyramid. To that effect, the classic system is compared with the partnership approach, in which each shareholder would be liable to tax on his part in total corporate earnings. We assume a global system, so that the individual shareholder would be subject to one of the marginal rates,

TABLE I

Combined tax liabilities in the classic system under alternative assumptions

Statutory rates		*No distribution of dividends*			*50% pay-out rate of dividends after tax*			*Full distribution of dividends after tax*		
			Tax due			*Tax due*			*Tax due*	
Corporate	*Personal*	*Corporate*	*Individual*	*Total*	*Corporate*	*Individual*	*Total*	*Corporate*	*Individual*	*Total*
					(A) Corporate tax at 50%					
50%	10%	50	–	50	50	2.5	52.5	50	5	55
50%	30%	50	–	50	50	7.5	57.5	50	15	65
50%	50%	50	–	50	50	12.5	62.5	50	25	75
50%	70%	50	–	50	50	17.5	67.5	50	35	85
50%	90%	50	–	50	50	22.5	72.5	50	45	95
					(B) Corporate tax at 30%					
30%	10%	30	–	30	30	3.5	33.5	30	6	36
30%	30%	30	–	30	30	10.5	40.5	30	18	58
30%	50%	30	–	30	30	17.7	47.5	30	30	70
30%	70%	30	–	30	30	24.5	54.5	30	42	82
30%	90%	30	–	30	30	31.5	61.5	30	63	93

Source: Author's computations

proach to corporations has been waged primarily in the United States and in Canada. These are countries in which shares are held in registered form. The introduction of the partnership formula in jurisdictions in which corporate shares are held in bearer form, as in Continental Europe, is almost unthinkable, since the scheme involves the need to identify the shareholders. Yet, admittedly, the partnership approach, as just outlined, could be applied to "closed corporations", which typically are small in size, comprise few shareholders nor are the shares publicly listed. But the system would readily break down, even in the United States of America, indeed, for the many giant corporations, which have millions of shares outstanding that are actively traded on the stock exchanges.

D. The undistributed profits tax at the corporate level

The formulas discussed so far have in common that the tax burdens only one level; the obligation to withhold tax at source is essentially a device to hit the shareholders indirectly. We should now briefly turn to a system in which taxes are formally levied at the two levels, but in such a way that, in substance, dividends are only taxed once. In line with the position defended a moment ago, but contrary to some authors, we do not view this system as an integrationist scheme, although the outcome is largely equivalent.

The formula under discussion appears in variants. The first one would impose the undistributed profits at the corporate level and subsequently tax the shareholder when dividends are distributed out of current income or out of previously accumulated reserves. Abstracting from differences in tax rates at the corporate and shareholder levels, this system ensures that the corporate profits are taxed only once; tax duplication on dividends is thus removed.

Such tax on corporate undistributed profits could coexist with either a schedular flat rate tax or with a global tax on total net income at the shareholder level. In modern tax practice, the corporation would anyhow be expected to withhold a flat rate upon distribution of the dividends. But, whereas in a schedular system this withholding tax would act as a final tax, in a global system it would be creditable against the final liability of the shareholder on his overall taxable income.

The system here discussed has historically been of major significance. It provided the traditional way of taxing the corporation in Great Britain, which was the first country to introduce a modern income tax. That practice has been transplanted into British colonies and members of the Commonwealth. To that effect, the system just described was laid down in the 1922 British Colonial Model Income Tax Ordinance. While today several important LDCs such as India have moved away from this "British" formula, others, e.g. Malaysia, have essentially maintained it. [10] The system in Belgium previous to the 1962 tax reform also displayed the same basic features.

As already mentioned, this system is compatible with a *schedular* set-up, provided a flat rate would apply not only at the corporate but also at the individual level; one should then expect that, according to the doctrine of qualitative discrimination, the rate on dividends deriving from "pure capital" would exceed that on the corporation, whose profits derive from the combination of labor and capital inputs.

In this respect, one may recall that, until the introduction of a personalized surtax, in 1910, the British income tax displayed a schedular architecture, although a uniform flat rate (called the standard rate) was applied to the various schedules.

The divergence in the rates applicable to the undistributed profits (at corporate level) and the dividends (as received by the shareholders) is likely to encourage rich shareholders with adequate control over corporate affairs to artificially inflate the portion of profits retained. Obviously, retained profits could also be used as a shelter, within a *global* set-up, by high-income recipients whose marginal rate on dividends received exceeds the rate on corporate undistributed profits. If the rule-book of the *schedular* system is respected, the tax rate on dividends — "pure" capital income — would exceed that on undistributed profits — "mixed" income — thus also involving a stimulus to retain profits.

It is also revealing to notice that in Great Britain this original "undistributed profits tax" at the corporate level has not been preserved as the sole approach to taxing the corporation. As a matter of fact, in 1947, it was complemented by the "profits tax", which was operated quite independently from the undistributed profits tax. The base of the profits tax consisted of total profits, but the rate on the profits retained was lower than that on dividends. The juxtaposition of these two taxes resulted in a hybrid arrangement, which involved amongst other things, a two-level taxation of dividends. In 1965, Great Britain introduced the "separate corporate tax" which is the next in our list of alternative arrangements.

E. The "classic system" or the "separate entity" approach

The fourth system in our list has until recently been widely in use in developed economies. Van den Tempel calls it the "classic system". [11] In our view, this epithet, while a useful shorthand expression, is a misnomer. As a matter of fact, nowadays, there is an unmistakable tendency towards eroding this system through various "integrationist" schemes, to be discussed subsequently. And, in the history of tax systems, the corporate tax on undistributed profits, along the lines of the traditional British system, has preceded the system we now analyze.

The mechanics of the classic system are rather simple. First, total profits of the corporation are taxed at a flat rate; no distinction is made between the retained and the distributed portion of the profits. The rate, nowadays, in developed economies, frequently reaches the 45-50 percent range. The (gross) dividends distribut-

10. *G.E. Lent*, op. cit., p. 726.

11. *A.J. van den Tempel, Corporation Tax and Individual Income Tax in the European Communities* (Brussels, 1970).

formula prevails, not only on sole proprietorships but frequently also on partnerships and corporations.[4] In the last section, we will ponder the interpretation to be given to that phenomenon.

In his 1977 survey of corporate tax structures in developing countries, George Lent mentions that in former French colonies and also in several Latin American countries as well the "enterprise system" still prevails, in one or another of the variants outlined.[5] This comes as no surprise considering the transplantation or the strong impact of the originally schedular, French system in those countries. Alongside the shift of schedular (or, more often, mixed) systems to global contours, the enterprise tax disappeared in high-income countries in Europe. This, as yet, diverging fate of the schedular system, and, more particularly, of the tax on business profits in the two groups of countries, also deserves some comment in the last section.

C. The "partnership" approach

The second system under discussion derives its widely accepted apellation from the way partnerships are taxed in most countries. The partnership cannot be imagined as carrying out activities in isolation from its partners — except in a purely formal sense. Hence, it would not be correct to tax both the partnerships and the partners on the same items of income. Such "double taxation of (distributed) income" is avoided if the "enterprise profits" approach, just mentioned, is applied in pure form. The predominant way of taxing income originating within a partnership consists in taxing that income in the hands of the partners and in disregarding the partnership as a taxable subject.

A similar approach is theoretically conceivable for corporations. But, as will be stressed in a moment, its implementation runs into intractable obstacles. In the "pure" partnership scheme, "each shareholder would have attributed to him a pro rata share in the earnings of a corporation during the part of the year he owns a stock".[6] The partnership formula, however, has not, so far, been put into practice anywhere as the basic statute for corporate profits.

In order to find a workable solution to a host of technical problems raised by the pure version of the partnership recipe, a "compromise" variant has been proposed in two official documents: the "Royal Commission on Taxation" in Canada (1967) and the "Blueprints for Basic Tax Reforms" (1977) of the United States Treasury.[7] In the complex mechanism proposed, a corporation tax, in the formal sense, would be maintained as a collection instrument, but this would be credited against the tax liablitiy on the individual's overall income. This compromise version apparently has minimal changes of being considered for adoption and would run into stubborn administrative problems, as shown in Charles Mc Lure's detailed analysis.[8] Accordingly, we will no longer dwell on its mechanics but on the deeper significance which the partnership approach, if it were effectively implemented, would hold for corporations. We naturally also look into the compatibility of this scheme with the schedular or global paradigms.[9]

First, in the partnership approach, the corporation, even if it is called upon to perform as a collector-at-source, fundamentally is not meant to be the taxpaying subject. The tax law looks through the "veil" of the juridical construction and identifies the shareholders as the true and final taxpayers. In the jargon of another, quite common expression, this approach adopts the "conduit" theory, whereby the corporation is not considered to form a "separate entity" for tax purposes.

Treating the corporation as if it were a partnership, would amount to an "integrated" system, whereby corporate profits would be taxed only once. But we prefer to apply the expression "integration" to schemes that alleviate the two-level taxation of dividends which is inherent in the "classic" system, to be discussed hereafter. In fact, there is no genuine integration, since the tax is effectively levied only on the shareholders.

The partnership approach would also have the merit of ending the discrimination between distributed and retained earnings of the corporation and between the corporate and non-corporate forms of doing business. The taxable base would indeed solely consist of income attributed to the individual shareholders.

The very fact that the "one-level" imposition now occurs at the personal level of the shareholders, not at the impersonal level of the corporation, would allow an easy insertion of the partnership approach into a *global-type* individual income tax, equipped with personalizing features. As against this, in a strictly *schedular* system, there would be no need to apply the partnership approach to the corporation; as a matter of fact, the object-related schedular system hits the profits of enterprises, in whichever form constituted, in an identical fashion. Hence, to hit the owners of the enterprise taxwise would be unnecessary; a schedular tax focuses on the production of taxable profits, not on their disposal.

We have alluded to the very serious problems of implementability which the partnership formula would encounter. In this respect, two considerations appear in order. The recent debate about the partnership ap-

4. A recent study by the Organization of American States mentions that in Latin America 12 countries out of 22 apply progressive rates of business profits. See, "Analisis comparativo del impuesto sobre las utilidades de las empresas en los paises de America", *Comercio Exterior,* Vol. 27, no. 1, 1977, p. 66.
5. See *George E. Lent,* "Corporation Income Tax Structure in Developing Countries", *IMF Staff Papers,* November 1977, pp. 724-5.
6. *Charles E. Mc Lure, Must Corporate Income be taxed twice?* (The Brookings Institution, Washington, 1979), p. 154.
7. *Report of the Royal Commission on Taxation, Vol. 4: "Taxation of Income"* (Queen's Printer, Ottawa, 1966), pp. 3-98; and *Blueprint for Basic Tax Reform,* U.S. Department of the Treasury (Government Printing Office, Washington, 1977).
8. *Mc Lure,* op. cit., mainly chapter V.
9. A method equivalent to the partnership approach would consist of taxing the shareholders on (a) dividends received, and (b) on capital gains, even unrealized ones. This system cannot possibly exist, since non-preferential taxes on non-realized capital gains defy effective implementation. See, *Richard A. Musgrave* and *Peggy B. Musgrave, Public Finance in Theory and Practice* (McGraw-Hill, 1973), pp. 282-3.

Within this framework, we proceed with a brief discussion of the main alternative methods that are actually used or which are conceivable as to the tax status of the corporation and of the latter's "underlying" shareholders. Fortunately, it appears possible to establish immediately some conclusions as to the degree of their compatibility with the schedular or global prototypes of income taxation. In the final section of this paper, we ascertain whether the circumstances in which business operates in the developing world entail some preference for one or another of the alternative schemes of taxing business profits.

II. ALTERNATIVES TO TAXING NET CORPORATE PROFITS

A. In general

It proves impossible to catalogue alternative corporate tax designs, or architectural styles, by reference to a single criterion. The alternatives depend on the answers given to the following "normative" questions:

(a) should the corporation be taxed at all on its profits? Could not the profits be apportioned over the shareholders and, accordingly, be imposed within the individual income tax?
(b) should the corporate form of business be treated taxwise in the same way as non-corporate bodies, or differently?
(c) should the corporate profits tax proper discriminate between retained and distributed earnings?
(d) even if the corporate profits tax exists formally, alongside the individual income tax, should dividends be taxed twice, i.e. first at the corporate level as a component of earnings, and afterwards as an item of the taxable income of individuals? Or should ways be devised to alleviate or to eliminate such "double taxation of dividends"?
(e) what is the concrete structural form and what is the rate structure at the corporate and at the personal level, and, if they are simultaneously levied, how do they interact?

The answers to these questions already prefigure the eight alternative systems now coming up for discussion. For each of those formulas, we intend to describe briefly the mechanics and their theoretical underpinnings. Without attempting a full survey, some important allocative, distributive and administrative implications are mentioned. We may illustrate a given formula by reference to actual "historical" systems and we give some indications about the geographical spread of that formula. In the process, some inferences in terms of the compatibility of that system with the schedular or global architecture of income taxation can already be drawn. One should add that, often, in actual practice, a given formula may be enacted in more than one variant.

B. The "enterprise" profits tax

In this system, all business units, irrespective of their legal form, are submitted to the same tax. In principle, the corporation, the partnership and the individual proprietorship are uniformly taxed on their net business profits. This is why we feel justified in calling this approach the "enterprise" profits tax.

Some major characteristics of this formula are obvious: there is no tax discrimination according to legal forms of business, and the corporate sector is not singled out for specific treatment. Also, the overall profits of the business units are assessed and no distinction is made between retained and distributed profits.

This type of tax, in its pure form, suits well the philosophy of schedular systems, in which not the legal form of the business but the nature of its activities and the factors of production employed is the major consideration. Business profits stem from the combination of labor and capital inputs. [2] The schedular tax focuses on the object of the tax or on the income produced. It does not primarily relate to the persons to whom the income flows.

It follows that, in strict schedular logic, once profits have been taxed at the business level, there is no need subsequently to reach income that is distributed. The (former) Italian "ricchezza mobile", for example heeded that principle. As dividends were already taxed as part of the overall profits of the corporation (in category B), they were not held taxable in category A, which covers income from capital.

Variants of and deviations from this pure schedular system are quite frequent. Thus, under the French schedular system, which existed from 1917 to 1948, the enterprise tax did not preclude the subsequent taxing of dividends in the hands of the shareholders, which was effected by way of a flat rate. Such a contaminated schedualr system resulted in so-called "economic double taxation of dividends" and re-introduced a differential treatment of corporate as against other forms of doing business. [3]

Other differentiations between types of business may occur. Thus, since 1951, the rates of the "ricchezza mobile" on corporate profits diverged from those on unincorporated units while individual proprietorships were eligible for personal deductions. In this connection, one should remember that historical schedular systems have not remained immune to personalizing devices, although the latter are structually incongruous. Once such personal elements are granted to individual persons, it makes sense to provide them equally for individual businesses. Another deviation, encountered in several Latin American schedular systems, concerns the rates employed: instead of a flat rate, a progressive rate

2. One difficult question concerns whether business receipts from movable or immovable capital must be taxed separately, in the appropriate schedule, or as part and parcel of overall profits. Practice appears to differ, but the second option makes for more simplicity. See *J. van Hoorn*, "Taxation of Business Organisations", *International Encyclopedia of Comparative Law*, Vol. XII. ch. 11 (The Hague/Paris 1972).
3. Within some mixed systems, in France and elsewhere, dividends have even been subjected to a triple tax as they were part of the overall income of well-to-do taxpayers, liable to the global complementary tax.

The Treatment of Enterprise Profits in Schedular and Global Frameworks of Income Taxation

by S.R.F. Plasschaert**

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I. INTRODUCTION

Apart from the individual or sole proprietorship in which the business coincides, legally and economically, with the owner, there are other forms of doing business in which a plurality of physical persons contribute equity capital to a business unit and pursue a common, profit-geared goal. Broadly speaking, company legislation distinguishes two legal forms of multiple-owner units, which are perhaps most appropriately characterized by the French expressions "sociétés de personnes" and "sociétés de capitaux". The partnership (French "la société en nom collectif") is the major representative of the first category; the partners remain liable, with all their personal property, for the debts incurred by the partnership.

In the corporation, or, in its British equivalent, the "limited liability company" (French; "société anonyme"), the owners or shareholders are committed only to the extent of their equity stake in the corporate body. In modern capitalism, the corporation has become the foremost legal vehicle for conducting business, and all large enterprises adopt that form. The corporation is also endowed with "legal personality"; in other words, the corporation can act in its own right and commit itself without the shareholders becoming directly involved. As regards the partnership, on the other hand, some countries grant it legal personality, others do not. [1]

The existence and the spread of multi-owner business units confront the tax legislator with an exceedingly complex web of problems, both substantive and technical. Statutory provisions vary considerably amongst countries, although some general trends can be identified. A voluminous amount of literature notwithstanding, several important issues have remained controversial; frequent shifts to other structural types of corporate taxes are not uncommon and suggest that no structural mould for corporate profit taxation has as yet been evolved that fully satisfies the criteria which public finance usually applies in assessing the comparative merits of various tax formulas. Those general yardsticks are (a) the allocation effects and, in the case of the corporate profit taxes under review, the impact on corporate financial structures and practices (such as the debt/equity and the dividend pay-out ratios); (b) the effects on the horizontal and vertical aspects of fairness in the inter-personal distribution of tax burdens; and (c) administrative feasibility.

Full treatment of the host of intricate tax issues which are raised by the operations of "collective" business units is not feasible within the compass of this article. Nor is it necessitated by our specific purpose, viz. to establish possible links between the respective schedular or global paradigms and alternative designs of corporate taxes. Accordingly, and in order to concentrate on the basic issues, we neglect some factors which would cause additional complexity. Thus:

— we onlv examine the tax status of the corporation, not of other legal forms of doing business, except where our subject matter, thus restricted, leads us to discuss the so-called "partnership approach";

— we assume that all shares issued by the corporation are held by domestic, individual shareholders. Hence, we do not delve into problems deriving from so-called inter-corporate dividends and with shareholdings by non-resident individual or corporate persons;

— there is no discussion about the proper way of defining the taxable base. The many problems related to the taxable base apply to all business units, irrespective of their legal form;

— we finally assume that the burden of any corporate profit taxes is borne by the owners of the corporate capital and is not shifted (either backwards into lower wages or forward into higher prices to consumers). While this traditional tenet has become subject to criticism, the opposite thesis has not been convincingly proven either.

* This paper forms part of a broader enquiry into the design and policy aspects of schedular, global and mixed systems of income taxation. Other parts of the study have been published in this *Bulletin* discussing "first principles" (1976/3), "the definition of gross taxable income" (1977/12), "the definition of statutory net income" (1978/5) and "the equity dimension" (1980/7).

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1. Whereas partnerships are legally independent in some countries (e.g. Belgium), but are not legal persons elsewhere (e.g. the Netherlands).

valid in the territory of the socio-political community in which they carry on their activities; or

(b) in cases where they are subject to tax in a socio-political community other than that in which they carry on their activities, they fail to provide the required information regarding their financial tax status to the competent tax authorities; or

(c) with respect to the amounts withheld by way of personal income from remuneration paid out to their employees, they calculate such amounts incorrectly or fail to submit payment thereof in due time.

(2) The physical person (individual) in the OAL or other legal entity who is responsible for any of the violations described in (1) above is subject to a fine of between 500 and 5,000 dinars.

(3) Citizens who fail to calculate, deduct, or submit payment of their taxes in accordance with applicable regulations, or who fail to do so in due time, may be subject to a fine of between 500 and 5,000 dinars.

(4) Competent authorities of a socio-political community who are responsible for and fail to fulfill the legal obligation to submit the excerpts from their taxation regulations for official publication are subject to a fine of between 500 and 5,000 dinars.

IV. CONCLUSION

Only recently have problems involving a double taxation in Yugoslavia begun to appear. Problems of international double taxation have become more numerous as Yugoslavia has expanded the extent of its international commercial relations. As in the case of most other countries. the Yugoslav approach towards resolving these problems has been the conclusion of Conventions for the Avoidance of Double Taxation. Problems of internal double taxation have become more widespread due to the recent trend towards greater decentralization of the Yugoslav political and economic systems. These problems have been dealt with by the enactment of relevant constitutional and legislative measures.

Double taxation problems in connection with juridical persons (i.e. legal entities) are much more prominent than those involving individual citizens. Although the measures enacted to date for the avoidance of double taxation may be sufficient as they apply to citizens, in many instances they have proved inadequate for dealing with such problems in connection with OALs and other legal entities. And if the current trends in the development and expansion of the nation's political and economic systems continue to follow the same course, there is no question that double taxation problems can only multiply and worsen. The Yugoslav authorities should not only recognize this situation, but should take the necessary steps to prevent it from becoming more complex.

is responsible for the payment of the tax debts of the partner leaving the country.

The two most important questions which arise in connection with the taxation of personal income are:

(i) To which socio-political community should the revenue from such taxes be paid?

(ii) According to the regulations of which socio-political community should such taxes be levied?

Due to the large number of citizens who reside, or whose families reside, in one socio-political community and work in another,[14] finding a suitable solution to these questions is a very significant aspect of the efforts to prevent the double taxation of citizens' income.

(2) The taxes levied against the income of foreign juridical persons (i.e. legal entities) must, as a rule, be paid according to the regulations of, and in favor of, the socio-political community in whose territory such income was realized. The taxes on the income of foreign physical persons (i.e. foreign citizens) must be paid according to the regulations of, and in favor of, the socio-political community in which such foreign citizen (temporarily) resides.

(3) The normal rule with respect to the taxation of personal income from agricultural activities is that such taxes must be paid according to the regulations of, and in favor of, the socio-political community in which the taxpayer resides. The logic underlying this rule is the fact that a large number of taxpayers in Yugoslavia own agricultural land both in the territory of the socio-political community in which they reside, and in the territory of another socio-political community. In exceptional cases, e.g. where a taxpayer owns agricultural land *only* in the territory of a socio-political community *other than* the one in which he resides, the taxes levied on income derived from agricultural activities engaged in such land must be paid to the socio-political community in which such land is situated.

(4) One major area which was not dealt with in Art. 266 of the 1974 Federal Constitution was the taxation of property and of the income from property. This problem was resolved in Art. 14 of the supplementary legislation,[15] which sets forth the following rules:

(a) Taxes on *immovable property* and related rights, on income from immovable property and related rights, and on the sale of immovable property and related rights must be paid according to the regulations of, and in favor of, the socio-political community in which such immovable property is located.

(b) Taxes on *movable property* and related rights, and on income from movable property and related rights, must be paid according to the regulations of, and in favor of, the socio-political community in which the taxpayer-owner of such movable property or related rights resides.

(5) Taxes levied against the income of Organizations of Associated Labor which engage in both economic and non-economic (e.g. hospitals, educational and cultural institutions, etc.) activities must be paid according to the regulations of, and in favor of, the socio-political community in which such activities are performed. Thus, for example, if an OAL located in Zagreb (Croatia) engages in activities in both Zagreb and Belgrade (Serbia), then the income attributable to such activities will be taxed according to the regulations of, and in favor of, the Republics of Croatia and Serbia, respectively.

The supplementary legislation dealing with double taxation problems also contains a number of rules concerning procedural requirements on the part of both the taxpayers and the tax authorities. For example, in specified situations taxpayers are obliged to provide the competent authorities with information regarding their residence or the residence of the families.

One very significant obligation assigned by the law to the tax authorities of the various socio-political communities is that they enter into compacts with their counterparts in other socio-political communities regarding the manner for announcing their respective taxation regulations. Such compacts are necessary in order that such information be easily accessible to authorities in one socio-political community who are required by virtue of the relevant Constitutional or legislative provisions to levy (i.e. assess, calculate and/or collect) taxes according to the regulations of another socio-political community. The law requires that such information be published in the Official Publications of each socio-political community, and that sufficient excepts of the regulations be included so as to enable the tax authorities of other socio-political communities to determine exactly matters in connection with the withholding and payment of taxes. The excerpts so published become effective in other socio-political communities 20 days from the date of their official publication.

E. Enforcement of the measures concerning internal double taxation

Enforcement of the measures concerning the avoidance of internal double taxation is regarded by the Yugoslav authorities as essential to maintaining the stability of the Yugoslav economy, as well as to preventing disputes between the various socio-political communities and to avoiding dissatisfaction and complaints on the part of the taxpayers involved. Consequently, very strict sanctions are imposed on taxpayers (i.e. both juridical and physical persons) who fail to comply with these measures. These sanctions are normally administered in the form of a fine, and can be summarized as follows:

(1) Juridical persons (i.e. OALs and other legal entities) are subject to a fine of between 5,000 and 50,000 dinars if:

(a) they fail to comply with the taxation regulations

14. This is often the case, for example, with respect to citizens employed by work organizations in the spheres of the building, tourism, and forestry industries.

15. Official Gazette of the Socialist Federal Republic of Yugoslavia, No. 33, Art. 14, July 23, 1976.

ated Labor and other Organizations of Associated Labor which are co-founders of that bank shall be taxed as the income of the recipients thereof in accordance with the regulations of, and in favor of, the socio-political communities to which the tax on the other income of such taxpayers must be paid (see rule (1) supra).

(3) Taxes levied on the personal incomes and revenues of workers and other citizens, with the exception of taxes on property and on income from property, shall be paid, in conformity with federal law, according to the regulations of, and in favor of, the socio-political communities in whose territory the workers or citizens concerned reside.

Similar rules to those set forth in Art. 266 of the Federal Constitution can also be found in the Constitutions of all of the Republics and autonomous Provinces, as follows:

(a) Art. 295 in the Constitution of the Republic of Bosnia — Herzegovina;
(b) Art. 41 in the Constitution of the Republic of Montenegro;
(c) Art. 83 in the Constitution of the Republic of Croatia;
(d) Art. 87 in the Constitution of the Republic of Macedonia; [9]
(e) Art. 111 in the Constitution of the Republic of Slovenia;
(f) Art. 100 in the Constitution of the Republic of Serbia;
(g) Art. 99 in the Constitution of the Autonomous Province of Kosovo; and
(h) Art. 98 in the Constitution of the Autonomous Province of Vojvodina.

D. Legislative measures

It soon became evident that the rules set forth in Art. 266 of the 1974 Federal Constitution, although they provided a basic foundation for the solution of internal double taxation problems, were not sufficient standing alone to prevent such problems. It was therefore necessary to supplement Art. 266 with the enactment of additional legislative measures containing more specific guidelines with respect to taxation matters involving a definite or potential risk of double taxation. Such a Federal law was passed in May 1975 [10] dealing with the regulation and solution of conflicts among the various Republican and Provincial tax authorities in connection with taxes, contributions and fees. It is interesting to note that this law was to be applied retroactively to any such conflicts which arose as from January 1, 1975. The provisions of this law were altered and supplemented one year later. [11] As they exist today, the principal components of this law can be summarized as follows:

(1) Taxes on the personal income of citizens (including income derived from working relations, e.g. wages, from agriculture, from economic and non-economic activities, from copyrights, etc.) must be paid according to the regulations of, and in favor of, the socio-political community in which the citizen resides. If a taxpayer changes his residence during the course of the tax year, he is regarded for purposes of that year's tax liability as having resided in the socio-political community in which he spent the greater part of the tax year. In cases where the residence of the citizen and that of his family (i.e. his spouse, parents and childresn, including adopted or legitimized children whom it is the citizen's legal responsibility to support) are not located in the same socio-political community, [12] then taxes must be paid according to the regulations of, and in favor of, the socio-political community in which the citizen's family resides. [13]
If a taxpayer moves abroad and does not settle his tax debts before leaving the country, the authorities are entitled to seize the taxpayer's property situated in Yugoslavia in payment of his debts. Should the taxpayer have donated his property to relatives, the latter are responsible for the payment of the taxpayer's tax debts. If the taxpayer — with a view to evading tax — sells his property to a third person, the latter will be responsible for the payment of the taxpayer's tax debts if the tax authorities are able to demonstrate that the purchaser knew about the taxpayer's intentions to evade tax. In case of partnerships it will be the partner staying in Yugoslavia who

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(a) first, to cover the bank's business (operating) costs;
(b) second, to finance the requirements (e.g. salary, etc.) of bank employees; and
(c) third, the remaining profit is pooled in the bank's funds and then distributed as common income to the bank members in proportion to their "contributions" towards the realization of such income.

The criteria used to determine what constitutes a "contribution" toward the realization of the bank's income are established in a separate agreement adopted by the bank members at the general assembly.

9. The Constitution of the Republic of Macedonia differs more widely from the Federal Constitution in respect of its provisions concerning double taxation than do the Constitutions of the other socio-political communities.

10. Official Gazette of the Socialist Federal Republic of Yugoslavia, No. 36, July 25, 1975.

11. Official Gazette of the Socialist Federal Republic of Yugoslavia No. 33, July 23, 1976.

12. These legislative provisions regarding the taxation of personal income differ from the rules which existed in this area during earlier periods in the development of Yugoslavia's tax systems. Previous methods utilized for the taxation of personal income (i.e. income from working relations, including salaries, wages, etc.), were:
(a) such taxes were paid in accordance with the regulations of, and in favor of, the socio-political community in which the taxpayer's employer (i.e. work organization) maintained its headquarters; or
(b) such taxes were paid in accordance with the regulations of, and in favor of, the socio-political community in which the taxpayer resided (without regard to the location of the residence of the taxpayer's family); or
(c) such taxes were paid in favor of the socio-political community in which the taxpayer's family resided, but according to the regulations of the socio-political community in which the taxpayer's employer (i.e. work organization) maintained its headquarters.

13. Such a situation might arise since, for personal income tax purposes, the citizen's residence is considered to be the socio-political community in which the citizen actually *lives*, regardless of where his family resides.

munities now have the voice of authority in this area.

Under this system, the only aspect of taxation which remains exclusively in the hands of the Federal authorities under the current Constitution is matters in connection with the collection of customs duties. In a purely legal sense, the sales tax also remains under exclusive control of the Federal authorities, since they are empowered to either regulate and administer the sales tax themselves, or to delegate this responsibility by Federal law to the Republics, autonomous Provinces, and Communes. And in practice the Federal authorities have elected to undertake such delegations, and the sales tax is now levied at three different levels: Federal, Republican (Provincial), and municipal.

B. The nature of the problem

Absent the enactment of any provisions to counter the effects of the expansion of fiscal sovereignty on the part of the Republics, the autonomous Provinces, and other socio-political communities, two basic types of problems might arise in the tax arena:

(1) It is possible, and even probable, that the tax measures and policies adhered to by the various socio-political communities would differ. Such differences might exist, for example, in the number of types of taxes imposed, the (juridical and physical) persons who are subject thereto, the manner in which these taxes are assessed and collected, the levels at which they are levied, etc. These differences, whether large or small, would most likely result in a variance in the level of the tax burden among the various socio-political communities. Such a lack of uniformity in the taxation system is open to charges of "discriminatory treatment of taxpayers".

(2) The lack of uniformity in the tax systems of the various socio-political communities also gives rise to double, and even multiple, taxation problems in the sense that, in the absence of any agreement to the contrary, the same taxpayer may be subject to tax on the same revenue or income in two or more socio-political communities.

C. Constitutional measures

The Yugoslav authorities have recognized the dangers inherent in the decentralization of the country's political and economic systems, and have taken a number of steps to circumvent these dangers. The two avenues they have followed to accomplish this end are: first, to include built-in safeguards within the constitution itself and, second, to supplement these safeguards, if required, with the passage of any relevant legislation (as discussed in Section D. infra). Constitutional provisions have thus been enacted which are aimed at avoiding each of the two basic problems discussed above.

In order to remedy the lack of uniformity in the tax systems and policies of the various socio-political communities and, in essence, to prevent the simultaneous existence of nine [7] different and poorly coordinated tax systems within the Federal Socialist Republic of Yugoslavia, Amendment XXVIII was added to the Constitution in June, 1971. This amendment introduces an obligation on the part of the Republics and autonomous Provinces, should it be necessary in order to ensure the unity and stability of the Yugoslav market, that they enter into common *compacts* among themselves concerning the coordination of their taxation systems and policies.

The thrust of this Amendment was incorporated into the body of the 1974 Constitution itself. Art. 265, Para 1 of the current Constitution states:

"The Republics and autonomous Provinces shall cooperate in the pursuit of tax policies and shall, by entering into compacts, formulate or alter the basic principles of their tax systems and policies whenever this is necessary in order to ensure the unity and stability of the Yugoslav market."

The second paragraph of the same Article goes on to state:

"In order to prevent and eliminate disruption in the market, Federal agnecies shall have the right and the duty to propose to the Republics and autonomous Provinces, in conformity with mutual compacts, that they: increase or decrease taxes and contributions fixed by the socio-political communities; temporarily postpone planned spending of a part of the revenue of the socio-political communities; and establish common foundations for the tax policies of the Republics and/or autonomous Provinces. Non-existence of compacts shall not prevent the Republics and autonomous Provinces from adopting regulations and other enactments in the area of their tax systems and policies within the framework of their rights and obligations."

These provisions represent an effort to curb any problems which might arise as a result of the lack of uniformity in or coordination of the tax systems of the individual socio-political communities. They do not, however, deal with the second basic problem, i.e. the possibilities of double taxation. In fact, the last sentence of Art. 265, Para. 2, indicates that the absence of compacts among the Republics and autonomous Provinces will not prevent them from independently establishing their own taxation systems and policies, which might ultimately result in double or even multiple taxation.

To prevent these possibilities of internal double taxation, Art. 266 of the 1974 Federal Constitution contains the following rules:

(1) Taxes imposed on the income of Basic Organizations of Associated Labor shall be paid according to the regulations of, and in favor of, the socio-political communities in whose territory such organizations regularly perform their acitivities.

(2) The resources which, as part of a bank's income, [8] are distributed among Basic Organizations of Associ-

7. Nine, i.e. including the Federal tax system, the tax systems of the six Republics, and those of the two autonomous Provinces.

8. Banks in Yugoslavia are founded (membered) by the various Organizations of Associated Labor, including those engaged in economic, as well as non-economic, activities. Income realized by the bank via the performance of its activities is allocated in the following way:

this convention was, however, limited to firms engaged in air and sea transport activities.

In 1967 and 1968 Yugoslavia concluded conventions for the avoidance of double taxtion with Norway and Denmark, respectively. The scope of application of these two conventions was limited to a small number of firms engaged in a limited number of specifically defined activities.

Yugoslavia's first, and to date only, comprehensive treaty for the avoidance of double taxation was concluded with France in 1974. [5] This convention is essentially patterned after the O.E.C.D. Model Tax Treaty. It applies to the taxation of the income and net worth of both physical and juridical persons.

Yugoslavia is currently engaged in negotiations for additional conventions for the avoidance of double taxation with a number of other countries, including Austria, Canada, Germany, the Netherlands and the United States. The Yugoslav authorities anticipate that these tax conventions will serve to accomplish not only their immediate purpose, i.e. the avoidance of international double taxation, but they will also facilitate the achievement of a number of other goals, including the stimulation, expansion, and elimination of barriers in connection with economic cooperation between Yugoslavia and other countries, as well as the decrease of Yugoslavia's balance of payments deficit.

III. AVOIDANCE OF INTERNAL DOUBLE TAXATION

A. The cause of the problem

Internal double taxation problems in Yugoslavia arise primarily as a result of the lack of uniformity and cooperation between legislators and the tax authorities in the various Republics and autonomous Provinces. The trends described above in Sections I.B. and C. towards greater decentralization of governmental authority and economic (enterprise) management and control began in 1968 with the adoption of the XVIth Amendment to the 1963 Constitution, and were carried even further with the enactment of the 1974 Constitution. These developments necessarily demanded a complete overhaul of Yugoslavia's political and economic systems, such that it is fair to say that the new Constitution wrought fundamental changes which, in turn, demanded a corresponding major reform of the country's taxation system.

Prior to 1968, internal double taxation problems were rarely encountered in Yugoslavia, either in theory or in practice. According to the 1963 Constitution (Art. 125), as well as under earlier Constitutions, rules governing the objects and types of taxes could only be established by Federal statute. The Republics and autonomous Provinces, as well as the lower territorial (local) authorities, had only limited taxation rights, which consisted primarily of the authority to grant certain tax exemptions and other facilities and, to a certain degree, the power to influence the establishment of tax rate levels.

Constitutional Amendment XVI of 1968 for the first time gave to the Republics and autonomous Provinces the right to decide, in conjunction with the Federal authorities, matters in connection with the objects and types of taxes (and other sources of budgetary revenues). Amendment XVI, Point 4 stipulates that "resources and types of revenue of *socio-political communities* [6] are established by law". Under the Yugoslav system of jurisprudence the enactment of laws falls under the joint authority of the Federal, Republican and Provincial governments.

This provision, therefore, represents the abandonment of the previous centralized and uniform system for the regulation of taxes in Yugoslavia, and its replacement by a system under which control over taxation methods and policies to be applied to the revenue of socio-political communities rests in the hands of the respective socio-political community. The amendment, however, reserved to the Federal government control over the taxation of the funds of the OALs, as well as the taxation of revenue derived from the trading of goods and rendering of services.

The fiscal sovereignty which was thus extended to the Republics and autonomous Provinces was not, however, put into practice until 1973. In that year, the majority of the independent Republics and autonomous Provinces passed their own laws regulating most of the types of income taxes levied against citizens.

The force of Amendment XVI was further expanded in the 1974 Federal Constitution. Article 264, Point 2, states: "*All kinds of revenue realized through the taxation of the sale of goods and services which are in commerce throughout the entire territory of the Socialist Federal Republic of Yugoslavia, as well as the manner and rates of this taxation, shall be defined by the Federal Statute, except for goods and services whose manner and rate of taxation are to be established by the lower socio-political communities under the authority of a federal statute*". This provision, as does Amendment XVI, dictates that the regulation of tax matters is to be shared between the Federal authorities and those of the lower socio-political communities. However, Art. 264 goes even further than Amendment XVI in the following two significant respects:

(1) The new Constitution grants to the lower socio-political communities authority not only to determine the nature of the revenue to be generated, but also the manner by which it is to be collected, and the rates to be applied.
(2) Art. 264 eliminates the express reservation of authority to the Federal government over the taxation of OAL funds, such that the socio-political com-

5. The Convention for the Avoidance of Double Taxation concluded between the Socialist Federal Republic of Yugoslavia and the Republic of France was signed with Protocol in Paris on March 28, 1974, and was ratified in Yugoslavia by the law of May 30, 1975. For the English text: see Supplementary Service to European Taxation, Sec. C.

6. Socio-political communities can best be described as the different levels of government existing throughout a nation. In Yugoslavia, these levels are, in order of importance, the authorities of the Republics and autonomous Provinces, the local (municipal) authorities, and the communal authorities.

Beginning in 1952, developments headed in the direction of the decentralization of governmental authority. Under the provisions of the 1974 Federal Constitution (which is still currently in force) the transfer of power from Federal to Republican and Provincial governmental bodies is virtually complete. Each of the Republics and Provinces is accorded far-reaching autonomy, which is exercised within a smaller-scale structural framework paralleling that found at the Federal level.

Thus, each Republic and Province has its own Assembly, its own Executive Council, and its own Presidency, as well as its own Constitution. The Federal State authorities and the Federal Constitution, although they still reign supreme in certain areas (e.g. international affairs, as well as for purposes of attaining national uniformity when the situation so demands, or in the event of an impasse between the various Republican and Provincial governments), have otherwise taken a "back seat" in the political arena and "left the driving" to the Republican and Provincial authorities.

The scope of authority extended to Republican and Provincial governmental bodies encompasses not only political and administrative matters, but also extends to the direction and control of economic, including financial and tax, developments within their respective territory. When formulating Republican (Provincial) legislation and policy, it is not surprising that the competent authorities are inclined to direct their efforts towards protecting the best interests of their own territory. This approach has logically led, albeit unintentionally, to conflicts among, infringements of, or mere lack of coordination between the legislation and policies adopted by the competent authorities in the individual Republics and Provinces, and taxation legislation and policies are no exception. In sum, the current structure of the Yugoslav government, based as it is primarily on the principle of decentralization of governmental authority, it is a significant factor underlying the recent appearance of internal double taxation problems in Yugoslavia.

C. The current structure of the Yugoslav economy

An analysis of the Yugoslav economy reveals that it too, as in the case of the country's political system, has developed in such a way as to provide an environment conducive to the creation of internal double taxation problems. The principle of decentralization which sets the scene in the political arena for the appearance of internal double taxation in Yugoslavia has its counterpart in the economic arena: the so-called "self-management" system. [3] Under the auspices of the self-management system, the bulk of authority in terms of economic (enterprise) regulation and control is placed in the hands of the working people. The scope of this authority extends beyond the mere management of production and other related activities, and encompasses the right to decide matters in connection with the generation, application and distribution of income, as well as a number of other rights.

This authority is exercised via the formation of "Organizations of Associated Labor (OALs)", [4] which can essentially be described as an association of workers who join together under the direction of a Workers' Council in order to manage and control economic (enterprise) activities for the purpose of realizing both their communal and individual socio-economic interests and requirements.

Outside of the strictly economic sphere, the working people are also granted authority with respect to the regulation of matters in the fields of education, science, culture, health, welfare, etc. This authority is exercised via the formation of so-called "self-managing communities of interest".

This movement away from centralized control of the economy and in the direction of widespread economic autonomy on the part of the various self-management groups may understandably result in a conflict of views when it comes to formulate economic policy. What is considered the "proper" policy by each group, and for that matter by each individual, will be a function of a number of different factors, viz. economic considerations (e.g. what branch of the economy is involved), individual situations (e.g. marital status, family size, etc.), geographic factors, etc.

II. AVOIDANCE OF INTERNATIONAL DOUBLE TAXATION

The most frequently encountered method utilized for the avoidance of international double taxation is the conclusion of bilateral or multilateral conventions for that purpose. Yugoslavia is not a party to any such multilateral conventions, but *has* concluded a number of bilateral conventions and is currently engaged in negotiations to this end with several other countries.

The first agreement concluded by Yugoslavia for the avoidance of international double taxation was the 1965 convention with Switzerland. The applicable scope of

3. 1974 Constitution, Article 9. See for an unofficial English translation of this article: Foreign Investment in Yugoslavia (1971), published by the Committee for Invisible Transactions of the OECD (Paris) at 57. Bogoev (note 1) at 204.

4. Organizations of Associated Labor in Yugoslavia can have one of three forms:

(i) A *Basic Organization of Associated Labor* is a component part of an Organization of Associated Labor (see (iii) infra) which constitutes a technological entity which is complete in itself and which is an independent and self-managing economic unit and which can have the character of an economic unit (it was formerly referred to as work unit or plant of independent departments in non-economic organizations);

(ii) A *Composite (Joint) Organization of Associated Labor* is a form of Organization of Associated Labor established through the merger of several Work Organizations of Associated Labor or Basic Organizations of Associated Labor operating within the Composite Organization of Associated Labor (for example: railways, postal and telecommunication services and other integrated entities);

(iii) An *Organization of Associated Labor* is a general term for those economic and non-economic organizations which carry on activities with socially owned resources and which are organized on a self-management basis. This kind of organization was formerly referred to as an "enterprise" (for the economic sector) and "institution" (for the non-economic sector).

Rules for the Avoidance of International and Internal Double Taxation in Yugoslavia

by Prof. Dr. Bozidar Jelčić*

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I. THE ROOTS OF THE PROBLEM

A. Identifying the problems

Until recently, Yugoslav literature, legislation and financial theory had not directed any particular emphasis towards problems in the area of double taxation. The basic reason for this lack of attention was that such problems have only recently begun to arise in Yugoslavia. This article will discuss the factors and developments which have caused the creation of double taxation problems in Yugoslavia, the nature and extent of such problems, and the measures that the Yugoslav authorities have undertaken in order to eliminate or control them.

As is the case in most other countries, double taxation problems in Yugoslavia can be divided into two major types: international double taxation and internal double taxation. International double taxation can be described as the taxation of the same taxpayer (whether a juridical or a physical person) with respect to the same income by two separate nations, in which the valid legislation of both nations grants them the right to levy such taxes. Internal double taxation, on the other hand, involves the taxation of the same taxpayer (whether a juridical or a physical person) with respect to the same income by two different competent administrations (governments) within the same country, in which the authority to levy such taxes is granted pursuant to valid domestic legislation.

An analysis of the first type of problem (i.e. international double taxation) tends to be rather straightforward and is essentially comparable to parallel situations in the majority of other countries. In other words, given the recent trend towards an increase in the level of commercial and economic relations between Yugoslavia and other nations, it naturally follows that such an increase is accompanied by a corresponding increase of problems in connection with international double taxation. The solution that Yugoslavia has employed to deal with these problems likewise parallels the traditional method, i.e. the conclusion of conventions for the avoidance of international double taxation. These conventions form the basis for the discussions in Sec. II below.

Not so easily summarized are those problems arising in the area of internal double taxation in Yugoslavia. In fact, owing to the unique structure of the Yugoslav political and economic systems, a discussion of such problems as they exist in Yugoslavia may even be more complex than in the context of most other countries. To really understand the cause, nature and impact of internal double taxation problems in Yugoslavia, one must first have a basic knowledge and understanding of the structure and operation of the Yugoslav governmental and economic systems, and the interrelationship they bear to the country's tax system. These background matters [1] are dealt with briefly in the remainder of this section. Sec. III below then deals specifically with the problems involved in the area of internal double taxation in Yugoslavia — why they have arisen, what they are like, and what is being done about them.

B. Structure of the Yugoslav Government

One look at the current structure of the Yugoslav government gives an immediate clue that problems of internal double taxation might easily be fostered under such a system. Yugoslavia is Socialist Federal Republic consisting of six independent Republics and two autonomous Provinces. [2] This form of government was first established in Yugoslavia in 1943; however, under this earlier version the bulk of governmental power was placed in the hands of the Federal authorities, the principal administrative organs being the Federal Assembly, the Federal Executive Council, and the Presidency.

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1. For a more detailed discussion of these matters see Bogoev, K., "Trends in Fiscal Federalism", BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, May 1977 at 201.

2. 1974 Federal Constitution of the Socialist Federal Republic of Yugoslavia (hereinafter "1974 Constitution"), Article 1.

APPENDIX III

Summary of tax changes and tax concessions

A. TAX CHANGES

1. Domestic and international passenger service changes — Airport tax will be raised to S$5/- and S$12/- for domestic and international flights from S$4/- and S$10/- respectively w.e.f. 1.4.81.

2. Duty on bets — Duty on bets will be raised from 10 percent to 15 percent w.e.f. 1.4.81.

3. Entertainments duty — W.e.f. 1.4.81 entertainment duties for cinemas, amusement parks, trade fairs and exhibitions will be at ad valorem rate of 35 percent against an average of 34.2 percent; and the present graduated duty rates for open-air cinemas and liveshows replaced by ad valorem duties of 15 percent and 25 percent respectively.
The present two lower admission classes of cinemas will be merged.

4. Duties on petrol — Duties on premium and regular petrol will be replaced by an ad valorem duty of 40 percent, based on pump prices. (New duty will be implemented after the Customs Act has been suitably amended).
New prices for premium are expected to be S$1.20 per litre (up from S$1.08) and for regular S$1.09 (up from S$1.00).

B. TAX CONCESSIONS

1. Separate assessment on unearned incomes of married women — Married women with unearned incomes derived from their own earned incomes in the past will be asssessed separately w.e.f. Year of assessment 1982.

2. Relief for disabled persons — Earned income relief for handicapped persons is increased from S$1,000/- to S$2,000/- w.e.f. Year of assessment 1982.

3. Personal income tax —
   i. Every resident taxpayer will be granted a tax rebate of 10 percent on his total income tax liability for the Year of assessment 1981.
   ii. For Year of assessment 1982, the personal income tax rates will be reduced by an average 13 percent.
   (See Appendix II and also the table showing old and new rates compared)

4. Estate duty — The exemption ceiling for estate duty on residential properties is increased from S$200,000/- to S$600,000/- w.e.f. 1.1.81.

Singapore personal income tax Old & new rates compared

	Y/A '80–'81		Y/A '82 onwards	
Chargeable income $	*New rate %*	*Tax payable $*	*New rate %*	*Tax payable $*
On the first 2,500	4	100	4	100
On the next 2,500	7	175	4	100
On the first 5,000		275		200
On the next 2,500	9	225	7	175
On the first 7,500		500		375
On the next 2,500	11	275	9	225
On the first 10,000		775		600
On the next 5,000	14	700	12	600
On the first 15,000		1,475		1,200
On the next 5,000	17	850	14	700
On the first 20,000		2,325		1,900
On the next 5,000	21	1,050	17	850
On the first 25,000		3,375		2,750
On the next 10,000	26	2,600	21	2,100
On the first 35,000		5,975		4,850
On the next 15,000	32	4,800	25	3,750
On the first 50,000		10,775		8,600
On the next 25,000	34	8,500	30	7,500
On the first 75,000		19,275		16,100
On the next 25,000	36	9,000	32	8,000
On the first 100,000		28,275		24,100
On the next 100,000	40	40,000	35	35,000
On the first 200,000		68,275		59,100
On the next 200,000	45	90,000	40	80,000
On the first 400,000		158,275		139,100
On the next 200,000	50	100,000	43	86,000
On the first 600,000		258,275		225,100
On the next 750,000	55		45	

land, and maintain desirable levels of intensity. For major projects such as the MRT, Marina City, Raffles City, Pulau Ubin and Pulau Tekong projects, and sizeable reclamation, the economic agencies should be fully involved in the planning decision. The Ministry of National Development must work in close collaboration with the JTC to ensure adequate allocation and development of land and physical resources for industrial development. Whilst industry will continue to be the catalyst for Singapore's economic growth, our future appears brighter as a services and information centre.

APPENDIX II

Individual income tax reduction under revised rates schedule from year of assessment 1982

Chargeable income group $	*Existing rates* $	*Revised rates* $	*Average tax paid* $	*Average reduction in tax* $	$	*Effective tax rate at end points* *Existing* $	*Revised* $
1 - 2,500	4	4	45	–	–	4.0	4.0
2,501 - 5,000	7	4	178	33	18.5	5.5	4.0
5,001 - 7,500	9	7	377	98	25.9	6.7	5.0
7,501 - 10,000	11	9	629	148	23.6	7.8	6.0
10,001 - 15,000	14	12	1,086	219	20.2	9.8	8.0
15,001 - 20,000	17	14	1,859	342	18.4	11.6	9.5
20,001 - 25,000	21	17	2,817	517	18.4	13.5	11.0
25,001 - 35,000	26	21	4,545	846	18.6	17.1	13.9
35,001 - 50,000	32	25	8,112	1,584	19.5	21.6	17.2
50,001 - 75,000	34	30	14,919	2,652	17.8	25.7	21.5
75,001 - 100,000	36	32	24,593	3,750	15.3	28.3	24.1
100,001 - 200,000	40	35	41,194	5,765	14.0	34.1	29.6
200,001 - 400,000	45	40	92,875	11,893	12.8	39.6	34.8
400,001 - 600,000	50	43	193,561	24,198	12.5	43.0	37.5
600,001 - 750,000	55	43	300,097	44,508	14.8	45.4	38.6
> 750,000	55	45	652,714	117,067	17.9	–	–

SCHEDULE

Distribution of tax burden in 1980

Chargeable income group %	*Taxpayers* *Percentage distribution* %	*Cumulative distribution* %	*Tax assessed* *Percentage distribution* %	*Cumulative distribution* %
1 - 2,500	37.2	37.2	1.4	1.4
2,501 - 5,000	24.1	61.3	3.7	5.1
5,001 - 7,500	12.3	73.6	4.0	9.1
7,501 - 10,000	7.1	80.7	3.8	12.9
10,001 - 15,000	7.3	88.0	6.8	19.7
15,001 - 20,000	3.6	91.6	5.8	25.5
20,001 - 25,000	2.1	93.7	5.0	30.5
25,001 - 35,000	2.5	96.2	9.6	40.1
35,001 - 50,000	1.7	97.9	11.5	51.6
50,001 - 75,000	1.3	99.2	16.4	68.0
75,001 - 100,000	0.3	99.5	7.2	75.2
100,001 - 200,000	0.4	99.9	15.8	91.0
200,001 - 400,000			6.1	97.1
400,000 - 600,000	0.1	100.0	1.5	98.6
600,001 - 750,000			0.7	99.3
> 750,000			0.7	100.0

One of the most effective ways to get more women to work is to site factories in or close to HDB housing estates. HDB should allocate more land in housing estates for the clean industries which should have higher priority over backyard factories. The Ministry of Social Affairs should implement promptly and cost-effectively the recommendations of the Study Team which was formed to examine ways and means to retain female workers in the workforce. These recommendations cover child-care facilities, leave for child-care, retraining scheme, part-time employment and income tax incentives.

56. Our retirement age is lower than many industrialised countries facing labour shortages and ageing population. Labour force surveys show that our workers begin to stop working after 50-55 years old, perhaps because of contractual forced retirement, reluctance of employers to continue employing older workers at senior levels of salaries or wages, or unwillingness of retired workers to want to continue working. As life-expectancy in Singapore has increased significantly, "premature" retirement is an economic waste. Our labour-short economy needs every worker still capable of productive work, especially when they have long experience in specialised skills. That their productivity may not be as high as when they were at their prime can be reflected in adjusted salary or wage rates for the older workers. Moreover, where "prematurely" retired workers tend to degenerate physically, Government will have to spend more for their social and health needs. The Government will encourage employers to retain retired workers and the retired workers to continue working through concessions on reduced CPF contributions of the over-60's. Regular retraining of workers before retirement could solve the problem of technological or skill obsolesence in retired workers. We may need to modify tax policies, besides graduated reductions of CPF contributions for workers over 60 years.

P. Finance

57. As we must upgrade and restructure our economy, we should divert less funds from and make available more liquidity for the private sector. We must capitalise on our comparative economic advantage of a strong financial position to maximise our growth potential. This can be done by liberalising our tax policy (eg reducing income tax rates and allowing more generous depreciation allowances for capital equipment) and reviving the role of the State as an entrepreneur to pioneer and stimulate investments in new industries and brain services.

58. Other tax proposals are: revised depreciation schedule to encourage automation and mechanisation and accelerated depreciation for computers and research and development equipment, tax incentives to promote research and development, removing or reducing certain stamp duties which impede economic growth, and incentives to promote offshore leasing.

59. When we started our industrialisation, the Government had to act as the pioneer or leader by investing in or providing loans to industries, as manufacturing was a new and untested field. Moreover, it paid lower returns than entrepot trade. Businessmen were therefore reluctant to invest alone, if at all. As we want to restructure and upgrade our economy quickly, the state must resume its role as an entrepreneur, not to supplant private enterprise but to encourage and assist entrepreneurs to venture their capital on new machinery with labour saving devices.

Q. Research and Development

60. Singapore has identified specific areas of promising industrial upgrading and our R&D policy should reflect this perspective. Without experience in the field of R&D, we should adopt a pragmatic approach to R&D planning, guided by the experience of those who have pioneered R&D in other developing countries, mainly the governments and the multinationals who have established R&D facilities in South Korea, Taiwan and other such rapidly industrialising countries.

61. Trained R&D manpower (engineers, scientists and technicians) is the critical factor. The best way to train R&D manpower is by immersion in R&D environment. We should expand and improve our higher engineering education, build a good research tradition in the University as well as nurture a pool of R&D workers, managers and leaders.

62. Besides offering fiscal incentives for companies undertaking R&D, Government must also invest in supporting R&D infrastructure. While we should preferably rely on private initiative, some Government funding in public research is necessary to stimulate private research. The question is how to decide on the minimum amount of Government funds needed to produce the right conditions for private industries to undertake R&D. The following measures are being examined:

a. Developing a Science and Technology Park adjacent to the Kent Ridge University to stimulate university-industry interaction;
b. Developing a Competence Laboratory in Material Science in SISIR. A knowledge of materials is a prerequisite for manufacturing. This laboratory will be aimed at servicing industries' needs, such as in the choice of technology, testing of manufacturers' claims and other extension services;
c. Developing the Engineering Development Division of the Applied Research Corporation as a resource centre for the application of microprocessor technology;
d. Setting up our own patent office to enable patents to be directly registered as it will be a great source of technical information for industries; and
e. Developing a suitable course in Tool, Die and Mould Design at the Singapore Polytechnic involving collaboration with private companies which will provide the necessary on-the-job training.

R. Energy

63. We have become more efficient in the use of energy as indicated by the decline in the energy-growth ratio from 1.74 in 1976 to 1.45 in 1977 and 1.37 in 1978. However our ratio is still high compared with Japan and EEC countries' ratio of between 0.8-0.9 for 1978. The uncertainty over supply, together with the preference of oil producers to hold back output, will lead to rising oil prices in the Eighties. We must ensure that our economic growth is not disrupted by energy shortages. At the same time, we must reduce our energy-growth ratio. We must encourage interest in, discussion on, and dissemination of energy-saving methods found effective in industry, office, shopping centres and hotels. We shall use a combination of inducements and punitive measures to conserve energy. Tax incentives will encourage and speed up investment in newer energy-efficient equipment to replace older energy inefficient machines, just as SIA has found it economic to sell off older aircraft which were fuel guzzlers and to buy new aircraft with fuel efficient engines. Fuel economy standards should be set to encourage use of smaller cars. Taxes will be used to encourage the use of fuel efficient cars. Improved public transport system should slow down the growth rate of car owners. As the implementation of energy policies falls under various industries, an Energy Coordination Committee has been formed to ensure consistency in our energy policies. The Ministry of Trade and Industry has set up an Energy Unit to coordinate conservation policies and to deal with energy-related matters.

64. Every consumer must pay the world market price of oil. Only when domestic energy prices reflect world prices can we be assured of adequate supplies. We are trying to procure oil through more stable sources such as Government-to-Government purchases in case oil supplies through the oil companies are disrupted for political reasons. We are also diversifying our sources of crude oil. In addition, we must explore other ways of generating energy rather than rely solely on oil. In Singapore, coal is the most feasible alternative to oil for generating electricity.

S. Land

65. Land in Singapore is scarce and cannot be increased by further reclamation except at great cost. There should be optimal utilisation of land not only to improve the social well-being of the people but also to achieve economic growth. We must therefore ensure that guidelines for the allocation of land are clear and consistent with the prevailing economic and social objectives.

66. Government must continue to direct, guide, coordinate and control all physical development activities in Singapore to ensure compatible and optimal usage of

service will be reviewed and adjusted regularly.

43. We must have good quality medical facilities to sell our services. Tax incentives should be considered for investment in private hospitals and in medical equipment.

44. We can promote our medical services through greater publicity of our services and facilities, holding of medical conventions, and publicising locally developed R&D work in medicine.

N. Construction consultancy services

45. During the last ten years our construction industry has built up substantial expertise and capacity. Potential markets for exports of construction consultancy services exist in neighbouring countries: the Middle East, Sri Lanka and Pacific economies. Our reputation and record in development and urban renewal are strong credentials for our construction expertise in planning and construction. We must do the following: build up track records of our local firms; modernise our construction industry by integrating the professionals with the contractors; provide financial and tax incentives to local construction firms exporting their services overseas; and beef up INDECO.

46. A 5 percent preferential margin has been given to local contractors in Government tenders to help them to get track records to sell their services overseas. Where local firms do not have the capacity or expertise, joint ventures with less than 50 percent foreign participation will also enjoy the concession pro-rated according to the local equity share. Other incentive measures include vertical integration by professionals and contracting firms, tax incentives and financial assistance through performance bond guarantee facilities.

47. The Ministry of National Development plans to beef up INDECO. The plan includes the restructuring of INDECO's capital diversification of projects, setting of export revenue targets, manpower deployment, and pooling of public sector expertise.

O. Resources for growth

(a) Manpower

48. The critical resource that we need to achieve high growth in the Eighties is the supply of skilled, technical and professional manpower. We need many more engineers, graduates, technicians and skilled workers, to achieve economic upgrading and restructuring. We will develop the full potential of our Talent Pyramid to maximise our manpower contribution to our restructuring.

(b) Forecast of demand[1] and supply of professional, technical and skilled manpower 1979—1990 (annual average)

	Real GDP Growth: 8% Productivity Growth: 5—7%		Real GDP Growth: 10% Productivity Growth: 7—8%	
	1979—80	1981—90	1979—80	1981—90
Engineers				
— Demand	590	770	620	820
— Planned output	350	420	350	420
— Shortfall	240	350	270	400
— Required enrolment	1,090	1,410	1,140	1,530
Other graduates				
— Demand	2,600	2,930	2,780	3,150
— Planned output	2,330	2,100	2,330	2,100
— Shortfall	270	830	450	1,050
— Required enrolment	2,950	3,290	3,130	3,630
Technicians				
— Demand	2,630	3,560	2,850	3,850
— Planned output	2,170	2,940	2,170	2,940
— Shortfall	460	620	680	910
— Required enrolment	4,430	5,300	4,770	5,960
Skilled workers				
— Demand	7,640	11,190	8,160	12,060
— Planned output	4,470	10,080	4,470	10,080
— Shortfall	3,170	1,110	3,690	1,980
— Required enrolment	15,160	21,545	16,080	23,630

1. Projections include requirements for new services, viz promotion of R&D activities, medical services and computer services.

49. More students must make it to the higher ranges of education in the Eighties by increased intakes and offering second chances to those who fail their entrance, and by part-time and full-time programmes for those already in employment. Only thus can we catch up with the backlog of earlier years, as well as meet the larger demands for professional and technical manpower. Failure to do this will undermine our efforts to upgrade and restructure our economy, unless we allow freer immigration of high level professional and technical manpower.

50. We must maintain standards of higher education and the quality of graduates, whilst we widen the range of courses to suit students of varying inclination and ability. Those who reach top grades must be measured against the graduates of the best universities in Britain like Oxford and Cambridge. We must, however, have a larger base of graduates to drive our economy forward in the Eighties and beyond, and to do this our general degrees pass students must be given second chances to make it.

51. Training of skilled workers must also be stepped up. Besides expanding the industrial training institutions, we should encourage employers to use the Skills Development Fund to upgrade and retrain the skills of their workers. We should also encourage and provide for continuous retraining of managers and workers to upgrade their skills because of the faster changes in technology in our upgrading economy.

52. The Council on Professional and Technical Education had deliberated on the issues and examined the need for trained manpower to support our economic restructuring programme. Its recommendations have been adopted by the Government.

53. University education provides only the basic training of professionals. They will need work and commercial experience and exposure to competition to sharpen their skills. They must also measure up to international standards of professional competence if we were to achieve the objective of developing Singapore as a centre of higher technology manufacturing and brain services. Protectionist and close-shop practices of professional cartels will discourage overseas talents from coming to Singapore and therefore deprive us of a necessary source of better and changing technology. Such practices make our professionals complacent and lethargic: they lead to inbreeding and the exclusion of fresh ideas. As they are protected from the pressure of competition, the best in a person is never brought out.

54. We must remove close-shop practices by liberalising registration requirements. The authority to decide on application for registration should not be with the professional bodies. These professional bodies must bear the onus of justifying their recommendation to reject an application.

55. We can also optimise our scarce manpower by encouraging more women and "prematurely" retired persons to work.

H. Trade

25. In the Eighties, we will export more higher value added and technology goods. The Multinational Corporations (MNCs) can export such products successfully. By successfully promoting the better industries, we will have achieved our export target. Trade development is therefore dependent on our industrial development.

26. The Department of Trade should continue to assist the better local manufacturers to develop their export markets to upgrade their operations. It can provide supporting services without interfering with our liberal trade policy. The Trade Development Section in the Department of Trade will carry out this task. Annual export targets for regions and priority markets will be set. Its operational plan should be reviewed and improved annually.

27. We will expand the re-export and transshipment of non-traditonal products. Local manufacturers and traders will be encouraged to make more use of trading houses or to group together to form larger trading companies. We will encourage trading companies to venture into international marketing and to develop Singapore as a major warehousing and distribution centre. Incentive schemes should be modified where appropriate to encourage local traders to form larger companies and venture into new areas of trade.

28. In domestic trade, the Department of Trade will pursue the twin objectives of security of essential supplies and stability in their prices. We will maintain our open trading policy to obtain essential supplies from the most economical sources. We will encourage more competition and educate consumers. We will continue to attack profiteering and cartel practices by trade associations.

29. Trade documentation procedures will be continually simplified. The processing of export and import declarations and the collection and compilation of trade statistics will be computerised where appropriate.

I. Tourism

30. World tourism will continue to grow. We should target for 12 percent growth in tourists to induce more hotels. More hotels will keep room rates competitive and induce hoteliers to employ staff more efficiently. New hotels with better design can lower staff-room ratio. We must encourage tourists to stay longer and spend more. We must promote high yield traffic such as conventions, exhibitions and trade fairs. We should develop Singapore as a tourist junction like London for tourists to the region.

J. Transport and communications

31. The transport and communications sector grew rapidly in the Seventies to become the third largest sector (share of GDP — 1970: 12 percent; 1979: 18 percent). This was due to the high growth of air, sea and telecommunication services. For the Eighties, the sector must continue to perform well if we are not to lose out as a major communications centre.

32. The targets set by the Ministry of Communications for sea, air and telecommunication services for the Eighties appear low when compared with the achievements in the Seventies. MinCom should review the targets regularly. Such services must continue to be one of our growth pillars. Moreover, they provide essential services on which the growth of other sectors will depend. We must not lower our economic ambition, especially after we have sunk in the large investments in the port, airport and telecommunication exchanges and equipment.

K. Computer services

33. The computer services industry is desirable for Singapore because it is knowledge-intensive and non-polluting and requires less manpower and energy. Computers can raise the technology and productivity of other sectors. We have the following advantages to develop computer services: a growing domestic and Asian market; many of our young people are literate in English and Mandarin and are numerate; good infrastructure, especially telecommunications; and strategic location.

34. We must step up computer manpower training. Students in our schools, Polytechnic and universities should have easier access to computers. To step up computerisation and develop a computer software industry, we must train more programmers and system analysts (we will need 5,800 senior staff by 1990). National University of Singapore should expand and upgrade its Computer Science Course, and EDB should proceed with plans to establish computer training centres. We should give training grants and scholarships through the Skills Development Fund to encourage companies to send their staff for training in computer software.

35. We must stimulate computerisation in the public and private sectors. To encourage more use of computers, the Ministry of Finance has allowed accelerated depreciation on computers and peripheral equipment for all sectors of the economy. Computerisation of public administration should be accelerated. The Ministry of Finance should organise and implement a programme to computerise the Government administration.

36. We must attract internationally reputable software companies by intensive promotion and through tax incentives. Beside granting the International Consultancy Services Incentives, we should consider giving a 10 percent concessionary tax rate for more desirable projects and pioneer status for highly sophisticated software industries.

37. A high level Committee, chaired by Dr. Tony Tan, the Minister of Education, has been formed to lead, plan, implement and coordinate policies on computerisation, computer manpower training and the growth of the computer services industry. Its report on the development of computer services has been adopted by the Government.

L. Financial services

38. We should further expand financial services as we have laid the foundation in the Seventies. We must develop Singapore as a "financial supermarket", offering the widest range of financial services. We should continue to sharpen our competitiveness, through higher productivity.

39. Insurance services should be aggressively promoted especially "non-traditional" services such as specialised risks and offshore business. We should adopt a more liberal policy to admit new insurance companies.

40. We should develop Singapore as a regional fund management centre. We should liberally allow reputable international and regional companies to list in the Singapore Stock Exchange and the trading of securities of companies not listed in Singapore. In addition, we should promote the development of the Singapore Gold Market as well as other promising markets, such as currency futures.

M. Medical services

41. We have not been realising the potential of selling high skill and high value-added medical services despite having the best medical facilities in the region. There were no concerted efforts to promote such services as a growth area. The potential of developing Singapore as a regional medical centre exists because there is a large catchment of patients in the region and in our tourist and expatriate population. We should therefore develop Singapore as the Medical Centre of the region by selling high skill and high value-added medical services. This can be achieved without sacrificing standards of health services for our own people. Indeed, specialist skills in Singapore will increase in standards and widen in range of specialisation with spin-off effects on our Government or University specialists, and medical students.

42. We msut train more doctors. University enrolment must increase. More specialists should be trained by sending our doctors for postgraduate training. The success of a medical centre, in large measure, depends on the reputation of the foreign doctors we can attract to Singapore. We must allow more foreign doctors to practise here. Our medical registry should be opened to foreign doctors with recognised qualifications without demanding reciprocity. The problem of Government doctors leaving for the private sector should be solved by increasing the output of doctors and correcting the unattractive pay in the Government service. Doctors leaving for the private sector are not net losses to Singapore. So long as the best are ready to pass on their knowledge and expertise to younger doctors training to be specialists, they can be given use of Government and University hospital equipment, supporting medical staff and beds in return for training postgraduate and undergraduate students as consultants and visiting professors. For those who remain in the public sector, terms and conditions of

b. Attract foreign investment and technology; we cannot reserve nor demarcate areas for local businesses nor compel foreign companies to combine with local companies.
c. Attract professional, technical and industrial skills and talents from overseas to lead us into higher growth and new businesses; we cannot adopt close-shop practices to protect the interest of local professionals at the expense of the wider economic interests.

9. We must continue to diversify our economy to achieve the economic security objective as well as to make our economy more competitive both within and in the export market. We must diversify:

a. Our economic activities; e.g. many international integration pyramids rather than few national integration pyramids in manufacturing; new brain services: computer, medical, consultancy and warehousing services.
b. Our markets: to get around the problem of protectionism and to expand our export to developing countries.

C. Scenarios in the eighties

10. The Plan takes into account both domestic and external factors in the eighties.

11. The domestic factors are as follows:

a. Domestic labour supply will grow more slowly in the eighties (32,000 now; 24,000 yearly in 1981—85; 16,000 yearly in 1986—90).
b. Rising expectations for better wages, which we can afford to pay only if we can create many higher skilled jobs. Expectations for better housing, recreational facilities and more comfortable living standards which can be realised only if they get much higher income from better paying jobs. We must respond by stepping up training and creating skilled jobs to realise the full potential of our people who will earn their living by marketing their skills, brains and talents.
c. We do not have a strong base of local entrepreneurs and will therefore have to continue to depend on foreign investment for skills, technology and market.
d. With inflation and rising incomes and the growing importance of the middle-income groups, our income tax rates will become over-progressive and discourage the more enterprising from exerting more effort and saving and investing more.

12. The external factors which will affect us in the eighties are as follows:

a. The slower growth of the industrialised countries in the eighties will prevent us from achieving high growth only if we do not upgrade and restructure our economy. It only means that to achieve high growth, we have to sharpen our competitive edge to get a bigger share of the world market. We must export higher skilled products. Some developed countries will adjust to the slower growth by protecting their labour-intensive industries. Others will restructure their economies from medium to higher technology industries. We can attract the medium technology industries only if we step up training.
b. Oil prices will continue to rise in the eighties. The impact will not be disastrous for the world economy, as it has adjusted well to the quantum jump in 1973/74. Alternative energy sources will become viable as oil prices increase. Only if we upgrade can we afford to pay for higher energy costs.
c. We face keener competition from South Korea, Taiwan, Hong Kong, and unless we restructure our economy we will face graver pressure in labour intensive products from other developing countries with abundant labour, especially China. On the other hand, as these developing countries expand and diversify their economies, they will import higher technology products which we may help to supply.

D. Targets

13. We must aim to achieve the following broad economic targets:
a. Real GDP growth of 8-10 percent per annum to reach present Japanese per capita GNP by 1990.
b. Productivity increase of 6-8 percent per annum.
c. Full and better paid, higher skill employment.
d. Lower than world inflation.
e. Healthy balance of payment.

E. Strategies

14. We shall upgrade and restructure our economy to achieve higher skill and value-added manufacturing and services. We will then realise the full economic potential of our people. We will also be in a stronger position to pay for higher oil prices, overcome protectionism and remain competitive in the export markets.

15. We must first break the vicious circle of low wages sustaining too labour-intensive activities, which lead in turn to poor productivity growth, an overtight labour market and slower economic growth. Corrective wage increases over 3 years will force employers to save labour. Underemployed labour will be released for more productive employment in the better industries and services. After the transition period of 3 years of corrective wages to untighten the labour market and bring it back to normal, we must continue to have market-oriented wage increases.

16. Wage increase alone is not enough to achieve economic restructuring. We must step up training at the universities, technical and industrial training institutions. We must also provide tax incentives to encourage automation, mechanisation and research and development.

F. Pillars of growth in the eighties

17. The achievement of our plan objectives, targets and strategies will depend on the following growth pillars:

a. Manufacturing
b. Trade
c. Tourism
d. Transport and communications
e. Brain services: computer, financial, medical and consultancy services.

G. Manufacturing

18. We shall transform the manufacturing sector into a more dynamic prime mover for high and sustained rates of economic growth. It will set the pace for high productivity increases in other sectors and provide better-paying jobs for our workers and more opportunities for our local entrepreneurs to participate in better industries.

19. As a prime mover, manufacturing must increase its share of GDP from 23 percent now to 31 percent by 1990. Its value-added should increase by 11 to 13 percent annually. Value-added per worker must catch up with other higher value-added sectors, to attract skills to industry.

20. We must manufacture more parts and components and assemble less end products. Parts and components are less visible than end products and are less prone to protectionism.

21. We should expand industrial servicing such as maintenance of sophisticated industrial and agricultural machines, aircraft, etc. We must exploit our strategic location at the centre of international waterways and air-routes by developing more sophisticated services for vessels and aircraft. There is a large market for other types of industrial services.

22. Our local manufacturers who cannot pay the market wages will relocate to other countries. As raw materials and semi-manufactures are key inputs for our future industries, we must encourage these manufacturers to process raw materials and manufacture simple components in relevant countries by exempting their remitted profits from our income tax. Our industries can concentrate on the higher value-added production, using these materials and components. On the other hand, we can export our higher value-added parts and components for assembly in the other countries.

23. We must improve and expand our supporting industries to link up with the higher value-added industries. Our local entrepreneurs should be encouraged to invest in these supporting industries, which do not require much capital and can find ready market in the Multinational Corporations (MNCs) operating in Singapore. However, they must be upgraded to provide reliable and precision parts and services. The Government can assist them with loans and incentives.

24. Our industries will require more land as they become more capital intensive. On the other hand, the large claims for land for social and recreational purposes will continue unabated. The Ministry of National Development must accord higher priority to industrial land and set aside more land in or near housing estates for the clean and higher value-added industries.

plant and machinery, equipment and other assets, rationalisation of stamp duties, investment allowances and incentives to encourage research and development. Individuals are encouraged to excel through periodical adjustment of the income tax rates to take into account inflation and growth in the economy. Singapore belongs to all Singaporeans. It is our niche in the world. The people face difficult times. It is an uncertain world. There is disharmony between the superpowers. The political equilibrium in the world is precarious. The people must be prepared for the worst but the worst must hold no fear for the people. Recession, unemployment, higher oil prices, protectionism, regional conflict, security threats, international turbulence — they threaten livelihood. The people cannot avoid getting wet in bad weather, but if they have made adequate preparations, they can put their raincoats on, and when they get indoors, change into dry clothes."

APPENDIX I

Highlights of "Singapore's economic development plan for the eighties"

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A. Stock-taking of achievements and shortfalls in the seventies

1. Growth in the Seventies was slightly higher than in the Sixties (Real GDP growth — Sixties: 8.7 percent; Seventies: 9.4 percent). However, the first half of the Sixties was a period of slow growth (5.5 percent) because economic activities were predominantly traditional, with low growth potential. Foreign investment in manufacturing was negligible. In the second half of the Sixties, after our independence, growth accelerated (12.9 percent).

2. Double-digit growth rates continued into the Seventies until the oil crisis and world recession of 1974-76 interrupted the Economic Strategy Programme. Economic upgrading slowed down as we shifted to economic activation to get as many jobs as possible. We became less selective of the industries we wanted to promote. We lowered our economic ambition and resigned ourselves to a lower growth target of 6-8 percent. On the growth momentum built up in 1966-73, our economy managed to weather the recession sooner and faster than we expected. (Growth rates exceeded target in 1978: 8.6 percent, 1979: 9.3 percent, 1980: 10.2 percent). Moreover, with the advantage of a headstart in export-oriented industrialisation, we did not feel the pressure of competition from labour-abundant developing countries.

3. On hindsight, we were overcautious in our response to the oil crisis and the world recession. We were content with merely reacting to events, and not responding enough to the challenges and opportunities ahead. It was understandable that the popular wisdom was one of caution and resigned acceptance of slower growth, as the four-fold oil price increase was a traumatic experience. However, South Korea, Taiwan and Hong Kong pressed ahead with high growth. Their real GDP per capita growth after the oil crisis (8.0 percent) was higher than before (6.6 percent). Before the oil crisis, our growth (11.4 percent) was higher than theirs. After that, it was lower (6.0 percent). Their businessmen were compelled to be more efficient to survive the world recession, protectionism and higher domestic wages (23 percent compared with our 11 percent wage increase, 1976-78, in terms of US dollar). Their productivity increased faster than ours.

4. The Economic Strategy Programme of the seventies has however benefited us. Our economy is more diversified. We now have a stronger infra-structure to develop financial, telecommunication, port and air services further. Although it is still too labour-intensive, our manufacturing base is now wider. We have been liberalising our immigration policy to attract skills and talents. We have been expanding professional, technical and industrial training. Investors' confidence in Singapore has strengthened. If not for the Economic Strategy Programme, our growth would have been slower.

B. Lessons for the eighties

5. We must draw lessons from our experience in the Seventies to plan ahead for the eighties. The main lessons are in the following paragraphs.

6. Our wages must be related to the labour market. In a full employment economy, low wages will lead to an over-tight labour market. Inefficient businesses, which have no place in a fully-employed, open competitive economy, will continue to hoard labour which should be more productively employed by more efficient firms. The efficient businesses, squeezed for labour, will be hindered from expanding and upgrading. Even they will find it comfortable not to introduce new technology and to automate and mechanise. The efficiency of every firm from the most efficient to the least efficient, will be lowered. In an overtight labour market, with excessive job hopping, employers find it cheaper to employ excess men, as the holding cost of idle or unproductive workers is less than the cost of new and better machines or of introducing better management and work system and the inconvenience of displacing inferior managers by better managers.

7. Low wage does not bring out the best in a worker. It discourages training. In their efforts to get more workers for industrial training, while wages are low, training institutions such as VITB and EDB are compelled to use expedient methods such as paying and increasing the allowances to get workers to attend training courses. When the allowance is not much different from the wage, training is wasted as the trainee does not put in his best efforts or is not employed in the skill for which he is trained.

8. Another lesson is that we must continue with our economic philosophy of open and free competition. It is a harsh but effective approach of rewarding the capable and punishing the incapable. We have no choice, given our small domestic market, lack of natural resources and limited leverage in the world market. We cannot follow a self-sufficiency or self-reliance economic ideology. Our philosophy must be to:

a. Import from the cheapest reliable source for raw materials, machinery, parts and components; we cannot close up our domestic market to shelter local industries.

ment was studying the possibility of presumptive taxation of hawkers, restauranteurs, taxi-drivers, property brokers and other freelancing commercial intermediaries who did not keep proper accounts. Under this scheme, the Department would take sample investigative surveys to determine what these groups were earning. All those in these groups would be deemed to have chargeable incomes based on the findings. The onus of proof would then be on them; it would be up to any one of them, hawkers, restauranteurs, property brokers, etc. to rebut presumed taxable income by accounts which would show his true income to be lower.

The Minister said that Singapore was restructuring her economy. For this to succeed, Singapore must make it worthwhile for workers, especially the young, to spend time and effort in acquiring skills and knowledge. They would find it worthwhile if they could earn more and retain more of their incomes. A worker's effort must not be penalised through too steep a tax. While tax rates must be progressive and linked to ability to pay in order to lighten the burden on the lower income groups, they must never be so high as to suppress the will to strive and to excel. Last year, every taxpayer was given a reduction in tax ranging from 6.8 to 19.9 percent depending on his tax bracket. The average reduction in tax was 16.1 percent.

For Year of Assessment 1981, the Minister proposed to retain the existing tax rates. He explained that inflation, however, had pushed many wage-earners into higher income tax brakets. To take account of the pernicious effect of inflation on tax burdens, and to give Singaporeans further incentive for their effort, the Minister proposed to give a tax rebate of 10 percent to every taxpayer on his total tax liability.

In other words, if a resident taxpayer is assessed to have a tax liability of S$5,000/- on the existing rates, he will be given a tax rebate of S$500/- or 10 percent of his assessed tax. If his tax liability is S$300/-, he will get a tax rebate of S$30/-.

The Minister said he was not revising the tax rates for the Year of Assessment 1981 because tax returns had already been sent out and computer assessments based on the existing programmed rates had begun. Any change in tax rates for this year would delay the work of the Inland Revenue Department inordinately.

The Minister said he proposed to make the following changes to tax rates but applicable only from the Year of Assessment 1982, i.e. on incomes earned this year. (See Appendix II.)

In the revision of tax rates, the Minister said he had paid special attention to the senior clerical, supervisory and skilled grades, and the middle-income group. These are the groups whose chargeable incomes generally fall within S$5,000/- and S$75,000/-. They will enjoy the largest reduction in tax in percentage terms, a reduction ranging from 17.8 to 25.9 percent.

The Minister said in changing the Rates Schedule, he had decided to merge the lowest two tax brackets and levy a common tax rate of 4 percent for this new first taxable bracket of up to S$5,000/- chargeable income. Taxpayers in the existing lowest tax bracket of S$1/- to S$2,500/- will not benefit from any tax reduction. For the Year of Assessment 1980, there were 141,843 taxpayers or 37.2 percent of the total number of taxpayers in this bracket. Together they contributed only 1.4 percent of total personal income tax collections. The average tax assessed was S$45/- which is not enerous. In contrast, the top 14,547 taxpayers, constituting only 3.8 percent of the total number, paid S$266.8 million or 59.9 percent of total tax collections of S$445.5 million. A large proportion of the tax incidence was therefore borne by this small group of taxpayers whose chargeable incomes exceeded S$35,000/-. The table which is attached to the Schedule shows the distribution of the tax burden among the various income groups.

The Minister said he had decided to give substantial reductions in tax as the objective was to encourage, not to smother, individual drive and enterprise. The highest marginal rate of 55 percent would be reduced to 45 percent and on chargeable income exceeding S$750,000/-. With the proposed change, very few individuals would be paying tax at more than 40 percent effectively on their chargeable incomes.

The Minister explained that except for the first tax bracket the reduction granted varied from 12.5 to 25.9 percent and the overall average reduction was 13.0 percent. The revenue loss was estimated at S$78 million.

(iv) Estate duty

The Minister recalled that in the 1979 Budget, an additional exemption of up to S$200,000/- was granted in respect of residential houses in an estate. That was in addition to the S$100,000/- exemption which was granted for assets other than residential properties.

To ensure that the concession continued to give relief to beneficiaries in the lower and middle income groups, it was proposed to raise the exemption ceiling for residential properties from S$200,000/- to S$600,000/-. This was to take account of the rise in property prices in the last two years and to protect the dependants of the deceased who might otherwise have to dispose of their family homes to pay estate duties.

The new exemption ceiling will apply to all deaths occurring on or after January 1, 1981. The loss in revenue is estimated at S$23 million.

(v) Concluding remarks

In this concluding remarks the Minister said, "*The tax changes this year are a continuation of the liberalisation of the tax system begun in financial year 1978, when the Minister for Finance reduced personal income tax rates substantially. Further changes in the tax system including income tax, may be expected in the next two or three years. We shall adjust our tax regime as income patterns change, as spending habits change, and as investment behaviour changes. Our taxes are designed not to punish effort both collective and individual effort. They are also designed to encourage investments in order that we can enjoy a more productive future.*

Business enterprises have been encouraged to invest and expand, through various tax concessions introduced in previous Budgets, e.g. realistic capital allowances for

II. THE FINANCIAL YEAR 1981 BUDGET

On the financial year 1981 Budget, the Minister quoted figures for total estimated expenditure and expected revenue for the financial year.

III. REVENUE AND TAX CHANGES

A. Some figures

For financial year 1981, total revenue was estimated to be S$6,335 million. Below are some of the figures quoted by the Minister:

	million	million
(a) Recurrent expenditure	S$4,579	
(b) Development expenditure	S$5,044	
Total budgeted expenditure		S$9,623
(c) Income tax	S$2,460	
Other taxes	S$3,875	
Total estimated revenue		S$6,335
Deficit		S$3,288

B. Tax changes

After quoting figures for the total budgeted expenditure and revenue, the Minister proposed the following tax changes for the new fiscal year:

(a) Revision of domestic and international passenger service charges;
(b) Duty on bets;
(c) Entertainments duty; and
(d) Duty on petrol.

(a) Revision of domestic and international passenger service charges

The existing rates of domestic and international passenger service charges are S$4/- per passenger for flights to Malaysia and Brunei and S$10/- per passenger for flights to other destinations.

With effect from April 1, 1981, the domestic and international passenger service charges will be raised to S$5/- and S$12/- respectively.

(b) Duty on bets

At present, the duty on bets is 10 percent of the amount of bets. This duty has not been raised since 1947. It may be one reason why the amount of bets has increased from S$7.3 million in 1950 to S$320 million in 1979. The Minister has, therefore, decided to raise the duty on bets from 10 to 15 percent of the amount of bets.

(c) Entertainments duty

In September 1980, the Cinematograph Film Exhibitors Association applied for approval to merge the present two lower admission classes of cinemas and to do away with the lowest class. The Minister has decided to allow the merger of the two lower class seats.

At the same time, the entertainments duties for cinemas including drive-in cinemas, amusement parks, trade fairs and exhibitions, will be changed to an ad valorem rate of 35 percent. The present graduated duty rates for open-air cinemas and live-shows, such as stage-plays, variety shows and circuses, will also be replaced by ad valorem duties of 15 and 25 respectively. The existing rates of 15 percent for professional boxing and wrestling and 10 percent for games and sport other than trial of speed of animals, vehicles, motor vessels or aircraft, will remain.

(d) Duties on petrol

The duties on premium and regular petrol have not been increased since January 1976. The specific duties of premium and regular petrol amounted to 47.6 and 51.0 percent of pump prices respectively in 1976. Since then, prices of petrol have gone up significantly without any adjustment in duty. As a result, the specific duties of premium and regular petrol form only 33.3 and 34.5 percent of pump prices today.

It is proposed to adopt an ad valorem duty for premium and regular petrol. The present import and excise duties are specific in nature, being S$3.60 per dal (decalitre) for premium petrol and S$3.45 per dal for regular petrol. These will be replaced by an ad valorem duty of 40 percent, using pump prices as the basis of assessment.

C. Tax concessions

The Minister then proceeded to announce the following tax concessions:

(i) Separate assessment on unearned income of married women

Option for separate assessment on earned incomes was first given to married women in 1963. It is clear today that many married women are capable of deriving unearned incomes in their own right. This, however, has not been given due recognition by the tax laws. Amendment was therefore proposed by the Minister to reflect the current income position of married women. From the Year of Assessment 1982, all married women who can satisfy the Comptroller of Income Tax that their unearned incomes are derived from their own earned income in the past shall be allowed to have these unearned incomes assessed in their names.

This will reduce the combined tax burden of husbands and wives. It should encourage married women to remain in the work force, particularly those with tertiary or professional qualifications.

The loss in revenue is estimated at S$3 million.

(ii) Relief for disabled persons

The Minister said that 1981 being the International Year of Disabled Persons, as a contribution, he proposed to increase the earned income relief for handicapped persons from S$1,000/- to S$2,000/-. This is in recognition of the contribution of disabled persons in the work force and to encourage more active participation from the disabled population. This relief will take effect from Year of Assessment 1982.

(iii) Personal income tax rates

The Minister disclosed that the Inland Revenue Depart-

To help local industries to upgrade, the Economic Development Board (EDB) encouraged them to have joint ventures or licensing arrangements with foreign companies with the necessary technical know-how and access to export markets.

D. Research and development (R&D)

Recalling his previous year's Budget Statement in which he announced five tax incentives for the benefit of manufacturers conducting Research and Development, the Minister said in addition to these incentives, the EDB would consider extending the tax exemption period to pioneer companies which would invest or expand R&D activities.

Other measures to promote R&D activities would include the development of a Science and Technology Park and the expansion of the material science laboratories at the Singapore Institute of Standards and Industrial Research.

E. Trade development

On trade development, the Minister said that protectionism would continue to plague Singapore exporters. The long term solution would be for Singapore manufactuers to restructure and produce higher value-added products, less vulnerable to protectionism. Local companies are now becoming more active promoting their products overseas.

Along with the need to improve and upgrade the quality of Singapore-made products, the Minister urged the management in industry to increase their international marketing skills substantially.

The Department of Trade would assist by engaging consultants and experts to conduct marketing seminars and workshops.

F. Services development

In his previous year's Budget Statement, the Minister had announced that in the 80s, Singapore would be developed into a financial supermarket offering a wide and sophisticated range of financial services. As part of its operational plan to advance this objective, the Monetary Authority of Singapore (MAS) is reviewing the structure and operations of the financial sector.

MAS is reviewing in particular, the Insurance Act, the Banking Act and the Finance Companies Act. It would continue to promote new foreign financial institutions to open up branches and offices in Singapore. It would encourage existing local and foreign banks to expand the scope and depth of their business. Banks were responding to the call to expand and improve their services by introducing new schemes such as the gold and silver passbook accounts and by installing more automated teller machines (ATMs). The Singapore Clearing House Association was formed to enable automated cheque clearing. This is in line with the Government's emphasis on increased productivity and computerisation and is expected to result in even better services for bank customers. Fixed rate Singapore dollar bonds were issued for the first time last year giving banks another avenue for tapping long term funds.

The promotion of the computer services industry would form an integral part of Singapore's economic restructuring programme in the 80s. The public sector would take the lead in computerisation. A National Computer Board would be established. Tourism would also continue to be an important growth sector for Singapore in the 80s.

G. Energy policy

On energy policy, the Minister said energy would become an increasingly more critical resource for Singapore's economic development.

He added that the twin objectives of the Singapore's energy policy were, firstly, to ensure that the economic growth in the 80s was not disrupted by energy shortages, and secondly, as oil was scarce and expensive, to maximise efficiency in the usage of energy.

Energy conservation would be pursued through campaigns and a system of incentives to encourage energy saving. So far, accelerated depreciation was allowed only for plant and machinery in industrial enterprises. The provision on accelerated depreciation would be extended to cover approved energy-saving capital expenditure incurred by non-industrial enterprises.

The Minister disclosed that both the Ministry of Finance and the Ministry of Trade and Industry would study the criteria, guidelines and mechanics of implementing this scheme. They would also extend the investment allowance scheme administered by the EDB, to include cover capital expenditure incurred by manufacturing companies to save energy. The EDB would work up specific guidelines on this.

H. Manpower development

The Minister recalled that in his 1980 Budget Statement, he had dwelt at length on the critical need to train enough manpower for the higher skilled industries and the brain services Singapore wanted to promote in the 80s.

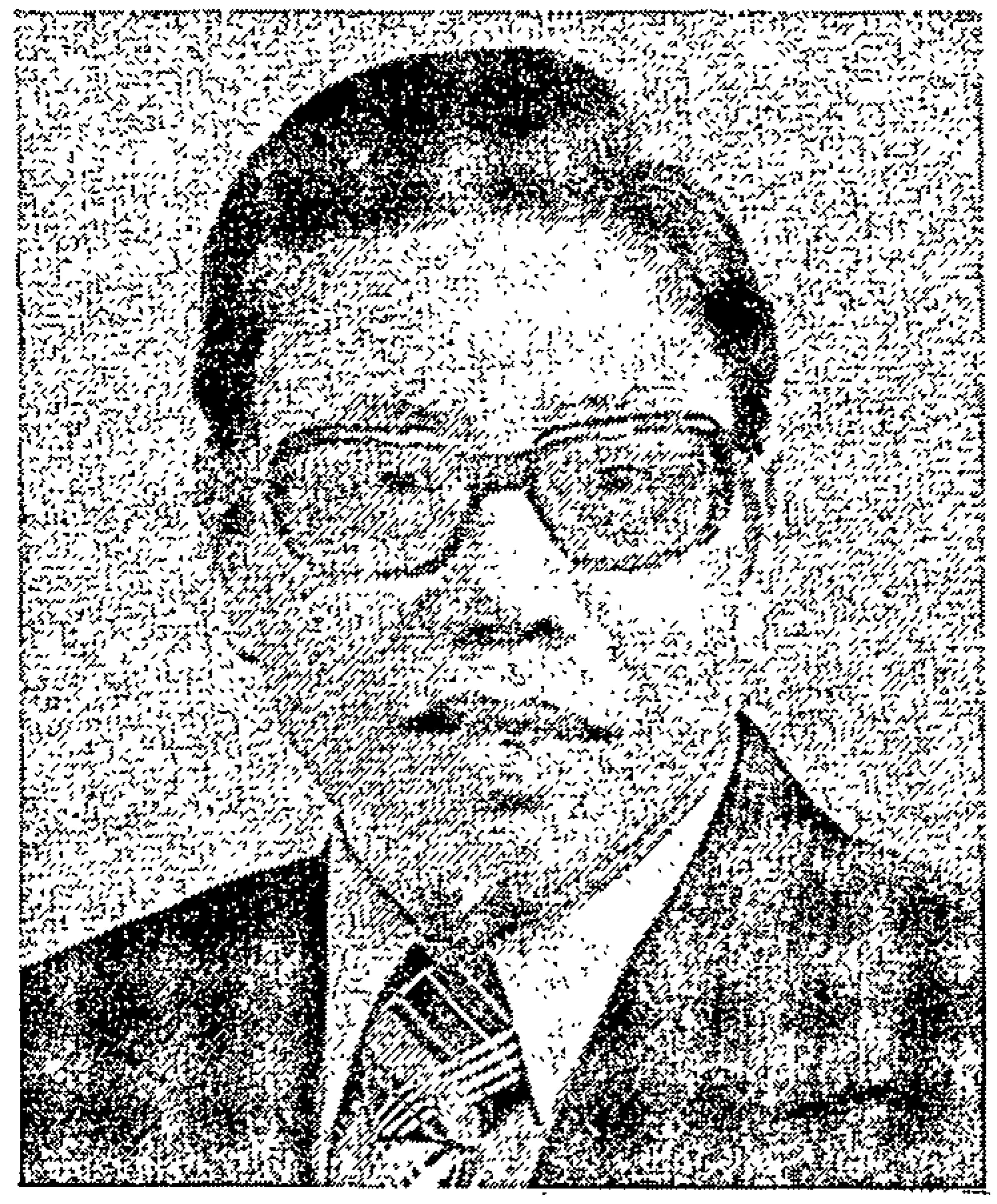
The efforts to prepare workers, employers and managers for a difficult task of economic restructuring would have to include the inculcation of proper work and management attitudes. So far, Singapore had concentrated on workers' attitudes. Singapore must now extend her focus to include managers and employers.

I. Concluding remarks on economic policy

In his concluding remarks on Economic Policy, the Minister said 1981 would be a difficult year for Singapore and 1982 even more so.

Singaporeans could not wish the depressing outlook away. They must, as before, assess the problems realistically and respond accordingly. They would survive, work together and press on intelligently with economic restructuring, plus a change in work attitudes. If Singaporeans developed new cooperative habits on the factory floor, complete with Quality Circles and a close worker-management relationship, Singaporeans would make it.

SINGAPORE'S 1981 BUDGET



SUMMARY

by Lee Fook Hong, FCIS, FAIA

On March 6, 1981, the Minister for Trade and Industry, Mr. Goh Chok Tong, presented his 1981 Budget to the Parliament of the Republic of Singapore. This is the third and last of Mr. Goh's Budgets.

From recent press reports, Dr. Tony Tan will take over from Mr. Goh Chok Tong as Minister for Trade and Industry sometime in June 1981. The presentation of the next Budget seems to be the responsibility of Dr. Tony Tan in 1982.

I. ECONOMIC POLICY

A. Singapore's economy in 1980

Before dealing with revenue and tax changes, the Minister made a brief review of the Singapore's economy in 1980. He said Singapore's economy grew robustly in 1980, achieving a double digit rate of growth of over 10 percent since the oil crisis of 1973/74.

Growth in Singapore's economy was evenly spread. Manufacturing grew by 12 percent, financial and business services by 17 percent, and transport and communications by 12 percent. Singapore's external trade expanded by 34 percent in dollar terms. In volume terms, it increased by 15 percent, much higher than the growth in world trade of 3 percent.

The key to the long term success of Singapore's economic restructuring strategy was not higher wages nor fiscal incentives. It was manpower development.

B. Economic Development Plan in the 80s

On economic development for the 80s, the Minister said his Ministry had prepared an indicative 10-year Economic Plan for the Eighties. Highlights of the Plan are summarised in Appendix I. Briefly, the prime objective of the Plan is to develop Singapore into a modern industrial economy based on science, technology, skills and knowledge.

The Minister then proceeded to touch on the specific growth factors of the economy of Singapore. He spoke on industrial development, research and development, trade development, services development, energy policy and manpower development.

C. Industrial development

On industrial development, the Minister said that Singapore continued to attract good quality industries. New investment commitments in 1980 reached a record high of S$1.4 billion excluding petrochemicals.

Most gratifying, many existing international companies were upgrading their manufacturing operations. They were investing in new capital equipment and technology to increase output and labor productivity.

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Second annual yearbook on countries in Asia and the Pacific containing articles on specific issues and per country information on political, economic and social developments, travel and tourism. (B. 51.702)

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Proceedings of the 9th Meeting of the Study Group on Asian Tax Administration and Research (SGATAR). Manila, The Secretariat, 1979. 538 pp.
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CANADA

1979 BRITISH COLUMBIA TAX SEMINAR

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will remain half that on death: at the top it but only at the bottom of the scale.

As a result people are deterred from transferring their property during their lifetime. This is undesirable. Business property, in particular, should be permitted to pass more freely from one generation to another.

I propose therefore to recast the lifetime scale. At the bottom the charge on gifts will remain half that on death: at the top it will become two-thirds. I also propose limiting cumulation to 10 years and extending the capital gains tax roll-over relief to gifts into trust, to avoid a double charge.

I hope that, by encouraging gifts, the Exchequer will benefit as well as the taxpayer. I also propose to increase the annual exemption to £ 3,000.

Capital transfer tax is also holding back the supply of land for new entrants to the farming industry. Tax is not the only factor, of course. But is is important to maintain a proper balance between owner-occupied and let land, allowing for their different value.

I have in mind the unequal treatment of let land. At present, no relief is normally given on let land. In future relief will be available at 20 percent. Agricultural land not subject to a lease will continue to receive relief at 50 percent.

The difference in the rate of relief recognises the lower value that let land commands and the lower tax burden it attracts as a result. The facility to pay CTT by interest-free instalments will be extended to let agricultural land and the limit of £ 1/4m will be removed.

Avoidance

Next, trusts. I am grateful to all who responded to our consultative paper. I propose to tackle some matters this year: but on discretionary trusts draft clauses will be prepared for further discussions and we shall legislate next year. Meanwhile, there will be a final extension of the transitional period to March 31, 1983, or March 31, 1984 where an application has to be made to a Court.

I also propose dealing with certain avoidance devices which centre on the market value rule for capital gains tax purposes, and aligning the capital gains tax rules with the new income tax rules developed following the Vestey case.

The net effect of all these proposals in the capital tax field will be a cost of £ 5m this coming year but a gain of £ 15m in a full year — the saving from the anti-avoidance measures exceeding the cost of the reliefs I have proposed.

I intend to include one stamp duty provision in the Finance Bill which will help those buying council houses. This will ensure that stamp duty will be payable only on the discounted price that the buyer actually pays and not on some higher figure.

Last year I introduced a number of measures to help small firms. In addition to the major new initiative to establish Enterprise Zones, these included a venture capital scheme, improved tax relief for small workshops, and a reduction in the rate of corporation tax for small companies.

All these measures have been widely welcomed. The 11 proposed enterprise zones have stimulated intense interest among investors and the private sector has begun to respond even before the zones are formally established.

Meanwhile provision of private finance for small factory units has grown rapidly. The continuing strong demand for small workshops shows the strength of the small business sector.

But we can and must do even more to help existing small businesses to grow, and to encourage new businesses to start up. This remains an essential key to new jobs.

First, VAT. I propose that, as last year, the registration thresholds should be increased in line with prices — on this occasion from £ 13,500 to £ 15,000. This change will take effect from midnight tonight.

Corporation tax

Second, I propose to increase from £ 70,000 to £ 80,000 the limit up to which the lower 40 percent rate of corporation tax is payable by small companies. I also intend to respond to one of the longstanding complaints from small companies, which is the relatively high marginal rate of tax which they have to pay when profits exceed this limit.

The limit at which the full corporation tax rate of 52 percent becomes payable will be raised from £ 130,000 to £ 200,000. This will make for a gentler progression from the small companies' rate to the full corporation tax rate. The cost of these changes will be £ 12m in 1981-82 and £ 21m in a full year.

Third, new businesses depend on ready access to fresh the capital. Last year I relaxed the conditions governing tax relief for interest on money borrowed to invest in close companies. That was good for smaller companies.

This year I am relaxing the conditions for industrial co-operatives and partnerships.

Fourth, as the House knows, the Government will shortly introduce new clauses at committee stage of the Companies Bill, to enable companies to purchase their own shares. Corresponding changes are needed in the present tax structure to help with a number of problems arising in small and family businesses.

I am, therefore, asking the Inland Revenue to issue a consultative document on this subject this summer, with a view to legislation in next year's Finance Bill.

Fifth, I intend to extend the venture capital scheme introduced last year. This scheme encourages investment in small businesses by allowing capital losses on shares in unquoted trading companies to be set off against income.

At present, it is confined to investment by individuals. I propose to extend the scheme now to investment by companies, some of which may be able to provide funds for expanding small firms.

Business start-up scheme

One of the biggest problems faced by people thinking of starting their own business is the difficulty of attracting sufficient risk capital to finance it during its critical early years.

The amounts of additional money needed can be modest — at least as compared with the sums which the big financial institutions commonly deal with. But they can be crucial in the individual cases.

The individual private investor has for many years had little encouragement to help fill this gap in the capital market. I propose to change this.

The private investor can often contribute not only risk capital, but also direct personal business experience. The opportunities are certainly there.

What is needed is to make it more attractive and more rewarding for private investors to seize them.

I am, therefore, introducing an entirely new tax incentive to attract individual investors to back new enterprises. It is designed for the outside or minority investor in certain new small trading companies, as distinct from the owner of the business, his close family and associates.

I am calling it the Business Start-up Scheme. Under the scheme an investor will be able to obtain relief against income tax on up to £ 10,000 invested in any one year.

The relief will be given in addition to the range of tax reliefs already available to the company itself, provided the investment is maintained for at least five years.

The Scheme will relate only to genuine new business enterprises of the kind I have in mind. There will be strict rules to ensure that it is not used for investment in financial or passive operations. Nor, of course, for tax avoidance.

I am introducing the new scheme in the first instance for a three year period, beginning with the coming financial year 1981-82.

This Business Start-up Scheme will be unique, not only in this country, but among our main trading competitors. It will be a striking new incentive to channel investment into small businesses.

Last year I referred to the growing practice of employers providing free petrol and said that I should be bound to contemplate action if it continued to spread. This warning has largely been ignored.

I propose therefore to take action which will ensure that tax is chargeable in all cases where petrol is provided for private use of a higher paid employee or director.

The Inland Revenue will consult employers' organisations over the administrative implications of the various possible methods of achieving this.

Travel expenses

Most people have to pay for their own travel to work, whether by rail or by road. Some people have their travel costs met by their employers. Most of these pay tax on that benefit. There is, however, one small, but growing, group — not more than one commuter in 10 — who get their travel costs tax-free.

When an employer contracts with a transport authority for provisions of a season ticket to his employee, the benefit is not, under the present law, within the general liability to tax. This is a clear anomaly. And it is plainly right to bring this group into line with everyone else.

Similarly, a minority of employees are provided with credit cards which they use to obtain a wide range of goods and services which are charged to the employer. The employee may thus avoid paying tax on part of what is truly his income. This, too, is quite wrong. I shall ensure that all employees pay tax on benefits of this kind.

Fringe benefits

Following consultations which took place last year, I have decided for now to leave in place the earnings threshold below which the taxation of fringe benefits does not, in the main, apply. Company cars and other such benefits will therefore continue not to be taxed in the hands of those earning less than £ 8,500 a year.

Consistently with this approach, I propose to remove the charge to tax on medical insurance premiums paid by employers for the benefit of their employees earning less than this amount.

The Vestey case

One pre-war anti-avoidance measure needs to be brought up-to-date, following the decision in the Vestey case. This has shown that, among other imperfections, the rules dealing with avoidance of tax by way of transfers of assets abroad do not affect an individual who benefits from such a transfer but did not make or procure it.

I propose changes in these complex and technical rules, to take effect from today, which will ensure that the individual pays tax on any benefit he receives. I also propose to amend the rules governing the taxation of capital sums paid by trusts.

So far I have been dealing almost entirely with a group of measures that will have the disagreeable but necessary effect of increasing the revenue.

In order to secure the reduction in interest rates, most of that revenue must go to reducing the PSBR. But some can go, as it should, to lighten directly the tax burden on business and enterprise.

There is not enough for across-the-board measures. It is important to concentrate relief where it will be most effective. I cannot, for example, find room for a reduction in the National Insurance Surcharge, at a full year cost to the PSRB of £ 700m for each percentage point. Nor would a general reduction in corporation tax be appropriate, since it would not help companies who are so hard-pressed that they are making no profit. I therefore propose to bring help to business and to encourage enterprise in the following ways.

Stock relief

The first measure is one announced, subject to further consultation on the details, last November: the reform of the stock relief scheme.

This reform will tackle certain abuses of the old scheme which have attracted legitimate concern. It will also lift the threat of clawback — the withdrawal of tax relief when businesses reduce their stocks.

This was jeopardising the financial position of industry in the current recession. It was above all this problem of clawback that made it essential for the details of a new scheme to be announced as they were in our Consultative Document last November.

I have considered very carefully the representations which have since been made in response to my original proposals. As a result I propose to make certain detailed changes, including improvements in the transitional arrangements.

In particular, I have considered very carefully the concern which has been expressed to me by many businesses about how they would be affected by the proposed credit restriction: that is, the arrangements under which relief should be restricted to the extent that a business may finance its stocks by trade credit or other borrowings.

I have sought to balance the case in principle for the credit restriction against the fact that the other changes which I am making will in themselves reduce the scope for abuse under the old stock relief scheme.

In the light of the severe difficulties which many businesses are now facing, I have decided not to legislate for the credit restriction. This will be reviewed in the context of other possible changes in the promised Corporation Tax Green Paper.

These changes will increase the cost of the new schemes to the Exchequer. The fall in the rate of inflation would by itself have reduced that cost. But as a result of the changes I now propose, the cost in respect of profits earned in the present calendar year (1981) — tax on which will mostly be paid in 1982-83 — will be £ 450m.

This includes the cost of dropping the credit restriction, of about £ 75m in the first full year. Only a part year cost — about £ 180m — will fall in 1981-1982. There will be a continuing revenue cost for some time to come and equally a substantial benefit to industry.

I also propose a limited extension of consortium relief to enable consortium members to pass relief downwards to a consortium company.

Development land tax

First: under the present law, if industrial development is undertaken by the owner for his own use, tax is deferred until the property is sold or put to other use. I propose that for two years this relief should be extended to other types of development for the owner's use, including commercial and hotel development.

If a development is begun by April 1, 1983 there will be no DLT for an owner to pay on any part intended for his own use until the property is sold or otherwise disposed of.

Second: where property is extended there will in future be no charge if the extension does not increase the size of the building by more than one-third. The current limit is one-tenth.

My third proposal will reduce the burden of DLT on builders who acquire land for residential development and will be of particular benefit where land is released by local authorities and others for building homes. The cost of these measures is put at up to £ 5m in a full year, but the benefit to the economy could be much greater.

Taxes on capital

The measures I have just announced will in total be worth about £ 300m next year. And the tax measures alone will be worth over £ 400m in 1982-83.

But if we are to build a strong and vigorous economy we must do more to encourage and reward the creation of new enterprises, new wealth and new jobs. I turn, therefore, to the subject of capital taxation, which bears especially heavily on the owners of small businesses.

In a year in which we can give no income tax relief, I cannot make major changes in capital taxation. I do, however, propose to continue the process of making more sense of the structure of capital taxes.

First, Capital Transfer Tax. One new concept introduced as a feature of this tax was the idea of cumulating gifts made at any time in a person's life. Some allowance was made for the earlier payment of tax on transfers during life than on death, but only at the bottom of the scale.

As a result people are deterred from transferring their property during their lifetime. This is undesirable. Business property, in particular, should be permitted to pass more freely from one generation to another.

I propose therefore to recast the lifetime scale. At the bottom the charge on gifts fits is the direct consequence of high interest rates in the last two years: this applies in particular to the so-called "endowment profit" on current accounts on which no interest is paid.

Recent levels of bank profits are partly, of course, a cyclical recovery from the low level to which they fell in the mid-1970s. Also, the banks have needed to make provision against the effects of inflation and to rebuild the reserves needed to underpin the valuable support they give to businesses in difficult times. That is why I took no action last year.

However, I undertook to keep developments under review. The last year has seen further high banking profits, probably at a level not very different from the record profits of 1979.

Certainly the contrast with the sharply reduced profits of industrial companies is if anything more striking. In present difficult circumstances, I cannot avoid the conclusion that I should require the banks to make a special fiscal contribution.

This will take the form of a special one-for-all tax on deposits of banking businesses. which are in operation today. The tax will be charged by reference to non-interest bearing sterling deposits in excess of £ 10m, averaged over the final three months of 1980.

The rate of tax will be 2½ percent. It will not be deductible against corporation tax.

I estimate that the clearing banks will be the source of about 90 percent of the revenue but the tax will apply to banking businesses generally. Altogether an estimated £ 400m will be raised in three instalments over the second half of 1981-82. This revenue will make it possible for me to give some help to the rest of industry this year which otherwise I could not afford.

Even so for the reason I have already explained it is necessary to look principally to the personal sector for the additional revenue needed. People in employment have in general had more money to spend. Extra tax will have to be levied on that expenditure.

No VAT increase but excises go up

I do not propose any increase in the 15 percent rate of VAT. As last year, most of the extra revenue needed must come from the excise duties. Increases would be necessary again this year simply to keep the rates of duty in line with the general movement of prices.

Even when that had been done, however, many of the duties would be lower in real terms than they used to be. For example, since April, 1975, the beer duty has risen by only about half as much as prices generally.

I am proposing to increase the excise duties to produce, in total, about twice as much additional revenue as would be required to compensate for one year's inflation.

First, the duties on alcoholic drinks and tobacco. From midnight tonight I propose to increase the duties on drinks by amounts which, including VAT, represent about 4p on the price of a typical pint of beer, 12p on a bottle of table wine, 25p on a bottle of sherry, and 60p on a bottle of spirits.

On tobacco, I propose from midnight on Friday to increase the duty by an amount which, including VAT, will represent 14p on a packet of 20 cigarettes.

There will be consequential increases for other alcoholic drinks and tobacco products. But a little less for pipe tobacco which is used particularly by pensioners.

I estimate that the increase on alcoholic drinks will yield £ 500m in 1981-82 and £ 515m in a full year. The increases on tobacco will raise almost exactly the same.

The duties on matches and mechanical lighters, which have not been raised since 1949, will be increased substantially — to raise an extra £ 15m a year.

Car owners pay their shares

Road fuel must also make a substantial contribution. The duties on petrol and derv will be increased from 6 pm tonight by the equivalent, including VAT, of 20p a gallon.

These increases should yield an additional £ 910m from petrol and £ 270m from derv in 1981-82 and the same in a full year.

I propose to increase the Vehicle Excise Duty on all vehicles by about 15 percent. The annual duty on cars will thus increase by £ 10 to £ 70. As the duty on derv is being increased in line with that on petrol I do not propose any differential increase on heavy lorries. The VED increase should yield £ 225m in 1981-82 and the same in a full year.

Finally, I propose extending the car tax to motor-cycles, scooters and mopeds. This tax is charged at 10 percent on the wholesale value and is in addition to VAT. There is no longer any reason why these machines should be treated any differently from motor cars. The change is estimated to raise about £ 10m in 1981-82 and £ 15m in a full year.

In all, these changes to the indirect taxes should raise about £ 2,400m in 1981-82 and about the same in a full year.

With the partial exception of the road fuel and Vehicles Excise Duties, the increases fall on those products which are bought by private consumers. Had all these excise duties simply been increased in line with inflation this would have added 1 percentage point to the RPI. The increases I propose could add up to a further point. This is the maximum impact effect on prices. But in the longer run, by reducing public borrowing, they will help to bring inflation down and ensure that it stays down.

Income tax: no adjustment for inflation

I come now to income-tax. Once again I must have the main priority in mind — the need to contain public borrowing, so as to make it possible to secure lower interest rates and ease the conditions in which the trading sector of the economy has to operate.

Inflation raises the real burden of income-tax. This is because allowances and rate bands are fixed in money terms. As the value of money falls so too does the value of these allowances and bands.

It was in order to counteract this effect that this House in 1977 carried a measure which required Governments to raise the tax allowances by each year's inflation unless Parliament explicitly decided the contrary.

To implement this formula now would mean increasing allowances by about 15 percent. In the circumstances of this year, that simply is not possible. The incomes of most people have been rising in both money and real terms: but many companies have seen their profits virtually disappear, with serious implications for jobs and investment.

In these circumstances it will not be possible this year to make any increase in the income-tax allowances or rate bands.

The House will be asked to approve a Resolution to this effect. A Treasury Order is also being made today, following the procedure laid down in the 1980 Finance Act, setting out what the increases have been in the thresholds and allowances if indexation had been possible. The House will wish to know that full indexation of the allowances and rate bands would have reduced the full year yield of income tax by £ 2½ bn.

This decision has not been lightly taken and I share the disappointment everyone will feel. It does enable us to avoid, as I am sure is right, the need for any change in the basic or other rates of income tax. And it does enable me to tell the House, as I am glad to be able to do, that we propose that Child Benefit, and one-parent family benefit, will both be fully price-objected in line with the forecast of inflation. Next November child benefit will, therefore, go up by 50p a week per child, to £ 5.25. The one-parent family benefit will go up by 30p to £ 3.30 per week.

Company car

At a time when the real burden of income-tax has to be increased, it is all the more important that it should be fairly shared.

The benefit of a company car is already subject to tax, but the tax scales fall well short of the true value.

The amounts assessed to tax are less than half the AA's estimate of the annual costs of running a car. Last year we prescribed an increase of 20 percent in the scales from this April, just about enough to keep them rising in line with the costs of motoring.

I now propose they should be increased by a further 20 percent in April, 1982. For company cars which have little or no business use there is a higher schedule of taxation.

I propose to raise the business mileage below which this charge applies from 1,000 to 2,500 miles a year with effect from this April.

United Kingdom: BUDGET '81-82

A tough budget: no adjustment of income tax; petrol, drink and tobacco taxation up; windfall tax on oil and bank profits.

Extracts from the Budget Speech pronounced on March 10, 1981 by the Chancellor of the Exchequer, Sir Geoffrey Howe.

Relief for social purposes

There is one group to whom we should pay special attention this year — despite the economic constraints we face. I refer to the disabled. For this is the International Year of Disabled People. The Secretary of State will be announcing tomorrow an increase in Mobility Allowance. I shall mention some other measures now.

The special income tax allowance for the blind has stood at its present level since 1975. I propose to double it to £ 360. I hope this will be of some help to blind people in tackling the very real problems they have to face.

Many representations have been made to me for relief from VAT on all purchases made by charities. I have regretfully concluded that such relief would be impossible to administer fairly or economically and would in any case cost too much.

However, I do propose to extend existing VAT reliefs for the disabled and the charities serving them. For example, the present zero-rating for articles given to hospitals will in future cover ambulances and wheelchairs. The benefit of this zero-rating will also be extended to institutions caring for the handicapped. Car adaptations for disabled drivers will also be relieved from VAT. The necessary Treasury Order is being laid today.

I am also proposing changes which will widen the scope of the reliefs from capital taxation for trusts for the disabled. And to encourage unemployed people to work for voluntary bodies, the amount a person can earn without affecting unemployment benefit will be increased from 75p per day to £ 2 per day.

The total cost of these measures is relatively modest. But if put alongside the tax reliefs I announced last year in respect of covenanted gifts to charities, the overall amount is substantial.

The House may like to be reminded that tax relief on covenants at the higher rates of tax becomes effective from April 6, 1981 at a revenue cost of £ 20m.

These reliefs should greatly improve the fund-raising ability of charities. I shall be arranging to publicise these reliefs, and the opportunities they offer, much more widely.

There is one other matter to which I should refer. I announced last year that we planned to bring into tax the invalidity, sickness and other incapacity benefits.

We had expected that this might be from April 1982. In part because of pressures on Civil Service staff numbers, we propose to postpone this. I confirm however, that when Invalidity Benefit does come into tax, the 5 percent deduction made from the November 1980 uprating will be restored.

More revenue: increase of oil taxation

I come now to the range of measures that are necessary to raise the extra revenue for this year. First the North Sea. In deciding on particular measures I have had to take into account recent developments and future prospects for North Sea oil, and the implications these have for Government revenues.

In 1980 production in the North Sea at 80m tonnes of oil was less than predicted — only four-fifths what had been expected two years before.

The production difficulties experienced in the past year have led to a major revision of output levels over the next few years. The Secretary of State for Energy has just published reduced forecast ranges for North Sea production in the years to 1984.

While oil production is likely to be lower than once expected, oil prices are much higher. Increases since 1978 in the real price of oil have brought substantial benefits to the oil companies, which face a very different prospect to that when the present tax regime was introduced.

Such has been the rise in the oil price in recent years that I believe that the Exchequer should properly look to this area for additional revenue beyond what will accrue from existing taxes.

However, even after the measures I am about to announce the increase over the medium term in Government revenues from the North Sea will be smaller than was once expected.

In my statement last November, I foreshadowed the measures I had in mind for increasing the Government's share of these revenues while maintaining incentives for further exploration and development. Consultations with the oil industry have taken place and I can now announce detailed proposals.

I intend to introduce a new tax — the Supplementary Petroleum Duty — broadly as outlined last November. The new tax will be at a rate of 20 percent on the total value of oil and gas produced, after deduction of an allowance of 1m tonnes a year for each field.

It will be deductible in computing liability to Petroleum Revenue Tax and Corporation Tax.

In response to representations by the industry, gas supplied to the British Gas Corporation from earlier North Sea fields will be exempted. And there will be provisions for the new tax to be refunded where fields do not fully recover their initial development expenditure.

The new tax will be payable in monthly instalments. This will make a useful contrition to achieving a smoother public-sector cash flow through the year. I shall also invite the industry to consider with the Inland Revenue how a broadly similar pattern of payments might be introduced for PRT.

I also announced in November last year that the special reliefs devised for PRT were under review. I now have proposals to make involving some restriction of these reliefs. I hope that the Minister of State, Treasury will have the opportunity of covering them in more detail in the debate.

There are a number of other minor changes to improve the oil taxation regime — partly made in response to the industry's own views.

The new tax, together with changes to the PRT reliefs, will raise an extra £ 1bn in 1981-82. There will be a substantial continuing yield in later years.

The oil companies have urged that my objectives of more revenue, and a more efficient and economical pattern of tax relief, could be better secured by a thoroughgoing reform of PRT, which would make it unnecessary to introduce a permanent new tax.

Officials have over several months given exhaustive consideration to this possibility, but without success, and no other proposals which I could regard as satisfactory have been put forward from any other source. But I do not close my mind to the possibility that modified proposals producing a broadly similar yield might be forthcoming.

I propose, therefore, that the new tax, SPO, should in the first instance have legislative effect only for the 18 months ending on June 30, 1982. This will allow ample time for further study and consultation before permanent arrangements are introduced in next year's Finance Bill.

Bank tax

Apart from oil, one other business sector has largely been protected from the effects of the recession, and that is banking. Indeed bank profits in recent years have increased sharply, both absolutely and by contrast with the experience of most other businesses. A substantial part of these pro-

C. Time of filing income tax returns

A resident alien whose income is derived solely from wages, salaries, interest, dividends, allowances, commissions, bonuses, fees, pensions, or any combination thereof, is required to file his income tax return on or before March 18 of each year, covering the income of the preceding calendar year. A non-resident alien engaged in trade or business must file his return on or before April 15 of each year.

Married persons are required to file a joint or consolidated return that includes the income of the husband and the wife. The spouses are not allowed to file separate returns except if it is impractible for the spouses to file a consolidated return and, in such cases, the income declared in both returns is consolidated and the tax is computed on the joint income.

When the due date of the filing of the return falls on a Saturday, Sunday or holiday, the return may be filed on the next business day.

D. Payment of tax

Any tax due must be paid at the time the return is filed. If the tax exceeds ₱ 2,000, this may be paid in two equal installments. The first installment is payable upon filing of the return and the second installment on or before July 18 following the close of the calendar year. The withholding tax already withheld by the employer shall be deducted from the first half of the income tax liability and only the balance shall be payable as the first installment.

E. Tax treaties

The Philippines has effective tax treaties with Sweden, Denmark, Singapore, Canada, France, United Kingdom, Autralia, Japan and Belgium. Treaties with the United States, Finland, Pakistan, New Zealand, Malaysia, Italy have been signed and are awaiting ratification by the respective governments.

The tax treaties contain provisions regarding tax exemption of dependent personal services. By way of illustration, under the Philippines-Australian tax convention, a resident of Australia who has been in the Philippines for a period of not more than 183 days in a taxable year is not subject to Philippine tax or compensation for personal services if: (a) the remuneration is paid by or on behalf of an employer who is not a resident of the Philippines, and (b) the remuneration is not deductible in determining the taxable profits of a permanent establishment which the Australian employer has in the Philippines. [20]

20. Article XV (2), Philippines-Australia Income Tax Treaty.

THE UNITED STATES – ISRAEL INCOME TAX TREATY: AN AMENDING PROTOCOL

By Dr. Yitzhak Hadari*

A Protocol to the Income Tax Treaty between Israel and the United States was signed in Washington on May 30, 1980. The Protocol amends the Income Tax Convention which was signed on November 20, 1975, but has not yet entered into force. The treaty and the amending protocol are waiting for the advice and consent of the United States Senate, and thereafter for the proper decree of the Israel Minister of Finance, before they will enter into force.

The Protocol adds a New Article 15-A which provides, subject to certain limitations, that charitable contributions by a citizen or resident of the United States, or a resident of Israel, to charitable organizations of the other contracting country will be eligible for deductions or credits for the purpose of the income tax laws of the country of the contributor.

The Protocol changes the Israeli withholding tax upon distribution of dividends by an Israeli subsidiary to its United States parent corporation. Under the Treaty the general withholding tax is 25 percent of the gross dividends and, under certain conditions, is reduced to 12.5 percent when the recipient is a corporation. The Protocol increases the Israeli withholding tax to 15 percent when the Israeli subsidiary has been subject to reduced corporate tax under Israel's Encouragement of Capital Investment Law.

That tax incentive law provides for corporations qualified in 1978 and later for 30 percent Israeli corporate tax instead of the normal 61 percent tax on retained earnings. Because the United States refuses to provide tax-sparing for this specially reduced tax the Israeli withholding tax is designed to prevent the result that upon distribution of dividends the United States will collect part of the taxes that Israel waived. Such part is, generally, the difference between the United States corporate tax rate and the reduced Israeli effective rate after the United States foreign tax credit for Israeli taxes.

Other provisions of the Protocol include an income tax treatment concerning the tax on profits levied on financial institutions under Israel's Value Added Tax Law.

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cludes that received by his wife — is available. The standard deduction for a working wife may be taken whether the taxpayer uses the itemized deduction or the optional standard deduction.

B. Optional standard deduction

In lieu of itemizing deductions, a citizen or resident individual may elect a standard deduction of ten percent of gross income without need of substantiating the same.

C. Personal exemptions

A single person, or a married person legally separated from his or her spouse, is allowed a personal exemption of ₱ 3,000. A married person is entitled to a personal exemption of ₱ 6,000; however, a husband and wife who are not legally separated are allowed to deduct only one such exemption from their aggregate income. A head of the family [19] is entitled to a personal exemption of ₱ 4,500.

In addition, a married person or head of a family is allowed an exemption of ₱ 2,000 for each legitimate, recognized natural, or adopted child wholly dependent upon and living with them. The child must be 21 or under, unmarried, and not gainfully employed, or must be incapable of self-support because of a mental or physical defect. The number of dependents for whom additional exemptions may be claimed cannot exceed four, except for dependents who otherwise qualified as dependents prior to January 1, 1980 in which case they are allowed only ₱ 1,000 as additional exemption. No additional exemption is allowable for parents (whether or not residing with the taxpayer), parents-in-law, or dependents of a married resident alien whose dependents continuously reside outside the Philippines.

A taxpayer who marries or has additional dependents during the taxable year generally may claim such personal exemptions for the entire year. If a taxpayer, spouse, or any dependent dies or a dependent reaches the age of 21 during the taxable year, personal exemptions may be claimed as if the death or attainment of age 21 occurred at the close of the year, and the personal exemptions may be taken for the entire year.

Under certain conditions, a non-resident alien engaged in trade or business may claim an exemption equal to the exemption allowed by the income tax law of his country of origin to citizens of the Philippines, but such exemption cannot exceed that allowed under Philippine law for citizens or residents of the Philippines. The Bureau of Internal Revenue has recognized the United States, Switzerland, Spain, and the United Kingdom as granting exemptions to citizens of the Philippines. Citizens of these countries who are non-residents of the Philippines are entitled to both personal and dependent exemptions.

19. A "head of family" includes an unmarried man or woman with one or both parents, or one or more brothers or sisters, or one or more legitimate, recognized natural, or legally adopted children living with and dependent upon him or her for their chief support where such brothers, sisters or children are not more than 21 years of age, unmarried, and not gainfully employed or where such children are incapable of self-support due to mental or physical defect.

VIII. ADMINISTRATIVE MATTERS

A. Withholding tax on wages

To facilitate the collection of income taxes, the Tax Code provides for a withholding tax on wages system which is primarily applicable if:
(1) there is an employer-employee relationship; (2) there is payment of wages; and (3) both the employer and employee are within the taxing jurisdiction. Under this scheme, the employer is mandated to deduct and withhold from this employee's wages actually or constructively paid on the basis of the withholding tax tables prepared by the Minister of Finance for various payroll periods. The withholding tax depends on the amount of wages and number of dependents. The amount withheld is creditable against the final income tax liability of the employee.

Wages include all taxable remunerations for services performed by an employee for his employer, including the cash value of all remunerations paid in any medium other than cash. As indicated earlier, certain no-cash benefits are not includible in the employee's gross income and, hence, are not subject to withholding tax.

The Withholding Tax on Wages Regulations exempt certain payments to employees from withholding tax, to wit:
- facilities or privileges of relatively small value offered or furnished by the employer merely as a means of promoting the health, goodwill, contentment or efficiency of the employee;
- amounts given to employees, either as advances or reimbursements for travelling or other bona fide ordinary and neceassary expenses incurred or reasonably expected to be incurred in the business of the employer, subject to certain conditions.

Failure of the employer to deduct and withhold the taxes due will render him liable for the payment of the deficiency withholding tax plus a surcharge at the rate of 25 percent of the amount of taxes that should have been withheld and interest rate of 20 percent per annum. However, if the income has been reported by the employee and the income tax paid thereon, the tax shall no longer be collected from the employer but the employer may still be held liable for penalties for failure to withhold. In addition, the salaries paid to employees will not be allowed as a deduction from the employer's gross income.

B. Who are required to file income tax returns?

A resident alien who has a gross income of at least ₱ 3,000 for the taxable year is required to file an income tax return. Regardless of the amount earned, a non-resident alien engaged in trade or business in the Philippines is also required to file an income tax return. On the other hand, a non-resident alien not engaged in trade or business and from whom the appropriate withholding tax has been withheld by the withholding agent need no longer file an income tax return.

only allowable deductions are those expenses paid or incurred in carrying on any business or trade conducted in the Philippines.

2. Personal expenses

In addition to business expenses, an individual taxpayer may deduct certain expenses or payments even if incurred for a personal purpose. Some of these deductions are:

(a) Interest

Interest paid within the taxable year on indebtedness of the taxpayer is deductible unless the debt was incurred or continued to purchase bonds or other securities, the interest of which is tax-exempt. This deduction applies even if the interest is on a personal indebtedness.

A cash basis individual taxpayer who incurs an indebtedness on which interest is paid in advance through discount or otherwise shall be allowed to deduct the interest in the year the indebtedness is paid. However, if the interest is payable in periodic amortizations, the amount of the interest which corresponds to the amount of the principal and which is amortized or paid during the year shall be allowed as a deduction in such taxable year. No interest shall be allowed as a deduction if both the taxpayer and the person to whom the payment has been made or is to be made are related parties. [17]

For non-residents, the interest allowable as deduction is the proportion of interest paid within the year which gross income from Philippine sources bears to total gross income from all sources.

(b) Taxes

All taxes paid or accrued during the taxable year are deductible except: (1) income tax; (ii) foreign income and excess profits taxes for which tax credit is claimed; (iii) estate and gift taxes; (iv) taxes assessed against local benefits; (v) taxes paid on articles imported by the taxpayer where such importation is not connected with his trade or business; and (vi) excess electric energy consumption tax.

Customs duties, business, occupation, license, privilege, excise and stamp taxes and any other taxes of any name or nature paid directly to the Philippine Government or to any political subdivision thereof are deductible. Automobile registration fees are considered as taxes. But, the term "taxes" means taxes proper and no deduction shall be allowed for surcharges or penalties which result from delinquency. [18]

Non-residents may claim deduction for taxes only to the extent connected with income from Philippine sources.

(c) Losses

As a general rule, only losses which are incurred in trade or business or in a transaction entered into for profit are deductible. Moreover, losses incurred by an individual in one line of business cannot be offset against income from another line of business.

The exception is the so-called casualty loss. Losses from fires, floods, storms and other casualties, and from robbery, theft and embezzlement can be deducted. The taxpayer is required, however, to submit a declaration of loss within 45 days from the occurrence of the casualty or event that caused the loss. Failure to comply with this requirement precludes the taxpayer from claiming a deduction.

Non-residents are allowed deductions from losses sustained in the Philippines.

(d) Bad debts

Bad debts (whether business or non-business) ascertained to be worthless and charged off within the taxable year may be deducted. Bad debts must be shown to be worthless in fact and in law. Reasonable steps to collect the debt must be taken, although the taxpayer does not have to institute legal action if it appears that such effort will prove useless.

Non-residents are allowed bad debt deductions for those that have arisen in the conduct of trade or business in the Philippines.

(e) Charitable contributions

Gifts made to certain qualified Philippine organizations within the taxable year are deductible up to an aggregate amount not to exceed six percent of the taxpayer's net income computed without the benefit of the charitable contribution deduction. However, there are contributions to certain institutions which are deductible in full and are not included for purposes of computing the six percent limitation.

(f) Medical care expenses

These expenses can be claimed only by citizens and resident aliens.

Medical care expenses incurred and paid in the Philippines during the taxable year for the diagnosis, cure, mitigation, treatment or prevention of diseases (excluding amounts for medicines) of the taxpayer, his spouse or his dependents are deductible. The deduction shall not exceed ₱ 500 each for the taxpayer and his dependents, and may not exceed ₱ 2,000 in the aggregate. Premiums for medical or life insurance are not deductible.

(g) Basic tuition fees

Again, only citizens and resident aliens may avail themselves of this deduction.

Expenses incurred and paid in the Philippines during the taxable year for basic tuition fees of taxpayer's dependents who are studying in high school are deductible. The deduction shall be limited to ₱ 250 for each of the taxpayer's dependents and may not exceed ₱ 1,000 in the aggregate.

(h) Deduction for working wife

Standard deduction of ten percent of the gross income received by the taxpayer's working wife — but not to exceed ₱ 500 if the gross income reported in the return in-

17. Section 30 (b)3(B), Tax Code.
18. Section 80, Revenue Regulations No. 2.

building of the corporation in the Philippines did not constitute income to the taxpayer since no part of the allowance redounded to the benefit of the taxpayers. Neither was a part of the allowance retained by the taxpayer and his wife.

Following this principle, the cost of air tickets and other traveling expenses given to the expatriate for head office consultations and other bona fide business purposes should not be treated as additional taxable compensation.

D. Moving expenses

On the same principle as in the case of travelling expenses, moving expenses actually incurred by the expatriates and paid for by the company — and which did not redound to the personal benefit of the employee — need not be included as part of gross taxable income.

E. Medical expenses

Ordinarily, facilities or privileges, such as medical services or so-called courtesy discounts on purchases furnished or offered by an employer to his employees generally, are not considered as wages subject to withholding if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, goodwill, contentment, or efficiency of his employees. [15]

F. Entertainment and representation allowances

The Withholding Tax on Wages Regulations do not consider as wages, and therefore not subject to withholding tax, "amounts paid specifically — either as advance or reimbursements — for travelling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer", provided they are specially identified. In a ruling dated January 30, 1962, the Bureau of Internal Revenue held as follows:

Under the pertinent provisions of Section 2 (c) of Revenue Regulations No. V-8, as amended, fixed lump sum allowances in the form of representation and transportation given to an officer of a corporation are not considered as wages, hence, not subject to the withholding tax on wages if they are ordinary and necessary expenses reasonably expected to be incurred in the business of the employer and they are properly accounted for and specially identified as such in the books of accounts of the corporation.

If the above conditions are met, allowances for representation and transportation are not considered as additional wages.

The company should consistently require employees to submit the receipts issued by the entity or person to whom payments were made and not those issued by the employees in order to be able to take a business deduction other than as additional compensation. Thus, in the case of *Collector of Internal Revenue v. Goodrich International Rubber Co.*, [16] the Supreme Court disallowed the deduction from the corporate taxpayer's gross income of representation expenses incurred by the officers because they were not based on the receipts issued by the entity to which payment was made but upon the receipts issued by the officers entitled to representation expenses.

VII. DEDUCTIONS

An individual taxpayer may claim either the itemized deduction or optional standard deduction (OSD) from his gross income. Itemized deductions must be substantiated with supporting receipts or documents and are subject to examination. On the other hand, the OSD may be claimed without need of supporting documents. If a taxpayer does not signify in his tax return the election of the OSD, he is presumed to have chosen the itemized deductions. The OSD can be claimed only by citizens or resident aliens.

A. Itemized deductions

1. Unreimbursed business expenses

Normally, expenses incurred by the expatriate in the pursuit of the business of the company such as entertainment and travelling which are paid and reimbursed by the company present no real problem so long as they are properly supported. However, if these expenses are not reimbursed by the company, the executive may claim them as deductions from his gross income subject to certain conditions.

An executive who on account of the nature of his duties is expected to entertain clients, prospective customers or company guests may claim entertainment expenses as deductions from his gross income. The present tax rules require, in general, that such expenses be directly related to the active conduct of the taxpayer's business. A taxpayer claiming entertainment expenses must substantiate his deductions with appropriate supporting documents and indicate the following elements for each such expenditure:

(a) amount, time and place of entertainment;
(b) person entertained;
(c) the business purpose thereof; and
(d) business relationship to the taxpayer of the person entertained.

A salaried individual cannot deduct more than 10 percent of his gross compensation income as representation expenses.

Amounts spent for business travel while away from home are deductible as business expenses. The basic requirement for the deduction is that the amount must be directly related to the pursuit of a trade or business. The deduction for travelling expenses includes travel fares, meals and lodging, and expenses incidental to travel such as expenses for telephone and telex, secretarial service, baggage charges, tips, fares, and other transportation costs.

For non-resident aliens engaged in trade or business, the

15. Section 2, Revenue Regulations No. V-8-A, as amended.
16. G.R. No. L-22265, December 22, 1967.

Failure on the part of the employer to withhold the proper tax will result in the disallowance of the payment which is otherwise deductible as a business expense.

Some of the ususal fringe benefits are:

A. Company-provided housing

As a general rule, housing allowances furnished to employees in addition to cash salary must be included as part of compensation subject to withholding tax. [10]

However, if living quarters are furnished to an employee for the convenience of the employer and as a necessary incident to the proper performance of his duties, the value thereof need to be considered as compensation subject to withholding. [11] If the nature of the service requires the furnishing of lodging for its proper performance — and without it the service may not properly be rendered — and in lieu thereof the employer gives a housing allowance, such allowance should not be treated as part of the employee's gross amount but it is to be regarded merely as a business expense on the part of the employer.

Normally, the "convenience of the employer" rule is used as the basis for non-inclusion of the value of the quarters furnished at actual job-site.

The tax treatment of housing not provided at work site is illustrated in the case of *Collector of Internal Revenue v. Henderson.* [12] In this case, the taxpayer was the president of a large Philippine corporation. The taxpayer and his wife entertained officials and customers of his employer-corporation in the apartments furnished by the latter and successively occupied by him as president thereof. The taxpayers were childless. The apartment that they first occupied consisted of a large sala, three bedrooms, dining room, two bathrooms, kitchen and a large porch, and the quarters in which they subsequently lived consisted of a kitchen, sala, dining room, two bedrooms and a bathroom. These quarters exceeded their personal needs. The apartments were big but they had to live in apartments of a size beyond their personal needs, because, as president of the corporation, he and his wife had to entertain his company's officials and guests.

Were it not for the fact that he was required by his employer to live in those apartments, he and his wife could have chosen an apartment only large enough for them and spent from ₱ 300 to ₱ 400 as monthly rental. The taxpayer claimed that of the allowances for rentals and utilities granted to him, only the amount of ₱ 4,800 annually, the maximum they would have spent for rental, should be considered as his taxable income and the rest treated as expense of the company.

The Philippine Supreme Court sustained the taxpayer since it observed that the exigencies of the taxpayers' high position, not to mention social standing, demanded and compelled them to live in more spacious and pretentious quarters, like the ones they occupied. Although entertaining and putting up guests of the employer-corporation was not his predominant occupation as president, he and his wife still had to entertain and put up house guests in their apartments. That is why his employer had to grant him allowances for rental and utilities, in addition to his basic salary, to take care of those extra expenses for rental and utilities in excess of their personal needs. The fact that the taxpayer had to live or did not have to live in the apartments chosen by the employer was of no moment, for no part of the allowance redounded to their personal benefit. Their bills for rental and utilities were paid directly by the employer to the creditors. Thus, the Court ruled only the amount of ₱ 4,800, the reasonable amount they would have spent for house rental and utilities such as light, water, telephone, etc., should be the amount subject to tax and the excess was to be considered as expenses of the corporation.

In a ruling dated December 4, 1975, the Bureau of Internal Revenue, applying the principles of the *Henderson* case, held that the amount reimbursed by the corporate employer to its expatriate-president equivalent to the cost of house rental and utilities in excess of that needed for personal purposes was not subject to income tax. Conversely, if the employer directly pays for the housing and utilities and the expatriate contributes to or reimburses the employer for a sufficient amount allocable to his personal or family needs, there is no need to reflect in his income any additional compensation on account of the company-provided housing.

While the rule that the housing allowance or rental including utilities must be pro-rated in accordance with the above principles, there is no administratively fixed or accepted percentage as to how much in the use of the house should be attributed to the personal needs of the executive. This is basically a factual issue.

B. Company-provided car

Key employees are usually provided with cars. If the company-provided car is used in the pursuit of the employer's business, no income should be attributed to the executive by reason of the car. If the car is used also for personal reasons, there is, strictly speaking, some risk that the tax authorities might attribute a value to the personal use and consider it as additional taxable compensation to the executive. There is no hard and fast rule on this matter. In *Jamir v. Collector of Internal Revenue,* [13] the Supreme Court allowed the taxpayer to deduct three-fourths of the car's depreciation and the driver's salary since the car was used by the taxpayer more for business than for personal purposes.

C. Travel expenses to head office

In the *Henderson* [14] case, the Court held that allowances for travel expenses granted by the corporate employer to the taxpayer's wife in connection with her trip to New York at the behest of the corporation to help in drawing up the plans and specifications of the proposed

10. Ibid.
11. Section 2, Revenue Regulations No. V-8-A, as amended, otherwise known as Withholding Income Tax Regulations.
12. G.R. Nos. L-12954 and 13049, February 28, 1961.
13. G.R. No. L-16552, March 30, 1962; SCRA 718.
14 Supra, footnote 12.

Section 5. Definition.

A "non-resident alien individual" means an individual -
(a) Whose residence is not within the Philippines; and
(b) Who is not a citizen of the Philippines.
An alien actually present in the Philippines who is not a mere transient or sojourner is a resident of the Philippines for purposes of the income tax. Whether he is a transient or not 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 Philippines and has no definite intention as to his stay, he is a resident. One who comes to the Philippines 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 Philippines, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned.

The above guidelines are vague and have remained practically the same since they were first adopted. It is to be noted, however, that the aforequoted Regulations frequently refer to the intention of the alien as to the length and nature of his stay. Since the intention must be shown by facts and circumstances surrounding the alien's stay in the Philippines, the question of whether an alien is a resident or not is basically factual. However, the Bureau of Internal Revenue, in a 1958 ruling, held that a holder of a pre-arranged employment visa who worked in the Philippines for a period of more than one year was a resident.

Philippine court decisions defining residence for non-tax purposes are of no help since they prescribe somewhat different standards. Thus, a person is deemed a resident of the place where he has his abode, and lives permanently, and to which he intends to return after a temporary absence. [6] For tax purposes, the lack of a definite intention as to his stay in the Philippines makes an alien a resident.

If an alien is a non-resident, his status is either one engaged in trade or business in the Philippines or not so engaged.

The criterion used by the Tax Code in determining whether or not a non-resident alien is engaged in trade or business in the Philippines is the length of his stay. [7] Thus, if the aggregate stay of a non-resident alien in the Philippines is more than 180 days during any calendar year, he is considered as engaged in trade or business even if he did not perform any personal services or transact any business during his stay. On the other hand, a non-resident alien is not considered as engaged in trade or business in the Philippines if his total stay was for 180 days or less during the year, even if during such stay he actually performed personal services or engaged in business activities.

The gross income received by alien individuals employed by regional headquarters established under Presidential Decree No. 218, or by OBUs under Presidential Decree No. 1034, or by alien employees of subcontractors or service contractors engaged in petroleum operations is subject to a final withholding tax of 15 percent. Gross income includes salaries, wages, annuities, compensation, remuneration or other forms of emoluments for performing services.

IV. SOURCE OF INCOME RULE AS TO COMPENSATION

As stated, a non-resident alien is taxed only on his Philippine-source income.

The rule is that compensation is Philippine-source income if paid for services rendered in the Philippines irrespective of the place of payment, of the place where the contract for service was made, or of the residence of the payor. If the services are performed outside the Philippines, the compensation is foreign-source. The decisive factor is therefore the place of performance of the services.

When the services are performed partly within and partly without the Philippines and no accurate segregation can be made for services performed in the Philippines, the amount to be included in the gross Philippine-source income shall be determined by an apportionment of the time spent in rendering the service, that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of services within the Philippines bears to the total number of days of performance of services within and without the Philippines.

V. DEFINITION OF THE TERM GROSS INCOME

In general, gross income includes compensation for personal and professional services, business income, profits from sales and dealings in property, interests, rents, dividends and gains, profits and income derived from any source whatever unless exempt by law. [8]

Where services are paid for in kind, the fair market value thereof is generally includible in gross income. [9]

Thus, overseas premium, hardship allowance, bonus, cost of living and educational allowances for the expatriates' children are subject to tax. Moving expenses (which are paid or incurred for the convenience of the employer) are not taxable. In the same manner, reimbursed bona fide business expenses which are covered by adequate expense reports are not taxable.

VI. TAXATION OF NON-CASH BENEFITS

It is customary to extend non-cash or fringe benefits to expatriates. It is important to examine the taxation of these fringe benefits for two reasons: to determine their inclusion in the employee's gross income, and their liability to withholding tax on wages.

6. Caraballo v. Republic, G.R. No. L-15080, April 25, 1962; 4 SCRA 1055.
7. Section 22 (a), Tax Code.
8. Section 39, Revenue Regulations No. 2, otherwise known as Income Tax Regulations.
9. Section 41, Revenue Regulations No. 2.

Philippine Taxation of Alien Individuals

by Cornelio C. Gison* and Serafin U. Salvador, Jr.**

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I. INTRODUCTION

An alien accepting employment in the Philippines should be aware of the Philippine rules governing income taxation of alien individuals. This article will generally discuss some basic rules. Its primary objective is to apprise multinationals of the tax problems affecting their Philippine expatriates. An awareness of these problems may aid a foreign investor in its tax planning to minimize the impact of Philippine taxation on its expatriate employees and ultimately on the company.

II. CLASSES OF ALIEN TAXPAYERS

The tax status of an alien taxpayer is important in determining his tax base and rate. For Philippine income tax purposes, there are four types of alien taxpayers:

1. Resident aliens.
2. Non-resident aliens engaged in trade or business in the Philippines.
3. Non-resident aliens not engaged in trade or business in the Philippines.
4. Aliens belonging to special categories:
   (i) Aliens employed by regional headquarters of multinational corporations. [1]
   (ii) Alien employees of Offshore Banking Units (OBUs). [2]
   (iii) Aliens employed by subcontractors or service contractors engaged in petroleum operations under Presidential Decree No.87. [3]

Resident aliens are taxed like citizens at graduated rates (range: 3-70 percent) on their net income from world-wide sources although any foreign tax paid on foreign-source income can normally be claimed as a foreign tax credit subject to the "per country" and "overall" limitations. [4]

Non-resident alien individuals are taxed only on income from Philippine sources. If a non-resident alien is engaged in trade or business in the Philippines, he is taxed on his net Philippine income at the same progressive tax rates as applicable to resident aliens. If a non-resident alien is not so engaged, he is taxed at a flat rate of 30 percent of his gross Philippine income.

III. DETERMINATION OF RESIDENCY OR NON-RESIDENCY STATUS

The Tax Code merely defines a "non-resident alien" as an individual whose residence is not within the Philippines and who is not a citizen thereof. [5] The guidelines prescribed by Section 5 of the Philippine Income Tax Regulations for determining whether an alien is a resident or not are of no practical use since they are too general. They state as follows:

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1. Presidential Decree No. 218, "Prescribing Incentives for the Establishment of Regional or Area Headquarters of Multinational Companies in the Philippines", June 16, 1973.
2. Presidential Dceree No. 1034, "Authorizing the Establishment of an Offshore Banking System in the Philippines", September 30, 1976.
3. Presidential Decree No. 1354, "Imposing Final Income Tax on Subcontractors and Alien Employees of Service Contractors and Subcontractors Engaged in Petroleum Operations in the Philippines under Presidential Decree No. 87", April 21, 1978.
4. The credit for taxes paid to a foreign country is subject to two limitations: "per country" and "overall" limitations. Therefore, the credit for taxes paid to any foreign country cannot exceed that percentage of Philippine income taxes which taxable income from sources within that foreign country bears to entire taxable income from all sources. The total credit allowed is further limited to that proportion of Philippine income taxes which a taxpayer's net income from sources outside the Philippines bears to his entire net income from all sources.
5. Section 20 (g), National Internal Revenue Code of 1977 (hereinafter cited as Tax Code).

1979/80 continues to be subject to a maximum penalty of only 25 percent.

I am of the view that the penalties levied should bear some relation to the prevalent rates of interest. Otherwise, even taxpayers who can well afford to pay the tax due will postpone tax payments and utilise such funds for further investment. I, therefore, propose that where tax in respect of any year of assessment prior to 1979/80 is unpaid on 1st April, 1981, or goes into default subsequently, the maximum penalty should be raised to 50 percent.

I am giving an opportunity to taxpayers who have not paid their taxes for years prior to 1979/80 to settle all their tax liabilities before 1st April, 1981, without incurring the higher penalty of 50 percent.

3. Business turnover tax

(a) *The banking sector*

Mr. Speaker, the increase in banking activity in the past 3 years has resulted in a considerable increase in the volume of business and profits of banks. These profits are mainly a reflection of the increase in interest rates and the external transactions of the banks.

I, therefore, propose to impose a B.T.T. of 2 percent on the gross receipts of banks, excluding capital receipts. Receipts of the Foreign Currency Banking Units will, however, be exempt. The revenue from this source is expected to be Rs. 35 million.

(b) *Contractors*

The increase in building and construction activity has resulted in a number of persons entering into large contracts. In order to ensure that the revenue realisable from such activities is promptly collected, I propose to introduce a withholding tax in respect of contracts when the value of such contracts exceeds Rs. 500,000. The person making the payment will be required to withhold 2 percent of the gross amount payable and to remit the amount so withheld to the Inland Revenue Department. The contractor will get credit for such withholdings in the assessment of the B.T.T. payable by him.

(c) *Cement*

I propose to increase the B.T.T. rate on the local manufacture of cement (other than bagging) from the present rate of 1 percent to 10 percent. The additional revenue is around Rs. 50 million. This will not lead to an increase in the price of cement.

(d) *Ship chandlers and air-line caterers*

There has been a significant increase in the turnover of ship chandlers and air-line caterers in recent years owing to the liberalisation policy of this Government. As these are services which cater to the affluent, I propose to increase the B.T.T. on these businesses from 2 to 5 percent. The additional collections are expected to be Rs. 25 million.

(e) *Cigarettes*

Mr. Speaker, the Business Turnover Tax on cigarettes is being increased from 30 to 35 percent with effect from midnight. There will also, at the same time, be a small upward revision in the Tobacco Tax. These two measures will have the effect of putting up the retail price of all brands of cigarettes by 3 cents per cigarette.

The additional revenue expected is about Rs. 110 million.

4. Excise duty on liquor

I propose to increase the excise duty on all varieties of liquor with effect from midnight. The duties will be as follows:

	Rs. c.
Molasses arrack	38 40 per proof litre
Coconut arrack	44 50 per proof litre
Processed arrack	67 0 per proof litre
Country-made foreign liquor	78 0 per proof litre
Malt (Beer)	12 50 per litre

Import duties on foreign liquor are also being correspondingly revised in keeping with the higher excise duties.

Mr. Speaker, the new retail prices of arrack sold by the Sri Lanka Distilleries Corporation will be Rs. 34 per bottle for Coconut arrack and Rs. 28 for Special arrack. These new prices will also compensate for substantial cost increases which the Corporation has to incur in respect of its raw materials. I have already directed the Corporation to increase the price for toddy paid to producers from Rs.4.50 to Rs.6.00 per gallon.

The additional revenue expected from this proposal is around Rs. 85 million.

5. Postal rates

Mr. Speaker, my collegue, the Minister of Posts and Telecommunications intends revising the foreign postal rates to conform to certain international obligations arising from Sri Lanka's membership in the Universal Postal Union. There will also be some consequential changes in the inland postal rates. He also proposes to change the telephone tariffs. The details of the revised rates which will come into effect from 1st January, 1981, will be announced later by my colleague.

The additional receipts are expected to be around Rs. 160 million.

6. Export duties

Mr. Speaker, the revitalisation of our export sector and the export drive which our Government has launched is of crucial importance to our balance of payments. You are aware that my budgetary proposals during the last three years have been so devised as to ensure the attainment of this objective. The Government has at much cost to revenue reduced export duties on tea and coconut exports, and abolished those on minor agricultrual exports. To promote exports in the long term, replanting subsidies have been substantially enhanced. Schemes such as the revamped Duty Rebate Scheme and the provision of liberal tax incentives to the export sector have created the necessary climate for a successful export drive.

Mr. Speaker, you will thus observe that all possible incentives and facilities are being provided for our exports. As a further incentive for production and export of rubber, I have decided to increase the replanting cess of 35 cents per kilo which is currently levied on the export of rubber to 50 cents per kilo. The rubber replanting target now is about 17,500 acres per annum. It is necessary to augment the Cess Fund which finances this programme if this target is to be kept. In order to compensate for the increase in the cess, I propose to reduce the export duty on rubber by 15 cents per kilo by adjusting the sliding scale of export duty on rubber. The loss to revenue and the consequent gain to Replanting Funds, would be around Rs. 20 million in 1981.

Mr. Speaker, the rubber industry over the years has been engaged chiefly in producing and exporting rubber in its raw form. It is very essential that this pattern be changed. You will recall, Mr. Speaker, that the Government has already ensured that in the case of tea, incentives have been provided to encourage the export of tea in a processed form such as tea bags and tea packets. In the recent past, certain manufacturers have embarked on producing a semi-pocessed product out of rubber known as "Camel Back" which contains 60 percent rubber and 40 percent carbon black and other additives. At present, the export duty leviable on this processed product is the same as that of natural rubber. In keeping with our policy of encouraging the export of traditional products in more processed forms, I propose to levy export duty on Camel Back at 50 percent of the duty leviable on natural rubber. The same duty rate will apply to master-batch, which does not now pay any export duty.

The additional revenue that accrues as a result of these changes would be around Rs. 10 million.

All the above tax and revenue proposals are estimated to yield Rs. 605 million. Mr. Speaker, you will see that this does not go very far in bridging the deficit. This is because, we are more or less at the limits of taxation in this country. In 1979 our revenue was 26 percent of Gross Domestic Product. It was not possible to sustain this level of revenue because of the fall in tea prices leading to a reduction in export duties. It must also be realised that the sectors of the economy which are growing as a result of our tax and other incentives, do not, in the initial years, contribute anything to revenue. The expected revenue in 1981 will amount to 22 percent of estimated GDP. This too is quite high. Hence, Mr. Speaker, the additional revenue which I can raise cannot contribute more than marginally to bridging the deficit.

cise tariff entry and the rate structure relating to tyres with a view to making the legislative intent clearer and minimising the scope for disputes in classification and assessment, particularly in regard to off-the-road tyres used in bulldozers, scrappers and other earth moving equipment. While proposing the necessary amendments, I have taken care to maintain the existing rates of duties and duty concessions in respect of tyres both for agricultural tractors and their trailers.

Non-ferrous metals

The other major area where rationalisation of the tariff entries has been proposed is in regard to non-ferrous metals under the respective entries in the central excise tariff. There has been considerable debate and dispute on the question of assessment of waste and scrap of these metals. To set these at rest it is proposed to specifically cover waste and scrap of these metals under the respective tariff entries.

In addition to the above, a few other amendments to certain tariff entries as also the insertion of a separate tariff item for polyester film have been proposed. The details of these changes may be seen from the budget papers.

. . .

I had earlier stated that the resources gap estimated at existing rates of taxation is 1,810 crores Rs. The various tax measures I have presented, together with the reliefs offered, will yield net additional revenue of 271 crores Rs. to the Centre. This leaves an uncovered deficit of 1,539 crores Rs. This deficit may appear large, but taking a total view of the economic situation I believe it is within the limits of fiscal prudence. The inflationary potential of the budget must be viewed in the context of the full package of policy measures which I have outlined. This package contains many incentives for higher production and increased utilisation of capacity. This should stimulate a considerable supply response during the coming year and, as I have mentioned, signs of this upturn are already evident. I attach great importance to expanded supplies as the critical element in keeping inflationary pressures in check.

The package also contains important incentives to savings which will undoubtedly help in this regard. Furthermore, monetary and credit policies will be so designed as to ensure that government recourse to deficit financing takes place within a balanced and measured overall expansion of credit in the system.

Mr Speaker, Sir, the economic situation remains difficult and yet full of great opportunities for development and growth. I have tried to present a budget which gives maximum support to forces that can move us forward on the path of growth with stability and social justice. It sets the stage for all for us to work towards the achievement of our economic and social goals so clearly laid out in the Sixth Plan. Economic policy can only do this much. Hard work, discipline and the innate good sense of the people of this ancient land must do the rest.

Sri Lanka: BUDGET 1980

Reproduced below is an extract from the Budget Speech for 1980 presented on November 5, 1980 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. See for a detailed discussion of the Sri Lanka tax system our publication: *Taxes and Investment in Asia and the Pacific.*

1. Surcharge on income tax

It is my intention to allow the tax structure which has been in operation during the last three years to remain undisturbed without major changes. I, however, believe that at a time when the ordinary man is called upon to bear considerable burdens, due to the rise in the cost of living, those who can well afford to make some contribution to Government revenue should be called upon to do so. I propose to impose a once and for all surcharge of 10 percent on the income tax payable by all persons including companies for the year of assessment 1980/81. This measure will bring in a revenue of Rs. 150 million.

2. Changes in the Inland Revenue Act

There are also a few anomalies that have arisen as a result of the changes introduced by the Inland Revenue Act, No. 28 of 1979 and the Amendment Act, No. 24 of 1980 which need to be rectified.

(a) *Liability of small companies*

Mr. Speaker, small companies are liable to income tax at a concessionary rate of 20 percent on the first Rs. 50,000 of taxable income, at 30 percent on the next Rs. 100,000 of taxable income and at 40 percent on the balance. In terms of the Amendment Act, No. 24 of 1980, small companies which are also quoted public companies may pay tax at 40 percent on their taxable income, in which event they are not liable to pay dividend tax at 20 percent. In the alternative, small companies can continue to pay tax at the concessionary rate of 20 percent going up to 40 percent, in which event they will be liable to pay dividend tax at 20 percent.
Since the formation of small quoted public companies should receive every encouragement, I propose to amend the Inland Revenue Act to enable a small company which is also a quoted public company to pay tax retrospectively from the Year of Assessment 1980/81 at the concessionary rate of 20 percent going up to 40 percent and also be exempted from paying tax on the dividend declared.

(b) *Maximum rate of tax on capital gains*

The maximum rate at which any person is liable to tax on capital gains is 25 percent. This rate should apply to corporate and non-corporate taxpayers alike. In the Inland Revenue Act, No. 28 of 1979, the maximum rate of 25 percent on capital gains has been specified in the Chapter dealing with the rate of income tax for non-corporate taxpayers, but similar provisions have not been incorporated in the Chapter dealing with the liability of companies. I propose to rectify this omission with retrospective effect.

(c) *Tax holiday for exports*

Under Section 7A of the old Inland Revenue Act, export-oriented industries which were in existence prior to 1st April, 1972, were eligible for a tax holiday for 5 years based on the increase in export profits over the standard profit. The standard profit was the average export profit for 3 years preceding a date to be selected by the industries called the "relevant date".
Representations have been made to the effect that certain industries have not been able to obtain the tax holiday for the full period of 5 years as the new Inland Revenue does not cover their case.
I, therefore, propose to provide that an undertaking which —
(i) commenced to carry on a trade or business prior to 1st April, 1972, and
(ii) is approved under Section 7A(2) by notice published in the *Gazette* prior to 1st April, 1981,
will be eligible for the tax holiday for the full period of 5 years.
These industries will, however, be required to select a relevant date not later than 1st April, 1974, as it is not the intention of the Government to allow these reliefs to be claimed in perpetuity.

(d) *Applicability of maximum automatic penalty for tax in default*

Mr. Speaker, in terms of the Inland Revenue (Amendment) Act, No. 24 of 1980, the maximum automatic penalty on tax in default has been raised from 25 percent to 50 percent. But this increase is effective only in respect of the year of assessment 1979/80 and subsequent years. Any tax in default for the years of assessment prior to

Auxiliary duties of customs are now leviable on imported goods broadly on a three-tier basis. Items subject to a basic duty up to 60 percent ad valorem, for example, basic raw materials, bear an auxiliary duty of 5 percent ad valorem; on items such as semi-processed goods and intermediates, where the rate of basic duty is 60 percent ad valorem or above but less than 100 percent, the rate of auxiliary duty is 15 percent ad valorem; and where the rate of basic duty is 100 percent ad valorem or above such as on finished and consumer goods, the rate of auxiliary duty is 20 percent ad valorem. In other cases the rate of auxiliary duty is 5 percent ad valorem, except crude petroleum on which the rate is 9.50 Rs. per metric tonne. There are also some items which are fully exempt from auxiliary duty. My proposal is to increase the rate of auxiliary duty to 10 percent ad valorem wherever the rate of auxiliary duty is now 5 percent; to 20 percent ad valorem wherever the rate is now 15 percent; and to 25 percent ad valorem where the rate is now 20 percent. I do not, however, propose to increase the auxiliary duty on crude petroleum.

In line with the approach I have explained, I propose to withdraw the present full exemption from auxiliary duties of customs in respect of certain items of capital equipment and subject them to auxiliary duty of customs at the rate of 5 percent ad valorem. This increase would cover, among other things, imports of machinery as "project imports" as also items of machinery on which the concessional rate of 25 percent ad valorem is applied. This measure would, apart from yielding additional revenue, afford some additional protection to the indigenous machine building industry which has, of late, had to face a significant escalation in input costs.

I said earlier that I would exclude some items from the proposed increase in the auxiliary duties of customs. Imports of essential items like edible oil will be exempted from the proposed increase. Bulk petroleum products such as kerosene and high speed diesel oil and steel imported for buffer stock operations will also not attract the increased levy. Items on which import duty rates have been changed in the recent past with a view to maintaining parity with prices of domestic products have also been kept out of the purview of the increased levy. Further, keeping in view our commitments under the General Agreement on Tariffs and Trade, I propose to give up the auxiliary duty in respect of three items involving a small revenue sacrifice. Further details of the proposals are available in the Budget papers.

These proposals are expected to yield an additional revenue of about 250 Rs. crores.

Foreign newsprint

My next proposal relates to levy of import duty on newsprint. At present this item is fully exempt. There is a large foreign exchange outgo on imports of newsprint. There is no reason why this commodity should not bear a moderate rate of customs duty. I, therefore, propose to impose an effective customs duty of 15 percent ad valorem on imported newsprint. I expect this measure to yield an additional revenue of about 21 crores Rs.

Steel products

Imports of stainless steel bars and wire rods now attract a duty of 75 percent because they have industrial applications. But there is reason to believe that some of ports are being diverted for rerolling into strips and sheets used in the manufacture of utensils. I, therefore, propose to raise the effective customs duty on stainless steel bars and wire rods from 75 percent to 175 percent ad valorem. I have, however, taken care to see that this increase does not affect imports of stainless steel wire rods which are used for the drawing of wires. This measure is expected to yield an additional revenue of five crores Rs.

I also propose to raise the basic customs duty on plain shaft bearings from 60 percent to 100 percent ad valorem. This increase should help to restrict large-scale imports of bearings such as thin-walled bearings, which have been affecting the indigenous industry. This proposal is expected to yield and additional revenue of 2.75 crores Rs. On similar considerations it is proposed to raise the basic customs duty on computers and computer peripherals from 40 percent to 50 percent ad valorem. The likely revenue gain from this increase would be one crore Rs.

Textiles

I will now come to excise duties. The House will recall that in 1978 the Additional Excise Duties (Textiles and Textile Articles) Act was passed, in terms of which an additional duty of excise was levied on certain textiles and textile articles at ten percent of the basic excise duty leviable. The revenue from this excise levy was intended to meet the expenditure incurred by way of subsidy on cotton-viscose cloth. The production of cotton-viscose cloth is being stepped up, with emphasis on larger production of dhotis and saris which are of special significance to the poorer sections of society, particularly in rural areas. As a result, the provision for subsidy under this scheme would rise to nearly 100 crores Rs. in the coming year. The revenue at the existing rate of additional excise duty is only about 66 crores Rs. I, therefore, propose to raise the rate of additional excise duty from 10 percent to 15 percent of the basic excise duty on all the items which are now covered by the levy. This would yield an additional amount of about 33 crores Rs. and help finance the increased outlay on controlled cloth.

Special excise duties

As regards special excise duties, I propose only to continue them at the existing rates. The exemptions in force are also being continued.

Protection of labour

My remaining proposals under Union excise duties are mainly designed to achieve simplification and greater clarity.

Hon'ble members would be aware that there is a graded structure of duty on matches, the mechanised sector paying 7.20 Rs. per gross boxes, the middle sector paying 4.50 Rs. and the cottage sector 1.60 Rs. In the light of the report of the Dandekar Committee and a special study made by the government, it has become necessary to discourage a tendency of middle sector units towards mechanisation of certain labour-intensive processes. Accordingly, I propose that the concessional rates of duty, i.e. 4.50 Rs. for middle sector units and 1.60 Rs. for cottage units, will not be available if power is used in the labour-intensive processes of frame-filling, dipping splints in match composition, box making, box filling, labelling and band rolling and packaging. If such units use power for any of the above processes, they will be liable to a duty rate of 5.50 Rs. per gross boxes, which would be intermediate between the rate of 7.20 Rs. applicable to the fully mechanised sector and 4.50 Rs. now applicable to the non-mechanised middle sector. I would like to stress that this is not intended as a revenue measure. It is intended only to protect through the excise mechanism, the employment potential of the non-mechanised sector.

With a view to preventing the possible infiltration of the middle sector into the cottage sector and in order to ensure that the benefit of the lowest rate of duty accrues to genuine cottage sector units, it is proposed to reimpose a ceiling on the clearances by cottage sector units at concessional rates. The new ceiling, which is proposed to be fixed at 120 million matches per unit per annum, is much more liberal than the ceiling of 75 million that existed prior to the 1980 budget. The pattern of production and clearance will be kept under watch and this ceiling will be reviewed if circumstances so warrant. The changes I have proposed are fair to all segments of the industry and are designed to promote both employment and production in the best possible manner.

"Job" work

Another rationalisation measure relates to the concession available to manufacturers of goods falling under tariff items 68, who undertake work on "job" basis. Under the present scheme, duty is being effectively collected only on the "job charges" paid by the principal manufacturer to the job workers. In the operation of the scheme, however, several difficulties have been experienced, particularly on the question of what is "job work". There have been cases where some manufacturers have taken undue advantage of the concession. I, therefore, propose to replace the present scheme by one in which, instead of levying duty separately on the job charges paid to the job worker the duty will be paid by the principal manufacturer on the value of the finished goods. This step should be generally welcomed by ancillary units which undertake work on job basis.

Tyres

I also propose to rationalise the central ex-

Oil exploration and production

Earlier in my speech, I have referred to the prospective participation of foreign companies in the field of oil exploration and production, it is necessary to take several steps relating to tax matters. Firstly, it is proposed to extend the Income-Tax Act and the Companies Surtax Act to the offshore areas. Secondly, it is proposed to insert suitable provisions in the Income-Tax Act and the Companies (Profits) Surtax Act to enable the Central government to provide, by a notification in the official gazette for an exemption, reduction in rate or other modification in respect of income-tax or surtax in favour of any class of persons engaged in the business of mineral oils and gas in association with the Central government or any person authorised by it. Notifications under the new provisions when made will be placed on the table of both the Houses of Parliament. It is also proposed to amend Section 42 of the Income-Tax Act relating to special provisions for deductions in the case of business of the prospecting for, or extraction or production of mineral oils so as to extend its scope to cover cases where the government itself does not participate in such business but does so through any person authorised by it.

Renewable energy resources

While the search for additional quantities of oil should continue with unabated vigour, there is also an urgent need to accelerate the development and use of renewable energy resources and to promote their utilisation. The renewable energy sources which have already been brought to the threshold of commercial use by our scientists and engineers include solar, biomass and wind energy. Some fiscal incentives to promote use of these non-conventional forms of energy are called for. I, therefore, propose to enhance the depreciation allowance on machinery or plant installed for manufacturing renewable energy devices and systems from 10 percent available at present to 30 percent. Depreciation on renewable energy devices and systems used for business or profession will also be allowed at the enhanced rate. Other measures under contemplation by the government include loans to the relevant industries on suitable terms from financial institutions and exemption from certain taxes and duties.

Incentives for exports

I had earlier in my speech referred to the imperative need to promote our exports in view of our difficult balance of payments situation. To encourage establishment of export-oriented industries in the free trade zone, the government proposes to allow complete tax holiday in respect of units set up in these zones for an initial period of five years in lieu of other concessions.

Tea is one of our important export-oriented industries. At present, development allowance equal to 50 percent of the expenditure incurred on plantation of tea bushes in any new area or on any land which has been previously abandoned is allowed in computing the income from tea business. For this purpose, the expenditure qualifying for development allowance is restricted to 12,500 Rs. per hectare of land situated in hilly areas and 10,000 Rs. per hectare in other areas. Having regard to the increase in the cost of planting in recent years, I propose to raise these ceiling limits to 40,000 Rs. per hectare of land situated in Darjeeling district, 35,000 Rs. per hectare in respect of land situated in other hilly areas and 30,000 Rs. per hectare in plains.

Under Section 35B of the Income-Tax Act, domestic companies and non-corporate taxpayers resident in India are entitled to a weighted deduction in the compution of the taxable profits at the rate of one and one-third times the amount of qualifying expenditure incurred by them on development of export markets. The scope of this provision was curtailed last year as it had been misused for claiming a weighted deduction in respect of expenditure incurred in India on activities which had no direct relations with the basic objective of development of export markets. In order to guard against such misuse, while at the same time protecting all legitimate effort at export market development, the government is framing rules which will identify a number of specific activities to be allowed under Section 35B. The necessary notification in this behalf will be issued shortly.

Electronics is both a labour-intensive and export-oriented industry. I, therefore, propose to include the electronic component industry in the Ninth Schedule to the Income-Tax Act and provide that dividends derived by a domestic company from an Indian company engaged exclusively in the manufacture of electronic components will be completely exempt from income-tax.

Small-scale industry

Small-scale industrial undertakings enjoy certain tax concessions under the Income-Tax Act. For this purpose, an industrial undertaking is regarded as a small-scale industrial undertaking if the aggregate value of the machinery and plant installed therein as on the last day of the previous year does not exceed 10 lakhs Rs. I now propose to raise this limit to 20 lakhs Rs. in line with the new definition of a small-scale industry.

Under the existing law, in computing taxable income, a deduction equal to 20 percent of the profits and gains derived from the business of publication of books is allowed. I propose to extend this concession for a period of five years with effect from assessment year 1981-82.

Finance companies

At present, approved financial corporations and public housing finance companies are entitled to a deduction in respect of the specified percentage of income carried to special reserve, subject to certain conditions. The aggregate of the amounts qualifying for such deduction is, however, subject to an overall ceiling equal to the amount of the paid-up share capital. In order to enable such corporations and companies to build up such reserve further, I propose to double the present ceiling.

Sick dependent persons

Under the existing law, resident individuals and Hindu Undivided Families are entitled to a deduction in respect of medical treatment of physically or mentally handicapped dependents. I propose to double the amount of this deduction to 4,800 Rs. in respect of a dependent who is hospitalised for a period of 182 days or more during the relevant accounting year and 1,200 Rs. in other cases. The House will doubtless welcome this concession being given in the International Year for Disabled Persons.

Estate duty

I propose to give some significant concessions under the Estate Duty Act. The present limit of 50,000 Rs. for estate duty was fixed in 1958. I propose to raise it to 1.5 lakhs Rs., the same as under the Wealth Tax Act. I also propose to provide that one residential house or part thereof will be value for estate duty purposes on the same basis as for the purposes of wealth-tax. Since the Estate Duty Act can be amended only with the concurrence of state legislatures, a bill for giving effect to these proposals will be introduced later.

...

Indirect taxation

I now turn to my proposals on indirect taxes. My basic approach is that additional revenue should flow largely from increased production. However, there is need to mobilise additional resources to finance the Sixth plan. While seeking to raise additional resources I have nevertheless kept in mind the imperative need to avoid hardship to the middle and poorer sections of consumers and to provide a larger measure of relief to the small-scale sector of our industry.

Auxiliary duties of customs

Taking customs duties first, my principal proposal relates to auxiliary duties of customs. This duty has been levied on an annual basis since the 1973 budget.

While continuing this levy I also propose to raise the rates of auxiliary duties as a measure of additional resource mobilisation. In recent years we have been following a fairly liberal import policy. The difficult balance of payments outlook points to the need for conserving foreign exchange. The tariff mechanism, judiciously used can help conserve foreign exchange and also raise some revenue. I, therefore, propose to increase the rates of imports with a purpose to increase the rates of auxiliary duties by 5 percent ad valorem, on all categories of imports with a few well-merited exceptions. This will obviate a sharp increase in the landed cost of any particular article.

INDIA:
Budget Speech 1981

Opinions range from "not bold" and "disappointing" to "a fine job has been done"

Extracts from the Budget Speech 1981 pronounced on February 28, 1981 by the Finance Minister Mr. R. Venkataraman.

A detailed description of Indian taxation appears in our publication: *Taxes and Investment in Asia and the Pacific.*

With respect to the taxation proposals the Finance Minister said the following:

Individual income tax relief *

Income-tax and other direct taxes are important instruments for raising resources and reducing disparities. We propose to achieve these objectives by plugging of legal loopholes and effective administration rather than by enhancement of rates which often leads to tax evasion and generation of black money. My proposals are also designed to further our party's avowed policy of affording relief to the middle classes in these difficult times.

Hon'ble Members will recall that last year the exemption limit for income-tax on personal income was raised to 12,000 Rs. But the Nil slab rate was retained at 8,000 Rs. The House will be glad to know that I propose to raise the exemption limit for income-tax in the case of non-corporate tax-payers other than registered firms and Hindu Undivided Families with one or more members having separate incomes exceeding the exemption limit, from 12,000 Rs. to 15,000 Rs. With a view to providing significant relief to middle income groups, I further propose to raise the Nil rate slab from 8,000 Rs. to 15,000 Rs. and also restructure the rate schedule up to 30,000 Rs. The rate of income-tax on the slab of 15,001 Rs. to 25,000 Rs. will be 30 percent and on the slab of 25,001 Rs. to 30,000 Rs., 34 percent. The rates of income tax on higher slabs will remain unchanged. As a result of these changes, about 14 lakhs of tax-payers will go out of the income-tax net, I venture to claim that never have so many people been freed from the burden of income taxation at one stroke. Apart from this, another 11.5 lakhs of tax-payers in the income brackets of 15,001 Rs. to 30,000 Rs. will also get varying degrees of relief. The reduction in the tax liability at income level of 15,000 Rs. will be 990 Rs.; at 20,000 Rs., 495 Rs. and at 25,000 Rs., 220 Rs. There will be no change in the tax liability in the case of tax-payers having income exceeding 30,000 Rs. Thus I have provided in one year income-tax exemption and/or reduction to over 25 lakhs of income-tax assessees out of about 40 lakhs of assessees in the country.

At present, salaried tax-payers are entitled to a standard deduction in an amount equal to 20 percent of the salary up to 10,000 Rs. and 10 percent of the balance subject to an overall ceiling limit of 3,500 Rs. These limits were fixed in 1974. In view of the subsequent rise in prices, and as a means of relief to salaried tax-payers, I propose to enhance the rate of standard deduction to 20 percent, subject to a higher ceiling of 5,000 Rs. Hon'ble Members will be happy to know that this benefit will be applicable to pensioners also. At present, employees in receipt of conveyance allowance are entitled to a standard deduction of 1,000 Rs. only. It is now proposed that they should be given the benefit of full standard deduction.

In view of the urgent need to raise the level of savings in the economy, I propose to continue the compulsory deposit scheme for income-tax payers for another two years.

Relief for the corporate sector

The corporate sector has a crucial role to play in the growth of the national economy. I have earlier in my speech referred to the various steps taken for improving the climate for investment in industry. I now propose to reduce by five percent the surcharge on income-tax payable by all classes of companies, i.e. from 7.5 percent to 2.5 percent. This will add to the internal availability of funds in the corporate sector and should improve the scope for investment financing from their own resources. This step will reinforce the impact of the measures which I have indicated earlier for mobilising financial resources for industrial investment.

Advance payment of surtax

As hon'ble members are aware, all categories of tax-payers are required to pay advance tax on pay-as-you-earn basis. Surtax is, however, not payable by companies in advance. I propose to remove this anomaly and provide that surtax will also be payable in advance during the financial year preceding the relevant assessment year.

Tax concessions

The eleventh schedule to the Income-Tax Act contains a list of industries which do not qualify for specified investment related tax concessions under the Income-Tax Act. For example, investment allowance or tax holiday is not admissible in respect of these industries unless they are in the small-scale sector. Industries included in this schedule were originally considered to be of low priority. However, on reviewing the list, I do not find any justification for treating many of the listed industries as of low priority. Accordingly, 14 groups of industries will be removed from this schedule and will now become eligible for the specified tax concessions. These industries include electric fans, pressure cookers, glass and glassware, pigments, colours, paints, enamels, varnishes, blacks and cellulose lacquers, chinaware and porcelainware, mosaic tiles and glazed tiles, synthetic detergents, amplifiers or any other apparatus used for addressing the public, vacuum flasks and other vacuum vessels, etc. These industries, some of which have export potential, will now become eligible for the specified tax concessions.

Tax avoidance

Hon'ble Members will recall that the government had taken several measures last year to curb the use of private discretionary trusts as a device for tax avoidance. Another tax avoidance device that has come to the notice of the government is the creation of oral trusts. With a view to checking this abuse, I propose to subject oral trusts to income-tax at the maximum marginal rate and to wealth-tax at the flat rate of 3 percent, or at the appropriate rate applicable in the case of an individual, whichever course is more beneficial to the revenue. This proposal will take effect from the assessment year 1981-82.

Another device being used for avoiding proper tax liability is the creation of associations of persons without defining the shares of members. This enables the creation of a large number of taxable entities which, under the existing law, will be chargeable to income-tax separately, I now propose that such associations of persons be charged to income-tax at the maximum marginal rate and to wealth-tax at the flat rate of 3 percent, or at the appropriate rate applicable in the case of an individual, whichever is higher. This proposal will also take effect from the assessment year 1981-82.

* 1 crore = 100 lakhs
1 lakh = 100,000.

practically untouched in this year's budget, except for the enhancement in the rate of additional excise duty on specified textiles and textile articles.

1. Customs duty

(a) Revenue measures

It is proposed to effect an across-the-board increase in auxiliary duties of customs by five percent ad valorem on all imported goods. The rate of auxiliary duty is to be raised to ten percent ad valorem wherever the rate of auxiliary duty is now five percent, to 20 percent ad valorem wherever the rate is now 15 percent and to 25 percent ad valorem wherever the rate is now 20 percent. Further, the existing exemption from auxiliary duties in respect of certain items of machinery and capital equipment is being withdrawn and they will generally attract auxiliary duty at five percent. However, the increase in auxiliary duties will not apply to import of essential commodities such as edible oils, crude petroleum products such as kerosene, high speed diesel oil.

It is also proposed to raise the import duty on plain shaft bearings from 75 to 125 percent ad valorem and the basic customs duty on computers and computer peripherals from 40 percent to 50 percent ad valorem, and on stainless steel bars and wire rods from 75 to 175 percent ad valorem. Further, it is also proposed to levy customs duty of 15 percent ad valorem on imported newsprint.

(b) Proposed concessions

(i) Import duty (basic plus auxiliary) on certain specified intermediates for the manufacture of drugs is being reduced from 75 to 25 percent ad valorem.
(ii) Import duty on certain raw materials and components for the electronics industry is being reduced to 50 percent ad valorem.
(iii) Import duty on certain items of capital equipment and testing instruments for the electronics industry is being reduced to 30 percent ad valorem.
(iv) Import duty for colour scanners for the printing industry is being reduced from 100 to 60 percent ad valorem.

2. Excise duty

(a) Revenue measures

It is proposed to raise excise duty on specified textile articles from 10 to 15 percent of the basic excise duty rates to meet the additional expenditure anticipated on subsidy for production of controlled cloth.

(b) Concessions

(i) It is proposed to raise the existing limit for duty free clearances from Rs. 5 lakhs to Rs. 7.5 lakhs per annum for excise duty exemptions available to small scale manufacturers of 72 specified commodities. Further, in accordance with the revised definition of small scale units, the eligibility limit for investment on plant and machinery for availing excise duty concessions available to small scale manufacturers of certain goods is being raised from Rs. 10 lakhs to Rs. 20 lakhs.
(ii) It is proposed that the present duty exemption available to cotton and cotton-viscose blend hosiery articles be extended to all hosiery articles falling under item 68 of the Central Excise Tariff.
(iii) It is also proposed to give substantial duty concession to wollen fabrics produced on handlooms in the processing stage along the same lines as the concessions available to cotten fabrics produced on handlooms.

D. SPECIAL RELIEF

In this international year of the disabled, the Finance Minister has proposed concessions to the disabled in Income Tax, Customs Duty and Excise Duty. The relief in Income Tax has been mentioned in Direct Taxation. On the customs side, import duty on hearing aid appliances, Braille watches and Braille one-day alarm clocks for personal use is being reduced from 120 to 10 percent ad valorem. It is also proposed to exempt fully from excise duty Braille watches and Braille paper which is used by the blind.

priate rate applicable in the case of individuals, whichever course is more beneficial to the revenue.

3. Corporate taxation

(a) Rate of tax

At present surtax is not payable by companies in advance. It is proposed that surtax be payable in advance during the financial year preceding the relevant assessment year.

No change is proposed in existing corporate tax rate, but it is proposed to reduce the rate of surcharge from 7.5 to 2.5 percent of such income tax in cases of all classes of companies.

(b) Tax concessions

(i) The Eleventh Schedule to the Income Tax Act

It contains a list of industries which do not qualify for investment-related tax concessions under the Income Tax Act. It is proposed to remove 14 groups of industries from this schedule and these industries will now become eligible for specified tax concessions. These industries include electric fans, pressure cookers, glass and glassware, pigments, colours, paints, enamels, varnishes, blacks and cellulose lacquers, chinaware and porcelain ware, mosaic tiles and glazed tiles, synthetic detergents, amplifiers or any other apparatus used for addressing the public, vacuum flasks and other vacuum vessels etc.

(ii) Tax holiday

To encourage the establishment of export-oriented industries in the free trade zone, it is proposed to allow a complete tax holiday in respect of such units set up in these zones for an initial period of five years in lieu of other concessions.

(iii) Development allowance

At present, a development allowance equal to 50 percent of the expenditure incurred on planting of tea bushes in any new area or on any land which has been previously abandoned is allowed in computing the income from tea business. For this purpose, the expenditure qualifying for development allowance is restricted to Rs. 12,500 per hectare in respect of land situated in hilly areas and Rs. 10,000 per hectare in other areas.

It has been proposed, having regard to the increase in cost of planting in recent years, to raise the ceiling limits to Rs. 40,000, Rs. 35,000 and Rs. 20,000 per hectare of land situated in the Darjeeling district, hilly areas and in plains respectively.

(iv) Electronic industry

It is proposed to include the electronic components industry in the Ninth Schedule to the Income Tax Act and provide that dividends derived by a domestic company from an Indian company engaged exclusively in the manufacture of electronic components will be completely exempt from income tax.

(v) Book publishing industry

At present, in computing taxable income, a deduction equal to 20 percent of the profits and gains derived from the business of publication of books is allowed under section 80 QQ. It is proposed to extend this concession for a period of five years with effect from assessment year 1981-82.

(vi) Small scale industrial undertaking

It is proposed to liberalise the definition of "small-scale industrial undertaking" for the purpose of tax concessions under the Income Tax Act. An industrial undertaking will qualify for treatment as a small scale industrial undertaking if the aggregate value of the machinery and plant installed therein as on the last day of the previous year does not exceed Rs. 20 lakhs as against Rs. 10 lakhs at present.

(vii) Energy resources

It is proposed, with a view to promoting the development and use of renewable energy resources, to allow depreciation on renewable energy devices and systems at the enhanced rate of 30 percent as against 10 percent at present.

(c) Participation of foreign companies in the field of oil exploration and production encouraged

Firstly, it is proposed to extend the Income Tax Act and the Companies (Profit) Surtax Act to offshore areas. Secondly, it is proposed to insert suitable provisions in the Income Tax Act and the Companies (Profit) Surtax Act to enable the Central Government to provide by notification in the Official Gazette for an exemption, reduction in rate or modification in respect of income tax or surtax in favour of any class of persons engaged in the business of mineral oils and gas in association with the Central Government or any person authorised by it. Notifications under the new provisions when made will be placed before both Houses of Parliament. Lastly, it is also proposed to amend Section 42 of the Income Tax Act relating to special provision for deduction in the case of business of prospecting for or extraction or production of mineral oils so as to extend its scope to cover cases where the government itself does not participate in such business but does so through any person authorised by it.

B. ESTATE DUTY

It is proposed to raise the exemption limit of Rs. 50,000 to Rs. 150,000 for estate duty purposes. It is also proposed that one residential house or part thereof will be valued for estate duty purposes on the same basis as for the purposes of wealth tax.

C. INDIRECT TAXATION

A substantial portion of this year's additional resources is sought to be raised through an increase of five percent in auxiliary customs duties. Excise levies have been left two years of the plan period. Does this mean that budgets for the next three years of the Sixth Plan period will be free of deficit? This question remains unanswered.

8. The price rise during 1979-80 was about 21 percent. A price rise of 13 percent has already occurred up to 17 January 1981 for 1980-81. By the middle of February this rise is estimated to be about 17 percent and by 31 March 1981 it is expected to pass last year's mark. This steep rise in the general price level may lead to substantial demand for more wages.

Highlights

The following are the main proposals of the 1981 Budget presented by the Union Finance Minister, Mr. R. Venkataraman, on February 28, 1981 before the Lok Sabha:

A. INCOME TAX

1. Personal taxation

(a) Raising of exemption limit and restructuring of rates of tax

The exemption limit in the case of non-corporate taxpayers (other than registered firms and Hindu individual families with one or more members having separate income exceeding the exemption limit) is proposed to be raised from Rs. 12,000 to Rs. 15,000. The "nil" rate slab will also be raised from Rs. 8,000 to Rs. 15,000 concurrently with the restructuring of the rate schedule up to Rs. 30,000. The new rate schedule in the case of individuals, etc. (with the existing rates) is shown below:

Income range (in rupees)	*Proposed (%)*	*Existing rates*
Up to 15,000	Nil	(at present the rate on the Rs. 8,001 — 15,000 slab is 15% provided that no income tax shall be payable on income not exceeding Rs. 12,000)
15,001 — 25,000	30	(at present the rate on the Rs. 15,001 — 20,000 slab is 18% and on the Rs. 20,001 — 25,000 slab is 25%)
25,001 — 30,000	34	(as against 30% at present)
30,001 — 50,000	40	same as at present
50,001 — 70,000	50	same as at present
70,001 — 100,000	55	same as at present
Over 100,000	60	same as at present

The gestures in individual income tax at one sweep relieve an estimated 1.4 million middle income earners from income tax liabiltiy and are in consonance with the ruling party's "avowed policy of giving relief to the middle classes in these difficult times". Further, about 1.15 million taxpayers in the Rs. 15,001 — 30,000 income brackets will also get varying degrees of relief.

(b) Enhancement of standard deduction

At present, salaried taxpayers are entitled to a standard deduction of an amount equal to 20 percent of the salary up to Rs. 10,000 and 10 percent of the balance, subject to an overall ceiling limit of Rs. 3,500.

It is now proposed to provide standard deduction at a uniform rate of 20 percent in the case of all salaried taxpayers, subject to an enhanced overall ceiling limit of Rs. 5,000. The benefit of the enhanced standard deduction will be available in the case of pensioners and also in respect of employees in receipt of conveyance allowance.

(c) Relief in respect of medical treatment of physically and mentally handicapped dependents

At present, resident individuals and Hindu undivided families are entitled to a deduction in respect of medical treatment of physically and mentally handicapped dependents.

It is proposed to double the amount of this deduction to Rs. 4,800 in respect of the dependent who is hospitalised for a period of 182 days or more during the relevant accounting year and Rs. 1,200 in other cases.

(d) Compulsory deposit (income tax payers) scheme

It is proposed to continue the compulsory deposit scheme in the case of income tax payers for another two years. Individuals attaining the age of 70 years will, at their option, be entitled to receive back the entire amount standing to their credit in the compulsory deposit account.

2. Associations of persons and trusts

(a) Measures for plugging loopholes for tax avoidance

It is proposed to subject associations of persons to a maximum marginal rate of income tax in cases where the shares of members are not defined. Such associations will also be subjected to wealth tax at the flat rate of three percent or at the appropriate rate applicable in the case of individuals, whichever course is more beneficial to the revenue.

In the case of trusts, it is proposed to subject oral trusts to income tax at the maximum marginal rate and to wealth tax at the rate of three percent or at the appro-

Comments on and Highlights of the Indian Central Budget for 1981/82

by Dharmendra Bhandari *

Comments

1. Income tax concession for middle income earners has been widely welcome. This relief was long overdue in view of the fall in purchasing power of the rupee due to inflation. Thus in one year the Finance Minister has provided income tax exemption and/or reduction to over 2.5 million assessees out of the total 4 million assessees. This measure has also reduced the burden on the tax collecting machinery of collecting very little tax from a large number of low income taxpayers. It is felt that these concessions are not oriented towards saving and investment because no relief has been provided in the marginal rate of tax in the high income slabs.

2. The proposed reduction in the rate of surcharge from 7.5 to 2.5 percent of such income tax in cases of all classes of companies is also welcome. The relief in absolute terms works out higher for foreign companies (3.5 percent) than for domestic companies, 3 percent if closely held or 2.75 percent if widely held. The highest rate applicable to foreign companies is 75.25 percent including surcharge; this will be reduced to 71.75 percent including surcharge. This measure has not been considered enough by industry which has been expecting more forceful measures to promote investment at a time when this is crucial for achievement of rapid industrial growth. Further, this concession has been offset to a large extent by payment of surtax in advance.

3. In framing his other proposals for the corporate sector, the Finance Minister has kept in mind the need for export promotion. The introduction of a five-year tax holiday for industries established in free trade zones will help attract more new units in these zones. The extension of the provision relating to investment allowance to more industries, increase in development allowance for the tea industry and concessions for the electric component industry will stimulate the flow of funds to these industries, many of which have considerable export potential.

4. The fact that there is no significant increase in excise duty has been very welcome by the common man, since taxpayers account for an insignificantly small portion of the population. However, the steep rise in the tax of petroleum products to mop up an additional Rs. 1150 crores [1] and the increases of 20 percent in the case of steel and almost 40 percent in the price of pig iron to contribute Rs. 400 crores, the revised coal price to fetch Rs. 325 crores and the increase in freight and fares across the board in the railway budget to fetch an extra Rs. 356 crores, all prior to the presentation of the Central Budget, will lead to a price rise of a very serious nature.

5. The tax effort has been mainly confined to increasing customs levies by five percent. Considering the imperative need to minimise the budgetary deficit and also conserve foreign exchange reserves, the strategy appears to be sound. But his proposal to impose import duty of 15 percent ad valorem on newsprint has come in for wide criticism. Mr. Nani A. Palkhivala, eminent constitutional lawyer and taxation expert, said that the imposition of a levy on newsprint amounts to "placing tax on public information and knowledge".

6. The budgeted deficit of Rs. 1,539 crores is higher than the budgeted deficit of Rs. 1,445 crores in 1980-81. The revised figure of the deficit for 1980-81 is placed at Rs. 1,975 crores, after a record deficit of Rs. 2,700 crores in the previous year. This indicates the extent to which money supply has grown in the last two years. Further, credit has been taken in this year to the extent of Rs. 800 crores on account of a bearer bond scheme. This appears to be a gross overestimate in view of the poor collection till now. The experts thus feel that the actual deficit for 1981-82 may turn out to be much more than Rs. 2,000 crores.

7. The budget has also demolished the hope that objectives of the Sixth Plan can be achieved within the specified fiscal limits. The official budgetary deficit for the Sixth Plan was Rs. 5,000 crores not taking into account the projected realisation of Rs. 1,000 crores from special bearer bonds. Thus the budget gap during the five years of the Sixth Plan worked out to Rs. 4,000 crores. Of this, the current year — the first year of the plan — is expected to end up with a deficit of Rs. 1,975 crores as per revised estimate. The estimate of the deficit for 1981-82, as made in the budget, is Rs. 1,539 crores which may again go much higher than the Rs. 2,000 crores mark when the revised estimates are prepared. Thus the budgetary deficit taken into account in the Sixth Plan has already been reached in the first

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1. 1 crore = 100 lakhs; 1 lakh = 100,000.

cent.[21] In the Philippines, in the fiscal year 1976, luxury and semi-luxury goods categories accounted for only 1.4 percent of the sales tax revenue from domestic goods.[22] While no such data are available for Thailand, they are expected to follow the pattern for Indonesia and the Philippines.

Apart from the low revenue derived from the items attracting higher sales tax rates, the use of rate differentiation to impart some degree of progressivity has other limitations. The first concerns the disincentive effects which are likely to occur if high sales (or excise) taxes on consumer durables increase their price to such an extent that they are beyond the reach of even professional salaried classes. The above consideration may have been responsible for the "incentive goods" category in the new Indonesian sales tax structure. Secondly, as these countries are trying to industrialize, high sales (or excise) taxes may create excess capacity and unemployment by reducing demand for domestically produced consumer durables and other manufactured items. Thirdly, very high rates of sales tax on particular items (e.g. watches or perfumes) may provide incentives for smuggling and evasion.

Only Indonesia lists discrimination against capital intensive goods as one of the objectives of its rate structure. However, only one item, soft drinks bottled by automatic processes, attracting the highest sales tax rate, is covered under this objective, so it does not seem very important.

As noted in the section on "methods of avoiding multiple taxation", an additional aim of rate differentiation in Indonesia and Thailand is to mitigate the cascading and multiple taxation effects by applying lower rates of tax on many raw materials and intermediate inputs.

To conclude, the discussion in this paper has shown that in spite of the surface similarities in the sales tax structures of ASEAN countries (excluding Singapore), various structural features show many dissimilarities. As a result, not only are the economic effects of sales taxes in these countries likely to be different, but such divergence also increases the difficulty of achieving fiscal harmonization in the ASEAN countries.

21. These figures are based on the data supplied by the Directorate General of Taxation, Jakarta.
22. Based on the data supplied by the National Tax Research Center, Manila.

IFA NEWS

FRENCH BRANCH OF IFA

On March 11, 1981 the Board of the French Branch of IFA met in Paris under the Chairmanship of Mr. Max Laxan.

It was, inter alia, decided that on June 22, 1981 the subjects to be discussed at the Montreal Congress will be dealt with (see for these subjects 34 *Bulletin for international fiscal documentation* 514 (November 1980)).

On November 23, 1981, the evening will be devoted to the study of the "avoir fiscal" (imputation credit), its technical implementation, its economic impact and its merits in comparison to other methods to further investment in corporate shares.

the sales tax. The presumption is that, in many developing countries, there is a sharp distinction between different classes in their consumption patterns. Since income taxes are difficult to levy effectively, higher sales tax rates on goods consumed by the rich may compensate for the deficiencies of the income tax and may also impart a degree of progressivity to the tax structure.

Thirdly, rate differentiation may aid economic development and improve the balance of payments. The rate differentiation may aid economic development by transferring the purchasing power from the higher income groups to the government who would presumably allocate it to needed investment. However, since taxes would in part come out of saving, and since higher income groups are likely to have a relatively high marginal propensity to save, total saving would increase only if government has a higher marginal propensity to save than those paying taxes. The possibility that higher taxes need not necessarily be translated into higher government saving and investment has been recognised and has come to be known as the "Please effect".[17] The sales tax can also be structured to divert resources from the luxury goods sector and from goods with a large import content, thus aiding the balance of payments. However, care must be taken not to divert demand to untaxed goods or services with as high or higher import content, e.g. foreign travel.

Fourthly, rate differentiation has been justified on the grounds that it is necessary to bring about a better balance between demand and supply, especially in a developing economy. It is argued that a deliberate gap between supply and demand may be created for some commodities, which can be met by differential taxation.[18] Information requirements for using rate differentiation in such a manner are, however, likely to be considerable.

Finally, rate differentiation may also be used to discriminate against capital intensive techniques to promote employment and against imported goods to provide protection to domestic industries.

To what extent are the above objectives of rate differentiation discernible in the sales tax structures of ASEAN countries? To answer this, we first briefly state the sales tax rate structures in ASEAN countries. In Indonesia, the sales tax rates vary from 0.0 percent for most essential goods to 20.0 percent for luxury and selected capital intensive goods, with five other rates in between. Services are taxed at a uniform rate of 2.5 percent. In Malaysia, the basic sales tax rate is five percent, with only a handful of commodities attracting a 10 percent rate. In the Philippines, the sales tax rates vary from 1.0 percent on certain locally produced agricultural products to 50.0 percent for luxury items. For many semi-luxury items which are locally produced, the sales tax rates are progressive with respect to price. Thus, discrimination against imports of certain semi-luxury goods, e.g. T.V. sets, and agricultural products is a part of the formal sales tax structure in the Philippines. The sales tax rates on services vary from 1/4 percent on gross selling price of stock transactions to 20 percent on gross receipts of nightclubs. In Thailand the sales tax rates on goods vary from 1.5 percent on many raw materials to 40.0 percent on imported passenger cars, with nine different rates in between. The sales tax rates on services vary from 0.1 percent on sale or transfer of securities to 10.5 percent on gross profits from exchange of currencies, with seven different rates in between.

One of the main objectives of the rate differentiation in Indonesia, the Philippines and Thailand is the protection of domestic industries. This is evident from the earlier discussion on discrimination against treatment of imports as compared to domestic goods in the sales tax structures. In addition, in Indonesia during the 1970s, sales tax on domestically assembled goods was levied at a specially designated price which had the effect of reducing the effective rate. Thus, only Malaysia (and, of course, Singapore) does not attempt to use the sales tax rate differentiation as a device to protect domestic industries.

The objective of imparting a degree of progressivity to the tax system is also evident in the sales tax rate structures of ASEAN countries. Thus, the rate structures of Indonesia, the Philippines, and Thailand roughly follow essentiality criteria,[19] with the luxury category attracting the highest rates of tax. In Indonesia, however, there is a separate category of "incentive goods" which includes most of the consumer durables. These are taxed at a rate of 7.5 percent compared to the 20 percent rate on the luxuries. In the Philippines, the sales tax rates of some items, e.g. pens, watches, T.V. sets, vary positively with the gross selling price thus helping to impart a degree of progressivity. In Malaysia, while luxury items do not attract higher sales tax rates, they are subjected to excise taxes levied at a combination of minimum specific and ad valorem rates. Thus, Malaysia uses the excise system to impart a degree of progressivity in the tax system. Indonesia, the Philippines, and Thailand have very limited excise systems, consisting of excises on traditional items such as alcoholic, tobacco and petroleum products.[20]

While the objective of imparting progressivity is clear from the sales tax rate structures, its realization is likely to be limited due to the small revenue derived from the items attracting higher rates. Thus, in Indonesia, in 1975-76, only 6.6 percent of the revenue from domestic sales tax was from the items attracting the highest rate of 20 percent, while a further 24.6 percent was from the items attracting the 10 percent rate. In contrast, the lowest rate category of 5 percent contributed 68.7 per-

17. Stanley Please, "Saving Through Taxation: Reality or Mirage?", *Finance and Development,* March 1967, pp. 24-32. His explanation rests on the political pressures on the government to spend the revenues generated from the higher taxes.
18. This argument has been made by D.T. Lakdawala, "Value Added Tax", *The Indian Economic Journal,* Vol. 24, October-December 1976, p. 200.
19. In Thailand, however, the rate differentiation is much greater than any essentiality criteria may warrant. It is interesting to observe that among the three countries, only the Philippines makes any systematic attempt to determine the consumption patterns of different income groups through a survey of essentiality.
20. No excise taxes on petroleum products are levied in Indonesia, these being included in the oil company tax.

There is a general similarity in the treatment of capital goods in ASEAN countries. While there is no provision for exemption of capital goods under the sales tax laws, they are partially or fully exempted from the sales tax and customs duties under various fiscal incentive laws. [14] While relevant data are difficult to obtain, if the proportion of total capital goods exempted under the fiscal incentive laws is large, there may be a case for complete exemption of all capital goods. This is to avoid discrimination among various firms and industries. However, as noted above, broad development policy considerations are likely to require taxation of capital goods.

Except in Singapore, the main omission from the sales tax on services is the utility services. If such a tax is regarded as regressive, minimal household consumption of utility services may be exempted as is the practice in Singapore. The omission of professionals such as lawyers and accountants from the list of those subject to sales tax in Thailand and the Philippines should also be noted. Except in the Philippines where foreign travel is taxed under a separate statute, little effort is made to tax foreign travel in the ASEAN region.

Ideally, sales tax exemption should not be dependent on whether an enterprise is in the private or the public sector. However, Thailand exempts from sales tax a wide variety of enterprises in the public sector such as railways and port services. Such practices are particularly objectionable on resource allocation grounds.

D. Treatment of domestic, imported and exported goods

Unlike other forms of sales taxes, imports are not automatically covered under a manufacturers' sales tax. Thus, imports have to be brought under the sales tax net. However, imports and the corresponding domestic goods are unlikely to be taxed at the same point on the distributional channel. In some instances, imports are likely to be favored over domestic goods while in other instances the reverse is likely to be the case. The usual solution, however, has been to apply a mark-up to the import value of goods. The rate of mark-up varies among the ASEAN countries. In Indonesia, it is 5 percent, in the Philippines 25, 50 and 100 percent depending on the type of good, and in Thailand it varies from 3.5 to 31 percent. Malaysia does not apply any mark-up. The above mark-up rates apply to the import sales tax base. This base is defined in Indonesia and Thailand as c.i.f. value of imports plus the import duty; in the Philippines as home consumption value of an imported item, plus freight, postage, insurance and the customs duties and charges. While in Indonesia, there are substantial deviations between the sales tax rates on domestic and imported goods, in other ASEAN countries the domestic and import sales tax rates, with few exceptions especially in the Philippines, are identical. The main effect of the above treatment of imports is to transform the sales tax as a device to protect domestic industries, especially in Indonesia, Thailand, and the Philippines.

Since sales tax is a consumption levy, exports should be exempted and imports taxed in the same manner as domestically produced goods. The reasons for such a treatment have been stated by Due as follows:

"At given exchange rates, if exports are not freed of tax, domestic producers are placed at a disadvantage in foreign markets compared with firms in countries that do not impose equivalent taxes; and if imports are not taxed, foreign producers are given an artificial advantage over domestic producers. Were exchange rates free to move, the difference would not be nearly as great as might appear. . . . but the introduction of artificial elements into import and export prices in the form of sales tax differentials may distort international economic activity generally, particularly when the tax components of prices vary among commodities."[15]

All four of the ASEAN countries which do levy manufacturers' sales taxes exempt exports. However, varying degrees of the sales tax element remain. In Indonesia, direct exports as well as exports through wholesalers and others are exempted under Article 29(8) and (9) of the 1951 Sales Tax Act. However, as no special efforts are made to mitigate the cascading and multiple taxation effects on exports, complete exemption is impossible. In contrast, in the Philippines, a tax credit method is used for exports. Any excise tax or ad valorem sales tax, including that on services, can be credited against other tax liabilities of the manufacturer-exporter, provided the tax is shown as a separate item on the invoice. Sales to tourists directly made by a manufacturer are also considered as exports. Since Malaysia uses the suspension system to avoid multiple taxation and since its taxation of services is very limited, exemption of exports, including re-exports, encounters little difficulty. The practice in Thailand is similar to that of Indonesia, in that no special efforts are made to mitigate the multiple taxation and cascading effects of the sales tax on exports.

E. Rate differentiation

Even in a broad-based sales tax a case can be made for some differentiation in the tax rates. First, the traditional case for uniformity in tax rebates on the grounds that it does not create any excess burden as far as the choice between products is concerned has been found deficient. In an imperfect world of distortions and externalities, non-uniform rates are likely to be required to achieve greater efficiency in allocation of resources. However, while extensive theoretical work has been done on the differentiation in sales tax rates which would be optimal for efficiency, no simple rule has emerged which can be readily applied in sales tax design.[16] Therefore the policymaker may still prefer uniform rates.

Secondly, it is argued that rate differentiation is justified because it imparts some degree of progressivity to

14. See Zenaida S. Reyes. *Investment Incentive Laws of ASEAN Countries*, Quezon City, University of Philippines Law Center, 1978, for detailed provisions regarding exemptions of capital goods from the sales and customs taxes.
15. Due, op. cit., p. 152.
16. See, David F. Bradford, and H.S. Rosen, "The Optimal Taxation of Commodities and Income", *American Economic Review*, May 1976, pp. 94-101.

some exemptions. The first is to mitigate the regressivity of the general sales tax. This is generally accomplished by exempting unprocessed food and basic clothing. It should, however, be recognised that to the extent that exemptions of such goods increase their demand and thus their relative price, the full beneficial impact of such exemptions will not be felt by the very poor. A second reason for exemptions may be to promote certain social objectives such as education and health care. A third reason is to improve the balance of payments by exempting exports. A fourth, already referred to earlier, is on grounds of administrative ease; certain transactions and taxpayers are simply very difficult to tax. Therefore, it may be better to legally exempt them. Lastly, in the context of the manufacturers' sales tax, exemption of many raw materials and intermediate inputs is necessary to avoid multiple taxation.

There are two additional issues concerning the coverage of the sales tax which require discussion. The first is the question of whether capital goods should be subjected to sales tax. Since capital goods are inputs in the production process, the principle of non-taxation of inputs would suggest that capital goods should not be subjected to sales tax. It is argued that taxation of capital but not labour artificially encourages labour intensive techniques and thereby reduces efficiency. Also, such a tax reduces the favourable substitution effect on saving of consumption taxes. Moreover, non-exemption of capital goods makes more difficult the complete exemption of exports and other commodities. Thus, traditional arguments suggest exemption of capital goods. However, it has also been argued that sound development policy may require taxing rather than exempting capital goods.[10] This is because, in many developing countries, labour is artificially over-priced because of above-equilibrium wage rates in the organised sector, overvalued exchange rates, the impact of various fiscal incentive schemes for new investment, practices of foreign lending agencies, and so on. Therefore, taxing capital goods may, at least in part, redress the discrimination against using labour intensive techniques. Taxation of some capital goods, e.g. office furniture and motor vehicles, may also be defended on administrative grounds. If these capital goods are not taxed, elaborate efforts would have to be made to ensure that they are not resold to final consumers.

The second issue concerns the inclusion of services in the sales tax base. The discussion on this point has focused on whether those services provided to final consumers which have the characteristics of private rather than public goods should be taxed on a comprehensive basis or on a selective basis.[11] The case for comprehensive taxation has rested on its allegedly favourable effects on equity, revenue productivity, and tax neutrality among consumption choices. Recently, Gandhi has argued in favour of a more selective approach to taxation of services, suggesting that by using such an approach, "... *the developing countries might not be losing much in terms of the improvement in equity and elasticity that they would have achieved had they brought the bulk of the potentially taxable services sectors of their economies into the base of their general sales taxes.*"[12] However, since many of the services have to be exempted on social grounds (educational and health services) or on economic grounds (services supplied to businesses) or on administrative grounds (repair services), the difference between the two approaches may not in practice be very great.

We now turn to an examination of the exemption structures in ASEAN countries. While all the countries exempt unprocessed foodstuffs and other very basic necessities, Indonesia and the Philippines have recently introduced a one percent sales tax on many agricultural products and basic necessities. While this has been done to increase the sales tax base, it is also likely to increase the regressivity of the tax.

Indonesia, Malaysia and Thailand have provisions for exempting certain goods to promote social and educational objectives. Thus, in Indonesia, textbooks, certain goods delivered to charitable institutions, etc. are exempted from the sales tax. Similarly, in Malaysia, items such as approved educational and scientific materials and certain articles used by the blind are tax exempt. Except in the Philippines, the other countries provide a long list of raw materials and intermediate inputs which are exempt from the sales tax. In Indonesia and Thailand this is done to mitigate multiple taxation and cascading effects; in Malaysia this is done to facilitate the operation of the suspension method. Since the Philippines has been using variants of the value-added technique to avoid multiple taxation, no such list of exemptions is necessary.[13]

All the ASEAN countries define the term "manufacturer" broadly, including those who have a manufacturing activity performed by others on their behalf. The practice of exemption small manufacturers differs between goods and services. For goods, except in Indonesia, small manufacturers are exempted. The exemption level, however, is quite low in the Philippines where those with annual sales of ₱ 2400 or below are exempted, a level set in 1969. In Malaysia, till recently, those manufacturers whose annual turnover did not exceed M$ 20,000 and those whose annual value of work done on taxable materials supplied by another person did not exceed M$ 4,000 were exempt from the sales tax. However, in the 1981 budget, the above limits were raised to M$ 100,000 and M$ 20,000 respectively. Since no exemption levels are set for services, many small personalised services, such as repairs, are subject to sales taxation. In practice, however, these types of establishment are difficult to tax and frequently escape payment.

10. See, R.M. Bird, "An Appraisal of the Colombian Sales Tax", in R.M. Bird and O. Oldman (eds.) *Readings on Taxation in Developing Countries*, second edition, Baltimore: The Johns Hopkins Press, 1967, pp. 322-323.
11. For a detailed examination of this issue, see Ved. P. Gandhi, *Sales Taxation of Services in Developing Countries*, Washington: International Monetary Fund, DM/77/114, December, 1977.
12. Ibid., p. 7.
13. For a complete list of exemptions from sales tax in Indonesia, see *Business News*, Jakarta, May 2, 1979, No. 3292/3293 and May 4, 1979, No. 3294. For Malaysia, see *Warta Karanjaan, Sales Tax Exemption Order, 1978*, P.V.C.A. 421. The exempted items for the Philippines are in Section 202 of the *National Internal Revenue Code 1977*. For Thailand, see S. Valaisathien, *The Thai Taxation*, Bangkok: SGV-Na Thailand & Co., June 1975.

multiple taxation feature also leads to cascading effects, and therefore causes the tax to be more inflationary.

Two possible methods of avoiding multiple taxation are the suspension method and the value-added method. Under the suspension method, a certain sector of the economy is labelled as "manufacturers". Every firm in this group is licensed and such firms are allowed to purchase inputs without payment of sales tax. The sales tax becomes applicable only when a licensed firm sells to an unlicensed firm. The value-added method may be applied by using the subtraction or the tax credit technique. Under the former, deduction of some or all taxable purchases from taxable sales is allowed. The tax credit technique consists of providing a partial or a full credit for the sales tax paid on purchases against the tax payable on sales.

The methods used for avoiding multiple taxation vary among the ASEAN countries. In Indonesia and Thailand, neither of the above methods is used. Instead, in order to mitigate the effects of multiple taxation, a low or zero rate is applied to raw materials and other intermediate goods. Thus, in Indonesia, complementary materials and half-finished goods are taxed at a rate of 2.5 percent while many raw materials are taxed at 1.0 percent.[6] In Thailand, most raw materials are taxed at a rate of 1.5 percent.[7] In both Indonesia and Thailand, there is no provision to offset sales tax paid on services purchased by businesses. The severity of the multiple tax is, however, reduced in the case of services due to their generally low rates and the absence of any requirement for an arm's length transaction.

In Malaysia, the suspension method is used to mitigate the multiple taxation effect. Under the Malaysian system, however, there is a need to apply for refunds on goods on which tax has been paid. This need arises because sales tax is levied on imports and thus any taxable purchases from an importing firm would necessitate and application for refund. Given the very limited nature of sales tax on services in Malaysia (only nightclubs, dance halls and other such establishments are covered), only minor multiple taxation effects are likely due to their inclusion in the sales tax base.

The Philippines practice regarding multiple taxation went through an important change in 1978. Before Presidential Decree No. 1358 of April 21, 1978, two approaches were used to avoid multiple taxation. For goods, except automobiles, the value-added method using the subtraction technique was used. However, the cost of only those raw materials physically included in the product and on which the sales tax had been paid at the same rate as the finished goods was allowed to be deducted from the gross selling price. For automobiles, a tax credit technique was used. Since the 1978 decree, the value-added method using tax credit technique has been used for all goods. However, credit is given only on sales, excise, or mining taxes paid on any material, part, or accessory forming part of the finished product, provided these taxes are shown separately on the invoice. While the current practice reduces the extent of multiple taxation, it does not eliminate it. Thus, sales taxes paid on services purchased by businesses, and on some intermediate goods, e.g. capital goods and producers' consumables which do not form part of the finished product, are still not allowed to be deducted.

B. Valuation problem

This problem concerns the determination of the taxable price. Ideally, a broad based tax such as the sales tax should be neutral among various methods of doing business. However, since the manufacturers' sales tax is levied early in the production-distribution flow, it discriminates against those firms who integrate forward. There is an incentive, therefore, to push activities such as advertising and freight services as far as possible beyond the point of tax impact. Some firms may gain control over distributors and sell their services at artificially low prices. Conversely, powerful retail firms may integrate backwards and buy at artificially low prices from their manufacturing firms. Since the extent of integration is likely to vary among different products, the effective sales tax rate, other things being equal, is also likely to vary.

While various approaches such as uplifting provisions have been suggested to mitigate this problem, in practice, as Due has indicated, no approach is likely to be entirely satisfactory.[8] Moreover, any adjustment provisions are likely to increase the complexity of the tax.

ASEAN countries have made little attempt to solve this problem besides incorporating provision for an arm's length transaction for goods, but not for services, in their sales tax laws. This indeed seems to be the practice in most countries.[9]

C. Coverage and exemption structure

Since the sales tax is a broad-based tax, ideally it should cover as broad a range of commodities as possible. There are several reasons for this:

(1) If certain commodities are taxed but not others, the pre-tax pattern of consumption is affected, creating a potential excess burden. Also any exemption favours those people with a high preference for the exempted goods and shifts resources in that direction.

(2) Exemptions reduce the tax base, thus necessitating a higher rate on the remaining items to bring forth the same amount of revenue. This high rate may be, at least for a single stage tax, quite out of line with the trade margin, thus giving an incentive to evasion.

(3) Exemptions tend to complicate the administration of a sales tax. But at the same time it is worth noting that certain goods and services and certain taxpayers are, in practice, so difficult to tax that their exclusion is likely to ease rather than increase the administrative complexity.

In spite of the general acceptance of the need for a broad-based sales tax, several grounds exist for at least

6. These rates became effective under the decree of the Minister of Finance No. 175/KMK. 04/1979 of April 19, 1979.
7. Thailand, *Revenue Code*, 1975.
8. J.F. Due, *Indirect Taxation in Developing Economies*, Baltimore: The Johns Hopkins University Press, 1970, p. 87.
9. Ibid., p. 85.

TABLE 1

RELIANCE RATIOS[a] FOR SALES TAX IN ASEAN COUNTRIES, SELECTED YEARS

Fiscal Year[b]	Reliance Ratio				
	I[c]	M	P	S[d]	T
1970	12.9 (16.1)	Nil	24.5	2.9	21.7
1974	11;5 (18.4	6.8	18.7	2.0	20.6
1977	9.5 (22.6)	5.6	19.5	2.2	23.3
1979	8.5 (19.6)	5.7[e]	N.A.	2.0	20.6

Notes: I = Indonesia; M = Malaysia; P = Philippines; S = Singapore; T = Thailand.

a. Defined as proportion of total tax revenue accounted for by a particular tax.

b. Fiscal year for Indonesia and Singapore is April-March. Malaysia's fiscal year coincides with the calendar year. While Thailand's fiscal year is October-September, the data in this table refer to calendar year. Till 1975, fiscal year for the Philippines was July-June but since then it has coincided with the calendar year.

c. Figures in bracket are with respect to the non-oil tax revenue.

d. Excludes revenue from sales tax on hotel rooms and meals as data are not available for all years. Their revenue significance is, however, negligible, being 0.6 percent of total tax revenue in the fiscal year 1977.

e. Based on revised estimates.

Sources: Indonesia: Central Bureau of Statistics, *Monthly Statistical Bulletin*, Jakarta, various issues.

Malaysia: *Estimates of Malaysia's Federal Revenue*, Kuala Lumpur, various years.

The Philippines: Data provided by the National Tax Research Center in Manila.

Singapore: Accountant General's Department, *Financial Statements*, various years.

Thailand: Bank of Thailand, *Monthly Review*, various issues.

III. THE STRUCTURE OF SALES TAXES

In broad terms, the sales tax systems of ASEAN countries may be characterized as follows. Nominally, all the countries of ASEAN, with the exception of Singapore, levy sales taxes on goods at the manufacturing-importing level. As noted, Singapore does not levy any sales tax on goods. While in Singapore and in Malaysia, the sales tax is levied on only a limited number of services, their coverage is extensive in the remaining ASEAN countries.

The revenue importance of domestic sales tax — consisting of sales tax on domestically manufactured goods and on services, and of import sales tax — varies among the ASEAN countries. In spite of the decline in recent years, the revenue importance of import sales tax remains substantial in Indonesia, Malaysia, and the Philippines. No such data are available for Thailand. Thus, in Indonesia, the import sales tax accounted for 41.7 percent of total sales tax revenue in the fiscal year 1980.[2] The corresponding proportion for Malaysia was 45.2 percent for the year 1979, and for the Philippines 44.2 percent for the fiscal year 1976.

The proportion of total sales tax revenue accounted for by sales tax on services is quite high in the Philippines, being about one-third in the fiscal year 1976.[3] In contrast, revenue importance of sales tax on services is negligible in Malaysia, being only 4.0 percent of total sales tax revenue in the year 1979.[4] For Indonesia and Thailand, data on sales tax revenue from services are available only for the fiscal year 1976 and 1970 respectively. In both cases, the services accounted for about one-fifth of the total sales tax revenue.[5]

TABLE 2

EFFORT RATIOS[a] FOR SALES TAX IN ASEAN COUNTRIES, SELECTED YEARS

Fiscal Year[b]	Effort Ratio				
	I	M	P	S[c]	T
1970	1.16	Nil	2.45	0.38	2.71
1974	1.62	1.36	2,83	0.30	2.77
1977	1.76	1.29	2.12	0.35	3.12
1979	1.66	1.17	N.A.	0.34	2.73

Notes: I, M, P, S, T are as defined in Table 1.

a. Defined as the ratio of revenue from a particular tax to national income. For Singapore GDP is used as a national income measure, while for other ASEAN countries, GNP is used.

b. See footnote b for Table 1. The national income data are for calendar year.

c. See footnote d of Table 1.

Sources: For sales tax revenue, same as for Table 1. For national income: *International Financial Statistics*, various issues.

Given the above, the economic effects of the sales tax systems will be largely determined by the following features: methods of avoiding multiple taxation, the valuation problem, coverage of the tax and the exemption structure, treatment of domestic, imported, and exported goods, and rate differentiation. Each is discussed in turn.

A. Methods of avoiding multiple taxation

Under the manufacturer's sales tax, the tax is collected on sales by manufacturers to wholesalers or retailers. Multiple taxation may arise if the taxes paid on raw materials, capital goods, and other intermediate inputs are not allowed to be deducted from the final sales tax liability.

The existence of multiple taxation results in an arbitrary variation in the effective sales tax rates on various products and thus results in arbitrary non-neutrality among products and methods of doing business. The

2. This and the subsequent proportions in this paragraph are calculated from the same sources as for Table 1.

3. Based on the data supplied by the National Tax Research Center, Manila.

4. *Estimates of Malaysia's Federal Revenue*, Kuala Lumpur, 1980.

5. For Indonesia, this proportion is based on the data supplied by the Directorate General of Taxation in Jakarta. For Thailand, this proportion is based on the data given in Anan Lewchalermwong, *Taxation and Tax Reform in Thailand*, Bangkok: Kurusapha Ladprao Press, 1975. Table 6, p. 159.

Structural Features of Sales Taxes in Asean Countries*

by Dr. Mukul G. Asher**

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I. INTRODUCTION

The standard criteria used in an economic evaluation of a tax are those of equity, allocative efficiency, stabilization, capacity output, and revenue productivity. Since the extent to which a particular tax meets the above criteria is crucially dependent on its nature, structure, and administrative efficiency, their examination is a crucial first step in an economic evaluation of a tax.

The main purpose of this article is to examine the structural features of the sales tax systems of ASEAN[1] countries. While the space limitations do not permit full evaluation of the economic effects of the sales tax systems, many of these, as noted, are implicit in the discussion which follows.

II. THE ROLE OF SALES TAXES

While the general meaning of a sales tax as a tax on sales of all or a wide range of commodities is clear, it is not always easy to distinguish between sales and related taxes such as excise and gross receipts taxes. The need for comparability among countries may also necessitate some departures from the strict definition of the sales tax.

Among the ASEAN countries, Indonesia, the Philippines, and Thailand levy sales taxes on goods and on a wide range of services. Malaysia levies sales tax on goods and on a few minor services. In contrast, Singapore does not levy any sales tax on goods, but does levy sales tax on public utilities, and on hotel rooms and meals. In the Philippines, gross receipts tax on businesses at specific but graduated rates is also levied. Strictly, the Malaysian and Singapore taxes on services should be considered excises, but, for reasons of comparability, these taxes and the Philippines gross receipts tax are considered as sales taxes in this paper.

We now turn to the revenue importance of sales taxes in ASEAN countries as measured by reliance and effort ratios (see Tables 1 and 2). For both the ratios, the numerator is revenue from sales tax. The denominator for the reliance ratio is the total tax revenue while for the effort ratio it is national income.

The data in Table 1 indicate that while there is a substantial degree of reliance on sales tax by the Philippines and Thailand, Singapore's reliance on sales tax is negligible. Indonesia's reliance on sales tax is also substantial, if oil revenues are excluded. As compared to the reliance ratio, the variability of the effort ratio among the ASEAN countries, as shown in Table 2, is much less. However, once again the importance of sales tax in the total tax effort of the Philippines and Thailand, and of Indonesia, if only non-oil revenues are taken into account, is evident from the data.

* This article is a part of a larger project on sales, excise, and foreign trade taxes in the ASEAN countries carried out jointly with Anne Booth of the Australian National University, under the auspices of the Institute of Southeast Asian Studies. The author is grateful to the ISEAS for financing the study, and to Susan Osborne for helpful comments.
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1. The Association of Southeast Asian Nations (ASEAN) came into existence through a declaration signed by the governments of Indonesia, Malaysia, the Philippines, Singapore, and Thailand in Bangkok on August 8, 1967.

The use of time series is even more relevant since it concentrates on a specific country at different levels of development as measured by per capita income.

Our results further suggest that the advent of the oil boom (the sudden quadrupling of oil prices in the early 1970s) did not significantly affect the tax structure changes. During the entire period investigated the government relied largely on foreign trade taxes. This enabled it not to be concerned with added emphasis on direct taxes as it otherwise would have.

It is the opinion of the authors that Iran has the potential and capability of increasing its direct taxes once political stability is reestablished. Thus far it has failed to exploit this source as a vehicle of revenue earning potential. However, given the fact that the oil sector cannot serve as permanent source of public finance, and assuming the existing level of social services is to be maintained, more attention should be paid to direct taxes as an alternative.

INDONESIA:

Tax incentives for interest-bearing bonds purchased through the stock exchange

With a view to equalizing income distribution in society in conformity with the General Economic Development Policy of Indonesia, and considering the further development of the stock exchange as well as the greater need of funds by the business world for investment during the Third Five-Year Development Plan (1979-1985), it was felt necessary to attract those funds from the public by allowing the purchase through the stock exchange of interest-bearing bonds issued by private companies. To stimulate such activity tax incentives are granted under the Decree of the Finance Minister No. 58/KMK.04/1981 dated January 27, 1981.[1] The tax incentives apply to bonds issued up to March 31, 1984 which pay interest on a fixed date not earlier than three years before redemption. The bonds may be purchased by individuals or companies and by either residents or non-residents of Indonesia.

The tax incentives include:

— No investigation into the source of money used for the purchase of the bonds will be undertaken.

— Interest and other income from bonds will be subject to the 5 percent "tax on dividends, interest and royalties" as a final tax, thus being further exempt from corporate income tax and individual income tax.

— The value of the bonds will be exempt from net wealth tax.

— Transfer of bonds on resale will not attract liability to corporate income tax and individual income tax with respect to capital gains.

To safeguard the interests of the public when purchasing bonds of private companies entitled to issue and offer bonds on the stock exchange, it is revealed that such companies must have an authorized capital of at least 500 million Rupiahs with a paid-up capital of at least 100 million Rupiahs and a net worth of at least 100 million Rupiahs. The companies must have obtained a profit during the last two years before listing their bonds on the stock exchange and must have an earning ratio amounting to 10 percent of the invested working capital of the company.[2]

The listing of interest-bearing bonds by private Indonesian companies is a new vehicle as a means to acquire funds for investment in Indonesia. So far, companies have borrowed from banks and financial institutions. However, because of the government's credit ceiling policy, foreign banks are obliged to arrange many of their loans offshore to meet a strong demand from domestic borrowers and multinational companies. Bank Indonesia, the central bank, sets individual credit ceilings on each foreign, state and commercial bank to restrain money supply growth, running at about 40 percent annually.[3]

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1. Tax incentives granted to companies going public and to individuals buying shares through the stock exchange were already granted in the March 27, 1979 Tax Package discussed in an article entitled: "Indonesia: Tax Incentive Package to Support the Third Five-Year Development Plan (1979-1984)", by Jap Kim Siong in *Bulletin for International Fiscal Documentation* 1980/2-3 at 95-105.
2. Bulletin Ekonomi, Warta C.A.F.I., Jakarta, February 14, 1981.
3. "Credit Ceiling Policy in Indonesia Forces Foreign Banks to Arrange Loans Offshore", by Peter Knight-Barnard, in *The Asian Wall Street Journal*, Hong Kong, February 28, 1981.

revenue. As time went on taxes (direct and indirect) were relatively deemphasized and reliance on oil revenues grew even larger. With the relatively high level of revenues generated in the oil industry, the government did not find it politically prudent to increase taxes on income. Hence, despite the absolute increase in total income taxes collected, the relative share of taxes (as a fraction of GDP) vis-à-vis oil income fell.

It is also possible that the increase in total tax revenue relative to GDP comes about as a result of tax rate increases on other existing as well as new direct and indirect tax sources. This inference is in line with Chelliah's argument that one of the important underlying reasons behind the increased tax ratio was the introduction of new sources of taxes. [23]

A structural change was expected during the 1973-75 period because of a sudden and substantial increase in oil revenues. It is desirable, then, to test the impact of this sudden shift on individual coefficients. This will enable us to determine whether or not unexplained shifts or structural changes have in fact occurred during the 1973-75 period.

To this end, the "Chow test" was employed. [24] This test examines the validity of the hypothesis that the values of individual coefficients, in each regression, have changed between sample periods.

The test is conducted as follows. First, a regression over the first sample period of n observations (1960-72) is run. The sum of squared residuals of this regression is denoted by SSE_1. Next, extending the same period through 1975 (n + m sample period) another regression is run. The sum of squared residuals from this second regression is denoted by SSE_2 with k being the number of independent variables. Then

$$F = \frac{(SSE_2 - SSE_1)/m}{SSE_1/(n=k)}$$

is distributed as an F-statistic with (n-k) degrees of freedom.

The empirical estimate of F is given by

$$F = \frac{(.0991 - .0882)/3}{(.0882)/(16-4)} = 0.494$$

The critical value of F (3, 12) at the 95 percent level of confidence is 3.49. From this we may conclude that the value of individual coefficients, in each regression, has not significantly changed during the sample period. It follows that the increase in oil revenue after 1973 did not significantly affect the Iranian tax structure. This further supports our earlier arguments regarding income taxes and the negativity of sign carried by Y^p. [25]

To test our second hypothesis, a method similar to that used in testing the first hypothesis is employed. The second hypothesis states that as the economy develops, its tax structure changes towards more intensive collection of direct taxes.

The regression equation is specified as follows:

$$TR^d{}_t = \alpha\,(Y^p{}_t)^{b1}\,.\,(OP_t)^{b2}\,.\,(HR_t)^{-b3}\,.\,(AR_t)^{-b4}$$

or in log linear form,

$$\ln TR^d{}_t = \ln\alpha + b_1 \ln Y^p{}_t + b_2 \ln OP_t - b_3 \ln HR_t - b_4 \ln AR_t,$$

where TR^d denotes direct tax ratio defined as total direct tax divided by total tax revenue. All other variables have already been defined.

The estimated model using OLS is as follows: [26]

$$\ln TR^d = \ln 6.224 - \underset{(0.27)}{0.706} \ln Y^{p**} - \underset{(0.126)}{0.0031} \ln OP$$

$$- \underset{(0.078)}{0.293} \ln HR^{**} - \underset{(0.607)}{1.77} \ln AR^{**} \qquad F = 36.96^{**} \quad R^2 = 0.93$$

** Significant at the 99 percent level.

Note: Figures in parentheses are the standard errors of the regression coefficients.

The obtained results corroborate the hypothesis that heavy reliance was put on direct taxes (as opposed to other types) as the Iranian economy developed. HR and AR carry the expected signs and are significant at the 99 percent level of confidence. However, OP carries a negative sign which is not significant.

V. CONCLUSION

In summary, through the use of time-series analysis and by concentrating on one developing country, namely, Iran, we have been able to come up with results, some of which are consistent with those of cross-section studies. Specifically, our empirical results support past studies with respect to:

(a) total tax ratio changes as related to the degree of economic development;

(b) direct tax ratio changes at different stages of economic development.

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23. Chelliah, op. cit., pp. 294-295.
24. See Chow, G.C., "Test of Equality Between Sets of Coefficients in Two Linear Regressions: An Expository Note", *Econometrica,* XXVIII (3): 591-605, July 1960.
25. However, one cannot be conclusive about the significant effect of oil revenue changes in the Iranian tax structure, the reason being the short time period involved.
26. The test for autoregression was inconclusive for this model too. Although the coefficient of autoregression, ρ, was not statistically significant, the Durbin approach was used to further estimate the coefficients in the model to ensure that the original results were reliable. The estimated model using the Durbin approach is

$$\ln TR^d{}_{t2} = \ln 5.1 - \underset{(.23)}{.73} \ln Y^{p**} - \underset{(.120)}{.0027} \ln OP_2$$

$$- \underset{(.079)}{0.31} \ln HR^{**} - \underset{(.55)}{1.85} \ln AR^{**} \qquad F = 28.1 \quad R^2 = 0.92$$

Note: Figures in parentheses are the standard error of the regression coefficients. The subscript "2" is used to denote the result of the Durbin approach. Here again no significant change in the signs and parameters is observed.

Generally speaking, foreign trade helps to transform subsistence economies into monetary economies by providing a market for cash crops. "*Along with the agricultural and industrial sectors, the export sector also plays a vital role in determining the rate and structural pattern of a country's development.*"[17] These theoretical arguments, combined with the fact that past studies have used openness to represent the foreign trade sector, provide the basis for the inclusion of this explanatory factor in our model.

The use of per capita GDP as an indicator of the degree of economic development in our model seems obvious. Past studies have used it, and its inclusion in our model allows us either to substantiate or cast doubt on these findings.[18]

It is a matter of "conventional wisdom" that the less developed the country, the more it depends upon raw materials and agricultural production for its income generation. It is believed that a higher agricultural share of national income is associated with a lower per capita income, a larger subsistence sector, and a lower level of industrialization.[19] Consequently, one expects to find a negative relationship between agricultural share (the share of income generated in agriculture as a fraction of GDP) and tax ratio.

Since "... *in the process of economic development, emphasis is placed on improvement in education, health, and social welfare*",[20] a relevant question is: Should the proportion of government expenditure on health increase or decrease as the economy develops? Health is considered to be an infrastructural type of investment for the economies trying to develop. As a result, one would expect its relative share of total expenditure to be high in the early stages of economic development. Clearly, at later stages government priorities in regard to budget allocations change. This implies that the proportion of expenditure on health decreases.

Based upon the foregoing theoretical arguments, the following relationship is postulated.[21]

$$TR_t = a\,(Y^p{}_t)^{b1} \cdot (OP_t)^{b2} \cdot (HR_t)^{-b3} \cdot (AR_t)^{-b4} \qquad (1)$$

or

$$\ln TR_t = \ln a + b_1(\ln Y^p{}_t) + b_2(\ln OP_t) - b_3(\ln HR_t) - b_4(\ln AR_t) \qquad (2)$$

Where

t = 1, 2, ... 16 time periods
TR = total tax ratio (defined as total tax revenue divided by GDP)
Y^p = per capita GDP
OP = openness (defined as total exports divided by GDP)
HR = ratio of government expenditure on health
AR = proportion of income generated in agriculture, forestry and fisheries

The separate hypotheses state that the following partial derivatives should hold:

$$\frac{\partial(\ln TR_t)}{\partial(\ln Y^p)} > 0, \text{ which implies that } b_1 > 0 \qquad (3)$$

$$\frac{\partial(\ln TR_t)}{\partial(\ln OP_t)} > 0, \text{ which implies that } b_2 > 0 \qquad (4)$$

$$\frac{\partial(\ln TR_t)}{\partial(\ln HR_t)} < 0, \text{ which implies that } b_3 < 0 \qquad (5)$$

$$\frac{\partial(\ln TR_t)}{\partial(\ln HR_t)} < 0, \text{ which implies that } b_4 < 0 \qquad (6)$$

Since double logarithmic equation is postulated, the b_i (i = 1,2,3,4) coefficients measure respective elasticities.

The estimated model, using the ordinary least squares (OLS) method, is as follows:[22]

$$\ln TR_t = \ln 0.205 - \underset{(.308)}{0.486} \ln Y^{p*} + \underset{(.143)}{0.213} \ln OP^* - \underset{(.089)}{0.189} \ln HR^{**} - \underset{(.69)}{1.01} \ln AR^* \qquad F = 9.07 \quad R^2 = .77$$

* Significant at 90 percent level.
** Significant at 95 percent level.

Note: Figures in parentheses are the standard errors of the regression coefficients.

The result obtained strongly supports our general hypothesis of direct relationship between tax ratio and the degree of economic development in the case of Iran. All the variables in the model are significant and carry the expected signs except Y^p.

One explanation may be offered for the negativity of estimated Y^p coefficient ($b_1 < 0$). During the 1960-75 period the government relied heavily on oil as a source of

17. Ibid., p. 477.
18. See Tripathy, R.N., *Public Finance in Underdeveloped Countries* (Calcutta: The World Press Private Ltd., 1968), p. 2.
19. See Chelliah, op. cit., pp. 294-295.
20. Bash, A., *Financing Economic Development* (Chicago: The University of Chicago Press, 1964), p. 4.
21. When the linear model was estimated a high degree of multicollinearity was observed between pairs of variables. To correct for multicollinearity a double logarithmic model was estimated.
22. The test for autoregression was inconclusive. Although the coefficient of autoregression was not significant, the Durbin approach was used to further estimate the coefficients in the model to ensure that the original results were reliable. The estimated model using the Durbin approach is

$$\ln TR_{t2} = \ln .706 - \underset{(.29)}{.59} \ln Y^p{}_2 + \underset{(.133)}{.187} \ln OP_2 - \underset{(.084)}{.192} \ln HR_2 - \underset{(.65)}{1.2} \ln AR_2 \qquad F = 10.77 \quad R^2 = 0.80$$

Note: Figures in parentheses are the standard error of the regression coefficients. the subscript "2" is used to denote the results of the Durbin approach. As the model indicates, there is no change in the sign and the level of significance of the parameters.

III. RELIANCE ON DIRECT TAXATION

It has been noted that the extent of reliance on direct taxation usually increases with greater economic development. [12] When comparing the feasibility of direct tax collection at early stages of economic development to that at more developed stages, the following points can be made:

(a) Corporate taxes are usually levied at a flat rate on all companies at the early stages of development. [13]

(b) Usually, at the early stages of development, the owners of capital assets have a high degree of control over political institutions, thereby influencing tax legislation in their favor. Goode points out that, "*Intensive use of the property tax is blocked in most Latin American Countries by a small but politically powerful group of large land owners.*" [14]

(c) At the early stages of economic development, personal income tax generally has a very limited coverage. It frequently cannot be applied to the agricultural sector, for constitutional or administrative reasons. Hence, personal income tax plays a less significant role in the tax structure. [15]

From Table 1, it is evident that within the period of 1960-75, Iran's GDP rose from a low of $4,387 million to a high of $52,501 million. This implies an average rate of GDP growth of 18 percent. In view of these facts and the proceeding arguments it is the objective of this paper to determine the impact of economic development on Iran's tax structure.

TABLE 1

Iran's GDP and growth rate of GDP during 1960-75

Year	*GDP in million U.S. $*	*Rate of growth of GDP*
1960	4,384	0.15
1961	4,602	0.05
1962	4,949	0.08
1963	5,204	0.05
1964	5,814	0.12
1965	6,597	0.13
1966	7,133	0.08
1967	7,959	0.12
1968	8,912	0.12
1969	10,220	0.15
1970	11,671	0.14
1971	14,455	0.24
1972	17,444	0.21
1973	29,045	0.67
1974	46,594	0.60
1975	52,501	0.13

Source: Different issues of the United Nations Statistical Yearbook.

Accordingly, the following hypotheses are developed. First, there is a direct relationship between the degree of economic development and tax ratio. Second, as the economy develops, the tax structure of the country changes towards more intensive use of direct taxes, i.e. the relative share of direct taxes as a fraction of total tax revenues tends to increase.

To test the foregoing hypotheses, relevant data for the 1960-75 period are used. A multiple regression model using time series data is employed.

IV. VARIABLES AFFECTING TAX RATIO

It is hypothesized that the total tax ratio in Iran could be affected by the four variables selected to reflect the degree of economic development. Those variables are openness (defined in the introduction), per capita income, proportion of government expenditure on health, and proportion of income generated in agriculture, forestry, and fisheries. Generally, a higher volume of trade has been treated as a favorable factor in accelerating the growth rate of different countries. [16] The argument in favor of increased reliance on trade is strong for pre-revolutionary Iran. Capital goods are vital for the economy if it intends to grow. Exports are the best source of obtaining the needed foreign exchange. The revenues obtained from exports facilitate the finance and implementation of development plans.

12. Hinrichs (1966), op. cit.
13. Clearly, not much revenue can be generated by such a levy because (a) company income is often only a small part of national income; (b) if the tax on companies where high, there might be less incentive for private investment; and (c) more importantly, because of "loopholes" in tax laws, a substantial degree of tax avoidance might take place.
14. Goode, R., "Reconstruction of Foreign Tax Systems", in R. Bird and O. Oldman (eds), *Readings on Taxation in Developing Countries* (Baltimore: The Johns Hopkins Press, 1964), p. 178. Absence of records, inaccuracy of the records kept, dubious means of assessing the value of capital assets, and administrative problems make this type of tax costly and inefficient to collect. Unless there are some changes in the social, economic, and political institutions, adoption of capital and wealth taxes — without wholesale evasion — would seem to be impractical.
15. There are three reasons for the low level of personal income tax collected at this stage. First, there are problems in defining income. Second, there are difficulties in assessing individuals' incomes, even if one knows how to define income. A large sector of the economy is not monetized, and wage-earners, independent craftsmen, and small shop-keepers are unable to read and write well enough to complete the simplest income tax return. Sometimes, even if income earners are so literate as to be able to keep records of their income, one can hardly rely on such documents; more than one set of income records can be kept in order to avoid tax payment. In the absence of a well-developed banking and credit system, most transactions are conducted either in cash or barter. Consequently, it becomes very difficult for tax agents to trace out business transactions for income tax collection. Additionally, a voluntary tax payment is not common at the early stages of economic development. The alternative to this is the application of the pay-as-you-earn system. The latter approach covers only a small group of income earners in the community and therefore is neither equitable nor efficient (in terms of revenues generated). Parenthetically, it should be pointed out that at the later stages of economic development, the aforementioned problems (problems pertaining to corporate, income, and property taxes) will be dramatically reduced.
16. See Meier, M. (ed.), *Leading Issues in Development Economics* (New York: Oxford University Press, 1970), pp. 492-509.

Iran: Tax Structure Changes – A Time Series Analysis

by Sohrab Abizadeh * and Mahmood Yousefi **

The authors would like to thank Professor Janet Rives of the University of Nebraska at Omaha for her helpful comments. The responsibility for any errors, however, rests with the authors.

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I. INTRODUCTION

In the past two decades a number of researchers have attempted to investigate the tax ratio differences among developed and less developed countries (LDCs). [1] They have also extended their investigation to a group of countries at different stages of economic development.

Martin and Lewis [2] compared the revenues and expenditures for 16 countries at different levels of economic development. Their objective was twofold: (a) to determine the patterns of expenditures and sources of revenue as related to economic development and (b) to explore the pattern of taxes and expenditures suitable for different countries.

Martin and Lewis' study was followed by Williamson [3] who employed a more comprehensive approach. [4] Hinrichs [5] raised some questions regarding the validity of the former studies. He stressed "openness" [6] and concluded that the latter "*. . . may serve as a much better estimator of 'taxable capacity' than the usual per capita income measures.*" [7] Per capita income, however, is not the only factor determining the level of development as has been discussed elsewhere by one of the present authors. [8] Later, in a more thorough study of taxes, Hinrichs [9] became most concerned with the achievement of economic development.

Chelliah also conducted a study of taxation in developing countries. His major findings could be summarized as follows:

a. In the sample countries, the rate of growth of tax revenues has exceeded that of GNP; consequently there has been a rise in tax ratio.
b. One of the important underlying reasons behind the increased tax ratio was the introduction of new sources of taxes, namely sales as well as excise taxes. This is attributed to changes in the composition of taxes and tax rates. [10]

II. RELEVANCE OF PAST RESEARCH FOR PRE-REVOLUTIONARY IRAN

The purpose of the present study is to investigate the relevance of past research for pre-revolutionary Iran. [11] Specifically we are concerned about the changes in the total tax ratio and structural tax changes which have occurred as the Iranian economy has developed. This objective will be examined on the basis of the following considerations:

a. Highly developed countries exhibit a higher tax ratio than do the LDCs. It is particularly relevant to examine this ratio for a given country at various stages of development.
b. In order to clearly test the hypotheses concerning tax ratio, structural tax changes, and their relationship to the degree of economic development, extended time series data should be utilized. This approach will ensure that the time period is long enough to allow for changes in the level of development.

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1. Tax ratio is usually defined as the ratio of all taxes and tax-like changes (including gross social security contribution from private sector, if any) to gross national product (GNP) of gross domestic product (GDP).
2. Martin, A. and W.A. Lewis, "Patterns of Public Revenue and Expenditure", *The Manchester School of Economics and Social Studies,* XXIV (3): 203-244, September 1956.
3. Williamson, G., "Public Expenditure and Revenue: An International Comparison", *The Manchester School of Economics and Social Sciences,* XXIX (1): 34-56, 1961.
4. For criticism of Williamson's approach, see S. Abizadeh, "Tax Components and the Degree of Economic Development", unpublished Ph.D. dissertation, Oregon State University, 1976, pp. 26-27.
5. Hinrichs, H., "Determinants of Government Revenue Shares Among less Developed Countries", *The Economic Journal,* LXXV (299): 546-556, September 1965.
6. Defined as total imports as a share of GNP.
7. Hinrichs, op. cit., p. 546.
8. See Abizadeh, op. cit., pp. 48-58.
9. Hinrichs, H., "A General Theory of Tax Structure Changes During Economic Development", Cambridge: The Law School of Harvard University, 1966.
10. Chelliah, R.J., "Trends in Taxation in Developing Countries", *International Monetary Fund Staff Papers,* XVIII (2): 254-331, July 1971.
11. In the past few years, particularly the last two, the extent of economic dislocations which largely stem from political instability has been substantial. Hence, this study concentrates on the pre-revolutionary period 1960-75.

It should be recalled that the General Consumption Tax which in January 1979 was proposed by the Japanese Government was a certain type of value-added tax in that purchases could be deducted from sales. However, this proposal met with strong opposition and was consequently rejected by Parliament in December 1979. One of the important objections voiced by the opposition was that the tax payment mechanism of the General Consumption Tax was defective, so that many influential tax experts supported the value-added tax type introduced by the European Community under which tax on purchases is credited against the tax on sales.

It is the author's opinion that eventually a new large-scale consumption tax will be introduced in Japan patterned along the lines of the VAT as it is applied by the European Community. Although there are a number of problems inherent in this tax, it is currently the most sophisticated among the general consumption taxes. However, there is little doubt that the introduction of this type of VAT will also meet with strong opposition. Apart from the protests of the trade unions and the consumers, the strongest opposition is to be expected from the retailers so that the Government and Tax Committee are contemplating the exclusion of this group of enterprises from the new tax. The new tax would then be either a production or manufacturing tax or a tax encompassing manufacturers and wholesalers. It is likely that a credit mechanism will be adopted which is similar to that applicable in the European Community type of VAT. This means that most probably a non-cumulative type of turnover tax will be adopted. Since retailers will be excluded it is expected that taxable persons will be registered in one way or another to prevent abuse of the possibility to take a credit for tax paid on purchases.

The Government and the LDP contemplate designating the new tax as a "welfare tax" since they envisage earmarking the revenue derived from this tax for social security expenditure.

VI. CONCLUSION

The development of the Japanese economy has reached a stage wherein tax increases will be unavoidable, since there is no other way to liquidate the enormous financial deficit. Although a policy aimed at the increase of taxes is always difficult, the Japanese Government is at this moment in a rather fortunate position. Not only has the Government which rests upon the LDP a majority in Parliament but also some of the opposition parties agree in this respect with the LDP. The next general elections are relatively far removed — in 1983 — so that the Government — and in particular the Ministry of Finance so its seems — believe that at this moment the chances for a successful operation under which taxation will be increased on a large scale are best. However, a major concern remains and that is the international economic situation and the repercussion of such a tax increase on Japan's power to compete internationally.

Conference Diary

JUNE 1981

Georgetown University Law Center: The Third Annual Institute on Multinational Taxation, Washington, D.C. (U.S.A.), June 10-12 (English).

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: Das Steuerrecht der U.S.A./U.S.A. Tax Law (Seminar) (including: introduction to United States taxation; taxation of Swiss branch and subsidiary operations in the U.S.; tax treatment of special forms of investment in the U.S.; taxation of foreign income of U.S. taxpayers: basic principles; acquisition of a U.S. business), Zürich-Airport (Switzerland), June 11-12 and 15-16 (English, German).

JULY 1981

Management Centre Europe: Taxation of International Group Companies and Branches (Seminar) (including: taxation of branches; home jurisdiction; taxation of subsidiaries; taxation of shareholders), Brussels (Belgium), July 6-7 (English).

SEPTEMBER 1981

35th Annual Congress of I.F.A.: I. Mutual agreement procedure and practice: II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Georgetown University Law Center, Office of Continuing Legal Education, 600 New Jersey Avenue, N.W., Washington, D.C. 20001 (U.S.A.).

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen, Varnbüelstrasse 19, 9000 St. Gallen (Switzerland).

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

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

The International Tax Planning Association, 33a Warwick Square, London SW1V 2AD (United Kingdom).

IV. THE TAX INCREASES FOR FISCAL YEAR 1981

On January 13, 1981 the Japanese Government decided on a tax reform based on the recommendations of the Tax Committee and the Tax Committee of the LDP. This reform consists mainly of an increase of the present tax rates and is estimated to result in an increase of total tax revenue of 1,390 billion yen which can be broken down as follows:

corporate income tax	620 billion yen
liquor tax	280 billion yen
commodity tax	80 billion yen
stamp tax	350 billion yen
securities transaction tax	60 billion yen
total	1,390 billion yen

1. Corporate income tax

The rate of the corporate income tax is to be raised by 2 percentage points. The following rates will thus apply:

A. Tax rates for ordinary income not distributed as dividends

a. *Ordinary corporations*

(i) Corporations with a capital exceeding 100 million yen — 42 percent

(ii) Corporation with a capital not exceeding 10 million yen
- annual income exceeding 8 million yen — 42 percent
- annual income not exceeding 8 million yen — 30 percent

b. *Cooperative associations and corporations created for public interest* — 25 percent

B. Reduced rates applicable to ordinary income distributed as dividends

a. *Ordinary corporations*

(i) Corporations with a capital exceeding 100 million yen — 32 percent

(ii) Corporations with a capital not exceeding 100 million yen
- annual income exceeding 8 million yen — 32 percent
- annual income not exceeding 8 million yen — 24 percent

b. *Cooperative associations* — 21 percent

The above increased rates are to be applied to income derived in accounting years ending April 1, 1981 or later.

The *Keidanren*, which is the Japanese Federation of Economic Organizations, has objected to this tax increase since in its opinion this increase weakens the competitive power of Japanese export businesses and will in general have an adverse influence on business conditions. Therefore, it has requested the introduction of the rate increase only for a limited period of time.

It is the author's opinion that the corporate income tax rates will indeeed be reduced when the general consumption tax is introduced. In order to compensate to some extent for the increase in the corporate income tax rate, the Government decided to introduce a new special investment credit for investment in energy-saving equipment of 7 percent of the acquisition cost of such investment. The loss of revenue resulting from this measure is estimated to amount to 80 billion yen.

2. Liquor tax

The rate of the liquor tax will be increased by 10 or 25 percent. As a result the retail price of beer is increased from 240 to 265 yen (bottle of 633 ml), Japanese whisky (Suntory old) from 2,500 yen to 2,770 yen (bottle of 760 ml), special sake (rice wine) from 10,000 to 12,500 yen (per 1.81 litre).

3. Commodity tax

The number of items subject to commodity tax has been expanded and the rates have been increased. The tax is mostly levied on automobiles and electrical appliances.

4. Stamp tax

The rates of the stamp tax will be doubled.

5. Securities transaction tax

The rates of the securities transaction tax will be increased by 20 or 50 percent. For example, the rate of tax on the transfer of shares (except by portfolio holding companies) will be increased from 0.45 to 0.55 percent and the rate on the transfer of corporate debentures from 0.03 to 0.045 percent.

6. Individual income tax

The individual income tax will not be amended. However, the income tax rates of 1978 still apply so that the burden of income tax has relatively increased because wage increases to compensate for inflation have resulted in the imposition of higher graduated taxes.

Another problem is that the personal exemption for individual income tax purposes is less than the sustenance allowance which is granted under the law protecting a certain standard of living. For instance, the tax exemption for a family of four persons (taxpayer, spouse and two children) is 1,190,000 yen whereas the sustenance allowance available from the Government for a family of four persons is 1,620,000 yen per year. This discrepancy makes it possible for the so-called "poverty trap" to occur in Japan.

V. THE INTRODUCTION OF THE GENERAL CONSUMPTION TAX

Both the Tax Committee and the Japanese Government are planning to introduce a new large-scale consumption tax in 1982. The discussions of the subcommittee of the Tax Committee to take place in August or September 1981 will clarify the principles of this tax.

JAPAN:

Medium Term Tax Policy and the Tax Increase in Fiscal Year 1981

by Makoto Miura*

I. INTRODUCTION

On November 7, 1980, the Tax Committee [1] submitted a report entitled *"Measures for a change in the tax system to improve Japan's public finances"* [2] to the Prime Minister, Mr. Suzuki.

The main thrust of the "Report" is to recommend an overall increase of the taxes levied under the present tax system and the introduction of a new type of general consumption tax. In addition, on December 20, 1980, the Tax Committee presented a recommendation to the Prime Minister for a tax increase to be introduced in fiscal year 1981. At the same time, the Tax Committee of the LDP (Liberal Democratic Party), which is the present government party, recommended almost identical measures for a tax increase in fiscal year 1981. On the strength of these recommendations, the Japanese Government has decided to increase the taxes by 1,390,000,000,000 yen ($7,000,000,000), which is the largest increase introduced since World War II.

The Tax Committee will start its discussions on the introduction of a new general consumption tax in March 1981 for which purpose a subcommittee has been appointed. It will in August or September 1981 report on the feasibility of the introduction of such a consumption tax in fiscal year 1982.

II. THE BACKGROUND OF THE "REPORT"

The "Report" sets forth the reasons for the large-scale tax increase in the following manner.

The present deficit of the Japanese budget has reached tremendous proportions. In fiscal year 1980 only 62 percent of national expenditure was covered by national tax revenue. In the 1960s this ratio varied between 80 and 90 percent. Therefore, in 1980 the Japanese Government was obliged to issue bonds in an amount of 14,000 billion yen ($70,000,000,000) which was approximately 34 percent of the 1980 government expenditure and the cumulative amount of bonds issued to finance budget deficits has reached an amount of 72,000 billion yen ($360,000,000,000) by the end of fiscal year 1980 (which terminates at the end of March 1981). It is felt that in order to place the Japanese budget on a sound basis it will be necessary to finance at least 80 percent of national expenditure by national tax revenue, i.e. to restore the balance which existed in the 1960s.

In order to reach this goal — so explains the "Report" — national tax revenue must be increased and the ultimate target is an increase of approximately 3 percent of GNP in fiscal year 1984. One percentage point of this 3 percent considered necessary will be expected to be achieved through the automatic tax revenue increase, i.e. the increase of the tax revenue caused by economic growth. However, in order to obtain the remaining 2 percent the Government will have to increase the tax rates or to reform the tax system or to introduce new taxes. This 2 percent figure was estimated to amount to approximately 5,000 billion yen ($25,000,000,000) for fiscal year 1981. However, in reality it turned out to amount to 1,390 billion yen in fiscal year 1981. However, the Government will receive 4,470 billion yen as a result of automatic tax revenue increases through the increase of economic growth, which is the highest in advanced industrial countries.

III. SOME SIGNIFICANT CONCLUSIONS SET FORTH IN THE "REPORT"

The "Report" reaches the following important conclusions:

1. It states that there is no need for the reduction of the level of individual income tax, since the burden of this tax is as a whole lower than that in the European countries and the United States.
2. The introduction of an imputation system may be useful as a tool to achieve a certain measure of harmonization with foreign tax systems. It is noted that under the imputation system a shareholder is permitted to credit a certain amount of corporate income tax, which can be attributed to his dividend receipts, against his individual income tax liability. Therefore, the Tax Committee will for this purpose continue its discussions on this subject, placing special emphasis on the international repercussions.
3. The Committee foresees problems should a net wealth tax or a net worth tax be introduced so that it will continue its discussions on this subject.
4. The "Report" insists on the necessity of increasing indirect taxation. Not only should existing indirect taxes be increased, but the "Report" advocates the introduction of new turnover tax which is indicated as a "wide scale consumption tax".

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* Professor of tax law, Hosei University, Tokyo. Earlier articles published by Mr. Miura in the *Bulletin* are: "Japan: The Tax Committee recommends a large scale tax increase", in 32 BULLETIN 168 (1978), and "Japan: The 1979 tax reform — paving the way for a new tax", in 33 BULLETIN 390 (1979).

1. The Tax Committee (sometimes designated as "Tax Commission" or "Tax Council") is an advisory body which advises the Prime Minister on tax matters. It is composed of 30 members representing business and trade unions and also includes scholars, journalists and economists. The Tax Committee was established in 1956 and has almost annually submitted recommendations to the Japanese Government. The Government usually adopted these recommendations as a whole or to a large extent.
2. Hereinafter indicated as the "Report".

during the preceding four years, must file a return disclosing the name and address of each foreign person who was a shareholder at any time during the year, to the extent such information is "known by the corporation". Where a foreign person owns stock in a U.S. corporation through a nominee and the foreign person has not supplied the U.S. corporation with the necessary information, the nominee also must file an annual return. Publicly traded corporations are exempt from this requirement (but note that the identity of 5 percent shareholders in such corporations regularly will be supplied to the SEC under the securities laws).

The second type of information return involves "entities" other than U.S. corporations, i.e. foreign corporations and U.S. or foreign partnerships, trusts and estates. Where the entity is a partnership, trust or estate, it must file an annual return disclosing the name and address of each "substantial investor". The latter term is defined as a foreign person whose pro-rata interest in USRPIs is held by the entity had a fair market value of more than $50,000. For this purpose, if the entity is itself a "substantial investor" in a U.S. or foreign corporation, such entity's pro-rata share of the corporation's USRPIs are taken into account, without regard to whether the corporation was a USRPHC, and without regard to whether the entity's interest in the corporation was a "controlling interest". The same rules also apply where the reporting entity is a foreign corporation (even if it is publicly traded), except that the term "substantial investor" is not limited to foreign persons, i.e. the identity of both U.S. and foreign persons investing in the foreign corporation must be disclosed. The reporting entities also are required to furnish each of their "substantial investors" with annual statements reflecting the investor's share of USRPIs held directly or indirectly by the entity.

The new law contains a highly unusual provision making this second type of reporting requirement inapplicable if security is furnished to the IRS "to ensure that any tax imposed by chapter I (the income tax) with respect to United States real property interests held by such entity will be paid". It will be interesting to see what kind of security will be considered adequate by the IRS for it to be considered so ensured.

The third type of information return relates primarily to foreign individuals who (i) hold USRPIs having a fair market value of $50,000 or more, and (ii) were not engaged in trade or business in the U.S. at any time during the year. It also may apply to foreign entities which are exempt from the second type of filing requirement as described above either because they provide adequate security to the IRS, or because they have no "substantial investors". This third type of information return must disclose the name and address of the foreign person, and a description of the USRPIs held during the year.

In the case of each type of information return described above, additional information may be required by regulations to be prescribed.

G. Effect of treaty exemption

As already noted, the new law will not override treaty exemptions until December 31, 1984. Moreover, where an existing treaty is renegotiated and signed before 1985, but is not ratified by December 31, 1984, the existing treaty may continue to apply for up to an additional two years, depending upon what is provided in the new treaty or accompanying documents.

A new Canadian treaty had been signed prior to the enactment of the new provisions but has not yet been ratified. The new treaty contains a number of provisions which anticipated some of the earlier legislative proposals to tax foreigners on real property gains. Nevertheless, there are some significant differences, and whether or not this will cause difficulties in obtaining Senate ratification is not at all clear.

Several of the existing U.S. treaties provide that in the absence of a permanent establishment in the U.S., a resident of the treaty country would be exempt from U.S. taxation on gain derived from the sale of capital assets. Generally, this exemption does not extend to real property situated in the U.S., but the current Canadian Treaty is an exception, applying to U.S. real property as well as other assets. The effect of the new law where these treaties apply will be as follows:

1. Dispositions of real property held directly will be subject to tax, except under the current Canadian treaty in the case of Canadian residents without a U.S. permanent establishment.

2. The treatment of dispositions of interests in partnerships or of beneficial interests in trusts and estates holding real property is not absolutely clear.

3. Dispositions of stock in a U.S. corporation are still exempt, except possibly where the "collapsible corporation" provisions apply.

4. Distributions of real property by a corporation resident in a treaty country are treated in the same manner as described in 1 or 2, above, and distributions by such corporation of stock of a U.S. corporation are treated in the same manner as described in 3, above.

5. The reporting provisions of the new law will apply in any case.

6. Where property is transferred to a related person and gain on such transfer is exempt solely by reason of a treaty, the related person will not obtain a step-up in basis for the transferred property. It is not clear whether this rule will be applied to deny a step-up in basis for a foreign shareholder of a U.S. corporation where the corporation distributes a USRPI in liquidation.

qualify as a USRPHC for at least the next 5 years, even though the increase in value of its stock during such period is attributable entirely to its manufacturing operation. The rules applicable to investment through a foreign corporation or a partnership are quite different; they create taxable income only to the extent the gain is actually attributable to appreciation in value of USRPIs. This suggests the need for careful consideration of the form in which a foreigner makes future investments in U.S. real estate. Similarly, careful consideration is necessary in determining whether real estate and non-real estate assets should be owned through the same U.S. corporation. Such mixing of investments may sometimes prevent a corporation from becoming a USRPHC, thereby sheltering the real estate from the new tax. On the other hand, it is also possible that the effect of the mixing of investments may be that the real estate assets would taint the appreciation in value of the other assets.

C. Non-recognition rule

The new rule also modifies the "non-recognition" rules otherwise applicable under the Code, e.g. for like-kind exchanges, reorganizations, etc. Ultimately, regulations will be issued to deal with the entire matter, and it is now possible to predict what those regulations will provide. In the interim, the rule will be as follows: If a foreigner exchanges a USRPI in an otherwise tax-free transaction, then the non-recognition provisions will apply if, and only if, the property *received* by the foreigner in the exchange would be "subject to taxation" (taking into account any treaty exemptions) if sold by the foreigner.

D. Related party transactions

A two-part special rule has been included with respect to dispositions made after December 31, 1979 to a "related person". The first part involves dispositions made before June 19, 1980 (the effective date of the new tax); the transferee in such case does not obtain a step-up in basis. The inclusion of this first part of the rule was not a complete surprise. However, at the last moment, a second part was added involving a disposition to a related person, either before or after June 19, on which the gain was exempt under a treaty; again, the transferee is denied a step-up in basis. It is not yet clear whether the latter rule will be applied to a distribution from a U.S. corporation to a shareholder resident in a treaty country. While the corporation and the shareholder may be "related persons", the gain exempt by reason of the treaty is the shareholder's gain on the stock and not the corporation's gain on distribution of the property. Accordingly, the step-up in basis of the distributed property should not be precluded by the new law. However, it is quite possible that the IRS will seek a broader application of the statute and attempt to reduce the shareholder's stepped-up basis for the property distributed by the amount of exempt gain on the stock.

E. Real estate investment trusts

A domestically-controlled Real Estate Investment Trust (REIT) [4] is expressly excluded from treatment as a USRPI and therefore foreigners may sell shares in such companies without being subject to tax. However, a foreigner selling shares in a REIT which is not domestically controlled will be subject to tax under the new law to the same extent he would be subject to tax on a sale of shares of a U.S. corporation that is not a REIT.

In addition, the new law adds several provisions that may affect REITs and their shareholders. To appreciate these new provisions, it should be noted that for a REIT to maintain its status as such, it must distribute substantially all of its income on a current basis. A REIT is, in general, entitled to a deduction for the amount of current income it distributes so that, in effect, a REIT generally pays little or no tax. However, except as noted below, its shareholders are required to include in income as a dividend the amount of the distribution received from a REIT. To the extent any shareholder is a non-resident alien or foreign corporation, a dividend distribution is taxed at a 30 percent or lower rate prescribed by an applicable tax convention. Furthermore, in the event a REIT realizes a capital gain, it may pass on to its shareholders the benefit of the lower tax rate afforded to capital gains by denominating the appropriate portion of any distribution it makes as a capital gains distribution.

The new law provides two changes. First, it provides that any distribution made by a REIT to a non-resident alien or foreign corporation will be treated as gain from the sale of USRPIs owned by the REIT to the extent attributable thereto. This will have the effect of subjecting such gain to tax under the new law. Second, because gain from the sale of shares in a domestically-controlled REIT is not subject to tax under the new law, where a REIT is dometically controlled, any distribution made by it of a USRPI will, to the extent provided by regulations, require the REIT to recognize as gain the portion of the appreciation in value of the distributed USRPI attributable to the foreign ownership percentage of the REIT.

F. Enforcement of tax and information returns

The new law does *not* impose any requirement for withholding of tax. Instead, three types of information returns are required to be filed anually, with penalties of up to $25,000 per year for a failure to comply. First, every U.S. corporation which had at least one foreign person as a shareholder during the year and which was a USRPHC at any time during the year, or at any time

4. A REIT is a U.S. corporation, the shares of which ordinarily are widely-held, the assets and income of which are predominantly from real estate and mortgages on real estate. A domestically-controlled REIT is a REIT which at no time during the five-year period ending on the date of disposition (or shorter period since June 19, 1980) had 50 percent or more in value of its stock directly or indirectly (broad attribution rules apply) owned by non-U.S. persons.

sition of a stock of a foreign corporation will not be subject to tax (except in the limited circumstances under which prior laws imposed a tax). On the other hand, section 337 is made inapplicable to a disposition of a USRPI by a foreign corporation. Moreover, if a foreign corporation distributes a USRPI in liquidation or otherwise, it must recognize as gain any appreciation in value of the USRPI. Losses are not recognized, and apparently will not even be offset against gain where both appreciated and depreciated assets are distributed together. The new rules apply only to USRPIs owned by a foreign corporation (including the stock of certain U.S. corporations as described below); prior law continues to apply to assets of foreign corporations which are not USRPIs.

Mention might be made of a special election available to corporations resident in certain treaty countries. If such a corporation has a "permanent estblishment" in the U.S., it will have a right to elect to be treated as a domestic corporation for purposes of the new provision. This may be helpful, for example, where it is intended that the corporation will be liquidated and the appreciation in value of the U.S. assets at the corporate level is greater than the appreciation in value of the stock of the corporation.

(2) Rules relating to United States corporations

With respect to U.S. corporations,[2] the rules applicable at the corporate level remain unchanged. However, as noted above, foreigners' gains from the disposition of stock in certain U.S. corporations are made subject to tax. This is accomplished by including in the definition of "USRPI" stock of a U.S. corporation if, at any time during a base period, the corporation qualified as a United States Real Property Holding Corporation (USRPHC). The base period is the five-year period ending on the date of disposition or, if shorter, the period beginning after June 18, 1980 during which the taxpayer held the stock disposed of. The statute in effect presumes that every corporation meets this test unless the taxpayer "establishes" the contrary. The manner in which a taxpayer may establish the contrary is left to future regulations.

A corporation is a USRPHC" if the market value of the USRPIs held by the corporation equals or exceeds 50 percent of the fair market value of the sum of (i) its USRPIs, (ii) its interests in real property located outside the U.S., and (iii) its other assets used or held for use in a trade or business. Apparently, this test will be applied with reference to gross assets, i.e. without regard to mortgages or other liabilities. If a corporation owns a "controlling interest" in another U.S. or foreign corporation (i.e. ownership, determined by applying broad "attribution" rules, of 50 percent or more in value of all the outstanding stock), the 50 percent gross asset test is applied by taking into account a pro-rata share of each of the assets of the other corporation; if the stock owned in the other corporation is less than a "controlling interest", then the 50 percent test is applied by taking into account only the value of the stock in the other corporation. This can make a material difference when the other corporation has substantial liabilities (in effect, liabilities will indirectly be taken into account in valuing a non-controlling interest, but will be irrelevant in the case of a controlling interest).

It should be noted that the denominator for the 50 percent test does not necessarily include a corporation's total assets. For example, a corporation's investments in mortgages or securities would not be taken into account unless the corporation was in the lending business. Similarly, stock which does not constitute a "controlling interest" would not be taken into account unless the noncontrolling interest was in another U.S. or foreign[3] corporation which itself was a USRPHC at some time during the latter's base period.

There are two exceptions to the above rules. First, (i) if a class of stock is regularly traded on an established securities market, and (ii) at all times during the base period the taxpayer (together with certain related persons) owned not more than 5 percent of such class, then the shares of such class owned by the taxpayer are not considered to be a USRPI. Second, (i) if the corporation does not own a USRPI on the date of disposition, and (ii) if it held any USRPI interests during the base period, and such interests were disposed of by the corporation in a transaction in which all the gain was recognized, then the interest in the corporation will not be considered a USRPI. Unless the regulations provide some de minimis rule, the latter exception may not be of much practical value, since it is likely that a corporation will own *some* USRPI at the time of the disposition of its stock (e.g. a lease of office space).

A special rule is also provided for certain non-liquidating distributions made by a *U.S.* corporation (whether or not the U.S. corporation is a USRPHC) to a foreign shareholder. If the distribution consists of a USRPI (this would include the stock of a U.S. corporation which was a USRPHC during the base period, but would not include the stock of a foreign corporation), the distributing corporation's tax basis for the property distributed carries over to the shareholder with two adjustments. First, the basis of the property is increased by the gain, if any, recognized to the distributing corporation on the distribution; and second, the basis is increased by the U.S. tax, if any, paid by the distributee with respect to such distribution. Under prior law, the shareholder would have received a step-up in basis for the property.

One aspect worth emphasizing is the all-or-nothing approach used for investment through U.S. corporations. If a U.S. corporation meets the test of a USRPHC at any time during the base period, then the entire gain on the disposition of the stock will be subject to U.S. tax, even though none of the gain is attributable to U.S. real estate. For example, if a manufacturing business is begun by acquiring a plant, the corporation is likely to

2. Other than certain Real Estate Investment Trusts, discussed below.

3. The term "USRPHC" literally is not restricted to U.S. corporations, but may also apply to foreign corporations. However, whether or not a foreign corporation is or has been a USRPHC is relevant only where the U.S. corporation owns less than a "controlling interest" in a foreign corporation; the status of the foreign corporation as a USRPHC would then be relevant in determining whether the U.S. corporation is a USRPHC.

U.S.A.: Foreign Investment in Real Property Tax Act of 1980

by Herbert H. Alpert and Fred Feingold*

The provisions for subjecting foreigners to U.S. tax with respect to gains from the disposition of interests in U.S. real estate became part of the law on December 5, 1980, when the President signed the bill enacted by Congress. The following is a brief summary of the new provisions.

A. General provisions

The new law subjects foreign persons to tax on their net gains from the disposition of "United States real property interests"(USRPIs). This term is defined to include not only interests in real property held directly, but also interests in certain *U.S.* corporations. Interests in *foreign* corporations are not included in the definition of USRPIs, but, as noted below, compensating changes are made in the taxation of foreign corporations to ensure that they will not escape taxation on gains from the disposition of any USRPIs held by them.

With respect to partnerships, trusts and estates, foreign partners and beneficiaries are in effect treated as owning a pro-rata share of the USRPIs held by the entity. As a consequence, foreign partners or beneficiaries are subject to tax on (i) their respective shares of the gains from dispositions of USRPIs by the entity, and (ii) their gains from the disposition of their interests in the entity, to the extent such gains are attributable to USRPIs held by the entity. The implementation of these rules, which will raise many technical questions, is left to future regulations and is not discussed below.

The new tax applies to dispositions of USRPIs after June 18, 1980, except where the gain is exempt under an existing treaty, in which case the effective date is deferred until at least December 31, 1984. However, certain transfers made after December 31, 1979 between related parties may be affected by the new provisions.

In general,[1] the new tax will be at capital gains rates, i.e. at a rate not to exceed 22 percent, plus, in the case of a corporation, 1.67 percent, the latter being the effective rate of the add-on minimum tax on "tax preferences". Individuals are not subject to the add-on minimum tax, but they sometimes are subject to an "alternative minimum tax", and the latter provisions have been amended to provide that the total U.S. tax on a nonresident alien's capital gains from dispositions of USRPIs will not be less than 20 percent.

As many states or cities base their taxes on federal income tax definitions, the new law may also result in increased local income or franchise taxes for foreigners. This is most likely to be the case where real property interests are held directly or through a partnership, since, in such cases, the foreigner typically would be subject to local taxation. Sale of an interest in a U.S. corporation, however, probably would not result in local taxation.

B. Ownership of USRPIs through corporations

The most unusual part of the new law is the provisions dealing with corporations and shareholders. To appreciate the ramifications of these provisions, it is necessary to keep in mind the basic rule under U.S. tax law that a corporation does not recognize any gain or loss if it distributes appreciated property to its shareholders, either as an ordinary distribution in kind or as a liquidating distribution. This basic rule applies even where the shareholders obtain a step-up in basis for the assets distributed. Moreover, if a corporation adopts a plan of liquidation and completely liquidates within 12 months thereafter, section 337 provides that no gain or loss is recognized to the corporation on a sale of assets during that 12-month period. Where applicable, this rule applies even though the purchaser of the assets obtains a step-up in basis. There are, of course, exceptions to the above rules.

In light of the above-described rules, if the new tax were to apply only to dispositions of U.S. real estate held directly by foreigners, the tax likely would have little practical effect. The tax easily could be avoided if, instead of selling real estate, a foreign person sold the stock of a corporation owning the real estate. The purchaser could then liquidate the corporation and obtain a step-up in basis without a tax being incurred. Alternatively, in appropriate circumstances the corporation owning the property could adopt a plan of liquidation and then sell the property; the corporation would not recognize gain under section 337, and the foreign shareholder would be exempt from tax on his stock gain realized when the corporation distributed the sales proceeds in liquidation. Thus, provisions dealing with corporate ownership of real property were necessary in order to make the new tax meaningful.

(1) Rules relating to foreign corporations

With respect to foreign corporations, the new law approaches the problem only from the corporate level. An interest in a foreign corporation is *not* included in the definition of a USRPI; therefore, gain from the dispo-

* Partners of Roberts & Holland, New York (N.Y.), Washington, D.C. and Miami (Florida).

1. In certain circumstances, the highest tax rate applicable to ordinary income (46 percent in the case of corporations and 70 percent in the case of individuals) will apply to all or some portion of a gain from the disposition of a USRPI.

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

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

The International Tax Planning Association, 33a Warwick Square, London SW1V 2AD (United Kingdom).

Taxation Institute of Australia, 19th Floor, Caga Centre, 8-18 Bent Street, Sydney, N.S.W. 2000 (Australia).

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"Problems of Tax Reform"

by Professor Russel Matthews, Director of the Centre of Research on Federal Financial Relations, Australian National University, Canberra.

This highly interesting paper is the outcome of a short visit to Papua New Guinea by Professor Matthews for the purpose of addressing public meetings. Subjects discussed include: the objectives of and constraints of tax policy; the influence and effects of progressive taxation; the Australian tax system; loss of certainty and social justice; policy options for tax reform and the tax structure based on transactions and net wealth.

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Third edition. By Peter G. Whiteman, Stephen Allcock, Mark Herbert, David C. Milne and John Tallon. London, Sweet & Maxwell, 1980. Series "British Tax Encyclopedia". 688 pp., £42.
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Study of the taxation of foreign permanent establishments, mainly from the point of taxation of foreign permanent establishments in German tax law. The book is divided into three parts, i.e. a review of the applicability of the alternative elements which can be used in a model for international taxation of business profits and capital, the definitions of permanent establishments under various tax laws and, finally, the allocation of business profits and capital. An extensive index and bibliography are appended. (B. 102.701)

DIE BASISGESELLSCHAFT ALS INSTRUMENT BETRIEBLICHER STEUERPOLITIK

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Text of the new 1981 Law on Limited Liability Companies, including several practical hints for managers, directors, shareholders and their advisors. (B. 103.012)

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By Franz Klein, Paul G. Flockermann and Christian Kühr. Neuwied, Hermann Luchterhand Verlag, 1978. 1888 pp.
Comprehensive commentary on the German Individual Income Tax Law with extensive reference to case law and administrative rulings. The commentary is preceded by an introduction concerning the historical development and the system of the individual income tax and of related laws. An extensive index is appended. (B. 103.009)

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Study on tax planning under Indian tax laws for both individuals and corporate taxpayers. The author also deals with some instruments which help the taxpayer in taking recourse to tax planning such as creating trusts, executing wills, taking insurance, etc. (B. 51.649)

INTERNATIONAL

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Edited and supervised by Annemarie Mennel. Prepared by Rita Domann, Harmut Groos, Wolfgang Hauser, Hans Mayer, Ingo Müssener and Dorothea Strömberg. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1980. 418 pp., 120 DM.
Loose-leaf publication in German (when finished in two binders) containing an outline on a comparative basis of the major taxes levied in 19 countries (the nine of the European Communities and also other European and non-European industrialised countries). The initial release contains the German Federal Republic, United Kingdom, France, Italy, the Netherlands, Sweden. Other forthcoming countries will include Belgium, Denmark, Greece, Ireland, Japan, Canada, Luxembourg, Norway, Austria, Portugal, Switzerland, Spain and the U.S.A. (B. 103.007)

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Evoluzione legislativa dal 1974 al 1979. Milan, Editrice Il Sole — 24 Ore, 1979. 464 pp.
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First Arab business yearbook consists of two parts: Part A concerning Pan Arab data describes taxation in the Arab world covering the following countries: Algeria, Bahrain, Djibouti, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, United Arab Emirates, Yemen Arab Republic and the People's Republic of Yemen, prepared by Ernst & Whinney (Chartered Accountants) and Whinney Murray & Co. Part B covers country data, e.g. government institutions, foreign investments, import regulations, economic and financial information. The countries covered are: Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, Yemen Arab Republic, Yemen People's Democratic Republic. (B. 51.650)

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By Allan Taitz. Don Mills, CCH Canadian, Ltd., 1980. 197 pp., $19.
Monograph describing the corporation net worth tax levied in some provinces in Canada. Examples and forms are appended. (B. 103.004)

INDUSTRIAL ASSISTANCE PROGRAMS IN CANADA

Interpretation, law and regulations. 6th Edition. By Phillip H. Doherty, Peter E. McQuillan and Marc R. Sylvain. Don Mills, CCH Canadian, Ltd., 1979. 255 pp.
Sixth edition of guide to the various forms of government assistance available to Canadian industry. Certain income tax incentives are also covered. (B. 103.042)

INVESTING IN CANADIAN FILMS

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Study designed to explain how investments in Canada are taxed and to provide explanations of how to reduce personal taxes. The information is based on tax law as of March 1, 1980. (B.103.045)

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A practitioner's guide. 2nd Edition. By Peter E. McQuillan, Phillip H. Doherty and Graham E.B. Donald. Don Mills, CCH Canadian, Ltd., 1979. 85 pp., $7.
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LES POLITIQUES ECONOMIQUES CHINOISES

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FOREIGN INVESTMENT IN COLOMBIA

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By Rüdiger Parsche and Georgios Spanakakis. Munich, Ifo-Institut für Wirtschaftsforschung, 1978. Ifo Studien zur Finanzpolitik, No. 23. 340 pp.
Comparative analysis of the income taxation of individuals in the EEC member countries with emphasis on the taxation of agricultural income. (B. 102.923)

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Study of the tax law and tax policy of the European Economic Community. The book was completed at the end of 1979 and covers an analysis of the tax provisions of the EEC Treaty, especially those relating to the free movement of goods and discriminatory taxation (B. 103.036)

DIE UMSATZBESTEUERUNG DER LANDWIRTSCHAFT IN DEN LÄNDERN DER EG

By Rüdiger Parsche and Georgios Spanakakis. Munich, Ifo-Institut für Wirtschaftsforschung, 1977. Ifo Studien zur Finanzpolitik, No. 22. 200 pp.
Comparative analysis of value added tax with respect to agricultural turnovers in the EEC member countries. (B. 102.922)

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CYPRUS IN INTERNATIONAL TAX PLANNING

A practical guide for foreign firms and individuals. By Chrysses Demetriades. London, Kluwer Publishing, Ltd., 1980. 447 pp.
Guide containing information acquired from practical experience on using Cyprus for international operations and international tax planning. It is designed to provide information on doing business in Cyprus, especially when used as an off-shore financial centre, as a place for direct investment, as a stepping stone in tax treaty planning and as a place for retirees. The material is up to date as of the end of March 1980. (B. 102.981)

DENMARK

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Second revised edition of monograph explaining the income taxation of corporations and associations in Denmark. Texts of relevant statutes are appended. (B. 103.041)

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FRANCE

LE SYSTEME FISCAL FRANÇAIS

Questions pratiques concernant les entreprises étrangères qui ont des activités ou des intérêts en France. Prepared by Claude Gambier. Paris, Editions Francis Lefebvre, 1980. 142 pp.
Description of the French tax system (company tax, personal income tax, employer's payroll tax, value added tax and other taxes). Forms of doing business in France by foreign enterprises are dealt with. An English edition, "The French tax system", is also available. (B. 102.869)

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TAXATION REVENUE AUSTRALIA 1978-1979

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Third revised edition of a general guide explaining several aspects, including tax aspects, of saving by means of securities. (B. 103.019)

ARBEITSTABELLEN FÜR DEN STEUERPRAKTIKER

5. vollständig überarbeitete und erweiterte Auflage. By Friedrich Hubner. Vienna, Industrieverlag Peter Linde GmbH., 1980. 103 pp., 258 ÖS.
Fifth edition of the working tables for use by tax practitioners which outline rates of tax deductions and other tax facilities for the years 1976 to 1980 (without wage tax) as of July 1, 1980. (B. 102.998)

BUNDESABGABENORDNUNG

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Textbook providing extensive commentary on the Federal Fiscal Code, with reference to Austrian (and, as far as applicable, German) case law. (B. 102.025)

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Kennzahlen — Formeln — Methoden. By Emil Weinzierl. Vienna, Industrieverlag Peter Linde GmbH., 1980. 402 pp., 297 ÖS.
Practical guide providing an introduction to business economics, particularly those aspects enabling entrepreneurs to better make decisions with respect to business management, e.g. financing, investment, cost accounting, valuation of fixed assets, profitability, business capacity, etc. (B. 103.018)

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By Cornelia Leitl. Vienna, Verband der wissenschaftlichen Gesellschaften Österreichs, 1979. Dissertationen der Wirtschaftsuniversität, No. 29. 216 pp.
Dissertation on the concept "force of law" in court proceedings and the violation thereof under the provisions of the Austrian Fiscal Code and the rulings dealing with tax procedures issued by by the Austrian "Länder". (B. 102.999)

STEUERLICH RICHTIG PLANEN!

4., neu bearbeitete Auflage. By Franz Weiler. Vienna, Industrieverlag Peter Linde GmbH., 1980. 140 pp., 172 ÖS.
Monograph on tax planning in Austria. The author discusses such questions as the legal form of enterprises, tax allowance in the case of mergers, possibilities to influence profit taxation, depreciation, investment allowances and other questions which are of interest to foreign and domestic investors in Austria. (B. 103.016)

BENELUX

MERKENBESCHERMING IN DE BENELUX

By W. Mak and H. Molijn. Deventer, Kluwer; The Hague, Fenedex, 1980. Fiscale en juridische documentatie voor internationaal zakendoen, No. 8. 126 pp., 39.50 Dfl.
Monograph dealing with the protection of trademarks in the Benelux. Relevant statutes are appended. (B. 103.001)

BRAZIL

A FISCALIZAÇÃO NA EMPRESA

By Francisco das Chagas Mariano. Fortaleza-CE, Thema Publicigráfica, Ltda., 1977. 245 pp.
Manual on all a company must know to comply with its fiscal obligations, analyzing the goods trade tax, industrialized products tax, income tax, and service tax. (B. 18.033)

QUESTOES FISCAIS

By Francisco das Chagas Mariano. Fortaleza-CE, Thema Publicigráfica, Ltda., 1977. 270 pp.
Studies on administrative fiscal matters and jurisprudence formulated in the courts of six of the states of the Brazilian nation. (B. 18.034)

the case of industries set up in other areas the percentage of investment/reinvestment should not be less than 15 percent.

3. The income from fisheries, poultry, duck, cattle and dairy farming and horticulture is exempt from income tax for a period of ten years with effect from July 1980 irrespective of whether the owner of such enterprise is a company or not. The only condition is that the investment in such an enterprise must not be less than 10,000 Tk.

B. Alternative incentive to tax holiday

(1) Accelerated depreciation

As an alternative to the tax holiday, there is provision for allowance of accelerated depreciation. An industrial undertaking owned by a company registered in Bangladesh set up by 30 June 1982, in the more developed areas, is entitled to accelerated depreciation at the rate of 80 percent of the cost of machinery or plant of the undertaking in the year in which commercial production begins and the remaining 20 percent in the following year. For an undertaking set up in less developed areas, accelerated depreciation of 100 percent is allowed in the first year of commercial production.

(2) Investment allowance

In addition to accelerated depreciation, as a special incentive an investment allowance of 20 percent of the cost of machinery or plant of an undertaking set up in more developed areas and 25 percent for an industrial undertaking set up in the less developed areas is granted in the first year of commercial production.

In order to enjoy the facilities of accelerated depreciation and investment allowance, the undertaking is required to be approved by the National Board of Revenue. The application for approval is to be made within four months of the month in which the undertaking goes into commercial production.

The industries mentioned under "Tax holiday" are entitled to accelerated depreciation and investment allowance, but undertakings which ask for tax holiday are not entitled to accelerated depreciation and investment allowance.

IV. OTHER INCENTIVES

A. Exemption of interest on foreign loan

(1) Interest on money borrowed from outside Bangladesh under a loan agreement entered into with any such financial institution in a foreign country as may be approved in this behalf by the Government.

(2) Interest on money borrowed or debt incurred in a foreign country in respect of the purchase outside Bangladesh of capital plant and machinery or raw materials to the extent such interest does not exceed the amount of interest calculated at the rate approved by the Government.

B. Employment of foreign technicians and exemption of their earnings from tax

The newly set up industrial undertaking may employ a foreigner as a technician under a contract of service approved before the commencement of his service or within one year of such commencement by the National Board of Revenue. The technician may be employed before commercial production for the purpose of the erection of the factory building, the installation of plant and machinery or the trial production or after commencement of commercial production. Such a foreign technician is allowed a tax exemption in respect of his salary in Bangladesh for three years from the date of his arrival in Bangladesh, subject to the condition that his salary is also exempt from income tax in his country of domicile. Thereafter, tax-on-tax is exempted for a further period of five years if the tax on salary of the technician is paid by the employer on his behalf.

The tax rates are fixed by the Parliament every year through the Finance Act.

In next issues:

Japan: Medium term tax policy and the tax increase in fiscal year 1981
— by *Makoto Miura*

United States: Foreign Investment in Real Property and Tax Act of 1980
— by *Herbert H. Alpert* and *Fred Feingold*

Iran: Tax structure changes: a time series analysis
— by *Sohrab Abizadeh* and *Mahmood Yousefi*

Structural features of sales taxes in ASEAN countries
— by *Mukul Asher*

Taxation of non-residents in India for royalties and fees for technical services
— by *Dharmendra Bhandari*

3. Rates of income tax

Where taxable income		Tax thereon	
Exceeds (1)	But does not exceed (2)	Fixed amount (3)	Flat rate on amount exceeding figure in col. (1) (4)
Tk.	Tk.	Tk.	percent
–	5,000	–	10
5,000	10,000	500	15
10,000	15,000	1,250	20
15,000	25,000	2,250	25
25,000	40,000	4,750	35
40,000	60,000	10,000	45
60,000	80,000	19,000	55
80,000	100,000	30,000	60
100,000	–	42,000	65

Total tax in each slab is the amount in column (3) plus column (4).

Income tax is chargeable on capital gains as detailed below:

(a) Where the capital gains arise as a result of disposal of capital assets after more than 12 months from the date of their acquisition	Income tax at normal rate on total income (including capital gains)
(b) Where the capital gains arise as a result of disposal of the capital assets after two years but before five years from the date of their acquisition	Income tax at the normal rate on total income (including capital gains) or income tax at 35 percent on the amount of capital gains, whichever is lower
(c) Where the capital gains arise as a result of disposal of the capital assets after five years from the date of acquisition	Income tax at the normal rate on total income (including capital gains) or income tax at 30 percent on the amount of capital gains, whichever is lower

B. Companies

All companies incorporated in Bangladesh are assessed to tax at company rates. Foreign corporations or associations of persons do not ipso facto qualify for assessment as companies. However, the Income-tax Act provides for declaration of such corporations or associations as "companies" by the National Board of Revenue upon application.

The rate of income tax for companies for the current assessment year (1980-81) is as below:

(i) On the total income excluding income from dividends from a company registered in Bangladesh:

	Rates of tax
(a) in the case of every industrial company using wholly or mainly indigenous raw materials	50 percent of total income
(b) in the case of any other industrial company	55 percent of total income
(c) all other companies	60 percent of total income

A rebate of 10 percent of the tax is allowed to a Bangladeshi company on so much of the income accruing or arising (excluding income on which export rebate is allowed) outside Bangladesh as is brought into Bangladesh.

(ii) On income from dividends declared and paid by a Bangladeshi company in respect of the share capital issued, subscribed and paid after 14 August 1947 — 15 percent of the income

(a) Where the capital gains arise as a result of disposal of capital assets after not more than 12 months, income tax is payable at the normal rate on total income (including capital gains).

(b) Where the capital gains arise as a result of disposal of capital assets after 12 months, income tax is payable at the rate of 25 percent of such gains.

III. TAX CONCESSION TO NEW INDUSTRIES

A. Tax holiday

1. A new industrial undertaking owned by a company registered in Bangladesh under the Companies Act, set up by 30 June 1985 in places within a radius of ten miles of the municipal limits of Dacca, Narayanganj, Khulna and Chittagong, is entitled to a tax holiday for five years beginning with the month in which the commercial production of the undertaking is commenced. If the undertaking is set up in other areas of Bangladesh, the period of the tax holiday is nine years.

2. Tourist industries, i.e. hotels, motels, hunting lodges and private picnic areas, are also entitled to a tax holiday for five years if these are set up within 15 miles of the cities of Dacca, Rajshahi, Khulna and Chittagong, and seven years for such industries set up in other areas.

The tax holiday is available subject to the following conditions:

(i) The undertaking is to be approved by the National Board of Revenue. The application for approval is to be submitted to the Board within four months of the month in which the undertaking goes into commercial production.

(ii) Not less than 30 percent of the profit of the undertaking is to be reinvested in the undertaking or invested in the purchase of bonds issued by the Government in the case of tourist industries set up within a radius of ten miles of the municipal limits of Dacca, Narayanganj, Khulna and Chittagong, and in *(ii) Resident but not ordinarily resident*

If both the above two conditions are not satisfied, a resident individual would fall under the category of a resident but not ordinarily resident person.

(iii) Non-resident

Individuals who do not fall in any of the above categories are treated as non-resident.

B. Status of a company

A company may be either resident or non-resident in any year. The status of resident but not ordinarily resident does not apply to a company.

(i) Resident company

A company is resident in Bangladesh in any year if it is registered in Bangladesh under the Bangladesh Companies Act or if the control and management of its affairs are situated wholly in Bangladesh in that year.

(ii) Non-resident company

A company which does not satisfy the above conditions is treated as a non-resident company.

C. Status of firm or association of persons

A firm or an association of persons is resident in Bangladesh unless the control and management of its affairs are situated wholly outside Bangladesh.

A resident company or a resident firm or a resident association of persons is treated as resident and ordinarily resident for the purpose of determination of tax liability.

II. LIABILITY TO TAX

A. Individuals

1. Residential status

(i) A resident and ordinarily resident taxpayer is liable to pay tax on all income of any previous year which:
(a) is received or deemed to be received in Bangladesh in such year;
(b) accrues or arises or is deemed to accrue or arise in Bangladesh during such year;
(c) accrues or arises to him outside Bangladesh.

(ii) A resident but nor ordinarily resident taxpayer is liable to tax on all income as shown in (a) and (b) above and also on the income which accrues or arises outside Bangladesh during the previous year if it is derived from a business controlled in Bangladesh or a profession or vocation set up in Bangladesh.

(iii) A non-resident taxpayer is liable to tax on all income of any previous year as shown in (a) and (b) above.

All individuals, unregistered firms, Hindu undivided families and associations of persons having a total income exceeding 12,000 Tk. are liable to income tax on their taxable income, i.e. the income after deducting allowances.

2. Allowances

(a) Earned income relief: Tax is not payable in respect of "earned income" at the rate of 20 percent of such income or 5,000 Tk., whichever is less.

(b) Personal allowance: 3,000 Tk.

(c) Education allowance: This allowance is given at the rate of 800 Tk. for every child or child wholly dependent on the assessee, subject to a maximum of 2,000 Tk. and subject to the conditions that the total income of the assessee does not exceed 50,000 Tk. and the age of the child is not less than 5 years and not more than 21 years; where the expenditure of an assessee on the education of one child exceeds 800 Tk. or in the case of two children exceeds 2,000 Tk. the education allowance is restricted to 2,000 Tk.

(d) Allowance up to the extent of contribution to the Benevolent Fund and Group Insurance Scheme.

(e) Investment allowance is available at the rate of 30 percent of the total income or 30,000 Tk. whichever is less, in respect of the following:
- Contribution to a recognised Provident Fund or a Government Provident Fund.
- Premium paid for life insurance of the taxpayer or his wife or a minor child.
- Investment in new and fresh share capital or approved companies, debentures and debenture stocks issued by a company.
- Investment in the purchase of savings certificates and Government securities (including Development Loans).
- Investment in the purchase of books of a professional or technical nature or of general utility.
- Contribution by a Government servant for securing deferred annuity for wife and children subject to a maximum of 1/5 of the salary.

(f) Allowance for donation to any recognised education institution, hospital or any Government approved Flood or Relief Fund or to any other approved religious or charitable institution. The allowance is restricted to 20 percent of the total income of the assessee.

(g) Conveyance allowance: A salaried person who owns and maintains a car and does not receive any other conveyance allowance is entitled to an allowance of 3,600 Tk.; if any other power driven vehicle is owned and maintained the amount of the allowance is 1,800 Tk. and if no vehicle is maintained the allowance is 1,500 Tk.

SOME ASPECTS OF TAX LAWS IN BANGLADESH

by K.A. Gofran *

Economic co-operation between developed and developing countries has been an increasing phenomenon in the latter part of this century.

The transfer of technology and capital between states in the fields of trade and industry has necessitated knowing about taxes. In a bid to give a fair idea about the tax laws in Bangladesh, I have endeavoured to give a parameter of tax implications for international investors regarding some aspects of tax laws in Bangladesh.

I. STATUS OF TAXPAYERS

Income tax is not charged on the concept of nationality. A foreigner is treated for tax purposes like any other Bangladeshi. Liability to tax in respect of any previous year depends upon the residential status of a taxpayer as defined in the Income-tax Act. An assessee may be (i) resident and ordinarily resident, (ii) resident but not ordinarily resident, or (iii) non-resident.

A. Status of individuals

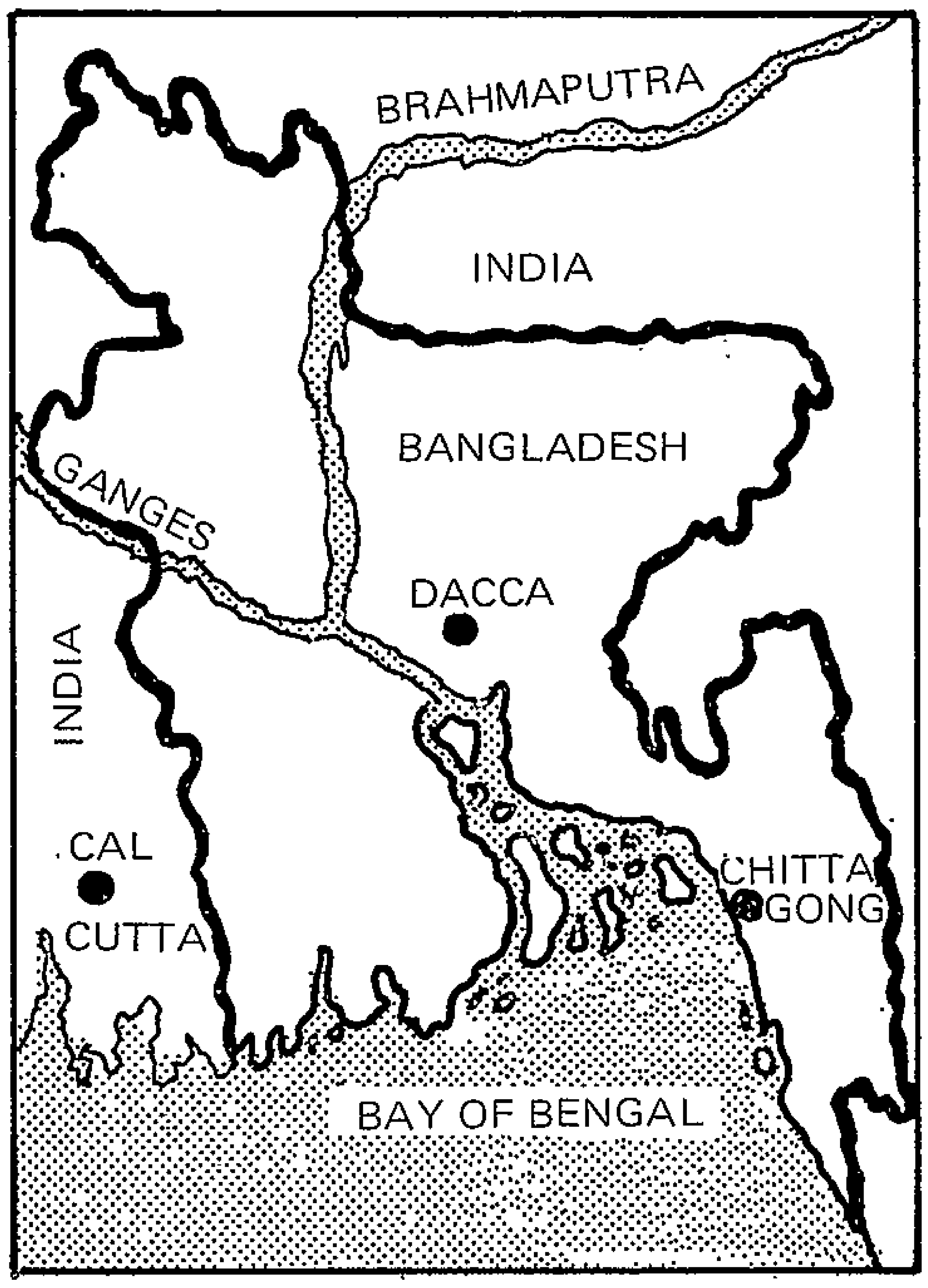
Before the above terms are explained, the definition of resident is necessary.

An individual is resident in Bangladesh in any year if he:
(a) is in Bangladesh in that year in all for 182 days or more; or
(b) maintains or has maintained for himself a dwelling place in Bangladesh in that year in all for 182 days or more and is in Bangladesh at any time in that year, or
(c) has been in Bangladesh in all for 365 days or more within four years preceding the previous year and is in Bangladesh for any time in that year otherwise than on an occasional or casual visit.

There is, however, some relaxation regarding the period of stay for a Bangladeshi serving abroad. If such a person comes to Bangladesh on leave or vacation in any year the period of stay is 90 days in place of "any time" referred to in paragraph (b). Similarly, the period of stay is 90 days in place of "any time in that year otherwise than on an occasional or casual visit" referred to in paragraph (c) above.

(i) Resident and ordinarily resident

Any person who is resident under any of the conditions as stated above must also satisfy the following two conditions to be treated as resident and ordinarily resident:
(a) he has been resident in Bangladesh in nine out of ten years preceding the previous year, and
(b) he has been in Bangladesh in all for more than two years during the seven years preceding the previous year.



1) Population:
87,657,000 (Page 59 of statistical year book of Bangladesh, 1979, published by the statistics Division, Ministry of Planning).

2) Area:
55598 sq. miles (Page 46 of above).

3) GDP per capita:
The GDP per capita is 745/- Tk. an estimated figure at constant factor price of 1972-73 as published at page 1-7 of chapter 1 of 2nd Five Year Plan of 1980-85 published by the Ministry of Planning, Government of the People's Republic of Bangladesh. 745/- Tk. is equivalent to US$ 50/- at the current exchange rate

4) Inflation rate:
17.9 percent (1970-78).

5) Currency:
1 taka = 100 paisa
(US$ 1 = 16.2635 Tk. as on 24.1.81)

* Editor, *Bangladesh Tax Decisions.*

lation that their employees resident in China for more than a year will have to pay income tax on a global basis".

An important clarification concerning tax liability for income earned abroad has been made in the detailed rules and regulations. Thus in the principal tax law, it is merely stated that an income tax shall be levied on incomes gained within or outside China by any individual residing for one year or more. In the rules and regulations, however, Article 3 states that only those who have been resident in China for five years or more shall be taxed on their income earned abroad; for those who have been resident between one and five years, their liability for income earned abroad is limited to that part actually remitted to China. A resident is defined as one who resides in China for a full 365 days within a tax year, with no allowance for temporary absence from China. It is to be noted that in both the joint venture tax law and the individual income tax law, a "tax year" is defined to start on January 1 and end on December 31 on the Gregorian calender.

As in the case of joint venture income, a tax credit is also provided for individual income. Article 16 stipulates that personal income tax already paid outside China for income earned abroad may be credited against individual income tax liability computed according to the tax rate prescribed in the tax law.

Articles 17 through 27 are again concerned with administrative matters, including the penalty for violating the provisions of the tax law.

IV. ASSESSMENT AND CONCLUSION

By clarifying certain concepts and provisions of the principal tax laws, as well as by stating clearly the administrative procedures to be followed, the detailed rules and regulations for the implementation of the joint venture income tax law and individual income tax law have cleared up some misapprehensions and uncertainties on the part of prospective taxpayers, particularly foreign business firms and individuals. In the case of the joint venture law, the most important clarifications concern the definitions of first profit-making year and taxable income, and the rules governing depreciation, inventory valuation, and deductible expenses. In the case of the individual income tax law, the meaning of a "resident" is more precisely defined, and tax liability in respect of income earned outside China is considerably more circumscribed than would appear from the text of the principal law. Also, both sets of rules and regulations explicitly allow income taxes already paid abroad to be credited against a firm's or an individual's total tax liabilities inside China. As noted in the present author's previous article, these are among the issues about which foreign corporations and individuals are most concerned. Their clarification has cleared the air and to that extent the two sets of rules and regulations are a positive step towards the realization of the main objective of the tax laws, namely to facilitate China's modernization while at the same time ensuring an adequate source of tax revenue.

Despite this advance, some unresolved problems still remain. First, in the joint venture tax law, it is expressly stated that "the income tax rates on joint ventures exploiting petroleum, natural gas and other resources shall be stipulated separately" (Article 3). No such information is available in the rules and regulations, though the Deputy Director of the Bureau of Taxation was reported to have told a visiting delegation from the American Chamber of Commerce in Hong Kong that the tax rates for the extraction of coal and crude oil would be fixed at 8 percent and 5 percent respectively.[3] Second, although a tax credit is now provided for, China has not yet signed any formal tax treaty with other countries in order to avoid double taxation. Third, as mentioned above, while the term "first profit-making year" has now been much more clearly defined, the formal "tax holiday" is still confined to one year only, which compares unfavourably with the prevailing practice in other developing countries anxious to attract foreign investment and technology. Fourth, as also mentioned earlier, the discrepancy between the tax rates applicable to firms inside and outside the Special Economic Zones remains disconcertingly large. Fifth, accounting conventions and methods of foreign firms may differ considerably from that currently in use in China, and since the right of interpreting the rules and regulations rests entirely with China's Ministry of Finance, some difficulties concerning accounting practices may conceivably arise unless a standardized set of rules and procedures can be agreed upon by both sides.

Whether foreign firms and individuals will be deterred by these uncertainties from investing and working in China remains to be seen. However, a recent news report is revealing in this respect. Since the promulgation of the joint venture law in 1979, China is said to have concluded some 330 joint venture and cooperative agreements, with a total investment of some US$ 1,800 million. Of these, however, only 17 are joint ventures inside China, while the rest are either projects on the joint exploration of offshore oil, or cooperative projects and joint ventures in other countries or Hong Kong and Macau.[4]

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3. See *Economic Reporter* (English edition), Hong Kong, Dec. 1980, p. 12.
4. Ibid., p. 36.

A Further Note on Tax Developments in China

By Y.C. Jao*

I. INTRODUCTION

In a recent article in the *Bulletin*, the present author discussed the introduction of two new taxes — joint venture income tax and personal income tax — in the People's Republic of China and their economic significance.[1] The new tax laws, enacted at the National People's Congress in September 1980, contain only general statements with no specific details as to their enforcement. Because certain concepts and provisions in the laws are not precisely defined, there are also uncertainties about their interpretation.

The two tax laws do state explicitly, however, that detailed rules and regulations for their implementation will be formulated by the Ministry of Finance (Article 17 of the Joint Venture Tax Law and Article 14 of the Individual Income Tax Law). This was done by the Ministry towards the end of the year, when two sets of such rules and regulations were published on December 13, 1980.[2]

The purpose of this short note is to summarize the main points of these rules and regulations, particularly with a view to clarifying certain ambiguities that have caused considerable concern to foreign business firms and individuals.

II. JOINT VENTURE INCOME TAX

When the Joint Venture Income Tax Law was passed last September, the general reaction among foreign firms wishing to invest in China was that while it marked a breakthrough in China's policy towards foreign investment, further clarification of its contents was necessary. Specifically, many foreign firms were concerned about the shortness of "tax holiday", the precise meaning of "first profit-making year", the absence of tax credit, the lack of references to depreciation rules and accounting practices, and the discrepancy between the tax rates payable on profits of joint ventures and those earned by firms in the Special Economic Zones. Some of these problems have been taken care of by the newly released rules and regulations.

There are altogether 35 articles in the rules and regulations. The most important ones can be briefly noted as follows.

Article 5 defines the term "the first profit-making year" more precisely. It means the year "in which a joint venture has begun making profits after its losses in the initial stage operation have been made up"; in other words, carry-over of losses is explicitly taken into account for the purpose of determining the first profit-making year. However, the formal "tax holiday" is still confined to one year only.

Articles 8 through 18 are concerned with the more technical aspects of taxation, such as the definition of taxable income (for which different formulae are prescribed for manufacturing industries, commerce, service trades and others), non-deductible items, assessment and depreciation of fixed assets, amortization, valuation of inventory, etc. For example, for the depreciation of capital assets, the straight line method is prescribed (Article 12), while for the valuation of inventory, the joint venture firm is allowed to choose one of the following methods: first-in first-out, shifting average, and weighted average (Article 18).

Other Articles (19 through 31) deal with the submission of tax returns, accounting procedures, penalty for violation of the tax law, etc.

Article 32 stipulates that income tax paid abroad by a joint venture or its branches on income earned outside China may be credited against the firm's total tax liabilities, but such credit shall not exceed the tax payable on income derived abroad computed according to the tax rate in China's tax law.

III. PERSONAL INCOME TAX

As pointed out in the present writer's previous article, "the general reaction to this new tax (individual income tax) is that it seems to be aimed primarily at foreigners, since the present average income of most Chinese is so low that the flat monthly allowance of 800 yuan a month (about US$ 6,530 a year) virtually excludes all the working Chinese population from the tax bracket. Foreign companies are also worried about the stipu-

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1. Y.C. Jao, "Recent Developments in China's Tax System", *Bulletin for International Fiscal Documentation*, Jan. 1981, at 16.
2. For the English version of the full texts, see *China Economic News*, Supplement No. 11, Hong Kong, December 17, 1980, and the Bureau's own publication, *Taxes and Investment in Asia and the Pacific*, China chapter, Appendices 16 and 17.

useful in their sensitive task of formulating fiscal and tax policies. It can therefore be said that the SGATAR papers and discussions have helped, however indirectly, in the reshaping of the tax systems and in the formulation of effective tax policies by the responsible officials in some of the SGATAR countries.

The SGATAR projects which have been discussed earlier are examples of the concrete and solid accomplishments of the Study Group. The significance and usefulness of these projects cannot be overemphasized. They remain as good sources of information for government policy makers, tax administrators, businessmen, and other interested parties.

Finally, there is no question of the fact that SGATAR has been very successful in the unquantifiable aspects of promoting regional cooperation and the fostering of good will among its member countries. The SGATAR countries have realized that by reasons of geography and cultural affinity, it is inevitable that they will have to interrelate and interact with each other and they are aware that these things are better accomplished in an atmosphere of friendship and mutual respect. SGATAR, in its own way and among its members, has accomplished precisely this.

XVII. PROSPECTS FOR SGATAR

The idea of creating SGATAR first came into being in 1970 during the fifth Southeast Asian Ministerial Conference for Economic Development. Ten years later, SGATAR is still active while the SEAMCED, which was responsible for its creation, has given way to other more active regional groupings. If this is any indication of SGATAR's usefulness, then it might safely be predicted that the SGATAR will be here for a long while yet. The benefits that have been derived by the member countries from SGATAR are more than enough assurance that the Study Group will continue to be performing its functions and achieving its goals in the immediate and distant future.

A New Blow to Tax Treaty Shopping?

Netherlands patent holding company required to withhold U.S. tax on royalties

The U.S. Revenue recently issued Ruling 80-362 which established that where a Netherlands patent holding company is used as an intermediary by an individual person who is a citizen and resident of a foreign country with which the United States has no income tax treaty to receive U.S.-source royalties, the company is required to withhold 30 percent U.S. withholding tax. The text of the Ruling is reprinted below.

ISSUE

Are royalties paid for the use of a patent in the United States, under the circumstances described below, subject to United States tax?

FACTS

A, a citizen and resident of a country other than the United States or the Netherlands, licenses the United States rights on a patent to *X*, a Netherlands corporation. *X* is a bona fide corporation unrelated to *A*. *X* agrees to pay *A* a fixed royalty each year in return for the patent license. *X* relicenses the patent to *Y*, a United States corporation, for use in the United States. *Y* agrees to pay *X* royalties based on the number of units produced by *Y* each year under the patent. *X's* fixed royalty to *A* is not contingent upon the receipt of royalties from *Y*. *A's* royalty income is not effectively connected with the conduct of a trade or business within the United States within the meaning of section 871(b) of the Internal Revenue Code.

Article IX(1) of the United States—Netherlands Income Tax Convention, T.D. 5778, 1950-1 C.B. 92, as amended by the United States—Netherlands Supplementary Income Tax Convention, 1967-2 C.B. 472, provides that royalties paid to a resident or corporation of the Netherlands shall be exempt from tax by the United States. There is no income tax convention between *A's* country of residence and the United States.

LAW AND ANALYSIS

Section 861(a)(4) of the Code provides that royalties for the privilege of using a patent in the United States are treated as income from sources within the United States.

Section 871(a)(1)(A) of the Code imposes a tax of 30 percent of the amount received from sources within the United States by a non-resident alien individual as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.

Section 1.871-7(b) of the Income Tax Regulations provides that royalties, including royalties for the use of a patent, constitute fixed or determinable annual or periodical income to which the 30-percent tax rate imposed by section 871(a)(1)(A) applies.

Section 1441(a) of the Code provides that all persons, in whatever capacity acting, having the control, receipt, custody, disposal or payment of any of the items of income specified in section 1441(b) (to the extent that any of such items constitute gross income from sources within the United States), of any non-resident individual shall deduct and withhold from such items a tax equal to 30 percent thereof.

Section 1.1441-2(a) of the regulations provides that royalties are included in the items of income enumerated under section 1441(b) of the Code.

In the present factual situation, the royalties from *Y* to *X* are exempt from United States tax under Article IX(1) of the Convention. However, the royalties from *X* to *A* are not exempt from taxation by the United States because there is no income tax convention between *A's* country of residence and the United States providing for such an exemption. Since the royalties from *X* to *A* are paid in consideration for the privilege of using a patent in the United States, they are treated as income from sources within the United States under section 861(a)(4) of the Code and are subject to United States income taxation under section 871(a)(1)(A).

HOLDING

Royalties paid by *X* to *A* are subject to United States tax at the 30 percent rate pursuant to section 871(a)(1)(A) of the Code. *X*, under section 1441(a), is required to withhold from the royalties paid to *A* a tax equal to 30 percent of such royalties.

In three subsequent SGATAR meetings, therefore, the ACTAR issue was discussed. The advantages (mainly that of providing continuity and facilitating the exchange of information) of having a permanent organization such as the ACTAR were discussed. However, in view of the existence of SGATAR and other organizations which were already serving the same purpose for which ACTAR was to be created, it was decided not to endorse the proposal. The Study Group hoped that the International Seminar on Taxation for Asian Countries (ISTAC) which Japan was sponsoring and the National Tax Research Center of the Philippines would expand their present activities to include fully or partially the functions envisioned under the proposed ACTAR.

XV. SGATAR PROJECTS

Following its main objective of exchanging information on each other's tax structures for the purpose of improving one's tax system, the Study Group on Asian Tax Administration and Research has embarked on and completed several projects aimed at providing meaningful information on the tax systems and practices of SGATAR's member countries.

The first of these projects was the *Glossary of Tax Terms in Member Countries of the SGATAR* which was published in 1978 by the Philippine National Tax Research Center for the Study Group. The *Glossary of Tax Terms* is a handy compendium of the tax definitions of tax terms and phrases commonly used in SGATAR countries. Its objective is to present a more or less comprehensive listing and clear description of these tax terms to serve as convenient reference material during international conferences in taxation and as a basis for comparative studies which may be conducted by interested parties.

The Glossary is divided into two parts: Part I which presents a consolidated glossary of tax terms used by two or more countries, and Part II which is a glossary of tax terms as defined in the internal laws of the individual countries of SGATAR.

The second SGATAR project is entitled *Tax Systems of Selected Countries in Asia and the Pacific*. This project is a synopsis of the tax systems in each of the SGATAR member countries and is aimed at providing simple and factual information to investors and other members of the business community; to government administrators and policy makers who can broaden their perspective through an insight into comparative tax practices and procedures; and to students and researchers in public finance and other interested parties.

The *Tax Systems* is made up of three parts: *Part I* consists of the country papers briefly describing the structure of the tax system of each member country by an identification of the tax bases, rates and significant administrative provisions; *Part II* is a comparative presentation of the significant elements of the tax systems of the member countries; and *Part III* is a presentation of the fiscal incentives offered by each member country to promote economic development. The Philippine National Tax Research Center has submitted the completed project during the tenth SGATAR meeting in Jakarta, Indonesia.

A third project now underway is a sequel to the *Tax Systems* entitled *Tax Administration Procedures of Selected Countries in Asia and the Pacific*. The project's objective is to analyze the various phases and stages of tax administration procedures in SGATAR countries and recommend measures designed to maximize tax benefits through maximum tax administrative efficiency. This project was proposed and approved during the ninth SGATAR meeting in Manila and is expected to be completed in 1981.

Finally, during the tenth meeting in Jakarta, the Philippine delegation presented a new proposal for another SGATAR joint project. The project, entitled *Property Valuation Practices in Selected Countries in Asia and the Pacific*, was approved by the member countries and the Philippine National Tax Research Center was again designated to undertake the project.

The main goal of this SGATAR project is to come up with a descriptive, informative and comparative study of the property valuation practices of member countries. Specifically, it aims to meet the following objectives:

(a) gather information on the classification of property/landholdings; type of property covered by property taxation; and methods or valuation techniques employed;

(b) determine similarities and differences in the valuation of properties of the member countries;

(c) identify specific problems on property valuation common to all member countries;

(d) look into the revenue performance of the real property tax.

XVI. SGATAR ACCOMPLISHMENTS

The past decade has witnessed an increase in the scope of influence and activities of regional organization. There has been an irreversible trend towards groupings and alliances in almost all fields of human endeavor. The overriding goal of economic development, particularly among the developing nations, became the impetus that drew these countries together to work for common goals, interests and ideals. The Study Group on Asian Tax Administration and Research has been a product of this decade.

In its ten years of existence, the Study Group, during its annual meetings, has discussed 39 major topics and issues all relating to fiscal policy, tax systems and administration, and tax research. These annual meetings have served as an effective forum for the exchange of ideas and information among the member countries. They have also been very effective as an avenue for the ventilation of taxation problems and discussion of their possible solutions.

Tax officials from the SGATAR member countries have found the information and experiences they have gained from the SGATAR meetings and discussions very sale of land under land taxation, whereas in other countries these are classified as income tax.

Rates on land are imposed by Federal or Central governments as well as by local or district governments. In almost all participating countries, the revenues from land taxes comprise the principal source of finance for local governments.

On the other hand, land tax revenue when compared to central government revenue is generally small. It is only when compared to total local government revenue that property taxes play an important role.

The problems encountered in the area of land taxation in most countries are concentrated on administration and valuation.

2. Development of fiscal incentives to promote domestic and foreign investments

In general, all participating countries already have a considerable number of fiscal incentives to promote investments. Several participants, however, expressed doubt as to the effectiveness of fiscal incentives in encouraging development.

Some participants were of the opinion that both the host country as well as the home country of the investor should benefit from the incentives. Others, however, found that the advantages were questionable. As an example, Malaysia and Japan both have locational incentives, aimed at developing certain sites or regions. Even in the case where a given region showed definite industrial development, neither Malaysia nor Japan could say with certainty to what extent the locational incentives were contributory to that development.

The delegates were in agreement that other factors, such as infrastructure, availability of skilled labour, communication and other facilities, were of greater importance to prospective investors than tax exemptions or allowances.

With regard to the exchange of experiences concerning technology transfer, most of the participants of the meeting identified this as a difficult area of taxation. Exemptions were not seen as the real way to achieve development or technology transfer.

In the issue of overlapping administration on fiscal incentives, it was agreed that a synchronized approach between tax offices and other government offices may be the answer.

3. Reporting and statistical systems for tax administration purposes

Statistics are of major importance for the tax administration machinery of any country, as they provide the basis for revenue estimation and are a valuable source of baseline data for decision and policy making.

Reporting, in particular management reporting, is an equally important means by which management of an enterprise can be exercised. Some of the participating countries classify reports as informational reports, which are primarily used for tax administration.

Although the reporting systems in the participating countries vary from country to country, they all provide a picture of the activities of the national economy including income, property, consumption and distribution. This information is indispensable in the estimation of the tax revenue in relation to the preparation of the government budget.

In the framework of standardization and simplification, all participating countries are gradually computerizing the inter-office administrative work, although they do so at different levels and to different degrees, in accordance with the needs and means of the country concerned.

Suggestions were made to improve the effectiveness of reporting by conducting frequent seminars and training courses for tax administrators to achieve optimum efficiency and effectiveness.

4. Administrative implementation of income tax treaties

All participating countries have concluded tax treaties, including some under negotiation with other countries. Practical problems that arise in the administration of the agreements are generally resolved by reference to the provision of the agreement concerned and the domestic law. No serious problems are encountered in the administration of tax treaties.

Several countries experience problems in deciding the correct amount of head office expenses that are deductible in calculating the taxable income of branch offices and subsidiaries. The meeting agreed that this was intrinsically a question of obtaining adequate information.

As most of the participating countries had adopted the OECD model in form and intent, thought was given to having some multilateral type of convention in the future.

XIV. ATTEMPTS TO "FORMALIZE" SGATAR VIA ACTAR

Considering that SGATAR is just an "informal" Study Group with no permanent structural machinery to carry out its functions, there have been several attempts (as will be noted in the discussions of the 1st, 2nd, 3rd and 4th meetings) to create a more formal organization. The idea was first advanced during the 1st SGATAR meeting in Manila when the Philippine delegation proposed the establishment of a permanent tax center in Asia to be called the Asian Center for Tax Administration and Research (ACTAR). The Philippine proposal was based on the need for regional tax cooperation in Asia and on the fact that existing facilities cannot cope with the present needs. ACTAR was proposed to act as a clearing house for the exchange of information and to conduct seminars and conferences among tax officials in the region. In principle, most of the SGATAR member countries agreed with the idea but they requested more time and further study before finally deciding on the proposal.

(a) the exploitation of the gap between company and individual tax rates;
(b) over-reporting of expenditures;
(c) taking advantage of loans to or from stockholders; and
(d) supply of incomplete and false information.

To counter the above problem, most of the SGATAR countries have adopted remedial measures such as the imposition of punitive or special tax rates on undistributed profits and the use of more effective audit procedures.

2. Management practices in the enforcement of the income tax law

On the second topic common problems in the enforcement of the income tax laws were found, including:
(a) non-compliance with the requirement of filing income tax returns;
(b) underdeclaration or non-declaration of income by those who have filed returns;
(c) difficulty in determining the veracity of deductions claimed by those who have filed returns; and
(d) collusion between taxpayers and tax authorities.

One remedial measure employed by most of the participating countries is computerization. This modern technique ensures a more efficient processing of returns and collection of tax. The use of taxpayer code numbers for identification purposes is also common among the SGATAR countries. Tax information campaigns designed to improve the level of public tax consciousness, thereby increasing voluntary compliance, are also undertaken in most countries.

3. Problems and recent improvements made in the tax collection machinery

The third topic dealt specifically with methods of collecting taxes with particular emphasis on the system of tax payment, collection by enforcement and problems of late payments; control of taxpayer's account and tax payments; and problems on receivables, particulary the causes of accumulation of receivables and steps taken to remedy the situation.

The two predominant tax payment schemes used in SGATAR countries are the self-assessment and the tax office assessment methods. Most countries also use withholding or salary deduction schemes of collecting taxes. To enforce collection, administrative and judicial measures are commonly resorted to.

The most common measures to control taxpayer's accounts and records of payments are the use of taxpayer account numbers, registration cards and ledger accounts. Regarding the problem of accumulating receivables, the major causes pointed out are the evasive devices of taxpayers and slow processing of tax receipts due to lack of manpower and inadequate computer services. Steps taken to remedy this problem are improved computerization and judicial measures.

4. Problems and recent developments in dealing with tax evasion

All the participating countries agreed that tax evasion is a growing problem resulting in tremendous revenue losses to their respective governments. As reported, the most common forms of tax evasion include:
(a) unreported income of taxpayers through non-filing of returns, omission of certain types of income like dividends and fixed deposit interest and other similar methods;
(b) understatement of income through reduction in or non-recording of sales and incorrect accounts;
(c) improper and unallowable deductions; and
(d) false allocation of income through, among others, false charges for salaries and diversion to fictitious partners.

Among others, an intensified campaign to ferret out tax fraud information was reported to be underway in most SGATAR countries to remedy the above problems. Also, a more effective use of auditing and the computer are being resorted to.

XIII. TENTH SGATAR MEETING IN JAKARTA

The second meeting of the second round (the tenth meeting) of SGATAR was held in Jakarta, Indonesia, 17-21 1980. A total of 35 delegates from eight member countries participated in the meeting. The host country, Indonesia, sent four observers and, for the first time, Korea, a non-member, sent two observers.

Mr Sutadi Sukarya, Indonesian Director-General of Taxation, was unanimously elected chairman of the meeting while Mr. Sikwan Sutanto, Technical Adviser for Investment Affairs of the Directorate General of Taxation, discharged the duties of the Secretary-General.

The Indonesian Minister of Finance, Dr. Ali Wardhana, gave the opening remarks expressing the hope that the Study Group would continue to encourage the development of closer economic ties among the countries of the region.

The 10th meeting is the second time that Dr. Ali Wardhana, Messrs. Sukarya and Sutanto performed the same tasks they did in 1972.

The meeting discussed four topics, namely: (1) land taxation; (2) development of fiscal incentives to promote domestic and foreign investments; (3) reporting and statistical systems for tax administration purposes; and (4) administrative implementation of income tax treaties.

1. Land taxation

On the first topic, it was noted that taxes on land in the region take the form of both property taxes and transfer taxes. Land taxes fall into the category of property taxes while stamp, gift and death duties fall into the category of transfer taxes. Some of the participating countries classify the taxes on profits gained from the

Most of the participating countries have already adopted methods and procedures to cope with said increases in the volume of tax returns,the most common of which are the following:

(a) streamlining in the processing of tax returns;
(b) adoption of sample checking instead of complete checking of all tax returns;
(c) tolerances allowed in the case of small discrepancies in the income and claims for deductible items;
(d) computer checks which make possible the quick and efficient handling of a large volume of work of a repetitive nature;
(e) legislative assistance through the enactment of tax laws reducing the number of tax returns in the case of low income earners; and
(f) delegation of powers with respect to making certain decisions down to lower graded officers according to defined levels of responsibility.

The Japanese "blue return system" was cited as an effective method of streamlining the processing of tax returns.

3. Recent developments in dealing with tax avoidance arrangements

On the third topic of problems and recent developments in dealing with tax avoidance arrangements, a distinction was made between "tax avoidance" and "tax evasion". Fortunately, all the SGATAR countries have the same interpretation of the two terms. It was reiterated that "tax avoidance" refers to the legal means by which taxpayers are able to take advantage of loopholes and deficiencies in the tax laws while "tax evasion" refers to the illegal and criminal means by which a taxpayer defrauds the government of its revenue.

Most of the participating delegations reported the presence of widespread tax avoidance in their respective countries, made possible through the operation of a variety of income splitting and diversion schemes. They agreed that this is a problem of serious dimensions and is particularly prevalent in the business community which has the greatest resources available to obtain the necessary legal and accounting skills in devising tax avoidance arrangements.

To counter the problem of tax avoidance, it was agreed that there should be a continuing review of existing tax laws to plug any loopholes that ingenious taxpayers capitalize on. Also, it was recognized that tax officers need a great deal of technical skill and expertise to combat the complex problem of tax avoidance.

4. Organization and implementation of staff training

All the participating delegations reported on the various systems and techniques employed in their respective countries under staff training programs. The need for in-depth staff training as a means by which tax officials obtain the necessary technical and management skills vital to the successful administration of a tax office was accepted.

The staff training methods vary from country to country. Some countries such as Japan have established taxation colleges which train the tax officials not only in taxation subjects but also in accounting and other related disciplines. Others have established within their management and training structures special staff training sections which are run by officers skilled in teaching methods. Finally, the problem of retaining qualified staff was discussed since most SGATAR countries face this problem. The higher salary structures in the private sector was cited as a major cause of this problem and until the taxation offices can match these higher salaries, the difficulty of retaining qualified staff will continue to be a problem.

With the eighth meeting in Wellington, the SGATAR annual meetings have come full circle. It was unanimously agreed by the delegates that, considering the benefits derived from them, the annual SGATAR meetings should continue.

XII. NINTH SGATAR MEETING IN MANILA

As in the first round of annual SGATAR meetings, the Philippines again hosted the first in the second round (the ninth meeting) of SGATAR. It was held in Manila, 11-17 November 1979, with 37 delegates * and observers participating from the eight SGATAR member-countries.

Mr. Efren I. Plana, Philippine Commissioner of Internal Revenue and head of the Philippine delegation, was unanimously elected Chairman of the meeting. Dr. Angel Q. Yoingco, Executive Director of the Philippine National Tax Research Center, again acted as the Secretary-General, the same position he held during the first SGATAR meeting in Manila in 1971.

Minister of Finance, Cesar A. Virata, welcomed the delegates on behalf of the Philippine government and delivered the keynote address, the same task he also had the privilege to perform during the first SGATAR meeting held in Manila. Minister Virata praised the SGATAR for having successfully provided a forum for fruitful discussions, exchange of ideas, experiences and problems on tax policy formulation, administration and research.

There were four major topics on the agenda of the ninth meeting and these were: (1) problems in dealing with family-owned or closely-held corporations; (2) management practices in the enforcement of the income tax law; (3) problems and recent improvements made in the tax collection machinery; and (4) problems and recent developments in dealing with tax evasion.

1. Problems in dealing with family-owned or closely-held corporations

Regarding the first topic: such corporations have resorted to certain tax avoidance and tax evasion practices to minimize their tax liabilities. The most common of these practices are:

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* Mr. Ray P. Kellaway, chief delegate of the New Zealand delegation, passed away on the opening day. He was replaced by Mr. Paul Novak as head of the delegation.

Study Group on Asian Tax Administration and Research (SGATAR)

~ An Experiment in Regional Tax Cooperation ~ Part II

By Angel Q. Yoingco * and Sutadi Sukarya **

3. Role of computers, microfilming and other modern techniques in taxation offices

With the exception of Australia and Japan, the SGATAR member countries were found to be in the early stages of computer application. It was hoped therefore that they would learn much from the experiences of Australia and Japan. The substantial benefits that can be gained from the use of computers was acknowledged without question. As pointed out, some of the benefits were speed and accuracy in processing tax returns and documents, savings in labor costs and storage capability. The data stored in computers of tax administrations may also be used in the production of national statistics, the examination of proposals for changes in tax laws and in the formulation of national economic policy.

XI. EIGHTH SGATAR MEETING IN WELLINGTON

The eighth SGATAR meeting was held in Wellington, New Zealand, 12-17 November 1978. Twenty-eight delegates representing the eight member countries of SGATAR participated in the meeting.

Mr. Ray P. Kellaway, Chief Deputy Commissioner of the New Zealand Inland Revenue Department, was unanimously elected Chairman of the meeting. The task of the Secretary-General was given to Mr. Paul Spicer, Chief Executive Officer (Administration), also of the Inland Revenue Department.

Mr. Hugh Templeton, the Minister in charge of the Inland Revenue Department, welcomed the delegates and delivered the opening address. He emphasized the benefits which can be derived from regional cooperation and commenced on the vital and important task of formulating tax policy and carrying out the administration of tax laws.

There were four major topics discussed in the meeting, namely: (1) practical problems in dealing with the taxation of multinational companies; (2) methods of dealing with increases in the volume of tax returns; (3) methods and recent developments in dealing with tax avoidance arrangements and (4) the organization and implementation of staff training.

1. Taxation of multinational companies

The taxation of multinational companies is one source of problems common to all the participating countries. The policy of multinationals to minimize their tax liabilities through the transfer of profits to countries with a low tax structure including tax haven countries is regarded as the basic problem confronting the SGATAR countries. The problem is aggravated by the lack of resources to adequately check the financial records of multinational companies. More specifically, these difficulties are brought about by the following:

(a) insufficient information held by the resident company on the methods applied by the overseas parent company in fixing prices and other charges;
(b) lack of expertise on the part of tax officials in handling tax audits and investigations;
(c) inadequate comparative information particularly where the multinational company is in a monopoly situation; and
(d) the processing of accounting information through highly sophisticated computer systems which are programmed and controlled within the parent company's country of residence.

To overcome the above problems, most SGATAR countries employ the "arm's length" method in determining the taxable incomes of multinational companies. This means that the profit ratios expected are those that would have been derived had the parties to the transactions been "uncontrolled" or independent. Another remedy employed by some of the participating countries is the introduction of withholding tax systems at source with respect to payments of interest, dividends and royalties to the parent companies. Finally, the participating countries agreed that there should be greater cooperation and discussion among them in the exchange of information relative to multinational companies.

2. Methods of dealing with increases in the volume of tax returns

The second topic discussed concerned the methods of dealing with increases in the volume of tax returns.

* Executive Director, National Tax Research Center (NEDA), Manila, Philippines.
** Director-General of Taxes, Ministry of Finance, Jakarta, Indonesia.

change in income apportioned under the California formula which bears no relationship to the commercial realities.

5. Substantial profits may be earned in some developing territories but may well not be available to the organisation outside those territories by reason of exchange control regulations.

6. Quite apart from taxation considerations, there are many regulations which protect minority shareholders and ensure that companies in which government or the public have minority shareholdings are dealt with on a rigorous "arm's length" basis. But the California formula, based on assumed unity, is applied to all profits where there is more than a 50 percent common interest. Minority shareholders are thereby called upon to pay taxes on a fictitious allocation of the profits of a Group in which their interest is confined to a minority interest in one of the members.

7. The computation of world-wide profits according to the rules of a political sub-division could be a Herculean task, particularly where home country accounting standards differ substantially from those followed in the tax-levying political sub-divisions.

   The adoption of a California type tax reporting system would thus entail considerable additional expense in providing the necessary information and in recasting the accounts of a group of companies to conform with a political sub-division's accounting principles. This cost is multiplied in cases where other political sub-divisions adopt similar but not identical systems. If sufficiently significant, such costs would inevitably find their way into higher consumer prices. In addition, the use of a California-type system virtually guarantees double or multiple taxation of the same income, which also increases costs.

   Moreover, the acceptance of the California system could give encouragement to other governments who could be led to believe that its adoption, perhaps in modified forms, would give rise to substantial additional tax revenue however unjustified this may be. The system is especially injurious during the start-up of a new business since the formula will produce fictitious profits, particularly if the initial investment is a heavy one.

   In view of the situation explained in the foregoing, the ICC has adopted the attached Resolution which it recommends should be given the widest possible publicity.

Resolution

The ICC views with concern the inevitability that an increase in cases in which profits taxes are levied by political sub-divisions unencumbered by treaty obligations, will result in mounting double taxation of profits (which tax treaties set out to avoid). This is particularly so if the basis of assessment in any such political sub-division is not entirely consistent with that of the country itself and extends to operations carried on outside the country. This problem has manifested itself in an acute form in connection with the attempts of the State of California to impose the "global" or "unitary" form of assessment based on income of companies involved in international operations outside the U.S.

The dangers of double taxation and the administrative problems arising from the taxation policy of California, and other political sub-divisions, have undoubtedly deterred would-be investors from making investments which would otherwise have been undertaken. This approach, if it should spread, could easily become a most important threat to international trade since international operations would inevitably be confronted with a real danger of multiple taxation of the same profits and unacceptable administrative burdens. The dangers were also recognized by the Council of the OECD in rejecting the so-called "global" method in its recent report on Transfer Pricing (*Transfer Pricing and Multinational Enterprises* (OECD, Paris, July 1979) pp. 14-15).

The ICC reconfirms its view that, as a general rule, tax should be based on a fair measure of income as computed by reference to the amount which could be expected to arise between independent parties dealing at arm's length. This rule has universal application. The ICC therefore recommends that, in all cases where the taxation policies of political sub-divisions extend to non-domestic operations, all possible measures should be taken to ensure that the terms of an agreement or treaty dealing with taxation on income should bind all authorities having jurisdiction within the boundaries of each contracting State. This recommendation is in accordance with the OECD model taxation Convention 1977 (Art. 2) and a considerable number of international friendship, trade and shipping treaties.

tries, but the taxing authorities now regard business as being prima facie unified if it meets the test of common ownership only, notwithstanding the fact that it may be operating in many disparate business enterprises and autonomous units. Now, the California authorities determine organisations as prima facie being unitary on the basis of a more than 50 percent common ownership, and tax returns are required on a world-wide consolidated basis so that the formula is applied to global world-wide profits.

Despite claims by the State taxing authorities that the three factor system attributes a fairer share of profits to the taxing authorities, there is no denying that the system is arbitrary and completely inappropriate in the international context and can result in taxation by the State of the income of corporations that have no real contact or connexion with that State.

This California initiative has attracted the attention of other States, so that Oregon and Alaska have passed legislation enabling similar methods to be used (although Alaska has quickly eliminated it for oil production operations where the effect would be to decrease profits taxable in Alaska) and eight other States have been reported to be about to adopt, or to be considering the adoption of, this method.

Under the U.S. Constitution, each State has the right to tax profits of business carried on in that State and recently the U.S. Supreme Court has endorsed in the case of *Moorman Manufactoring Co.* v. *Bair* the right of one State to use the so-called unitary method having regard to one factor only, namely, sales — albeit in inter-state commerce (i.e. the case did not involve sales outside the U.S.). The U.S. Supreme Court has, however, recently ruled in the case of *Japan Line Ltd.* v. *County of Los Angeles* that the powers of the States must be subsidiary to any international agreement entered into by the U.S. on a national level and to the constraints of the U.S. Constitution which was interpreted as not permitting multiple taxation of foreign commerce. It was also decided that the rights of the States must not involve the impairment of the U.S. to speak with one voice in international affairs. The U.S. should ensure therefore, that States limit their purview to profits directly related to the activities of the U.S. taxpayer in situations where international trade or foreign relations can be adversely affected through unitary taxation. The present claim being pursued by California appears to be directly in conflict with the friendship, trade and shipping treaties which the U.S. have concluded with many countries and which are designed to encourage trade and investment.

When the U.S./U.K. Tax Treaty came up for re-negotiation following a change in the U.K. corporate tax structure, the negotiators agreed that the Treaty should include a clause preventing States from applying the "unitary" basis to profits of companies within a U.K. Group in so far as they were operating outside the U.S. Without this limitation total income charged to tax levied by States could have exceeded that attributable to the U.S. by the Federal Government but, nevertheless, the clause gave necessary recognition to the sanctity of territorial taxing rights which would be satisfied on an "arm's length" basis. Ratification of treaties requires the approval of the U.S. Senate and, although the Foreign Relations Committee recommended adoption of the Treaty incorporating the restriction mentioned above, the Treaty failed to attract the necessary two-thirds majority in the full senate vote. It should be noted that in the meantime the Treaty had received full approval by the U.K. Parliament. Those Senators objecting to ratification claimed to be motivated by a concern not to infringe State rights in an unconstitutional way (a concern shown to be misplaced since, as previously mentioned, the U.S. Supreme Court has now said that such rights are constrained by international agreements) and, since the U.S. administration judged that the Treaty would not pass in the agreed form, it acquiesced to an amendment which had the effect of permitting States such as California to require business of U.K. groups to be subject to California tax by reference to world-wide profits.

Acting upon advice from its U.S. contacts the U.K. Government judged that the Senate would not countenance the re-introduction of the State limitation and, whilst expressing regret that U.S. administration could not deliver the Treaty as negotiated, accepted the revised provision on the basis that it was the best deal obtainable. This acceptance was, however, coupled with a publicly announced condemnation of the "unitary" basis as extended to international operations.

There is hardly any need to list those factors which would distort income allocation if each political subdivision, e.g. California in the U.S., is allowed to have regard to world-wide profits of a foreign multi-national and the following summary does not pretend to be exhaustive.

1. Sales values are determined by a number of factors which have no uniform relationship to profits. For example, the proportion of sales taxes varies enormously from country to country and a high sales tax increases sales values but does not necessarily increase profits. (An example of this distortion arises in connection with the current proposal to levy a "windfall profits tax" on the oil industry in the U.S. If this proposal is adopted the gross sales in the U.S. would substantially increase but the after-tax profits would not increase in the same ratio.)
2. Payroll costs will vary significantly between one country and another dependent upon the prosperity of the country concerned. The California formula assumes that the higher the payroll the higher the proportion of profits, but this can be and often is the complete reverse of the truth.
3. Property costs in under-developed territories are normally far lower than they are in more advanced countries but, once again, this does not necessarily mean that the profits arising from those properties are lower.
4. Exchange fluctuations can have a marked effect upon profits earned as between one country to another. A change in the value of the dollar resulting in an increase or decrease in dollar equivalents of earnings in other countries will be accompanied by a

The International Chamber of Commerce:

THE POTENTIALLY DANGEROUS EFFECT UPON INTERNATIONAL COMMERCE OF THE "GLOBAL" OR "UNITARY" BASIS OF ASSESSMENT

In the preceding issue we published the article: *"Identification of the source of income – the unitary system of taxation"* by James C. Redmond evaluating the pros and cons of the separate accounting system and the unitary system of taxation. We also published a statement of the Council of the Dutch Employers' Federation which it submitted to the California Senate Committee on Revenue and Taxation outlining its objections against the unitary system of taxation.

We now take pleasure in reproducing Document 180/195 Or. Rev. in which the International Chamber of Commerce, Paris, sets forth its opinion on the subject.

In the past thirty years or more international commerce has expanded at a rapid rate to the benefit of all peoples, particularly those in the more advanced industrialised countries. To a large extent this trend has been the result of government initiatives in lowering trade barriers and in providing, through bilateral agreements, a measure of certainty in relation to the proper measure of taxation by each of the taxing authorities involved. The explosion in technological innovation has been fostered by these arrangements, enabling companies to utilise knowledge not available in one country alone. The complexity of modern manufactured and processed products has necessitated a chain of facilities in different locations to exploit each process to the best advantage.

Strategic direction requires central planning, but most complex organisations which have developed into multinationals grant as much autonomy as possible to the plants located in individual countries.

The complex nature of modern business involves many transactions which cross fiscal frontiers and taxing authorities are understandably anxious that taxable profits should be fairly measured in each of the countries concerned. The principal area of difficulty has been concerned with the price at which raw materials, semi-manufactured goods and completed goods are transferred from one branch or subsidiary of an organisation to another in a different country, and the internationally accepted principle which governs inter-group pricing is based on the arm's length or market value method.

This principle is in some cases implemented by detailed regulations and in many cases by general guidelines which provide for proper and consistent commercial criteria to be adopted. In the United States, for example, there are detailed regulations issued under Section 482 of the Internal Revenue Code which governs these matters.

Other countries have followed the U.S. initiative. For example, the Federal German Republic and the United Kingdom are in the process of formulating their own rules. Treaties between countries such as the U.S. and the U.K. provide for inter-change of information to assist in the adoption of uniformity in these matters, and it is customary for the administrators to discuss differences of approach, at the request of the taxpayer, where differing procedures result in the same profit being taxed in both countries. In all cases, however, where international agreement exists, the guiding principle is the "arm's length price" which would be appropriate in the case of independent persons. The Council of the OECD has recently adopted a recommendation on the determination of transfer prices between associated enterprises, which endorses this principle. (*See Transfer Pricing and Multinational Enterprises* (OECD, Paris, July 1979).)

The procedures outlined above are generally accepted by international business since they follow the maxim that an operating unit should exact a fair price when selling goods or services to another part of the same organisation. Apart from fiscal considerations, a fair price system is also necessary where the company acquiring or disposing of assets has to have regard to minority interests.

It is accepted that, in the absence of proper regulations, taxpayers could be tempted to divert profits from countries imposing high tax rates to those where tax rates are lower and this adds to the necessity of ensuring that a system of fair prices prevails.

In so far as the U.S. is concerned, the regulations issued under Section 482 are aimed at ensuring a fair allocation of taxable profit to the U.S. as a whole and there is no justification for altering such allocation by completely arbitrary means.

However, for many years inter-state commerce in the U.S. has been bedevilled by the inability of States to agree to a uniform system of profit allocation and many States have adopted a formula basis unrelated to the "arm's length" principle. It is not uncommon for States such as California to have regard to the total profits of the U.S. enterprise including foreign subsidiaries and arbitrarily to allocate a profit to California by a three factor method. This method compares State sales, property and payroll with total figures for each enterprise concerned. Total figures at one time were confined to U.S. operations, but more recently California has extended this principle to foreign corporations carrying on business in California either through a branch or subsidiary and has demanded from those corporations information on a world-wide basis. There can be no justification for adopting this formula in the case of a group of companies or foreign corporations operating in a number of countries, some of which will be much more advanced industrially than others and all of which would have differing economic environments. Until fairly recently, the California authorities have applied this three factor system only to genuinely unified business operations in a number of States or in a number of different coun-

Perhaps the most fascinating possibility is that the Bahamas should become a center for the setting up of manufacturing companies operating under sub-contract. In the future, assembly work in electronics will be a major source of employment and it has already been demonstrated that, because of the minimum size of electronic components, these can be carried by air at a minimal cost for assembly and subsequent sale in the markets of the world. This form of company could be a major source of employment of Bahamians in a new field, but it is absolutely imperative that it should be possible for the expatriate managers to come in, set up and direct the operations for the first few years. It is interesting that a small country like Liechtenstein, whose international reputation is normally that of a letter-box tax haven, has a population of which 60 percent is employed in local industry. Presumably, it is not necessary to underline further the value of such companies to the Bahamas. They could bring to it a new prosperity based on a substantial employment of skilled labour in new technologies.

BRITISH INLAND REVENUE POISED TO ATTACK CORPORATE PROFITS IN TAX HAVENS

The British Inland Revenue has been instructed by the Government to issue a consultative document on 'Tax Havens and the Corporate Sector'. The most important legal weapon in the hands of the Inland Revenue for the last 30 years to counter international tax avoidance in the corporate sector has been section 482 of the Income and Corporation Taxes Act 1970. (This section made unlawful, company migration, transfers of trade abroad, and certain transactions relating to overseas companies). The section reinforced exchange control, and now that sterling is free on the international exchanges, it is felt that section 482 has lost some of its bite.

The Inland Revenue is, however, loth to repeal section 482 without some replacement, on the ground that there might be a loss to the revenue by further tax avoidance. It states that there has been a marked increase of tax avoidance in the corporate sector in recent years, and the Government wishes to counter avoidance of U.K. tax by accumulation of profits and investment in tax havens.

It is proposed that the United Kingdom should emulate the U.S.A., Germany, Canada, Japan and France by imposing a tax charge on unremitted income and capital gains of overseas companies controlled by U.K. residents. Corporate shareholders resident in the U.K. will be taxed in the U.K. on the proportion of income and capital gains represented by the ownership of shares by parent companies in the U.K. The tax will apply to all interests in excess of 10 percent.

The charge will apply if the controlled company is resident in a country with 'a privileged tax system' and if the dividend distribution to the U.K. is not substantial. The 'privilege' referred to is absence of tax, or tax substantially lower than the U.K. Genuine trading activities and transactions in the tax haven would be excluded from the charge.

This attack on tax haven companies is supplemented by a further consultative document issued by the Inland Revenue which proposes changes in the law relating to criteria for determining company residence for tax purposes. At present the U.K. rule is the test of 'central management and control'. According to the Inland Revenue, the considerable weight given to the place where the formal meetings of directors takes place has been eroded by instant communication, rapid transport, and changes in the ways in which companies decide and implement policy. Accordingly, the new rule proposed to decide company residence is the test of practical day to day management, or principal acts of management, or principal place of business. The place where the formal meetings of directors takes place would no longer have its present significance.

answer to those assaults is a creation of real management by resident managers and this involves, as a prerequisite, a flexible system of work permits for important top management until local people can be trained to do the job. Unless this is done, then one can see a pretty dismal future for companies set up in tax havens.

Where services or goods or facilities are transferred between external companies and tax haven companies, under common control, it will be essential for the future that these transactions, i.e. the transfer pricing adjustments, should be at arm's length. This concept of arm's length is now a matter of consensus between all governments, and figures in almost every double tax treaty, and is common to almost every organization which speaks with any authority on international business relationships in their fiscal context. As regards tax havens, the problem of transfer pricing is even more difficult than it is between companies established in two or more developed countries with fully-fledged fiscal systems. This arises because of the inordinate suspicions that national tax authorities have of any operations within tax havens so that any discussion on transfer pricing where a tax haven is involved means that, in tennis terms, you start the argument at a "15-love" disadvantage and possibly, where tax authorities are either recalcitrant or obstreperous, it might even be a "40-love" disadvantage.

There is, of course, a real limit to the value of a tax haven company. If, as is the normal case, a tax haven has no double tax agreements with the outside world, this means that transfers of dividends and interest are penalized by comparison with similar flows coming out of other countries. Only the Netherlands Antilles and Switzerland have any important international double tax treaties and in the case of other tax havens, like the Bahamas, this means that profits generated inside the tax havens can only be used without tax penalty by treating the tax free funds as an ever-circulator. This is probably not a major hazard inside a group of companies because the funds can normally be lent at interest outside the tax haven for financing new development elsewhere.

As regards the positive possibilities in the Bahamas for setting up companies, it is obvious that it would be a good base for shipping company management. The failure of the group of seventy-seven[4] to abolish flags of convenience shows that the management of shipping companies from tax havens has an interesting future.

There is a growing tendency by large companies to set up their own captive insurance company subsidiaries and there is no reason why the Bahamas should not be able to capitalize on this possibility.

I need not say anything on the subject of setting up banking companies in the Bahamas because most of them are here because of this possibility. I would be the last person to tell bankers how to run their business, but I do feel that the banking companies in the Bahamas will come in for increasing scrutiny by the tax authorities of other countries, unless they can show that the operation is autonomous and properly managed in the Bahamas.

There should be a fruitful future for the setting-up of companies in the Bahamas for the purchasing of international raw materials and subsequent selling to companies around the world. The only essential fact that must be borne in mind is that the transactions between controlled companies should be at arm's length.

Patent licensing companies should have a useful part to play in the Bahamas, especially if patent licenses are sold to third parties in other parts of the world. Here again, it is essential that the Bahamas company has a mind and management of its own and is not a stooge company.

International holding companies, intermediate between the top company in a multi-national and the operating companies down below, can act as temporary warehouses for dividends, interest and royalties within a group.

Spur Oil Ltd. v. Her Majesty the Queen

(Federal Court of Canada 22.2.80)

Spur Oil, a subsidiary of Murphy Oil of Canada, allegedly bought crude oil from Tepwin Co. a Bermuda corporation owned by Murphy Oil of Canada. Tepwin charged Spur Oil a freight charge of 27c a barrel. This charge was disallowed by the Canadian Revenue and the disallowance was the reason for Spur's appeal.

Tepwin was in fact set up by Murphy Oil of Arkansas, the parent of Murphy Oil of Canada, on behalf of the latter. All the acts of control and management of the operations and decisions of Tepwin were done in Arkansas, Calgary, Alberta and Montreal. The Bermuda directors and officers were mere scribes for Murphy Oil in Arkansas. They exercised no control and management and made no decisions on operations. As regards the procurement of crude oil and its transportation, they did nothing and did not even give instructions on these matters. Tepwin was supposed to buy oil in the Middle East and have it transported to Portland, Maine. But Murphy Oil Trading, headquartered in Arkansas did all that. All invoices to Tepwin were from Murphy Oil Trading and so were all bills of lading and evidence of title. The freight was a bookkeeping entry. It was instructed to be charged by the parent company and Spur's accountants said they would 'bury it before going to bed'. Arkansas instructed the solicitors in Bermuda to write up directors' minutes declaring a dividend equal to the freight charge. The whole of the freight charge was in fact declared and passed by way of taxfree dividend to Spur's parent company.

Expert evidence showed that the freight contract was not typical of the market at the time, did not constitute fair market value, and did not have any valid commercial reasons. It was found that officers and directors of Tepwin did not exercise management and control of its business. They merely carried out instructions given by Arkansas, or Calgary from the parent or associated companies.

The transactions of Tepwin were found to be artificial on the ground that Tepwin was resident in Arkansas or Canada but not in Bermuda, and that contracts executed by Tepwin were done while it was resident in Arkansas or Canada.

4. UNCTAD led by Peru.

port to and from major industrial countries, good telex communications and efficient telephone communications with the rest of the world.

Sixth Commandment
Effective legal, accounting and administrative facilities

It should be possible to set up companies quickly and efficiently and to obtain efficient help in operating those companies.

Seventh Commandment
The ambiance of the tax haven should be attractive

There is a tax haven fairly remote from the inhabited world called Pitcairn Island. I am told that its inhabitants are descendants of Captain Bligh of the Bounty and no doubt it would be interesting to have long talks with his descendants, but as this is presumably the only matter one could engage in on the island there is no great reason to go there. There is another tax haven called Campione, which is an Italian enclave inside Switzerland. One of the problems about Campione is that apart from anything which may amuse you in your hotel bedroom your only alternative occupation is to visit the casino across the road; while this may have its interest, this is hardly a full-time occupation for an international investor.

Eighth Commandment
Adequate commercial legislation to enable companies and trusts to function effectively; adequate and prompt official procedures for setting up and administering companies.

Ninth Commandment
Facilities for the importation of top personnel and for the acquisition of governmental work permits for them

While it is true that letter-box companies can survive without any real management, my feeling is that any future tax havens must possess real top managment and, initially at least, this has to be imported from wherever the top company operates. Without a flexible system of work permits for expatriates, no tax haven has any future in the real world where foreign governments will attack fiscally any company in a tax haven which is without effective mind and management in the tax haven.

Tenth Commandment
Government blessing of a positive kind for the operations of non-resident owners

It is not sufficient that the government merely tolerates companies wishing to come under the protection of the tax haven government, there should be positive encouragement for them to do so.

I have indicated that the problem of tax haven companies in future is that they will have to show that they represent economic reality in substance as well as satisfying legal forms. In other words, the future represents a search for legitimacy.

One of the difficulties which has accompanied the setting up of companies in countries like the Bahamas is that the managements of parent companies are possessed of, what I like to call, the Maria Theresa complex. Maria Theresa was, you may recall, the Empress of the Great Empire of Austria-Hungary. At one stage in her career she was involved in a fairly nefarious conspiracy with the Emperor of all the Russias and the King of Prussia to dismember the Kingdom of Poland. She didn't like the idea very much but nevertheless took part in the partition of Poland. The French writer, Voltaire, said of her, "elle pleurait et elle prenait" which can be loosely translated as, "she cried and took her share of the loot". The top managements of companies which have subsidiaries inside countries like the Bahamas have often felt that the set-up was not entirely respectable but they have nevertheless been very happy to accept the tax free status of the proceeds from the tax haven, and also to run the tax haven company on a shoestring.

On the other hand, governments in many countries have asserted that the setting up of companies in the Bahamas is a "rip-off" and that the profitability of companies in the Bahamas is the other side of the coin to their loss of revenue that would otherwise have accrued in their own territories, if the tax haven companies possess business and economic reality. This assertion is nonsense.

There has been an increasing tendency by these countries to pass legislation to prevent the avoidance of tax caused by the flight of capital to tax havens and the challenge of this legislation has been an emphasis on two factors. Firstly, that they should be truly resident in the tax haven in the sense that mind and management is present there, and secondly, that the pricing of transactions between related companies outside and inside the tax haven should be at arm's length.

This means that the letter-box company is already condemmed to death and that, for the future, tax haven companies must be able to show that they have a life of their own and that they have an economic and commercial purpose. In other words, the emphasis will in the future be on "mind and management" vs. "sham". If anyone needs further persuading on this matter, he should study the judgement in the Canadian case of Spur Oil vs. Her Majesty the Queen, where a judgement was delivered in the Federal courts of Canada on the 22nd February 1980. [3] The judgement runs to thirty-seven pages and spells out why in that case the Canadian government was able to secure a verdict which in effect destroyed the tax haven subsidiary which had been set up. The judge in the Spur Oil case said that the people running the tax haven company were nothing more than the scribes of a certain gentleman in Toronto noting his commands and obeying his wishes, passing resolutions and declaring dividends at his behest so that the company in the tax haven could properly be designated a caricature and a sham.

Therefore, an urgent problem faces all companies set up in the Bahamas if they wish to survive the attacks and assaults which will be made upon them by national governments outside the tax havens. The only adequate

3. See box on next page.

The main attraction of the Bahamas as a center of international banking is that it is a no-tax haven. The French, as usual, have a word for this type of country and they have called tax havens in that exquisite phrase, "les paradis fiscaux". I suggest that for "no-tax havens" there are Ten Commandments. They are not written in any tax bible anywhere but they are nevertheless the indicators for a tax haven which are acceptable to those in search of a fiscal paradise.

First Commandment
The absence of income tax and capital tax

It used to be said by Oliver Wendell Holmes that taxes were the price of civilization — I prefer to say that they were the cost of the handout society.

Second Commandment
The absence of withholding taxes

Although Switzerland is classified as a tax haven, it does in fact levy a withholding tax of 35 percent on dividends and interest leaving Switzerland although this percentage is reduced through the medium of several double tax treaties with other countries.

Third Commandment
Freedom of inward and outward cash flows

This would mean that there were no exchange controls or other inhibitions on the movement of cash, whether by way of loans or other capital payments or dividends or inward advances and that there should be no limitation as to the currencies in which cash moves in either direction.

Fourth Commandment
Political, economic and social stability

This is perhaps the most important of the Commandments becasue the only real choice that international capital has in relation to any particular country is whether it wishes to enter that country or not. International capital is extremely sensitive to instability and this has been shown in the virtual destruction of the State of Lebanon as an international financial centre once its political and social stability became questionable.

Fifth Commandment
Adequate and inexpensive international communications

This covers such matters as rapid and efficient air trans-

MICKEY MOUSE: A BRITISH TAX EVADER

Fleet Street in London is the centre of the national newspaper industry. It employs 6000 people by way of casual labour, at high rates of pay. Under the rules of Pay-as-you-earn, no Income Tax is deducted from casual earnings. The casual workers, when signing for their pay, were required to give their names and addresses. When the Inland Revenue examined the pay dockets, they found that the names on the dockets were in the highest degree unlikely to have visited printing premises. They included Mickey Mouse of Sunset Boulevard, Donald Duck of Hollywood, Sir Gordon Richards (the great jockey) of Tattenham Corner, and J.F. Kennedy of the White House.

The employers did not know the true names, but the trade unions did. They operated a "closed shop", and knew all the casuals. The union authorised each casual to go to work. He received his pay. He signed his pay docket as Mickey Mouse or whatever, and went home. The Revenue were defeated in their attempts to find the true names, because the employers did not know them. The Unions did, but the Revenue had no access to the Union books, and no powers to insist.

In his affidavit to the Court, the inspector of taxes said that even the proposal for collecting full tax for the future caused a strike which cost 10 million copies of newspapers, even though the employers and the Unions agreed with this proposal. His main objective was to secure full collection of tax for the future, to stop the tax loss. He considered that he would collect more revenue this way than if the first tried to collect back taxes from hostile workers, in a situation where no records were available to the Revenue. He could not have collected any back taxes, and there might be an indefinite delay in the introduction of new arrangements. Hence the guarantees that future signatures would be genuine, and the price for getting this was a Revenue amnesty for the past tax not paid.

The story might have ended there, but the legality of the Revenue amnesty is about to be tested before the House of Lords. The National Association of the Self-Employed, some of whose members claim to have been harassed recently by the Revenue for past tax deficiencies, have applied to the Courts for a declaration that the Revenue had acted unlawfully in granting an amnesty, and seeking a writ of Mandamus directing the Revenue to collect the past tax in accordance with the law. The question before the Court was whether people should be taxed by law, or untaxed by concession. The Court of Appeal found that the Revenue was exercising a dispensing power, which had been refused to the Crown on the occasion of the Bill of Rights in 1689, which had been presented by the House of Commons to William of Orange and his wife, Queen Mary. (The Bill of Rights is the nearest approach to a written constitution in the United Kingdom. The provisions, so far as applicable, were subsequently introduced into the U.S. constitution.)

The Inland Revenue have appealed from the Court of Appeal to the House of Lords. If the Lords declare the Inland Revenue to have acted unlawfully, what then? Where do they collect the lost tax from, Sunset Boulevard? Or the White House? Mickey Mouse must be laughing, but the question of whether the Revenue can exercise the dispensing power is a serious matter. It puts all the extra-statutory concessions in jeopardy. The courts have indicated on several occasions that they don't like them. If they disappeared overnight, it would indeed be pretty awful for the general body of taxpayers, who might yet come to the conclusion that the affair of Mickey Mouse and the Fleet Street casuals is anything but funny.

The Commonwealth of the Bahamas as a Center of International Business Investment*

By Alun G. Davies**

I find myself a little like the ugly duckling in the banking farmyard because I am outside the world of banking. I have never understood bankers because I have found that they don't have nuch respect for money, except when they are thinking of lending it to me, when it becomes all-important. I understand most of you are offshore bankers and when I asked what the difference was between a banker and an offshore banker I was told it was merely a suntan. I should imagine that in the present highly tense international situation of currencies that the banker's job, which used to be considered so conservative and safe, has become highly dangerous. In fact, I understand that in your industry the present definition of a coward is a man who dared to leave the bank and volunteer to fight against the Russians in Afghanistan.

We have been hearing about the value of the Bahamas as a center of international business investment but I feel a little like the small boy when the Emporor was parading in the nude and he was advised by all his courtiers that nobody would notice, and nobody did, except a small boy who observed that the Emperor was wearing no clothes.

The main attraction of the Bahamas is that it is a tax free center but this, apparently, is a factor nobody notices and takes for granted.

In international business, the minimization of tax is, of course, a legitimate business objective. It is indeed an objective of most of the members of mankind, including the casual labourer in the British printing industry who was found by the United Kingdom Inland Revenue the other day to have forgotton to pay any income tax on his earnings for several years. This was due to the fact that while the employer had to make returns on the employees, these returns were signed by characters like Mickey Mouse of Sunset Boulevard, J.F. Kennedy of the White House, and many other international characters — in other words, the British workman cloaked himself behind anonymity, thereby avoiding paying many millions of pounds to the United Kingdom Exchequer. [1]

A large section of the national economy of most countries is not in dialogue with the Revenue authorities and this silent section has been variously called the "subterranean society" or the "black economy". There are other even more pejorative names which have been applied to it. The size of the "black economy" in most of the developed countries is probably between 10 and 15 percent of the gross national product and this is causing a great deal of worry to the various tax authorities.

The courts have always said that individuals and companies are entitled to prevent the Revenue authorities from putting their hands in the taxpayers' pockets but normally this rule applies to legitimate methods of escaping tax and not to the more elementary methods such as single entry bookkeeping, namely, the passage of money straight from the till into the taxpayer's pockets.

There has been a great deal of international sermonizing notably by organizations like the Council of Europe, the European Economic Community, and the United Nations Group of Government Tax Experts. Broadly, they are all contemplating a comprehensive multinational attack on the avoidance of tax and the evasion of tax in the international field.

Apart from the international organizations, which of course are spearheaded by national governments, these governments themselves take a pretty poor view of what they consider to be *the unwarranted increase* in avoidance and tax evasion in the international field including the use of tax havens such as the Bahamas. Indeed, *The Times* of London referred to the views of national Government on this matter as being like the angry rhinoceros which will turn and charge at the sound of its own droppings. We all know that the rhinoceros is not over-endowed with intelligence and that its reactions are slow and cumbersome, nevertheless, it carries at the end of its face a vary large and sharp horn which can do a great deal of damage to the human anatomy. This rhinoceros reaction has been shown in the case of the United Kingdom by making it unlawful, without the consent of the U.K. Treasury, to create companies overseas, including the Bahamas. [2] In the case of Canada, the reaction has been to attack Bahamian companies as containing no substance and so far as the U.S. is concerned, to treat them as being artificial and fictitious. It is necessary therefore that companies set up in the Bahamas be companies of substance, properly directed from the Bahamas. The day of the letter-box company is finished. The writing is on the wall because it is well known that governments outside of the Bahamas will, if they can, eliminate attempts to create profit centers within the Bahamas which are tax free. The only effective counter measure to this international pressure is to make quite certain that companies in the Bahamas have a mind and management of their own, and that the relationship between them and affiliated companies outside the Bahamas is at arm's length.

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* (Revised) Paper submitted at the Second International Banking Conference under the joint sponsorship of The Association of International Banks in the Bahamas and The Central Bank of the Bahamas on March 17, 1980, at Nassau, Bahamas.

** Tax consultant, President of the International Fiscal Association.

1. See box on next page.
2. Section 482 Income and Corporation Taxes Act 1970.

Article 15
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 the Convention enters into force provided that at least 6 months prior notice of termination has been given through diplomatic channels. In such event, the Convention shall have no effect in respect of transfers of estates of individuals dying, gifts made, and generation-skipping transfers deemed made after the December 31 which either is or next follows 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. . . . . . , 19 . .

For the United States of America:

. . . .

For . . . .

. . . .

Residence and Intent to Remain in the U.S.A.

The U.S. Revenue recently issued Ruling No. 363 establishing that an employee of an international organization who entered the United States on a so-called G-4 visa and who intended to remain in the United States indefinitely, which intent persisted until his death, was a resident of the United States and that his estate was subject to U.S. estate tax. The text of the Ruling reads as follows:

ISSUE

For purposes of the federal estate tax imposed by Section 2001 of the Internal Revenue Code, was a person who entered the United States as a non-immigrant alien on a "G-4" visa a resident of the United States when that person intended to remain in the United States indefinitely at the date of death?

FACTS

The decedent, *D*, a citizen of a foreign country, was an employee of an international organization until death. In 1965, *D* entered and remained in the United States with a "G-4" visa. A "G-4" visa is a non-immigrant visa granted to employees of international organizations. After arrival, *D* formed the intent to remain in the United States indefinitely and the intent persisted until death in 1978.

LAW AND ANALYSIS

Section 2001(a) of the Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2101(a) of the Code sets out a table of graduated rates of tax to be applied to the taxable estate of a decedent who was a non-resident not a citizen of the United States at the time of death. The taxable estate of a decedent who was a citizen or resident of the United States is subject to the tax in accordance with the table set out in section 2001.

Section 20.0-1(b)(1) of the regulations provides that a resident decedent is one who, at the time of death, was domiciled in the United States. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later moving. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile.

The Supreme Court of the United States, in *Elkins v. Moreno*, 435 U.S. 647 (1978), held that, under federal law, a non-immigrant alien holding a "G-4" visa has the legal capacity to establish domicile within the United States. The Court concluded that when federal law, such as the statute that governs the granting of "G-4" visas, did not impose restrictions on intent or duration of stay, Congress intended that, while permanent immigration would normally occur through immigrant channels, non-restricted non-immigrant aliens could adopt the United States as their domicile under certain circumstances.

The question of domicile depends on whether the decedent had formed the intent to remain in the United States indefinitely. In the present situation, *D* was a resident decedent since, at the time of death, domicile had been established in the United States. *D* had formed the intent and did, in fact, reside in the United States with no definite, present intention of leaving. This is true notwithstanding that *D* had entered and remained in the United States with a "G-4" visa.

HOLDING

At the date of death, *D* was a resident of the United States. Therefore, the transfer of *D's* taxable estate is subject to the federal estate tax imposed by section 2001 of the Code.

EFFECT ON OTHER REVENUE RULINGS

In Rev. Rul. 74-364, 1974-2 C.B. 321, the Service concluded that a French citizen, who was the holder of a "G-4" visa that was valid at date of death, was under a legal disability and could not form the necessary intent to remain indefinitely in the United States. Rev. Rul. 74-364 is hereby revoked.

Pursuant to the authority contained in Section 7805(b) of the Code, this revenue ruling will not be applied with respect to decedents dying prior to December 29, 1980, the date of publication of this revenue ruling in the Internal Revenue Bulletin.

sonal services)) 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 or citizenship, 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 Article 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 serivces), ... 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 Article 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)) an amount equal to 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 under paragraph 1 or 2 shall include credit for any tax imposed by the other Contracting State upon a prior transfer or deemed transfer of property by the decedent if such property is included in the estate.

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 transfer 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 paragraph 1 or 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 and payment 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 10
Non-discrimination

1. Citizens of a Contracting State, wherever they are resident, shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which citizens of that other State in the same circumstances are or may be subjected. However, for purposes of United States taxation, United States citizens who are not residents of the United States are not in the same circumstances as citizens of . . . . who are not residents of the United States.

2. The taxation with respect to a permanent establishment which a resident 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 residents of that other State carrying on the same activities. The 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. Entities of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar entities 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 11
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 citizen. Such presentation must be made within one year after a claim under the Convention for exemption, credit, or refund has been finally settled or rejected.

2. The competent authority to which a case is presented 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 or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeaver 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 rules and regulations to carry out the purposes of the Convention.

Article 12
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 administration, 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.

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 and documents can be obtained under the laws and administrative practices of such other State with respect to its own taxes.

4. For the purposes of this Article, the Convention shall apply to taxes of every kind imposed by a Contracting State.

Article 13
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. The 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 14
Entry into force

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

2. The Convention shall enter into force upon the exchange of instruments of ratificiation 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.

2. Where by reason of the provisions 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 Contracting State in which he had a permanent home available; if such individual had a permanent home available in both Contracting States, he shall be deemed to have been domiciled in the Contracting State with which his personal and economic relations were closer (center of vital interests);

(b) if the Contracting State in which the individual had his center of vital interests cannot be determined, or if he had no permanent home available in either Contracting State, he shall be deemed to have been domiciled in the Contracting State in which he had an habitual abode;

(c) if the individual had an habitual abode in both Contracting States or in neither of them, his domicile shall be deemed to be in the Contracting State of which he was a citizen;

(d) if the individual was a citizen of both Contracting 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 of 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 his domicile shall be deemed, notwithstanding the provisions of paragraph 2, to have been in the Contracting State of which he 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 the Convention.

Article 5
Real property

1. Transfers and deemed transfers by an individual domiciled in a Contracting State of real property which is situated in the other Contracting State may be taxed in that other State.

2. The term "real property" shall have the meaning which it has under the law of the 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 or, of 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 real property as defined in paragraph 2 of Article 5 (Real property), transfers and deemed transfers by an individual domiciled in a Contracting State of assets (other than ships, aircraft, and movable property, including containers, pertaining to the operation of such ships and aircraft), 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 to include:

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to an enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to an enterprise solely for the purpose of storage, display, or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to an enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for an enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for an 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. Except for real property as defined in paragraph 2 of Article 5 (Real property), transfers and deemed transfers of assets by 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
Property not expressly mentioned

1. Transfers and deemed transfers by an individual domiciled in a Contracting State of property other than property referred to in Articles 5 (Real property) and 6 (Business property of a permanent establishment and assets pertaining to a fixed base used for the performance of independent personal services) shall be taxable only in that State.

2. If the law of a Contracting State treats a property right as property described in Article 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) but the law of the other Contracting State treats that right as an interest in a partnership or trust governed by paragraph 1 of this Article, the nature of that right shall be determined by the law of the Contracting State in which the transferor or deemed transferor is not domiciled.

Article 8
Deductions and exemptions

1. Debts deductible according to the domestic law of a Contracting State shall be deducted from the gross value of 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 an allocable or apportionable amount of any debts of the transferor or deemed transferor assumed by the transferee or deemed transferee, or to which the property is subject, 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 in 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 by an individual domiciled in the other Contracting State to his or her spouse shall be determined as follows:

(a) 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 the first-mentioned Contracting State; and

(b) in the case of the United States, the tax shall be computed by applying the tax rates applicable to an individual domiciled in the United States.

5. A Contracting State which may tax the transfer of an estate solely by reason of Article 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) shall allow a credit against its tax in an amount no less than \$ 3,600, or shall allow an equivalent exemption in computing the tax otherwise due.

Article 9
Relief from double taxation

1. Where the United States imposes tax by reason of an individual's domicile or citizenship, double taxation shall be avoided in the following manner:

(a) where . . . . . imposes tax with respect to the transfer or deemed transfer of property in accordance with Article 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), 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 United States may tax in accordance with Article 5 (Real property) or 6 (Business property of a permanent establishment and assets pertaining to a fixed based used for the performance of independent per-

Title companies in Florida, I might add, are equally vulnerable.

XIII. PLANNING

The planning of the affairs of a non-resident alien in order to subject him or his estate to the lowest taxes legally permissible is an individualized study. However, the reader will have recognized that certain general rules may be gleaned from the previous portions of this article.

1. Avoid the risk of double domicile. Although the risk is small, the consequences could be disastrous. Adequate counseling can generally prevent the risk.
2. Check citizenship.
3. Take advantage of the gift tax exclusion of stock in domestic corporations. Stocks in these corporations are subject to estate tax if held until death.
4. Consider the formation of a foreign holding company for holding investments in the United States. Follow corporate formalities to ensure its recognition as an owner of its assets.
5. Consider changing investments in includible property into non-includible property.
6. Avoid custodial accounts in the United States.
7. Avoid storing or otherwise locating tangible assets in the United States, e.g. jewelry in a safe deposit box.
8. Consider the effect of recourse and non-recourse obligations on the calculation of the estate tax.
9. Avoid locating assets in high tax states, e.g. New York, California, and Connecticut.
10. Remember that lifetime gifts are subject to the higher gift tax rates applicable to residents, while a lesser tax rate is applicable to assets passing at death.
11. Transfer assets prior to changing status from a non-resident to a resident.

U.S.A.: Model Estate and Gift Tax Treaty

The Treasury Department's revised model treaty released November 20, 1980

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

3. Nothwithstanding any provision of the Convention except paragraph 4 of this Article, a Contracting State may tax transfers and deemed transfers of its domiciliaries (as determined in accordance with Article 4 (Fiscal Domicile), and by reason of citizenship may tax transfers and deemed transfers of its citizens, as if the Convention had not come into effect. For this purpose the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of 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 paragraph 3 of Article 8 (Deductions and Exemptions) or under Articles 9 (Relief from Double Taxation), 10 (Non-Discrimination), and 11 (Mutual Agreement Procedure); and
(b) the benefits conferred by a Contracting State under paragraph 1 of Article 13 (Diplomatic Agents and Consular Officers) upon individuals who are neither citizens of, nor have immigrant status in, that State.

Article 2
Taxes covered

1. The existing taxes to which this Convention shall apply are:
(a) in the United States: the Federal estate tax, the Federal gift tax, and the Federal tax on generation-skipping transfers;
(b) in .... : ....
....

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

3. For the purposes of Article 10 (Non-discrimination), the Convention shall 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 12 (Exchange of information), the Convention shall apply to taxes of every kind imposed by a Contracting State.

Article 3
General definitions

1. For the purposes of this Convention, unless the context otherwise requires:
(a) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory;
(b) the term " .... " means .... ;
(c) the terms "Contracting State" and "the other Contracting State" mean the United States or ...., as the context requires; and
(d) 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 the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires and subject to the provisions of Article 11 (Mutual agreement procedure), have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies.

Article 4
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 ....

of fairness and due process were met, and that the law upon which the judgment was based does not offend the forum state's settled public policy. Several justifications for the revenue rule have been put forth, including the possibility of embarrasing a neighbor sovereign, the necessity and difficulty of interpreting and reconciling foreign public policy with that of the forum, the effect on international relations, and the reluctance of courts to further the governmental interests of a foreign country. [121]

Until recently, it was through that perhaps the side of the revenue rule barring the enforcement of a judgment was an outmoded historic relic. [122] However, in the recent case of *Her Majesty in Right of the Province of British Columbia* v. *Gilbertson*, a Federal Court of Appeals upheld a District Court decision dismissing an action brought by a Canadian province to enforce an income tax judgment. [123] The principal bases for the decision in *Gilbertson* were twofold: first, the revenue rule, and, second, a lack of reciprocity in the enforcement of tax judgments between the U.S. and Canada.

The reciprocity requirement is simple, although somewhat circular. Generally, before one court will recognize the judgment of another court, a factor which is considered is the requirement of reciprocity, which is the principle that the courts of one jurisdiction will recognize a judgment from a second jurisdiction only if the courts of the second jurisdiction would recognize a judgment from the first jurisdiction's courts. [124] While noting that reciprocity is no longer a requirement, the Court in *Gilbertson* relied heavily on the absence of any reciprocal enforcement provision in U.S.—Canadian tax treaties, and the refusal by Canadian courts to recognize the tax judgment of a U.S. court in *United States* v. *Harden*. [125] In *Harden* the Supreme Court of Canada, relying on the revenue rule, refused to enforce a U.S. tax judgment against a taxpayer who fled to Canada with all her assets. The reasoning in these income tax cases would seem to be equally applicable to estate or gift taxes.

Although United States treaties routinely have exchange of information provisions, compared with income tax treaties, few have effective enforcement provisions. [126] However, even those with collection or enforcement provisions may not effectively handle all enforcement problems. A significant aspect of many of the enforcement provisions is that the taxes subject to collection thereunder are limited to amounts necessary to ensure that any exemption or reduced rate of tax granted under the treaty does not inure to the benefit of unintended beneficiaries. [127] These provisions thus would not be applicable to situations of the type presented in *Harden* or *Gilbertson*, where a taxpayer simply fails to pay the tax that is due and removes himself and his assets from the taxing state.

In the absence of an applicable treaty or clear indication that the taxing jurisdiction would enforce the taxes imposed by the other jurisdiction, the viability of the revenue rule casts doubt on the enforceability of foreign tax judgments in the United States and of United States judgments abroad. This reasoning would seem to call for a similar result where the taxing jurisdiction, whether U.S. or foreign, brings an original action based on its own tax laws in the other jurisdiction. [128]

XII. ATTORNEY'S LIABILITY

The "executor" is responsible for filing the estate tax return, disclosing all assets that may be subject to United States estate tax and paying all estate taxes. [129] In addition, the "executor" is required to notify the Internal Revenue Service of the name of every person holding a legal or beneficial interest in the estate, if the executor is unable to make a complete return of all of the gross assets of a decedent. [130] In certain cases, an executor may be held personally liable for payment of estate taxes. [131] Criminal penalties exist for failing to file a return or for filing a false or fraudulent return. [132]

The "executor" is any person in actual or constructive possession of any property of the decedent, if there is no executor or administrator appointed, qualified and acting within the United States. [133] Thus, the attorney may be the statutory executor liable for the filing of the return, the paying of the estate tax and the notification of beneficial interest. The problem is important. Our Florida office has come across many instances where Florida attorneys are acting as "trustees" or possibly nominees for foreign clients that own U.S. real estate.

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121. Her Majesty the Queen in Right of the Province of British Columbia v. Gilbertson, 597 F.2d 1161 (9th Cir. 1979), *aff'g* 433 F. Supp. 410 (D. Or. 1977).
122. According to the Restatement (Second) of Conflicts of Laws (1971), the enforceability of a judgment for the payment of taxes will depend on whether it is deemed to be penal. If it is, it will generally not be enforced. Secs. 89; 120, Comment d. The Restatement opines that a judgment for taxes in favor of a sister state is not penal. Sec. 120, Comment A. The Restatement refuses to express an opinion on whether an action by a foreign nation on a claim for taxes will be entertained in the United States, absent a treaty. Sec. 89, Comment b.
123. Her Majesty the Queen in Right of the Province of British Columbia v. Gilbertson, 597 F.2d 1161 (9th Cir. 1979), *aff'g* 433 F. Supp. 410 (D. Or. 1977).
124. 597 F.2d at 1164. The reciprocity requirement has fallen into some disfavor. See, e.g. Restatement, Second, Conflict of Laws (1971), sec. 98, Comment e.
125. United States v. Harden, 41 D.C.R. 721 (Sup. Ct. of Canada, 1963) *aff'g* Court of Appeal for British Columbia, 63-1 USTC ¶ 9217 (1962).
126. Compare, e.g. Netherlands (no collection provision) with Netherlands Income Tax Treaty, Art. XXII; Compare, Model Treaty, Art. 14 (Exchange of Information) with Model Income Tax Treaty, Art. 26(4) (Exchange of Information and Administrative Assistance). Of special interest in this regard is Norway, Art. IX (collection provision). This provision was not accepted by the U.S. and is deemed deleted and of no effect.
127. E.g., Finland, Art. VIII.
128. The author has settled one estate tax case favorably, primarily on the ground of lack of enforceability of a judgment.
129. I.R.C. secs. 2002, 6018(a).
130. I.R.C. sec. 6018(b).
131. 31 U.S.C. sec. 192. See Hochberg and Silbergeit, "Recent Cases Narrow Scope of Executor's Personal Liability for Estate Taxes", 7 *Estate Planning* 1 (January, 1980).
132. I.R.C. secs. 7201, 7203, 7206, 7207, 7269.
133. I.R.C. sec. 2203.

tion-skipping transfers, is treated as if he had made an actual lifetime or deathtime transfer, it would be anomalous to include transfers in the generation-skipping tax base which would be exempt if the deemed transferor was the actual transferor of the property. Accordingly, the statute provides that only property which if transferred outright by the non-resident alien would be taken into account under Chapter 11 (estate tax) or Chapter 12 (gift tax) is subject to inclusion in the Chapter 13 (generation-skipping) tax base. [113]

If the deemed transferor is alive at the time of the transfer, the statute provides that *"there shall be taken into account only property which would be taken into account for purposes of Chapter 12..."*. As a general rule, a non-resident alien is subject to gift tax only on *"the transfer of real property and tangible personal property situated in the United States at the time of the transfer"*. [114] The net effect of the foregoing is that except for certain expatriates only real property and tangible personal property situated in the United States at the time of the deemed transfer will be included in the generation-skipping tax base.

If the deemed transferor has died at the same time as, or before, the transfer, the statute provides that *"there shall be taken into account only property which would be taken into account for purposes of Chapter 11"*. If the deemed transferor had died owning the property he is deemed to have transferred, only real property located in the United States, tangible personal property located in the United States and intangible personal property deemed to be property within the United States would be included in his gross estate. Accordingly, only such property will be included in the generation-skipping tax base.

In cases where Chapter 13 is applicable to a non-resident alien deemed transferor, the generation-skipping tax is computed in accordance with the U.S. domestic estate tax rate table (as provided in sec. 2001(c)) and not in accordance with the substantially lower rates applicable to the estates of non-resident aliens. Accordingly, the generation-skipping tax will, in situations where the deemed transferor dies at the same time as, or before, the transfer, result in a greater tax than would be the case if the deemed transferor had died owning such property (i.e. the tax computed pursuant to sec. 2602 would exceed, in such cases, a tax computed pursuant to sec. 2101). [115]

It has been suggested that the generation-skipping tax can be avoided in situations where a non-resident alien is the deemed transferor by converting, prior to "transfer", any property "situated in the United States" into non-U.S. situs property. [116] Absent an attack by the Internal Revenue Service based on the "step transaction" or other similar doctrine, such a contention appears sound. [117]

XI. ENFORCEMENT OF TAX CLAIMS

Notwithstanding the imposition of a tax by the Internal Revenue Code, the collection of the tax may be more difficult. In the absence of a treaty with a provision that the countries will aid each other in the collection of taxes due under the convention, [118] the problem of the enforcement of the tax would arise where the Commissioner institutes a suit in a foreign jurisdiction to recover the taxes allegedly due, or where the Commissioner reduces a tax claim to judgment in the U.S. and then institutes an action in a foreign jurisdiction to enforce the U.S. court's judgment. [119]

Historically, tax claims, whether reduced to judgment or not, were not enforceable in foreign jurisdictions. [120] The basis for this lack of enforceability is the principle known as the "revenue rule". Like the "penal rule", with which it has been compared (the rule that one jurisdiction will not enforce the penal laws of another), the revenue rule constitutes a major exception to the general principles of comity, which ordinarily provide for the judicial recognition and enforcement of a foreign judgment upon a showing that the foreign court had jurisdiction over the parties, that the basic requirements

113. "If the deemed transferor of any generation-skipping transfer is a non-resident alien, the generation-skipping tax is to be imposed only to the extent that an estate or gift tax would be imposed in similar circumstances in the case of an outright gift or bequest by the alien." General Explanation of the Tax Reform Act of 1976, at 580.

114. Reg. sec. 25.2511-3(a). In the event that the decedent is an expatriate and sec. 2501(a)(3) is applicable, the non-resident alien is also subject to gift tax on intangible assets which are deemed to be situated in the United States. I.R.C. sec. 2511(b); Reg. 25.2511-3(a)(2). I.R.C. secs. 2103, 2104 and 2105.

115. In such a case, it has been suggested that the non-resident alien deemed transferor may be entitled to the unused part of the credit (as provided by I.R.C. sec. 2601(c)(3)) which would have been available if he had been a United States citizen or resident. See Covey, supra at 103-104. However, since the statute speaks of that "portion of the credit under sec. 2010(a)... which exceeds the sum of... the tax imposed by sec. 2001...", neither of which is applicable to a non-resident alien, it is most likely that no credit is available at all.

116. See Covey, supra at 103-104: Schmolka "Miscellaneous Foreign Overtones of Unified Rates, Generation-Skipping and Carryover Basis", in *Foreign Trusts and Foreign Estates: Planning for United States and Foreign Persons,* at 284-286 (P.L.I. 1977).

117. For example, an exchange of "U.S. situs property" for stock issued by a foreign corporation and then a distribution of the stock should not, absent attack on a step transaction or other related theory, constitute a "taxable distribution", as a non-resident alien would not incur a gift tax on such a transfer. Alternatively, a sale of the property and a deposit of the sales proceeds would appear to eliminate any generation-skipping tax problems, although it may be subject to income tax as "effectively connected income". But see Marie-Anne de Goldschmidt-Rothschild, 9 T.C. 325 (1947), *aff'd* 168 F.2d 975 (2d Cir. 1948).

118. E.g., Finland, Art. VIII; France, Art. 16 (effective October 1980); Italy, Art. VII; Union of South Africa, Art. XV, Protocol, Art. VII. See generally A.R. Johnson, L. Nirenstein and S.E. Wells, "Reciprocal Enforcement of Tax Claims Through Tax Treaties", 33 *Tax Lawyer* 469 (1980).

119. See Sidney I. Roberts, ed., "Selected U.S. Tax Developments", text (accompanying notes 29-48) by Arnold B. Panzer, 28 *Canadian Tax Journal* (July-August, 1980).

120. The origin of the revenue rule is generally credited to Lord Mansfield, who in the 1775 case of Holman v. Johnson, 98 Eng. Rep. 1120 (1775) observed that "no country ever takes notice of the revenue laws of another".

party to only four gift tax treaties: with Australia, Japan, France and the United Kingdom. This should be compared with the 13 estate tax treaties and the OECD Draft Treaty dealing only with taxes on estates and inheritances. [101]

A. Primary jurisdiction

The treaties reflect the United States' standard position of retaining its jurisdiction to tax based on domicile or citizenship. The determination of either status is made by each jurisdiction and an attempt to alleviate inconsistent determinations is provided by the allowance of an additional gift tax credit. [102]

B. Secondary jurisdiction

A second ground for imposing the gift tax is that based upon the situs of the property. The treaties prescribe rules for determining situs with respect to the more common types of property. The situs rules are used both for determining whether the transfer of the property is subject to tax and for the purpose of obtaining tax credit. [103]

X. GENERATION-SKIPPING TAX

A. In general

The Tax Reform Act of 1976 added a new Chapter 13 to Subtitle B of the Internal Revenue Code, [104] imposing a tax "on every generation-skipping transfer". The provisions seem modeled after the United Kingdom capital transfer tax. Although an extensive analysis of the new generation-skipping tax provision is beyond the scope of this article, [105] a few general comments are in order.

The tax on generation-skipping transfers is not imposed on the actual transferor of the property. The statute seeks out a "deemed transferor" [106] (who generally will be one of the parents of the transferee of the property) to whom the "transfer" [107] is attributed for the purpose of computing the tax. Once the deemed transferor is identified, the tax is computed, taking into account the current deemed transfer, [108] any prior deemed transfers of the deemed transferor, [109] any prior "adjusted taxable gifts" [110] and the deemed transferor's taxable estate (if the deemed transferor has died at the same time as, or before, the current deemed transfer). [111] The excess of the tentative tax on the sum of the aforesaid items (computed in accordance with the U.S. domestic estate tax rate table set forth in sec. 2001(c)) over a tentative tax computed on the sum of prior deemed transfers, prior adjusted taxable gifts [112] and the deemed transferor's taxable estate (if applicable) is the generation-skipping tax imposed on the current deemed transfer (disregarding any of the deductions and credits enumerated in sec. 2602(c)). In essence, the deemed transferor is treated, solely for the purpose of computing the tax, as if he had made an actual lifetime or deathtime transfer taxable at his highest marginal rates.

B. Generation-skipping and the non-resident alien

As might be expected, Chapter 13 dealing with the tax on generation-skipping transfers provides a special rule for non-resident aliens. Code sec. 2614(b) provides that:

> *"If the deemed transferor of any transfer is, at the time of the transfer, a non-resident not a citizen of the United States and —*
> *(1) if the deemed transferor is alive at the time of the transfer, there shall be taken into account only property which would be taken into account for purposes of chapter 12, or*
> *(2) if the deemed transferor has died at the same time as, or before, the transfer, there shall be taken into account only property which would be taken into account for purposes of chapter 11."*

In cases where a non-resident alien is a deemed transferor, this section produces conformity between all three taxes (Chapters 11, 12 and 13). Since the deemed transferor, for purposes of computing the tax on genera-

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101 For a discussion of the potential double, triple or even quadruple taxation of gifts and the lack of unilateral or treaty relief, see Jones, J.A. "Timeo Danaos", 2 *British Tax Rev.* 105 (1977).

102. E.g., Australia, Art. V; Japan, Art. V.

103. E.g., Australia, Art. III; Japan, Art. III.

104. Pub. L. No. 94-455, sec. 2006(a). The new tax is generally applicable to any generation-skipping transfer made after June 11, 1976, sec. 2006(c).

105. For excellent analyses of the new tax, see Covey, "Generation-Skipping Transfers in Trust", American Bankers Association; and Stephens and Calfee, "Skip to M'Loo", 21 *Tax Law Review* 447 (1977).

106. I.R.C. sec. 2612.

107. I.R.C., secs. 2611, 2613. The term "transfer" or "generation-skipping transfer" is defined to mean any "taxable distribution" or "taxable termination" with respect to a "generation-skipping trust" (or its equivalent). A "generation-skipping trust" is defined as any trust having "younger generation beneficiaries... who are assigned to more than one generation". For example, such trust would result where a grantor conveys property to a trustee, to pay the income to his son for life, with corpus being distributable to the son's children upon the son's death. A "taxable distribution", in general, may be defined as any distribution not out of the income of the trust from a generation-skipping trust to a younger generation beneficiary who is assigned to a generation younger than the generation assignment of any other person who is a younger generation beneficiary. I.R.C. sec. 2613 (a)(1). A "taxable termination" will generally occur when the interest or power of any younger generation beneficiary who is assigned to any generation older than the generation assignment of any other younger generation beneficiary terminates by reason of death, lapse of time, exercise or non-exercise (of the power) or otherwise. I.R.C. sec. 2613(b)(1).

108. I.R.C. sec. 2602(a)(1)(A).

109. I.R.C. sec 2602(a)(1)(B).

110. I.R.C. sec. 2602(a)(1)(C).

111. I.R.C. sec. 2602(a)(1)(D).

112. I.R.C. sec. 2602(a)(1)(C) provides that "the amount of the adjusted taxable gifts (within the meaning of sec. 2001(b)) be made by the deemed transferor" before the current deemed transfer is to be taken into account in computing the Chapter 13 tax. Sec. 2001(b) defined adjusted taxable gifts as "the total amount of the taxable gifts (within the meaning of sec. 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent".

Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000
Over $2,000,000 but not over $2,500,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53 percent of the excess of such amount over $2,500,000
Over $3,000,000 but not over $3,500,000	$1,290,800, plus 57 percent of the excess of such amount over $3,000,000
Over $3,500,000 but not over $4,000,000	$1,575,800, plus 61 percent of the excess of such amount over $3,500,000
Over 4,000,000 but not over $4,500,000	$1,880,800, plus 65 percent of the excess of such amount over $4,000,000

B. Rate base

Since January 1, 1967, the United States has limited the gift tax applicable to a non-resident alien to lifetime transfers of tangible or real property situated in the United States. [88] This is to be contrasted to the estate tax provisions that are applicable to transfers of tangible property also. [89] Thus, the gift tax provisions have little, if any, effect on the lifetime transfers of non-resident aliens, except perhaps to the transfer of real property. The major values in the world today are in intangible assets, e.g. shares of stock, debts, securities, patents, etc., all outside the purview of the United States gift tax on non-resident aliens. Moreover, tangible property can be removed from the United States for purposes of making a gift, although a prompt return would probably render the transfer taxable. [90] However, an attempt to transfer taxable property by sale followed by a forgiveness of the debt may be treated as a transfer of taxable property. [91]

C. Deductions

A citizen or resident of the United States who transfers property to his spouse is allowed a deduction ("marital deduction") in computing his taxable gifts for the first $100,000 of such gifts and for 50 percent of all gifts to his spouse exceeding $200,000 in the aggregate. [92] The marital deduction is limited to citizens and residents; it is not allowed to non-resident aliens. [93] In addition to the marital deduction, a citizen or resident of the United States is allowed a charitable deduction for the entire amount of all gifts made to various specified religious, charitable, scientific, literary or educational organizations, or to specified fraternal societies. [94] Although the lists of charitable purposes and donees to which a non-resident alien's gift may be eligible for a gift tax charitable deduction are similar, the deduction and the beneficiaries or donees are domestically oriented. Thus, gifts to corporations eligible for the deduction are limited to transfers to *domestic* corporations; and gifts to trusts, foundations or fraternal societies are allowed only if such gifts are to be used within the United States. [95]

The exclusion for annual gifts of $3,000 per donee per annum is available to both citizens or residents and non-resident aliens on the same basis. [96]

D. Expatriates

Similar to the United States estate and income tax provisions an exception is made for the taxation of United States citizens who voluntarily surrendered their United States citizenship within ten years of the gift and one of the principal purposes for the surrender was the avoidance of Federal income, estate, or gift taxes. In such case, the rate base includes the transfer of intangible property situated in the United States. [97] For this purpose, shares of stock issued by a domestic corporation and debt obligations of a United States person or the United States or a political subdivision are deemed property situated in the United States. [98] Unlike the similar provision applicable to the estate tax, the Code does not include as property subject to the Federal gift tax, shares of stock of a foreign corporation controlled by an expatriate. [99] Thus, it would appear that an expatriate could transfer intangible property situated in the United States to a holding or investment company that is later transferred to a donee or beneficiary without the imposition of a United States gift tax. Alternatively, the assets could be sold and the proceeds delivered to the donee. However, if the assets sold are precisely those repurchased by the donee, the sale and repurchase might be ignored. [100]

If the sales and repurchases are of publicly traded securities or shares which are sold and bought at fluctuating prices, the repurchase is not necessarily dispositive.

IX. GIFT TAX TREATIES

Reflecting the lack of interest in the federal gift tax applicable to non-resident aliens, the United States is a

88. I.R.C. secs. 2511, 2501(a)(3).
89. I.R.C. secs. 2103-2105.
90. Cf. Marie-Anne de Goldschmidt-Rothschild, 9 T.C. 325 (1947), *aff'd* 168 F.2d 975 (2d Cir. 1948).
91. Geoffrey Davies, 40 T.C. 525 (1963).
92. I.R.C. sec. 2523.
93. I.R.C. sec. 2523(2)(1).
94. I.R.C. sec. 2522(a).
95. I.R.C. sec. 2522(b).
96. I.R.C. sec. 2503(b).
97. I.R.C. sec. 2511(b).
98. I.R.C. sec. 2511(b).
99. See I.R.C. sec. 2107(b) discussed primarily in text.
100. Cf. Marie-Anne de Goldschmidt-Rothschild, 9 T.C. 325 (1947), *aff'd* 168 F.2d 975 (2d Cir. 1948).

dit available is based upon the amount of tax imposed on the transferor's estate which relates to the property that is included in the decedent's estate. The amount of the credit is equal to the same proportion of the tax levied on the estate of the transferor (with some adjustments) that the property received bears to the transferor's taxable estate (decreased by any death taxes paid with respect to such estate); and the credit thus computed is limited to the amount of the increase in estate tax caused by the inclusion in the decedent's estate of the property received.

The credit diminishes with the passage of time. In the case of property received from a transferor who dies after the decedent, the credit will be allowable in full if the transferor dies within two years of the death of the decedent; however, no credit will be allowed if the transferor dies more than two years following the decedent's death. If the transferor dies within the ten-year period preceding the death of the decedent, the credit will diminish in 20 percent increments for each two-year interval following the death of the transferor, commencing with the third year following the transferor's death. [80]

D. Credit for gift taxes

A credit is available for gift taxes paid on transfers made before January 1, 1977. [81]

E. Credit for foreign death taxes

Following the principle that the country of situs has priority to tax no credit is authorized under the Code for death taxes paid to foreign governments. [82] A death tax treaty may permit a credit in the rare instance where a foreign state is given a prior right to tax. [83]

VIII. GIFT TAX

A supplement to the Federal estate tax is the United States gift tax. [84]

In addition to the Federal gift tax, various states have enacted gift taxes also, e.g. New York, California.

The Federal gift tax imposed upon the transfers of non-resident aliens [85] is very similar to the Federal gift tax imposed on citizens and residents, with certain significant differences: (1) the rate of tax; (2) the base to which the tax is applied; and (3) the limitations on deductions. Until recently there were only two gift tax treaties, with Australia and Japan. Recently gift tax treaties were signed with France and the United Kingdom.

A. Tax rate

As mentioned above, the Federal estate and gift tax rates are now unified for citizens and residents of the United States. However, the Federal estate and gift tax rate tables applicable to non-resident aliens are not unified. In contrast to the rate table used for taxing non-resident aliens on death, [86] the rate table applicable to lifetime transfers of non-resident aliens is the rate table which is applicable to life and death transfers of citizens and residents. Since the estate tax rate on non-resident aliens is lower than either the life or death transfer rates imposed on citizens and residents, a lifetime transfer by a non-resident alien is likely to be subjected to a gift tax that will exceed the tax that would have been applicable if the non-resident alien had held the property until death! A strange result, but the legislative history indicates that Congress was well aware of this anomaly. [87] Of course with the elimination of intangibles from the gift tax on non-resident aliens, the rate base is considerably different.

The gift tax rates are:

If the amount with respect to which the tentative tax to be computed is:	*The tentative tax is:*
Not over $10,000	18 percent of such amount
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000

80. I.R.C. secs. 2013, 2102(a).
81. I.R.C. secs. 2012(e), 2102(a).
82. Cf. I.R.C. sec. 2014.
83. E.g. Model Treaty, Art. 10; Netherlands, Art. II; United Kingdom, Art. V.
84. Title 26, Subtitle B, Chapter 12 U.S.C.
85. Like the estate tax provision, the statutory phrase is a "non-resident not a citizen of the United States".
86. The federal estate tax rates applicable to non-resident aliens are much lower than those applicable to citizens and residents. The lowest rate applicable to citizens and residents is 18 percent and the highest 70 percent. The comparable rates applicable to non-resident aliens are 6 percent and 30 percent.
87. General Explanation of the Tax Reform Act of 1976, at 529.

Unlike the computation of the federal estate tax of a citizen or resident (which is computed by determining the excess of a tentative tax on the decedent's taxable estate and adjusted taxable gifts over the aggregate amount of gift tax payable on all gifts made by the decedent after December 31, 1976), a non-resident's federal estate tax is computed by determining the excess of a tentative tax [69] on the decedent's taxable estate and adjusted taxable gifts over a tentative tax "on the amount of the adjusted taxable gifts". [70] Although it is understandable why a non-resident alien should not be able to offset the full amount of any gift tax he may have paid based on the higher rate table applicable to his actual lifetime transfers [71] (i.e. since the non-resident's estate tax rates are much lower than the gift tax rates, it would create distortion if an offset for actual gift tax paid was permitted), it is totally unclear why the offset for gift tax in the current statute only takes into account those taxable gifts of a non-resident alien which are not included in his gross estate (i.e. only "adjusted taxable gifts"). The legislative history is confused on this point. [72] If not amended, the statute would deny credit to a non-resident alien for any gift tax paid (based on the rate tables prescribed in sec. 2101(d)) on gifts which are subsequently included in his gross estate. [73]

At present the federal estate tax rate schedule applicable to a non-resident alien is:

If the amount with respect to which the tentative tax to be computed is:	*The tentative tax is:*
Not over $100,000	6 percent of such amount
Over $100,000 but not over $500,000	$6,000 plus 12 percent of excess over $100,000
Over $500,000 but not over $1,000,000	$54,000 plus 18 percent of excess over $500,000
Over $1,000,000 but not over $2,000,000	$144,000 plus 24 percent of excess over $1,000,000
Over $2,000,000	$384,000 plus 30 percent of excess over $2,000,000

VII. CREDITS AGAINST ESTATE TAX

A. Unified credit

With the adoption of a rate schedule applicable to cumulative lifetime and deathtime transfers, Congress also eliminated the $30,000 estate tax exemption for estates of non-resident aliens. [74] In its place, there is now a unified credit equal to $3,600. [75] Expatriated former United States citizens are allowed a credit of $13,000. [76]

B. State death tax credit

In order to partially alleviate the burden of the impositions of both a state and Federal estate tax on the same assets or transfer, the Internal Revenue Code authorizes a credit for state death duties. [77] The credit is limited to the actual state tax paid. However, since no state fails to impose a tax that is at least equal to the Federal estate tax credit, the full credit is always available to the estate of a resident or citizen. The credit allowable to the estate of a non-resident alien is limited to an amount which has the same ratio as the value of the property upon which state death taxes were paid bears to the value of the property situated in the United States. [78]

C. Credit for tax on prior transfer

The estate of a decedent (whether or not a citizen or resident) is entitled to a credit for the Federal estate tax paid on the transfer of property to the decedent by another decedent (designated by the statute as the "transferor"). The credit is available only if the property transferred to the decedent was included in the gross estate of the transferor who has died within a period beginning ten years prior to the death of the decedent and ending two years thereafter. [79] The amount of the cre-

69. The rate taxable used is much lower than that applicable to life and death transfers of citizens and residents and that applicable to lifetime transfers of non-resident aliens. See discussion below in text.

70. I.R.C. sec. 2101(b). "Adjusted Taxable Gifts" are those taxable gifts made by a non-resident alien "other than gifts which are includible in the gross estate of the decedent". I.R.C. sec. 2101(c).

71. See discussion below in text. Taxes on pre-1977 gifts are creditable.

72. "The Act also provides for the unification of estate and gift taxes in the case of estate of non-resident aliens who owned or transferred property situated in the United States. As under prior law, the gift tax provisions applicable to citizens and residents are also to apply to gifts of property situated in the United States by a non-resident alien. Also, a special estate tax rate schedule is to apply to the estate of non-resident aliens, as under prior law. The rate schedule is revised to provide rates ranging from 6 percent on the first $100,000 in taxable transfers to 30 percent on taxable transfers over $2 million. As in the case of the regular estate tax, the amount of estate tax would be determined by applying the unified rate schedule to the cumulative lifetime and deathtime transfers subject to United States transfer taxes and then subtracting the gift taxes payable on the lifetime transfers. The lifetime transfers to be taken into account in computing the estate tax would include gifts made by the decedent after December 31, 1976." General Explanation of the Tax Reform Act of 1976, at 529-530. The problem does not arise with respect to pre-1977 transfers for which a credit is available. I.R.C. secs. 2012, 2102.

73. This may not be true for residents of countries with which the United States has a treaty because either (a) the treaty specifically grants the credit or (b) the statute violates the equal protection provision.

74. I.R.C. sec. 2106(a)(3), repealed by Pub. L. No. 94-155, sec. 2001(c)(1)(F). The former $30,000 gift tax exemption was never applicable to non-resident aliens. See I.R.C. sec. 2521, repealed by Pub. L. 94-155, sec. 2001(b)(3).

75. I.R.C. sec. 2102(c)(1). Compare Model Treaty, Art. 10(5).

76. I.R.C. sec. 2107(c)(1)(A).

77. I.R.C. sec. 2011.

78. I.R.C. sec. 2102(b).

79. It is possible for property to be included in the transferor's gross estate even though the transferor died after the decedent in those situations in which includibility of the property in the gross estate of the transferee is not based upon ownership (by the transferor) at the time of death, but upon the basis of a pre-death transfer, e.g. a transfer by the transferor within three years of his death.

at the time of his death is situated or deemed situated in the United States is reduced by that proportion of the administrative expenses, losses and taxes attributable to them, based on the ratio that the value of the United States gross estate bears to the value of the entire gross estate wherever situated.[59] No deduction is allowed, however, unless the executor includes in the Federal estate tax return the value of the world-wide assets.[60] The requirement of including a list of the world-wide assets in the return is not for purposes of taxing the foreign assets, but is rather for the purpose of determining a proper allocation of the deduction. Accordingly, if an executor is willing to forfeit the deduction for administration expenses, losses, indebtedness and taxes, the foreign assets of the decedent need not be disclosed on the return.

In order to obtain a deduction, in addition to a schedule of world-wide assets, the Internal Revenue Service requires an executor to submit a certified copy of the schedule of claims and liabilities against the estate and expenses of administration filed under foreign death duties law. If no schedule was filed, then the executors must submit a certified copy of the schedule of these liabilities, claims and expenses which were filed with the foreign court in which administrations occurred. In the absence of such filings, a written declaration made under the penalty of perjury is required in order to obtain a deduction against the United States gross estate.[61] The expenses that are deductible include the general expenses of the decedent, the court fees and executor's fees, as well as the costs of gathering and reporting the assets, paying applicable taxes of the estate and liabilities of the decedent and distributing the assets to the heirs.

B. Mortgages and indebtedness in respect of property

A distinction is made under the Federal estate tax law between general liabilities of a decedent and those that can be satisfied out of specified property only, i.e. no personal liability mortgages and liens. If the decedent's estate is liable for the amount of an indebtedness, the full value of any property from which it may be satisfied is included as part of the value of the gross estate, the liability is apportioned among all assets and a proportionate amount is deductible. If the decedent's general estate is not liable, only the value of the equity of redemption (i.e. the value of the property less the mortgage or indebtedness) is includible in the gross estate.[62] Thus, the liability is deducted in full and is not apportioned.[63] The lesson is obvious. If the property that is subject to an indebtedness is not situated in the United States, a non-personal liability mortgage indebtedness (i.e. secured by the property alone) is not deductible; but if the decedent's estate were liable for the indebtedness, the obligation could be ratably deducted against the United States assets, even though the property itself would not be includible in the United States gross estate; provided, of course, a schedule of world-wide assets was disclosed. One the other hand, if the decedent has assets situated in the United States which are subject to an indebtedness, it is preferable that a personal liability relating to the United States property be avoided. Non-personal liabilities based on the security of the property alone are preferable. This would avoid apportionment. Normally, the decedent can accomplish this result by increasing the equity invested in the property; presumably even while on his death bed.

C. Charitable deduction

The amount of all transfers to the United States or any political subdivision or to any domestic corporation organized and operated exclusively for religious, scientific, or educational purposes or to a trustee or fraternal organization for use in the United States for similar purposes are deductible from the value of the gross estate.[64]

The amount of the transfer is either fully deductible or totally non-deductible depending on the domestic organization of the charity or the United States use. It is not apportioned as are expenses, liabilities and debts. The other limitations upon deductions applicable to the estates of residents and citizens are applicable to such transfers.[65] A return disclosing the world-wide assets is required although the reason for requiring disclosure of the foreign assets is not apparent since there is no apportionment.[66] Some treaties permit charitable deductions for transfers to charities of the other jurisdiction.[67]

D. Marital deduction

The marital deduction for transfers to a surviving spouse is not allowed. The significance of the unavailability of the marital deduction depends, in part, on the status of the marital property. The ownership of community property achieves the same result as a marital deduction where the surviving spouse has a vested interest in the property during marriage.

VI. TAX RATES

Notwithstanding that the federal taxable estate is limited to assets situated in the U.S., the rate is based only on those assets. There is no exemption with progression. State rates, however, may be based on world-wide assets, thereby increasing the effective tax.[68]

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59. I.R.C. sec. 2106(a)(1). Compare OECD, Article 9, which allocates debts to either immovable property or a permanent establishment and all other debts to the country of domicile.
60. I.R.C. sec. 2106(b).
61. Reg. sec. 20.2106-2(b).
62. Reg. sec. 20.2053-7. City Bank Farmers Trust Co. v. Bowers, 68 F.2d 909 (2d Cir. 1934).
63. Estate of Harcourt Johnstone, 19 T.C. 44 (1952), Acq., 1952-1 C.B. 5.
64. I.R.C. sec. 2106(a)(2).
65. I.R.C. 2106(a)(2)(E).
66. I.R.C. sec. 2106(b).
67. E.g., Canada, Art. III(2); Model Treaty, Art. 10(3).
68. E.g., New York taxes a non-resident's estate on its proportionate share of a tax on world-wide assets, i.e. taxation with progression.

If the interest in the partnership is treated as a separate chose in action, further decision must be made. Is it a debt, for example, from the other general partner or partners? No partner owns an interest in any partnership asset, all he owns is an interest in a partnership. On the death of a general partner, a partnership terminates and the only interest that the deceased partner's heirs acquire is a right against the surviving partners for their share of the assets remaining after satisfaction of all liabilities. Under this view, the location of the asset would depend on the location of the surviving partner or partners. Alternatively, the partner's interest in a partnership may be viewed as a separate interest in an entity similar to a share of stock in a corporation. This is the position adopted by sections 26 and 31 of the Uniform Partnership Act and sections 18, 20 and 21 of the Uniform Limited Partnership Act. Under these provisions, a decedent's interest constitutes intangible personal property, regardless of the assets owned by the partnership. For example, in *Blodgett, Tax Commissioner of State of Connecticut* v. *Silberman*, 277 U.S. 1, the Supreme Court of the United States held that for purposes of the Connecticut inheritance tax, a deceased partner's interest constituted intangible personal property, notwithstanding that a considerable portion of the partnership assets consisted of real estate located in New York. This is still the unanimous position of the United States courts when the question involves state death duties.

Assuming that a decedent's interest is intangible personal property, it would appear that its location would be at the decedent's place of domicile. The Internal Revenue Code does not define the location of all assets; nor does it contain a catch-all or remainder provision. Certain assets are given a specific situs. The remainder are left to court decision. If the courts make an interest in a partnership analogous to a share of stock, then the interest will be located in the country under whose laws the partnership was created. However, intangible property is not necessarily located in the country under whose law it is created. Prior law held that shares of stock and debt obligations were situated where the physical embodiment of the right was physically located at the date of death or at the location of the transfer books.

The fractional interest rule is clearly not the U.S. domestic rule. Under the Uniform Partnership Act and the Uniform Limited Partnership Act, a partner, whether general or limited, does not own a fractional interest in each of the partnership's assets. Notwithstanding this aspect of local law, there is authority that where the partnership terminates on death of the decedent that each partnership asset must be treated separately as if the partner had a fractional interest in each asset. [55] It is not clear whether the Internal Revenue Service accepts that position. In connection with the interpretation of the U.S.—U.K. Estate Tax Treaty, the position was rejected although it is possible to explain that position on the basis that the British position was contrary and a treaty should be interpreted in a consistent manner. Where the partnership does not terminate on the death, then the criteria for taxation may be the law under which the partnership was formed, similar to a corporation, or the place or places where the business is conducted. Compare GCM 18718, holding that a French société en commandite that did not terminate upon the death of a partner was a separate entity and the partnership's assets were not attributable to the estate of the resident alien decedent partners. [56] The entity was a partner in a New York partnership which was doing business in the United States. Under our Internal Revenue Code, a partner is deemed to be engaged in business if the partnership is engaged in business. Assuming that this concept applies under the estate tax provisions, the French société en commandite would have been doing business in the United States, yet the GCM concluded that the assets were not subject to estate tax. On the other hand, in Revenue Ruling 55-701, [57] the Internal Revenue Service concluded that under the U.S.—U.K. Estate Tax Convention the situs of a partnership interest is where the business is carried on.

4. *Trust interests*

A trust, on the other hand, is not deemed an entity but a conglomeration of assets. Accordingly, a non-resident alien decedent's interest in a domestic or foreign trust is deemed an interest in each asset of the trust. Taxation therefore depends upon the situs of each trust asset. [58] The rule seems inconsistent with the authority on partnership in situations where the partnership is respected as a juridical entity not terminating on death. It is also inconsistent with local substantive law which generally treats trusts as entities and beneficiaries owning a chose in action similar to a share of stock.

V. DEDUCTIONS

Since the gross estate of a non-resident alien for United States estate tax purposes is limited to the property situated in the United States, the deductions permitted to reduce the gross estate to the taxable estate are limited. The Code disallows (1) completely deductions attributable solely to property not situated in the United States, (2) a portion of the deductions not specifically allocable to any property situated in the United States. Deductions are apportioned, not disallowed, on the ratio of the assets includible in the gross estate to the total world-wide assets of the decedent. These apportionable deductions include, for example, administration expenses and general obligations.

A. Administration expenses, losses, indebtedness and taxes

In determining the non-resident alien's taxable estate, the value of that part of a decedent's gross estate which

55. Sanchez v. Bowers, 70 F.2d 715 (2d Cir. 1934), involving a Puerto Rican conjugal partnership that terminated on death.
56. 1937-2 C.B. 476.
57. 1955-2 C.B. 836.
58. Commissioner v. Nevius, 76 F.2d 109 (2d Cir. 1935), *rev'g* 30 B.T.A. 70, and rejecting the contention of a decedent who had a life estate and who exercised a general power of appointment that the beneficiary's interest was only a right against the English trustee. See also Rev. Rul. 55-163, 1955-1, C.B. 674.

unit. [44] The situs of such intangibles as partnership interests, goodwill of sole proprietorships, patents, trademarks, copyrights, franchises and similar rights apparently is to be determined under this broad, general regulation. In the absence of this authority some guidance may be gained from the U.S. tax treaties.

1. Industrial and commercial property rights

There are a number of situs issues that could arise in the field of industrial and commercial property rights: (1) situs of the property of the owner of the rights; (2) situs of the property of any licensee from the owner; and (3) situs of multi-territorial rights.

a. Owner

Under older United States treaties, patents, trademarks and designs are generally deemed to be situated in the United States if they have been issued or registered in the United States and copyrights, if exercisable in the United States. [45] These rules are within the broad ambit of the regulations, i.e. they are either issued by the United States government or are enforceable against any infringer in the United States. However, some rights are not statutory and do not require issuance or registration, e.g. a common law copyright or a trade secret. In one case, a famous non-resident alien author of a manuscript transferred it to his wife prior to registering the copyright in the United States and selling the rights to a publisher. The manuscript was held to have a foreign situs for gift tax purposes. [46] On the other hand, a transfer of rights in a manuscript subsequent to the registration of the copyright and sale was held to be a gift of property situated in the United States. [47] It is not clear whether the gift was taxable because it was a transfer of a copyright registered in the United States or because the purchaser had been a United States obligor. It would appear that it was the latter reason, since the court taxed the portion of the value attributable to Canadian serial rights also.

b. License to use

Since a license is not issued by any governmental agency but stems from a contract with a private licensor, if the person issuing the license is foreign it can be argued that the situs of the license would not be in the United States. [48] Under this theory, if a non-resident alien licensee of a patent were to die and the patent license had been issued to him by a non-resident of the United States, that license would not have its situs in the United States since it would not have been issued by a resident of the United States. As a matter of policy, it would appear that the licensor's residence should not be controlling, and the rule that has been adopted under the United States treaties that the licence to use a patent and trademark is located where exercisable should prevail. [49] Even this rule is subject to some dispute. [50]

c. Multi-territorial rights

Another question that may arise in connection with patents, copyrights and other industrial rights is the territorial use of those rights. A patent granted in the United States may also be registered in other parts of the world, as is also the case with a trademark or a copyright. It would appear that the rights should be treated as separate property for transfer tax purposes and subject to tax in each country of registration or use.

2. Unincorporated business interests

Neither the statute nor the regulations define the situs of an unincorporated business interest. A sole proprietorship may be treated in the income tax area [51] as a conglomerate of assets situated where physically located. However, this does not answer where the goodwill is located. The regulation description of the situs of an intangible right to be where it is issued, or the residence of the party against whom it is enforceable, does not appear to be applicable to goodwill. Goodwill is generally treated by United States estate tax treaties to have its situs where the business is principally carried on. [52] The provisions of the U.S. Model Treaty situate it where the business has a permanent establishment or fixed place. [53] This may raise problems in a situation where the decedent's trade or business was carried on in several countries.

3. Partnership interests

One of the largest investments that non-resident aliens have acquired in recent years in the United States is partnership interests in U.S. real estate. Is this a U.S. asset?

The situs of an interest in a partnership has not been judicially determined. Nor is it covered in the Code. There are at least three possible positions that the courts could adopt: (1) that the interest in a partnership interest, whether a general or limited partnership, constitutes a separate chose in action and is located where the entity is incorporated or the chose is located; (2) that the entity is treated in the same manner as a conglomerate of assets and that the situs of the interest is where each individual item of the partnership assets is located; and (3) that the situs of the partner's interest is where the business is carried on. [54]

44. Reg. sec. 20.2104-1(a)(4).
45. Canada, Art. II(k) and (l); old United Kingdom, Art. III(2)(h) and (j); old France, Art. 3(a)(e) and (f).
46. P.G. Wodehouse, 9 T.C. 487 (1952).
47. Sax Rohmer, 21 T.C. 1099 (1954).
48. See Clary, Edward T., "Territorial Limits of Fiscal Authorities on Succession and Wealth Taxes", 22d Cong. International Fiscal Association (1968), LIII *Cahiers De Droit*, Tome II at 378.
49. Canada, Art. II(k); United Kingdom, Art. III(2)(i); France, Art. 3(2)(f).
50. Article 8 of the OECD Draft Convention proposes that all intangibles should be considered as being situated at the domicile of the decedent.
51. Williams v. McGowan, 152 F.2d 570 (2d Cir. 1946).
52. E.g., Canada, Art. II(j); Japan, Art. III(1)(f).
53. Model Treaty, Art. 6(1).
54. In Boyd v. Attorney General for British Columbia, 36 DLR 266 (Sup. Ct. Can. 1917), the Supreme Court of Canada discussed the divergent views for taxation of a decedent's interest in an Ontario partnership that owned real estate in British Columbia and determined it was taxable. Each of the various theories for treating a partnership was adopted by at least one of the five judges participating in the decision. The more recent case of The King v. National Trust Company, 1933 S.C.R. 670 (Sup. Ct. Can. 1933) may indicate a reversal of that decision.

below. Deposits with persons not in the banking business, such as brokers, are includible in the decedent's estate. [31]

E. Debt obligations

Debt obligations of a United States person, the United States, a State, or any political subdivision thereof, or the District of Columbia are deemed property situated within the United States. [32] This provision, adopted in 1966, is a change from the prior regulations that treated any written evidence of intangible personal property, such as a bond for the payment of money, which was deemed to be the property itself, as situated within the United States, if the written evidence of indebtedness was physically located in the United States. The corollary is also true: a debt obligation of a foreign country to a foreign person will be deemed to be situated outside the United States whether or not it is evidenced in written form (which would normally be deemed to constitute the property) and is physically located in the United States. [33]

Debt obligations of certain domestic corporations do not have a U.S. situs if (a) less than 20 percent of the gross income of such corporation was derived from sources within the United States for the three year period preceding the date of the decedent's death, or (b) the debt obligation in question was part of certain debt issues, with respect to which an election had been made under subsection (c) of section 4912 of the repealed Interest Equalization Tax, or (c) the debt obligation was part of certain issues outstanding on April 1, 1971, which were treated as the debt obligation of a foreign obligor under the prior statute. [34]

Some estate tax treaties still contain a remnant of the dichotomy between obligations that were deemed to be the property and obligations that were merely evidence of the debt. For example, bearer government bonds and bills of exchange are still treated like currency and are deemed to have a situs where physically located under some treaties. [35]

F. Shares of stock

Shares of stock owned by a non-resident alien are deemed property within the United States only if issued by a domestic corporation. [36] This is true regardless of the location of the certificate at the time of death. [37] As a result, a non-resident alien can avoid the United States estate tax if he is willing to transfer his United States assets to a foreign entity that will be treated as a corporation for United States tax purposes. A "Stiftung" has been held not to be a corporation notwithstanding it is a separate juridical entity under the laws of Switzerland and Liechtenstein. [38]

Just as important as the characteristics of the entity is the decedent's treatment of it. Where the decedent treats the entity's assets as his own, the entity will be treated as an agent or custodian and its assets subjected to Federal estate tax. [39]

It has been suggested by some writers that a transfer of assets situated in the United States to a foreign corporation within three years of death will be includible in the non-resident alien's estate. [40] This may depend upon whether the transfer of assets in return for shares is a transfer for full consideration in money's worth. [41]

G. Retirement rights

Survivorship rights under pension and profit sharing plans would appear to be governed by the debt obligation rule, i.e. includible if the obligor is domestic. The exemption for insurance payments is inapplicable as it is limited to the proceeds of life insurance. However, to the extent the benefits are attributable to employer contributions and are payable from a qualified employee's trust forming part of a pension, stock bonus or profit sharing plan or consist of qualified retirement annuities, the value is excluded from the gross estate. [42]

H. Proceeds of life insurance

The amount receivable as insurance on the life of a non-resident alien is not deemed situated within the United States. [43] Policies owned on the lives of others are not covered. They may be treated as obligations of the insurer, in which case their taxation will depend on whether the issuer was a domestic insurance company. Alternatively, they may be treated as intangibles embodied in an instrument and taxed if the policies are physically located in the United States. Or, taxation may depend on the status of the life of the insured. The status of the issuer appears to be the most likely criteria.

I. Other intangible personal property

The Internal Revenue Code does not contain rules governing the situs of other intangible personal property. The regulations adopt the rule that intangible personal property has a situs in the United States if issued by or enforceable against a resident of the United States, a domestic corporation or a domestic governmental

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31. Rodolfo Ogarrio 40 T.C. 242 (1963), *aff'd* 337, F.2d 108 (D.C. Cir. 1964).
32. I.R.C. sec. 2104(c).
33. Reg. sec. 1.2105(1)(k).
34. I.R.C. secs. 861(a)(1)(B), 861(a)(1)(G) and 861(a)(1)(H).
35. Canada, Art. II(e); United Kingdom, Art. II(2)(b).
36. I.R.C. sec. 2104(a). *Contra*, OECD, Art. 8.
37. The exclusion of intangibles is legislative grace. It is not required by the U.S. Constitution. Burnett v. Brooks, 288 U.S. 378, C.B. XII-1, 362 (1933). Thus, the rule may be different for state death tax purposes. E.g., Cory v. Bank of America (Estate of Banerjee) 74 Cal. App. 3d 473 (Ct. App., 1st Div. 1977), *aff'd* 21 Cal. 3d 527 (1978).
38. Oei Tjong Sivan v. Commissioner, 327 F.2d 144 (2n Cir. 1957), *aff'd* 24 928 (1955).
39. Fillman v. United States, 355 F.2d 632, 66-1 U.S.T.C. ¶ 12.374 (Ct. Cl. 1966).
40. I.R.C. sec. 2104(b).
41. I.R.C. sec. 2035(b)(1). See Oei Tjong Swan, 24 T.C. 829 (1955) at 854, 857.
42. I.R.C. sec. 2039(c).
43. I.R.C. 20.2104-1(a)(4).

at the time of the gift and the trustee has reinvested in property situated outside of the United States at the date of death, it would literally be includible in the decedent's estate. On the other hand, if the decedent had not created the trust or had revoked it prior to investing in the foreign assets, the property would not be includible. Less extreme cases can be imagined when the decedent transferred assets situated outside of the United States to an independent trustee who unbeknownst to the grantor reinvested some of them in the United States, or a person to whom foreign situs assets had been given, in contemplation of death, reinvested them in the United States. All of these situations do not appear to be situations where tax should be imposed. It has been suggested that the provision was designed to avoid gifts of property which were situated in the United States and were converted into foreign situs assets soon before death. This situation has been covered by judicial decision where there has been a reinvestment. [20] Where there has not, there would seem to be no reason to impose a tax.

B. Real property

The situs of real property owned directly by a non-resident alien decedent is the place where the property is actually located. [21] The determination of the physical location of property should rarely be a problem, but the meaning of the term "real property" could, since neither the statute nor the regulations define real property. Generally, obligations secured by mortgages are considered debt obligations, rather than real property, under United States law. Most of our treaties are in conformity with that conclusion. [22] A similar problem relates to the includibility of a lease in the term "real property". For example, Article III, paragraph 2(a), of the old French treaty specifically excludes leases of less than 18 years from the definition of "real property". Presumably, any lease for 18 years or longer would have been deemed to be real property for the French—United States estate tax convention. In the absence of a treaty definition, it is doubtful that even a long-term lease is real property under United States law.

C. Tangible personal property

Tangible personal property physically present in the United States is deemed situated in the United States for Federal estate tax purposes. [23] A specific statutory exception has been made for works of art which are imported into the United States solely for exhibition purposes and are loaned for such purposes to a public gallery or museum. [24] Arguably, the statute was passed merely to give foreign owners of art collections security that exhibiting works in the United States would not produce adverse estate tax consequences and to thus promote the interest of the United States in having foreign private art collections made available for display in public museums. However, this is not clear as there appears to be no legislative history in point. The terms of the statute may be construed to tax all works of art unless on exhibition. Thus, if a non-resident alien were to die while his work of art were here for purposes of sale at an art auction, it could be subject to estate tax. The common law rule that personality follows the domicile of the owner [25] may not be applicable where it is clear that the owner has determined to dispose of the asset.

The harsh results of the general tangible personal property rule have been mitigated by judicial decision for those items of tangible property that are personal in nature, e.g. jewelry and personal effects of a vacationing non-resident alien. [26] On the other hand, personal property items that are not accompanying a non-resident alien on a temporary visit in the United States will be deemed situated in the United States. Examples are cash or jewelry left in a safe deposit box in the United States. [27] Assets in transit are generally deemed situated at the place of their destination. [28]

D. Bank deposits

Domestic bank deposits, withdrawable accounts with savings and loan associations or similar institutions, amounts held by insurance companies under agreements to pay interest thereon, and deposits with a foreign branch of a domestic corporation or domestic partnership engaged in a commercial banking business are not deemed property situated within the United States. [29] This statutory exemption was enacted to promote the banking interests of the United States, and is a corollary of section 861(c) of the Internal Revenue Code which exempts the interest earned on these deposits from United States income tax. If such deposits are effectively connected with the conduct of a trade or business within the United States, the estate and income tax exemptions are not applicable. A United States deposit with a United States banking branch of a foreign corporation or a foreign partnership will also be exempt if the foreign corporation or foreign partnership is engaged in the banking business and is deemed to be engaged in a trade or business within the United States at any time during the taxable year. [30] This rule is, of course, an exception to the general rule on debt obligations discussed

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20. See Marie-Anne de Goldschmidt-Rothschild, 9 T.C. 325 (1947), *aff'd* 168 F.2d 975 (2d Cir. 1948).
21. Reg. sec. 20.2104-1(a)(1).
22. E.g., U.K., Art. 6(2); France, Art. 5(2); Netherlands, Art. 6(2). But cf. Greece, Art. IV(2)(h).
23. Reg. sec. 20.2104-1(a)(2).
24. I.R.C. sec. 2105(c). Adopted originally as a Joint Resolution of Congress for the benefit of the National Gallery of Art. Pub. L. No. 749, 81st Cong. 2d Sess. (1950).
25. Two legal maxims conflict: mobilia sequentur personam (movables follow the person) and expressio unius est exclusio alterius (mention of one thing implies the exclusion of another thing). The former maxim was specifically disavowed by the Supreme Court in Burnet v. Brooks, 288 U.S. 378 (1933) stating "Congress did not enact a maxim" and taxing intangible personality with a U.S. situs.
26. Murchie v. Delaney, 82 F.Supp. 1976 (D. Mass. 1949), *aff'd* 177 F.2d 444 (1st Cir. 1949).
27. Rev. Rul. 55-143, 1955-1 C.B. 465.
28. E.g., Canada, Art. II(b).
29. I.R.C. sec. 2105(b).
30. I.R.C. sec. 2105(b)(2).

sions are found in the laws of many other countries, e.g. Netherlands, Germany, and the United Kingdom.

B. Resident

For purposes of the Federal estate tax, the term "resident" means a decedent who, at the time of his death, is domiciled in the United States. [9] This is to be contrasted with the use of the term "resident" for purposes of the Federal income tax. For that purpose, an alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States. [10] Thus, for income tax purposes, a taxpayer may have a dual *residence*. A taxpayer may not have a dual *domicile*. A taxpayer acquires a domicile in a place by living there, even if for only a brief period of time, with no definite present intention of later removing himself. Residence without the requisite intention to remain indefinitely or to return in the future is not domicile. Conversely, once United States domicile is established, an intention to change domicile does not effect the change unless accompanied by actual removal from the United States. [11] Since it is conceivable for an individual to have a domicile in the United States even though resident abroad, in order to avoid the application of the Federal estate tax to the world-wide assets on the basis of domicile, a taxpayer, as a minimum, should maintain a permanent residence located outside of the United States. Although a decedent may normally have one domicile only, that does not mean that the decedent may not be subject to tax by more than one jurisdiction, with each claiming the decedent as its domiciliary at the time of his death. [12]

IV. ASSETS INCLUDIBLE

The gross estate of a deceased non-resident alien is that part of his gross estate which at the time of his death is situated in the United States. [13] The entire gross estate of a non-resident alien is determined in the same way as the gross estate of a citizen or resident of the United States, [14] however, only that part of the entire gross estate situated in the United States is included in the taxable estate.

The stated test in determining what portion of a non-resident alien's estate will be subjected to Federal estate tax is the determination of the situs of the property owned by the decedent at his death. Situs, however, is not necessarily identical with location. It is a term used to mask a conclusion reached by either the legislature or the tribunal that it is appropriate, a value judgment, to impose a tax. The factors that enter into that value judgment may include ability to pay or, most importantly, an ability to enforce a determination. The situs rules are found in the Internal Revenue Code, the regulations promulgated thereunder, the decided cases and the various tax treaties.

A decedent's estate has the right to choose to apply either the statutory or the treaty situs rules, depending upon which it finds more favorable. [15]

A. Peculiarity of prior transfers

As most readers of this article know, property previously transferred by a decedent will frequently be included in his gross estate. The transfers that are incomplete for estate tax purposes include (1) transfers within three years of death; [16] (2) transfers, by trust or otherwise, over which the decedent had retained for his life or for any period not ascertainable by reference to his death, or for any period which does not in fact end before his death either: (a) the possession or enjoyment of, or the right to the income from, the property, or (b) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom, or (c) the voting rights in any stock that the decedent may have transferred during his life; [17] (3) a transfer, whether in trust or otherwise, and the enjoyment of the property is subject to any change by the exercise of a power by the decedent to either alter, amend, revoke, terminate or in any other way determine who shall enjoy the property, the property will be includible in the decedent's estate; and (4) finally, even where the decedent has not retained any power over the property transferred, it will be includible in his estate where: (a) the ownership or enjoyment of the property can only be obtained by surviving the decedent, (b) the decedent has retained a reversionary interest or a possibility that the property would be returned to the decedent himself or his estate or would be subject to a power of disposition by him, and (c) the value of that reversionary interest immediately before the decedent's death exceeded five percent of the value of the entire property (determined actuarially). [18]

Of particular interest for advisors of foreign investors is the peculiar provision that property that is the subject of any of the foregoing provisions on lifetime transfer is includible in the non-resident alien decedent's gross estate if the property was situated in the United States at *either* the time of transfer *or* at the date of the decedent's death. [19] The ramification of this provision could be surprising. For example, if a decedent transferred to a revocable trust property situated in the United States

9. Reg. sec. 20.0-1(b)(1).
10. Reg. sec. 1.871-2(b).
11. Reg. sec. 20.0-1(b)(1). Compare Rev. Rul. 74-364, 19746-2 C.B., 321 (A citizen of France admitted to the United States on a G-4 non-immigrant visa was held incapable of forming the necessary intent to remain in the United States) with Rev. Rul. 80-209, 1880-31 IRB 13 (An illegal alien present in the United States for years was ruled a domiciliary).
12. See In Re Dorrance's Estate, 309 Pa. 151, (1932), *cert. denied* 288 U.S. 617; and In Re Estate of Dorrance, 115 N.J. Eq. 268 (1931), *aff'd* 13 N.J. Misc. 168, *aff'd* 116 N.J.L. 362 (1936), *cert. denied* 298 U.S. 678 (1936), in which both Pennsylvania and New Jersey successfully asserted that they were the decedent's domicile.
13. I.R.C. sec. 2103.
14. Reg. sec. 29.2103-1.
15. See I.R.C. sec. 7852(d); Rev. Rul. 54-21, 1954-1 C.B.203.
16. I.R.C. sec. 2035.
17. I.R.C. sec. 2036.
18. I.R.C. sec. 2037.
19. I.R.C. sec. 2104(b).

In addition to the Federal government, the states also impose death and transfer taxes, although in many instances the state tax is merely an amount that would otherwise be paid to the Federal government.

Since many of the problems of practitioners will relate to Canadian investors, the largest investors in the United States, I should point out that the existence of the Canadian Treaty is not clear. Although Canada repealed its dominion estate tax in 1971, it has not formally terminated its treaty with the United States. The United States estate tax form for non-resident alien estates (706NA) is ambiguous about the existence of the treaty, as was the response of the prior International Counsel of the Treasury. However, the position of the present International Tax Counsel of the United States Treasury Department is that the treaty is still in force. This allows for an exchange of information about taxpayers and their assets between the two countries. The exchange of information provisions in the proposed Canadian income tax treaty will cover information on estate and gift taxes, as well as income taxes. Subsequent to the ratification of the income tax treaty, the United States intends to give notice of the termination of the estate tax treaty.

III. TAXPAYER CATEGORIES

For estate tax purposes, the Internal Revenue Code classifies persons as follows: (1) citizens, (2) resident aliens, and (3) non-residents, not citizens of the United States. [3] Both citizens and resident aliens are taxed alike. The taxable estate of a decedent who was a non-resident alien is similar to that of a citizen or a resident with the following differences: (1) The Federal estate tax imposed upon the transfer of an estate of a decedent who was a non-resident alien is limited to that part of the decedent's "entire gross estate" which at the time of his death was situated in the United States. (2) A separate rate schedule and unified credit is applicable. (3) As a result of the limitation of the gross estate to properties situated within the United States, deductions from the gross estate must be allocated. (4) Certain deductions are denied. (5) Credit for foreign death taxes is not allowed.

A. Citizen

The determination of citizenship cannot be ignored by advisors. We discovered a number of instances of foreign citizens being unaware of their U.S. citizenship in the course of our practice.

The term "citizen" is not defined by the Internal Revenue Code or by the regulations. It is defined by those sections of the United States laws applicable for purposes of nationality and immigration. [4]

Citizenship may be obtained either by birth or by naturalization. Similarly, United States citizenship may be lost by certain of the prescribed specific acts of expatriation. Generally, as the result of judicial decision, these expatriating acts are limited to those which evidence an intent to either forego United States citizenship or which are inconsistent with such allegiance. These judicial limitations are the result of the fact that the immigration and nationality statutes are, like any other statutes, limited by the Constitution of the United States. Accordingly, it has been held that loss of citizenship absent a subjective intent to become expatriated would involve an unconstitutional deprivation of a constitutionally protected right. [5]

The holding of foreign citizenship is not incompatible or mutually exclusive with holding United States citizenship. Examples of dual citizenship arise where the decedent was born in the United States of non-resident alien parents, notwithstanding the purpose of the parents' visit in the United States; or the birth of the decedent outside of the United States where both parents are United States citizens, one of whom lived at any time in the United States prior to the decedent's birth; [6] or even where only one parent was a United States citizen and the other parent was an alien, providing that the parent who was a citizen was physically present in the United States for a period or periods totalling not less than ten years, at least five of which were after that parent had attained the age of 14 years. [7] Moreover, in light of the strict protection the Supreme Court has provided for United States citizenship, many individuals who may have believed that they had lost their citizenship may be living under a misconception. For example, failure of an individual who was born outside of the United States but who is a citizen because of this parentage to satisfy certain return requirements, if he continues to reside for three years in the state of which he is a national by birth after age 22, no longer results in an automatic loss of citizenship. In this regard, note that the Federal estate tax return for a non-resident alien, Form 706 NA, requests the decedent's place of birth.

In the case of a decedent who leaves the United States and voluntarily surrenders his citizenship, if one of the principal purposes for the surrender was the avoidance of estate taxes and the decedent died within ten years of such loss of citizenship, the Code imposes the same tax rates as those applicable to any citizen or resident of the United States. In addition, it extends the definition of property situated in the United States to include the property situated in the United States owned by a foreign corporation in which: (a) the decedent owned, at the time of his death, ten percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation; and (b) the decedent owned or is considered to have owned, through the application of various attribution rules, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. This provision is applicable if death occurs within ten years following the loss of citizenship. [8] Similar provi-

3. This article will refer to this latter category as "non-resident alien".
4. Immigration and Nationality Act of 1952, 8 U.S. Code sec. 1401 et seq.
5. Afroyim v. Rusk, 378 U.S. 253 (1967).
6. U.S.C. sec. 1401(c).
7. U.S.C. sec. 1401(g).
8. I.R.C. sec. 2107.

Foreign Investors and the United States Estate, Gift and Generation-Skipping Taxes

by Sanford H. Goldberg *

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I. INTRODUCTION

The problems of juggling income tax, estate and gift taxes and the new generation-skipping taxes in planning a wealthy client's economic tax structure in one jurisdiction, the United States, is well appreciated by any reader of this article. Multiplying the jurisdictions multiplies the problems geometrically. Fortunately, my task is limited to the estate, gift and generation tax considerations applicable to a non-resident alien investing in the United States. The income tax planning, the planning for a change in residence or domicile, and the meshing of the planning for multiple jurisdictions is the subject of future articles.

II. SOURCE OF TAX

The United States tax on the transfer of assets of a non-resident alien is authorized by the estate, gift and generation-skipping transfer tax found in subtitle B of Title 26 of the United States Code. Taxation under the Code may be modified by an estate tax treaty, of which the United States has 13, a gift tax treaty of which the United States presently has four, and a generation-skipping tax treaty of which the United States has two. The present treaty negotiating position of the United States was announced on July 9, 1979, with the release of the Model Estate and Gift Tax Treaty. [1] The United States is also a party to the OECD Draft Convention on death duties. [2]

The existing United States estate tax treaties are with:

Australia	Greece	Netherlands	Union of
Canada	Ireland	Norway	South Africa
Finland	Italy	Switzerland	United Kingdom
France	Japan		

Estate tax treaty negotiations are presently being conducted with Denmark, Germany and Austria among other countries.

The existing United States gift tax treaties are with:
Australia — France — Japan — United Kingdom.

The generation-skipping taxes are covered in treaties with France and the United Kingdom.

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* Attorney, New York, New Jersey; Member, Tax Committee of Bar Association of the City of New York (1974-1977); Tax Section of New Jersey and American Bar Associations; Tax Section New York State Bar Association (Executive Committee 1973-1974); Executive Compensation Advisory Board, Tax Management, Inc., Foreign Tax Advisory Board, Tax Management Inc.; International Fiscal Association — Secretary 1977-1979, Vice President, 1980 (U.S.A. Branch); President — International Tax Association, 1976-1978; International Tax Editor, Journal of Taxation; Co-author, Column on Selected U.S. Tax Developments, Canadian Tax Journal, 1980 —; Adjunct Professor, N.Y.U. Graduate School of Law (Advanced Foreign Taxation), 1965-1977; co-Author: "Annotated Tax Forms — Practice and Procedure", Third Edition, Prentice Hall, 1969—; International Fiscal Association, "Investments by Canadian Persons in U.S. Real Estate", Special Seminar on Cross Border Real Estate Investments; "Canadian Investments in U.S. Real Estate", Canadian Tax Foundation; Firm: Roberts & Holland, New York, New York; Miami, Florida; Washington, D.C.

1. Convention . . . for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates and Inheritances, and Gifts (herein "Model Treaty").
2. O.E.C.D. Draft Convention for the Avoidance of Double Death Taxation with respect to Taxes on Estates and Inheritances (1966) (herein "OECD).

INHALTSVERZEICHNIS

Sanford H. Goldberg:

Ausländische Investoren und die Besteuerung bei Nachlässen, Schenkungen und Vermögensübertragungen bei überspringen einer Generation im amerikanischen Steuerrecht 147
Der Verfasser untersucht die Besteuerung unentgeltlicher Vermögensübertragungen unter besonderer Bezugnahme auf nichtansässige Ausländer. Er erläutert die Vorgänge, die in den Anwendungsbereich der jeweiligen Steuer fallen, die verfügbaren Freibeträge und die relevanten Steuersätze; ferner vermittelt er Hinweise darauf, wie, bzw. wo sich das Vermögen des Schenkers oder Testators zusammensetzen, bzw. befinden sollte.

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Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen: Das Steuerrecht der U.S.A./U.S.A. Tax Law (Seminar) (including: introduction to United States taxation; taxation of Swiss branch and subsidiary operations in the U.S.; tax treatment of special forms of investment in the U.S.; taxation of foreign income of U.S. taxpayers: basic principles; acquisition of a U.S. business), Zürich-Airport (Switzerland), June 11-12 and 15-16 (English, German).

SEPTEMBER 1981

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British Branch International Fiscal Association, New London Bridge House, 25 London Bridge Street, London SE1 9SX (United Kingdom).

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

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STATE TAX GUIDE
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APPENDIX II

Tax payable by various taxpayers with same annual income
(Hong Kong dollars)

	Single	*Single with 2 dependent parents*	*Married with no children*	*Married with 2 children*	*Married with 2 children and 2 dependent parents*
Annual salary/ income	$72,000	$72,000	$72,000	$72,000	$72,000
less:					
Personal and supplementary allowances	$22,500	$22,500	$45,000	$45,000	$45,000
	$49,500	$49,500	$27,000	$27,000	$27,000
less:					
Child allowance	––	––	––	$12,000	$12,000
Dependent parent allowance	––	$14,000	––	––	$14,000
Net chargeable income	$49,500	$35,500	$27,000	$15,000	$ 1,000
Tax thereon	$ 7,375	$ 4,100	$ 2,500	$ 1,000	$ 50
Effective rate	10.2%	5.7%	3.5%	1.4%	0.14%

Source: The 1981-82 Budget Speech, February 25, 1981.

APPENDIX III

Marginal tax rates applicable to salary tax/ personal assessment
(Hong Kong dollars)

		Net taxable income	*Tax rates*
(a)	Upon the 1st	$10,000	5 percent
(b)	Upon the next	$10,000	10 percent
(c)	Upon the next	$10,000	15 percent
(d)	Upon the next	$10,000	20 percent
(e)	Upon the remainder		25 percent

(Effective from the year of assessment 1978/79)

Source: Inland Revenue Ordinance, Chapter 112, Revised edition 1979, Second Schedule, p. 129.

APPENDIX IV

Tax payable by various taxpayers with same annual income
(Hong Kong dollars)

	Single	*Single with 2 dependent parents*	*Married with no children*	*Married with 2 children*	*Married with 2 children and 2 dependent parents*
Annual salary/ income	$50,000*	$50,000*	$50,000*	$50,000*	$50,000*
less:					
Personal allowances	$10,000	$10,000	$20,000	$20,000	$20,000
	$40,000	$40,000	$30,000	$30,000	$30,000
less:					
Child allowances	––	––	––	$ 5,500	$ 5,500
less:					
Dependent parent allowances	––	––	––	––	––
Net chargeable income	$40,000	$40,000	$30,000	$24,500	$24,500
Tax thereon	$ 5,500	$ 5,500	$ 3,000	$ 2,175	$ 2,175
Effective rate	11.0%	11.0%	6.0%	4.4%	4.4%

* Equivalent to $72,000 at 1980 prices.

APPENDIX V

Outcome of major tax reform recommendations as at February 25, 1981

Recommendation	*Government decision*	*Budget speech reference*
A	deferred	1979-80, Annex 15, p. 81
B	rejected	1979-80, Annex 15, pp. 81-82
C	accepted	1978-79, Para. 177
D	major recommendation rejected;	1978-79, Paras. 170-171
	minor recommendations accepted	1980-81, Paras. 277-278
E	partly accepted	1978-79, Paras. 172-176 and Annex 15, p. 135
F	major recommendation accepted; minor exceptions rejected	1979-80, Annex 15, pp. 84-85
G	deferred	1979-80, Annex 15, p. 85
H	rejected	1979-80, Annex 15, p. 86
I	major recommendation accepted; minor suggestions rejected	1979-80, Annex 18, p. 88

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OCTOBER 1981

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DECEMBER 1981

Investment & Property Studies: Overseas companies, setting up, uses & practices (including: tax efficient finance for overseas operations; successful use of tax havens; double tax agreements; personal taxation of international executives) (Seminar), London (United Kingdom), December 2 (English).

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FEBRUARY 1982

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JUNE 1982

The Inter-American Center of Tax Administrators (C.I.A.T.): XVIth General Assembly on the basic subject: Tax evasion and tax compliance, Asunción (Paraguay), June (date unknown yet) (Spanish).

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Business Perspectives Ltd., 11 Alexander Place, London SW7 2SG, United Kingdom.

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Institute for International Research, 70 Warren Street, London W1P 5PA, United Kingdom.

Investment & Property Studies Ltd., Norwich House, Norwich Street, London EC4, United Kingdom.

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The Design of Schedular and Global Systems of Income Taxation – **The International Dimension**

by Sylvain R.F. Plasschaert*

I. THE FRAMEWORK: COMPETING JURISDICTIONAL PRINCIPLES AND WAYS TO ALLEVIATE DOUBLE TAXATION

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I. THE FRAMEWORK: COMPETING JURISDICTIONAL PRINCIPLES AND WAYS TO ALLEVIATE DOUBLE TAXATION
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   B. Two major assignment rules
   C. Double taxation
      1. Unilateral relief in the residence countries
         a. The foreign tax credit
         b. The exemption method
         c. The separate rate system
         d. The deduction method
      2. Bilateral tax conventions
II. THE SCHEDULAR OR GLOBAL TAX ARCHITECTURE AND INTERNATIONAL TAXATION
III. CONCLUSION

A. International economic involvement

When factors of production flow across borders, the question arises which government has the right to levy taxes and according to which criteria. A British citizen, for example, may live in Switzerland on income from real estate on the French Riviera, possess shares in American companies and conduct business activities in Italy. Or a Dutch corporation carries out production in a number of foreign jurisdictions, both in Europe and Latin America, thus qualifying for the standard definition of a "multinational enterprise"; the same firm may also earn royalties upon the licensing of know-how to an unrelated company in India.

Unquestionably, international economic involvement is on the rise. Nowadays portfolios of securities held by individual or institutional investors, typically, are internationally diversified. More particularly, non-American portfolios tend to contain shares issued by American companies and traded on the New York Stock Exchange, the world's largest. But the flow of foreign income, in the form of dividends, interest payments and other proceeds from capital, accruing to individual taxpayers has become dwarfed by the profits or other proceeds from investments (such as royalty payments) which multinational enterprises obtain from their direct investments in foreign host countries.

The tax problems resulting from the international involvement of firms and individuals render the subdiscipline of "international taxation" exceedingly complex. Fortunately, for our specific purposes, there is no need to embark upon a full-fledged analysis of the subject. Yet, prior to discussing the compatibility of alternative techniques of taxing foreign income with the basic tenets of the schedular or global tax architecture, an overview of the main principles which, in the midst of a bewildering variety of detailed provisions, govern the field of international taxation appears useful.

B. Two major assignment rules

A sovereign country, in principle, enjoys unrestricted powers to design and implement taxes. However, a government's fiscal claim would remain theoretical if the physical possibility to reach the taxable object and/or the tax subject were lacking. Taxable objects and/or subjects must be linked with that country in a fiscally relevant way. Besides, the requirements of comity between nations and the need not to unduly obstruct international trade and investment impose significant restrictions on fiscal sovereignty by both custom and treaty law.

In essence, two basic principles shape the right of sovereign countries to levy taxes. They are, respectively, the "territoriality" or the "source" criterion, on the one hand, and the "residence", "domicile" or "situs" principle, on the other hand. Obviously, no problem whatsoever arises when the territoriality and residence rules coincide for a given taxpayer, e.g. those who are domiciled in a given country and who derive all their income from (whatever) domestic sources.

According to the *source* rule, income must be subjected to taxation in the country in which it originates, irrespective of whether the income accrues to a nonresident or to a resident taxpayer. In the first example above, France and Italy would be entitled to exert a tax claim on real estate and on business income respectively, whereas the United States would mobilize revenue out of dividends paid by U.S. companies to the foreign investor (abstracting from some difficulties in defining "source" and from divergent interpretations amongst countries).

Some good reasons support the claims to tax jurisdiction according to the territoriality principle. In the source country, inputs have been put to fruition by the non-resident, production is greatly facilitated by intermediate public goods, such as transport facilities,

* Professor at the University Faculties St. Ignatius, University of Antwerp, and at the University of Leuven (Louvain).

provided by the host government. A political argument which carries a nationalistic taint is that foreigners have been allowed to operate in the national economy and to compete with domestic entrepreneurs. Finally, in countries in which foreigners supply a substantial part of productivity resources, as is typically the case in the developing world, the adoption of only the residence principle would involve a significant loss of revenue. In terms of national accounting, in those countries, the Gross National Product (GNP) is smaller than Gross Domestic Product (GDP) on which the source criterion is predicated.

The *residence* principle assigns the taxing authority to the country in which the taxpayer has his residence. In this respect, tax law, generally, looks through formal criteria, such as the taxpayer's nationality, and retains the place where the taxpayer really has settled more or less permanently. In the above example, not Great Britain but Switzerland would lay claim to income taxation. For companies, most often, the locus of the effective management is the controlling factor.[1]

The justification for the claims by the residence or home country appears less solid. It could be asserted that the source or host country benefits from the inflow of factors of production which have been nurtured by educational and other outlays of the home country government; to the extent those resources could have been as productively employed in the home country, the latter sacrifices a portion of its potential welfare. Another and in fact probably the main argument in support of the residence criterion is related to the very philosophy of the global approach to income taxation which postulates that all net incomes, from whatever source derived, can be brought within the taxable base. But this remark already foreshadows our discussion in the next section.

If only either the source or the residence principle were unanimously applied, few problems would emerge as regards international taxation and, in principle, no double taxation would ensue. In the first hypothesis, for example, Switzerland would refrain from any jurisdictional pretense; only the various "source" countries would hit the net receipts flowing to the resident in Switzerland. Conversely, if the residence principle were universally and exclusively adopted there would again be no risk of international double taxation: Italy, France and the United States would renounce their right to tax, and the various incomes would only become liable to tax when they accrue to the resident in Switzerland.

But in actual tax practice and for valid reasons, many countries do concurrently implement the two basic jurisdictional rules. If countries were to exercise only the residence principle, they would forego any tax claim on income which originates within their borders and accrues to non-residents. No country has been willing to renounce this right. As a matter of fact, no government can reasonably be asked to grant exemption to non-residents on income generated within its boundaries. A government may be put under pressure to treat foreigners and nationals alike, in accordance with the "non-discrimination" standard, but it would be inequitable and unrealistic to expect governments to treat foreigners more leniently than their nationals. Hence, it comes as no surprise that numerous countries combine the taxation of residents on their world-wide income(s) and that of non-residents on proceeds originating within their borders.

One should add that countries which adhere exclusively to the territoriality principle renounce their claims on one type of revenue, viz., the one that could be secured by taxing its residents on income from foreign sources. Realistically, however, that country must heed the fact that the foreign host country will already have exerted a claim on the same income by virtue of the territoriality principle.

This overview of jurisdictional criteria must be complemented with two remarks about the taxation of non-residents in host countries. First, the host country subjects those incomes not only to its individual income or corporate tax (with, possibly, specific modalities, as discussed hereafter) but most often also to a withholding tax. The latter is levied when the incomes are effectively transmitted abroad (in the form of dividends, interest or royalties) to the non-resident recipient. Second, some countries only submit foreign income to their own income tax to the extent profits are effectively remitted by the foreign subsidiary to the resident parent company. In other words, dividends and not the total net earnings of the subsidiary are held taxable in the home country. This is the so-called *deferral rule*: foreign income only comes within the grasp of the residence state upon its effective remittance.

It follows that both the withholding tax on outflowing earnings of the subsidiary in the host country and the deferral rule discriminate against distributed profits and contain a built-in incentive to retain profits within the subsidiary in the host country — abstracting from the measures of relief for international double taxation mentioned hereafter and which may significantly modify this outcome.

The system just outlined, however, only applies to profits generated in subsidiaries, i.e. in business units abroad which are incorporated in the host country and enjoy legal personality. Subsidiaries are the prevailing form of doing business abroad. The other form, the branch, which is not a legal person, is commonly subjected to another tax status. Provided the branch can be characterized as a "permanent establishment", the profits accruing to it are subjected to the corporate tax in the host country, as are the profits of subsidiaries. The home country, however, taxes them on a current basis; total profits of the subsidiary are added to those of the parent company. Another difference is that remittances to the parent normally are not subject to the withholding tax. To simplify matters, in the subsequent analysis we no longer look at branches, but only at subsidiaries.

The deferral rule is to be contrasted with the *accrual* method, whereby all net profits of the foreign unit, whether retained or distributed, would be brought with-

1. Although some countries, notably the United States, relate "residence" to the country of incorporation.

in the taxable base within the home country. As just mentioned, the latter method is typically used with respect to foreign branches.

C. Double taxation

The preceding analysis readily suggests that the same income component becomes subject to double taxation whenever the residence state reaches for the taxpayer's world-wide income while the source state concerned observes the territoriality rule. Income or profits produced in the host country would be subject to (a) tax on income or profits and, upon distribution, to a withholding tax in the host country and to (b) individual income or the profits tax, predicated upon world-wide income, in the home country. Such a sequence of taxes, if unmitigated, would at present-day rates result in a confiscatory burden and would fatally discourage international economic intercourse.

Fortunately, a number of rules have been evolved to put order in the conflicting claims of sovereign countries and to alleviate international double taxation. These procedures fall into two distinct categories. Several countries which adhere to the residence principle unilaterally retreat from their claims on their residents' foreign-source income: to this effect, in setting their own tax parameters they take into account the taxes already suffered in the source country. Besides, sovereign countries have entered into bilateral tax treaties which harmonize the claims of the contracting governments and further eliminate elements of double taxation.

1. Unilateral relief in the residence countries[2]

a. The foreign tax credit

Among the four major systems to be distinguished, the foreign tax credit is widely used. In fact, the main capital-exporting countries, viz., the United States, the United Kingdom, the Federal Republic of Germany and Japan, apply the "foreign credit system", obviously with significant variants. In this approach, the taxes effectively paid in the host country on the dividends remitted are deducted from the tax on world-wide income which is due in the home country. Portfolio investors will be able to credit the taxes withheld on dividends and the like against the individual income tax in their country of residence. In some countries, and foremost in the United States, parent companies are also entitled to a credit, i.e. to deduct from their tax liability on world-wide profits, not only the withholding tax on dividends remitted, but also the underlying host country tax on the net profits of the subsidiary, to the extent that tax bears on the distributed portion of profits.

This system contains a built-in balancing mechanism which is illustrated here with respect to corporations. Assuming full distribution of profits, and whenever the taxes levied in the host country are lower than those in the home country (which is often, though not always, the case in developing countries), the parent company, when receiving the profits from abroad, pays what I would like to call a "balancing" tax. This extra tax amounts to the difference between the domestic tax theoretically due on the world-wide profits and the taxes incurred in the host country. For example, let us assume that the host country levies a 30 percent corporate tax and subjects dividends to a 20 percent withholding tax, whereas the home country imposes a 50 percent corporate tax on world-wide profits. In the host country, out of earnings of US $ 100, tax liabilities of $ 44 would already have been incurred. As a matter of fact, the host country would have applied a 30 percent corporate tax to the net profits before tax of $ 100 and have withheld 20 percent on $ 70 (i.e. on the profits *after corporate tax*). If we now assume that the home country assesses world-wide profits at 50 percent, the firm, upon the remittance of the prefits originating within its subsidiary abroad, would have to pay a balancing tax of $ 6 in the home country. However, in the contrary case, in which the creditable tax burden in the host country exceeded that in the home country, the firm would not be entitled to any refund.

Supposing (a) full distribution of the subsidiary's profits and (b) a higher tax rate in the home country as compared to the host country and under (c) the customary *ceteris paribus* assumptions, the firm would face the same tax burdens on its foreign as on its domestic projects. The tax factor would not disturb the efficient allocation of investible resources among countries. After-tax returns are equalized from the viewpoint of the investing company. So-called *capital export neutrality* would ensue.

As to the division of the revenue proceeds between the two countries, the source country will normally obtain the lion's share. The balancing tax levied by the residence country, if at all, will usually be small, the more that the deferral rule tends to reduce or to delay remittances to the parent company. But in case the host country, in order to attract direct investment from abroad, grants generous tax incentives, the benefit of such favors might be nullified by the balancing tax in the home country, which would then recoup whatever the host country has renounced. Tax sparing provisions in a number of bilateral agreements between developed and developing countries tend to counter this unfavorable boomerang effect of incentive provisions; the taxes condoned in the host country could nonetheless be credited against world-wide income taxation in the capital exporting country.

b. The exemption method

The second approach consists in exempting the foreign-source income from taxation in the home country. This method is tantamount to the application, in the two countries, of the territoriality principle. In the process, the residence country, in fact, abandons its claim to world-wide assessment on the basis of the residence principle. One related consequence is that, taxwise, foreign and domestic companies are put on equal footing in the host country. *Capital import neutrality* is

2. Where corporations are involved, this paper limits itself to an analysis of the relationship between taxation in the host country and corporate taxes in the home country; the complex issue connected with the relationship of the parent company and its shareholders is not dealt with there.

thereby achieved. The Netherlands and France adopt the exemption approach.

This approach contains an incentive, other things being equal, to channel investible funds to the host country, if the rate is lower than in the home country.

c. The separate rate system

A few other countries, such as Belgium (with respect to permanent establishments), apply a (substantially) lower rate to foreign-source than to domestic income. Double taxation is not thereby eliminated. Whether ventures abroad are taxed more heavily than domestic ones depends upon the parameters involved. It is conceivable, indeed, that the combined burden of a (comparatively low) tax on income in the source country and of the (much reduced) tax which the residence country levies on the foreign source income may be lower than the rate which applies to domestic income in the home country.

In case corporate taxes in the host and the home country carry the same rate, this system would result in a higher burden on income from foreign operations, as compared to domestic ones.

One may notice that this approach carves the theoretical, world-wide taxable base into two segments which are then taxed separately.

d. The deduction method

A last approach would consist in allowing the deduction of taxes already paid in the host country not against the home country *tax* (as in the foreign tax credit) but against the (world-wide) *taxable base* in the country of residence. The taxes due abroad, then, are viewed as costs of doing business. Although, to my knowledge, this system is nowhere used as the basic scheme for alleviating international double taxation, it is worth analyzing on account of its underlying philosophy and its implications for the allocation of investible resources between the home and host countries. Obviously, from the *viewpoint of the company*, in most circumstances, this deduction method is considerably less favorable than the "foreign tax credit" or the "exemption method"; hence, it will discourage the flow of outward investment from the home country. But this is precisely the outcome which the deduction method is striving for. It approaches the choice between domestic and foreign investment not in terms of the interests of the firm, but of those of *the home country;* more specifically, the extra revenue, which flows into the coffers of the Treasury — as compared to the "foreign tax credit" formula — must also be taken into account. It can be shown that such *national efficiency* is attained when the after-tax return from foreign-source operations equals the gross return from domestic ventures.[3]

2. Bilateral tax conventions

Unilateral relief measures often are inadequate to relieve all elements of double taxation. Further progress towards a more neutral international tax environment is achieved through bilateral double taxation agreements. Negotiation of such treaties is facilitated by a common set of concepts and criteria which have been multilaterally adopted within O.E.C.D.[4] Limitations in the withholding taxes levied by the source country on dividends and interest are one of the main ingredients of such conventions; royalties, as far as they do not derive from immovable property, are held to be taxable only in the residence state.

Among industrial countries, a comprehensive network of bilateral agreements has become established. The number of conventions between developed and developing countries, or between the latter, is also on the increase.

The asymmetry of investment flows between rich and poor countries, with the latter typically acting only in a capital-importing role, however, raises objections by developing countries about the appropriateness of O.E.C.D.-type conventions. Developing countries, therefore, strive towards adapting their bilateral conventions more to their needs. To some extent, treaty law heeds such desiderata. The concept of "permanent establishment" is somewhat broadened. Developing countries, especially in Latin America, are also loath to soften the fairly high withholding taxes which they apply on outflows of dividends and the like.

This brief discussion of prevailing rules in the field of international taxation suggests some rather interesting *conclusions*. First, although many countries apply the residence criterion and reach out for world-wide profits, the simultaneously exercised claim by the source country forces them to a substantial retreat. Second, on the whole — and although treaty law reduces the withholding taxes levied — the host countries exert, so to say, a right of pre-emption to taxable revenue. The various methods to alleviate international double taxation usually only leave a minor slice of the taxable cake to the home country. Even if the "deduction method" were applied, the home country would only retain a comparatively small portion of the taxable base out of foreign direct investments which have actually been made; but the deduction method would act as a disincentive against investments abroad.

II. THE SCHEDULAR OR GLOBAL INCOME TAX ARCHITECTURE AND INTERNATIONAL TAXATION

In the previous section we surveyed, in broad outline, generally accepted principles which bring some order in what would otherwise be an uncivilized struggle among countries for tax revenue. We now investigate, in systematic fashion, whether the territoriality or the residence principle, or a combination of the two, is compatible with the schedular or the global paradigms. Occasionally, so far, aspects of the specific query to

3. In the United States, the deduction method is advocated by several groups, especially in trade union circles. The theoretical analysis owes much to *Richard and/or Peggy Musgrave*, in various publications.
4. See *Company Tax Systems in O.E.C.D. Member Countries* (Organisation for Economic Co-operation and Development, Paris, 1973).

which this section addresses itself have already come to the fore.

Let us first look at *global income tax systems.*

As regards individuals, they aim at subjecting all income items to a progressive rate formula and at personalizing tax liability. One must therefore naturally expect that the global income tax system country will adhere to the residence criterion and reach for world-wide income. Otherwise, interpersonal equity between persons with the same overall income and identical personal circumstances would be seriously distorted. To turn the argument around: under the assumption that the global income tax would adopt the territoriality principle to resident taxpayers, the latter would gain by spreading their overall income over various jurisdictions. Such "splitting" into two or more separate lots would allow them to soften the full impact of high marginal rates.

A world-wide reach is clearly inherent in progressive taxation in a global income tax framework. But, both conceptually and in practice, the application of the residence principle in global systems is breached in several ways.

First, in order to effectively include foreign-source income in the world-wide taxable base, the home country must be in a position to ascertain the existence of those incomes obtained abroad. In some cases, as when multinational enterprises prepare consolidated accounts, the scope for concealing foreign source profits is severely curtailed — even abstracting from the fact that the "foreign tax credit" mechanism contains a built-in incentive to declare foreign-source income to the tax authorities in the home country. But, frequently, opportunities for hiding foreign-source income remain available to the alert taxpayer.

Income from so-called Eurobonds may serve as an appropriate example. From the early days of that market, in the 1960s, it has become standard practice to organize the issues in such a way that no withholding tax applies in the country of the issuer.[5] Countries in which the bondholder is residing oblige the latter to declare the interest from Eurobonds. But as these bonds are issued and circulate in bearer form and since bondholders have little difficulty in cashing the coupons in jurisdictions which do not withhold tax vis-à-vis non-residents, the opportunities for evading income taxation on Eurobonds are quite large, indeed. Accordingly, the fisc of the residence country, in attempting to capture foreign-source income, must often put its hopes on high standards of honesty and voluntary compliance of the resident taxpayer and on cooperation with foreign tax authorities. However, international collaboration, while progressing (as amongst E.E.C. partners), is still limited.

Second, while countries with global-type income taxation impose their residents on a world-wide footing, they are bound to apply, at the same time, the territoriality standard to non-residents. At an earlier stage we noted the reasons for this dichotomy. As a matter of fact, the fisc of the residence country only perceives those incomes that are produced within its territory; it has neither the right nor the physical possibility to meddle in the income streams of the same non-resident taxpayer that originate elsewhere. It follows that the taxation of non-residents bears on a "partial" taxable base; in other words, it has a "schedular" character. In fact, the taxable base for non-residents most often is segmented even more as each income type — say, salaries or various types of capital incomes — is usually taxed separately and, where feasible, through withholding.[6] The taxes on non-residents also have impersonal features. The tax (= object) and not the taxpayer (= subject) is the primary concern; personalizing features, such as allowances for dependents, would make no sense when only a portion of the overall income of the non-resident is canvassed and when the resident country, as long as it succeeds in securing the intended yield from the taxable object (preferably, through stoppage-at-the-source), may not even care to identify the income recipient.

Third, the residence countries, while asserting their right to impose the foreign-source incomes of their residents, are constrained in effectively taxing them, not only because of the inefficiencies in tax administration already mentioned but on account of the need to provide statutory relief for double taxation. Otherwise, as we have already explained at some length, the combined burden of source and residence countries would become prohibitive and their own companies would be prevented from entering foreign markets. The only alternative option would consists in retreating into an isolationist shell and in discouraging outward foreign investment; as discussed earlier, such a policy would call for the adoption of the "deduction method" (see I.C.1.d). Thus, the joint effect of the residence criterion and of the relief measures reminds one of the "Echternach" procession: two steps forward are followed by one step backwards. The tax revenue that accrues to the home country is usually a small portion of the yield preempted by the host country.

Fourth, the inclusion of foreign-source income in the taxable base of global systems is eminently sensible with respect to *individual taxpayers* whose tax liabilities are modulated by progressive rate formulas, according to the canon of (interpersonal) capacity to pay. The same rationale, however, is not appropriate for *companies.* As explained in another paper,[7] taxes on the corporate level, whether on total profits or only on retained earnings, should carry flat rates and impersonal features. This is particularly true for large, open companies (small, closed ones are often much more akin, in their economic characteristics, to partnerships).

5. When the country of residence of the company applies a withholding tax on interest paid to non-residents, the practice has emerged to assign the issue to an ad hoc small subsidiary in a tax haven (e.g. Luxembourg or the Netherlands Antilles). In a legally valid way, the issue is then launched by, say, a Luxembourg company; the small capital base of that "launching pad" subsidiary does not deter investors as the parent company unconditionally guarantees the obligations of that subsidiary.

6. Except for companies whose net receipts from whatever source (commercial turnover or income from capital participations) are merged into the same taxable base.

7. See *Sylvain R.F. Plasschaert,* "The Treatment of Enterprise Profits in Schedular and Global Frameworks of Income Taxation", in 35 *Bulletin for International Fiscal Documentation,* June 1981.

The ability-to-pay principle and the associated graduation of rates provide no solid argument for the world-wide taxation of companies operating on an international scale. But are there other rationales that can be construed in support of the world-wide taxation of corporate profits? By "splitting" their overall income over various jurisdictions, individuals can escape the brunt of high marginal rates; but this argument, which solidly backs the world-wide base for taxing the income of individuals, is not relevant for corporations which should be subject to flat rates. A multinational company would only fetch a lower overall tax burden, as compared to a hypothetical uni-national firm with the same aggregate taxable profits, if the tax rates abroad were lower than in the home country.

One other explanation stems from revenue considerations. A net capital exporting country would surrender all claims on a substantial part of taxable income if it were to apply only the territoriality standard: foreign-source income would only remain taxable in the host country, indeed. Although the ambitions of the resiscaled down, in order to avoid unbearable international double taxation, the world-wide reach of the residence principle, attenuated by the "foreign tax credit" mechanism, ensures a tax treatment of corporations which does not significantly discourage foreign investments and which provides, in many cases (when foreign tax rates are lower than those in the host country), a neutral treatment of national companies irrespective of whether they operate in the home country or abroad.

Another conceivable argument for world-wide taxation, and an eminent one, would point to the fact that foreign subsidiaries have intimate links with their parent company and are subordinated to the latter's overall strategy: often, the various stages of a vertically integrated production process are performed in different subsidiaries and are technically interdependent. Hence, the separate assessment of profits of the foreign subsidiary, in isolation from the overall functioning of the multinational enterprise, may be rather artificial. The large "internalized" payment flows, on account of trade or other transactions among associated units of the same multinational family, also give scope for manipulating the prices on internal trade so as to minimize overall tax burdens, by shifting part of the taxable base from the severely to the more leniently taxed country.[8]

But the most appropriate and logical way of taxing multinational enterprises in an integrated way would consist in the single assessment, in the home country, of the consolidated profits of the multinational enterprise, whereby the yield would be allocated over the various countries involved. There are many objections, both of principle and especially with respect to feasibility, that can be levelled against such a daring approach. Among other things, countries would have to agree, almost on a world-wide basis, about the "keys" for allocating the revenue, taxed and collected in the residence country, over all countries in which the firm is productively engaged. Accounting standards would have to be largely harmonized. Since a supranational tax authority, on a world-wide scale, is as yet unthinkable, this "world taxation" would have to be administered by the national tax authorities of the home country. And yet, such an approach can no longer be ruled out as unconceivable. As a matter of fact, some states in the United States, among them California, devise their state income taxation along those lines. California-based units of companies, with their headquarters outside the state, are assessed on the basis of the percentage which the Californian unit represents in the world total of given parameters such as turnover, employment and assets. In coming years, progress can be expected as regards the harmonization of accounting standards; the obligatory criteria, imposed by the "Financial Accounting Standards Board" in the United States, have in themselves already achieved uniformity in accounting for the foreign operations of the large number of U.S.-based multinational enterprises. While agreement on allocation keys would run into thorny questions, one must not overlook that in other areas of public policy, such as the apportionment of tax revenues over various levels of jurisdictions in federal states, similar problems had to be solved. Finally, the scheme of world taxation — or "unitary taxation", as it is termed in the Amrican states concerned — would do away with the need to monitor the internal or transfer prices practiced within multinational enterprises.

In sum, "unitary taxation", as specified a moment ago, is no longer to be discarded as an impossible dream, although its implementation on a large scale is still many years away. It would install a truly "global" type of income taxation, but of a special kind: as under present global income tax systems, corporations would be assessed on their world-wide net profits. But this would no longer occur after the source countries have applied their corporation tax to the subsidiaries within their borders whereas the "foreign tax credit" mechanism softens the imposition of the home country tax on world-wide income. Consolidated net profits would be assessed only once, *uno actu*, in the home country, and the revenue thus collected would be apportioned over all the countries in which units of the same multinational firm have been contributing to the overall profits.

We now turn our attention to *schedular* systems of income taxation, to ascertain how they should, and how they actually, treat foreign incomes accruing to their residents, on the one hand, and domestic income benefitting non-residents, on the other hand. In a first stage, we assume that the schedular system applied incorporates the ingredients which should logically follow from the schedular paradigm, i.e. from the segmented, separate assessment *and imposition* of different types of income. The schedular design is essentially object-centered; it should carry proportional rates which are differentiated according to the nature of the income involved. It comes as no surprise that pure schedular systems typically adopt the territoriality rule with regard to the international dimension of income taxation. That criterion focusses upon the object of taxation, not on the subject of the taxing process, i.e. on the

8. On the complex problems connected with those "internal" prices, see *Sylvain R.F. Plasschaert*, "Transfer Pricing in Multinational Enterprises — An overview of concepts and mechanics and regulations", ECSIM and Saxon House, 1979.

taxpayer. As, by definition, no progressive tax formulas are operated, there is no need to globalize the partial incomes in order to rationally set tax liabilities according to each taxpayer's ability to pay. Furthermore, as in a strictly, schedular system, each type of income would be administered separately; the assessment process would not, in itself, imply a global look at all incomes, including the foreign-source ones, contrary to what is required when the residence principle is being used.

With respect to non-residents, the stance of schedular systems is basically similar to that in global systems; as just mentioned, taxation of non-residents must, of necessity, have an impersonal and a schedular profile, the same outcome also derives from the object-centered character of schedular income taxation.

The same "objectivity" of schedular taxation also explains that residents are taxed only on domestic-source income; in "pure" schedular systems, differentiated personal circumstances and graduated rates should not determine the taxpayer's liabilities.

One may further notice that if all countries were to apply schedular income taxes and the territoriality rule as well, international double taxation would logically become impossible.

Although, *in substance*, in consistent schedular systems of income taxation only the source principle should be adopted, *in form*, any extension of the claims of a given country beyond the territoriality criterion and the conceivable exercise of the residence principle could be easily accommodated within a schedular system. To that effect, foreign income would form a separate segment of taxable income and be imposed at its own flat rate. This extension may derive from revenue considerations. As a matter of fact, countries may wish to lay claim on some revenue which would otherwise remain outside their reach; the potential revenue foregone would be of some importance whenever a given country has become a capital exporter and the seat of a growing number of companies which go multinational. But, even then, the schedular country would have to recognize the prior claim of the source country on the income which resident taxpayers receive from foreign sources; hence, the net revenue proceeds to the residence country are likely to be rather small.

In actual fact, in some countries, schedular systems have extended their claims beyond those postulated by the territoriality principle. Thus, before Belgium shifted to a more or less global system in 1963, some of the schedular taxes were based on the residence system. For example, residents were also subject to Belgian tax on proceeds from real estate abroad. Other examples could be cited. In this context, however, one must recall that some schedular systems had already turned into "semi-personalized" ones, thus rendering a world-wide taxation of income more advisable.

On the whole, today's developing countries adhere to either the source or residence principle, according to whether or not they have a schedular or a global-type system of income taxation. In passing, one may recall that the territoriality principle involves less revenue loss for a net capital importing, developing country than for industrial states which have the opposite characteristics. There are several exceptions to those general statements, however.

An interesting survey of Latin American practice generally confirms the above correspondence between jurisdictional rules and basic architectural styles of income taxation. Out of 20 countries, eight apply the criterion of world-wide income both to resident individuals and corporations. Among them one finds Colombia which has a global system; and Mexico where a hybrid scheme, with separate progressive taxes on labor and on capital incomes, is in force. Two countries, Brazil and El Salvador, apply the residence criterion only to individuals but the territoriality principle to companies — a practice which is also basically that of France.[9] The same overview of Latin America also reveals, interestingly, that "of the eight countries mentioned above — which totally or partially apply the world income criterion — all with the exception of Honduras have provisions in force with regard to admission of the foreign tax paid abroad as credit against the tax payable in the country, and Mexico even authorizes crediting of the exempted tax (tax sparing) with the exception of income deriving from capital gains.[10]

III. CONCLUSIONS

This paper deals with highly complex substantive and technical problems. In contrast to much of the literature on international taxation, it is advisable to go beyond the discussion on the competing criteria of residence and of territoriality and to investigate the measures, taken unilaterally by home countries and agreed-upon bilaterally, to alleviate international double taxation. As a matter of fact, the final tax burden on individuals and companies which are involved in international operations derives from the application of both the above-mentioned jurisdictional rules and of the procedures tending to delineate the claims of the host and home countries. The outcome of the residence-principle-cum-relief-measures tells a substantially different story than what could be superficially inferred from the residence criterion itself. Considering the prior enitlement of the source country to the taxable base, the residence country is bound to tune down its own claims.

One must also look at the objectives which underly the relief provisions enacted by the residence countries. Thus, the foreign tax credit, in given circumstances, involves exactly the same tax liability as if the individual taxpayer had received all his income from domestic sources. But in other cases, as under the exemption

9. For a synopsis of practices in major industrial countries, see *Mitsuo Sato and Richard M. Bird*, "International Aspects of the Taxation of Corporations and Shareholders", *IMF Staff Papers*, Vol. XXII: 2 (July 1975), pp. 452-53. This excellent study delves further into the subject by investigating the international aspects of those schemes which seek some degree of "integration" between the taxation of the corporate body and the latter's shareholders within a given state.

10. See *Latin America: Source versus Residence Principle* (Intertax 1978/11-12, pp. 443-44. Citation from p. 444).

method of relief, the unity of the taxable base is destroyed and foreign-source income is segregated from domestic-source income. Furthermore, for various reasons, theoretical and practical, the taxation of domestic-source income which accrues to non-residents is bound to have a schedular nature and impersonal features; it is taxed separately from other income of the same taxpayer (which is taxed by the latter's residence country).

Another finding which is often overlooked is that care should be taken to distinguish the taxation of corporations and of individuals. Modern corporations should not be subjected to progressive rates; hence, the ability-to-pay doctrine cannot possibly provide a convincing rationale for the world-wide taxation of corporate profits. And yet, countries with global-type income taxation assess corporations on world-wide profits. Upon further reflection, the world-wide reach of those corporate taxes could be predicated upon the objective of achieving so-called capital export neutrality, whereby the overall burden on foreign and on domestic investments is largely equalized. But if other views shape the unilateral relief measures adopted by the residence countries, world-wide taxation of corporate profits is no longer achieved, or not even aimed at.

Finally, we briefly discussed a conceivable alternative to taxing multinational enterprises. This approach would consist in assessing the world-wide profits in the home country, and in apportioning the revenue collected by that country over the countries in which the multinational enterprise operates through its subsidiaries, branches or other permanent establishments. This is, obviously, an ambitious scheme, which is beset by many difficulties and whose implementation is not feasible overnight. But, apart from the fact that a few states in the United States base their state income tax on this concept, one may not overlook that the present system whereby two basic jurisdictional principles often clash and relief measures are not able to completely eliminate international double taxation is neither an ideal nor a simple system.

INDIA:

Tax Incentives for Energy and Environment

In view of the social, economic and industrial needs of India, the government has introduced in the Finance (No. 2) Act, 1980, with effect as of September 1, 1980, a weighted deduction of 125 percent of expenditure incurred on all research and development programmes approved by the Secretary of the Department of Science and Technology.

The term "weighted deduction" is not mentioned in the Income-tax Act, 1961, as amended, but is understood to mean a deduction of more than the actual amount of expenditure so as to promote investment in such areas as desired by the Government.

A weighted deduction will be enjoyed by approved programmes for research and development absorbing imported technology or relating to the development of a new source of energy capable of being commercially exploited. It will also apply to R & D programmes geared to improving the efficiency of existing methods of energy generation and distribution as well as conservation of energy, or improving the existing processing and manufacturing techniques applied in agriculture, industry, etc. R & D programmes also entitled to the weighted tax deduction include development of watershed hydrologic instruments as well as watershed management and flood control; better techniques for utilisation or recycling of wastes, better techniques for reducing or controlling pollution and developing new sources of nutritional food for human consumption. In addition, the new sub-section (2B) of Section 35 of the Income-tax Act 1961, as amended, also covers R & D programmes related to production of improved or cheaper basic drugs for the treatment of communicable diseases or the more prevalent human and animal diseases; new methods or cheaper techniques of family planning acceptable to the masses; discovery of new building materials with a view to reducing cost or substituting scarce material with special references to rural areas, improving varieties of fertilisers, plant nutrients and plant production chemicals aimed at achieving greater yield per hectare, devising new manufacturing techniques of production of goods resulting in substantial conservation of foreign exchange by way of import substitution or through export promotion.

R & D programmes relating purely to market research, sales promotion, quality control, testing, style changes, etc. will not qualify for consideration. Similarly, expenditure incurred on acquisition of land or buildings will not qualify for the weighted deduction.

It should be noted that sub-section (2A) of Section 35 of the Income-tax Act of 1961, as amended by the Direct Taxes (Amendment) Act 1974 with effect as of April 1, 1974, already granted a 133 1/3 percent weighted deduction where an assessee pays any sum to a scientific research association or university or college or other institution approved by the prescribed authorities for research programmes undertaken by scientific research institutions or universities. With effect from September 1, 1980, R & D programmes undertaken in public sector companies shall also enjoy the 133 1/3 percent weighted tax deduction.

Report on the Anglo-Dutch Tax Seminar

HELD ON MAY 7-8, 1981 IN AMSTERDAM*

Outline of the program for the seminar

Thursday, May 7

Panel discussion — general comments on the new Netherlands—United Kingdom (income) tax treaty

Panelists:

(1) Mrs. A.H. Smallwood, Member of the Board of United Kingdom Inland Revenue.

(2) Mr. R.A. van Gorkum, Deputy Director for International Fiscal Affairs, Ministry of Finance of the Netherlands.

(3) Mr. J.F. Spierdijk, Loyens & Volkmaars, Den Haag.

(4) Mr. Lindsay Duncan, tax consultant, Amsterdam.

Mrs. Smallwood delivered a general discussion of the treaty as a whole, and many of the points she addressed are set forth in Sec. II. below. The speeches delivered by Messrs. van Gorkum and Spierdijk are reprinted in full in the May-June 1981 issue of EUROPEAN TAXATION (see below for further details). Mr. Duncan confined his remarks to the two Consultative Documents recently released by the U.K. Inland Revenue on "Company residence" and "Tax havens and the corporate sector".**

Friday, May 8

Morning Session:

A. Exchange of information

Speaker: Mr. Max Widmer, until April 1980 Chief of the Division for International Fiscal Law and Double Taxation Matters of the Federal Tax Administration of Switzerland.

B. The treatment of the concepts of domicile and residence under the Dutch and U.K. legal systems

Speakers:

Mr. John Avery Jones, Solicitor, London.

Mr. D.A. van Waardenburg, Executive Director, International Bureau of Fiscal Documentation.

Afternoon Session:

Panel discussion — open-floored question and answer period, with particular emphasis on the new Article 10(3)(d).

** The text of these two Consultative Documents is printed in full in 21 EUROPEAN TAXATION 2 (1981) at 56 et seq.

I. INTRODUCTION

The Netherlands and the United Kingdom have entered into a new treaty for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains. The new treaty was concluded on November 7, 1980 and entered into force on April 6, 1981, and replaces the earlier 1967 convention and 1977 protocol.

Although the changes introduced by the new treaty are not numerous, they are nevertheless important and will have far-reaching consequences for the affected taxpayers. This is particularly true of the new Subparagraph (d) which was added to Para. 3 of Article 10 on dividends.

The new Subparagraph (d) was designed specifically to curtail the growing use of Netherlands "conduit companies" to lower their overall liability to U.K. tax. Thus, the new provision makes it more difficult for companies resident in the Netherlands to obtain the one-half tax credit with respect to dividends paid by companies resident in the U.K.

Taxpayers have not exactly greeted the enactment of the new Subparagraph (d) with open arms. For one thing, they frown on the purpose of the provision, since it aims to close a loophole in the treaty by means of which it had been possible for them to chop an appreciable amount off their tax bill. But the problem in the case of the new Subparagraph (d) goes beyond the mere elimination of treaty abuse. In other words, not only does it prevent the extension of the tax credit to those taxpayers not intended to benefit under the treaty; in addition, it requires taxpayers who *are* entitled to the credit to *show* that they are so entitled.

This shifting of the burden of proof to the taxpayer is one objection which has been voiced against the new Subparagraph (d). Another criticism of the new provision is that its application is unclear in the case of a dividend distribution effected through a chain of companies. In other words, is it required that all the links in the chain of companies qualify for the credit? This question, in turn, raises other problems related to the scope, application, and interpretation of Subparagraph (d).

Given these questions and objections, and the potential for controversy which they create between the tax authorities and the affected taxpayers, the Dutch and British branches of IFA decided to arrange a seminar during which interested parties could pose their questions and generally air their views concerning the new Subparagraph (d) and the new treaty as a whole.

The forum for these discussions was the Anglo-Dutch Tax Seminar held in Amsterdam on May 7-8, 1981. The members of the panels represented both the Revenue and the private sector of both the U.K. and the Netherlands. The Seminar was attended by the tax representatives of Netherlands and U.K. companies, accounting firms and law firms.

The main focus of the discussions conducted during the course of the seminar was on the new Subparagraph (d). Other topics which were given special attention included the treatment of the concepts of residence and domicile under the Dutch and U.K. legal systems, and the treaty provisions for the exchange of information between the contracting states.

* This report was written by Mrs. C.S. Salomons-Bobbett and Ms. L.M. Stern with the assistance of the staff of the International Bureau of Fiscal Documentation.

The following pages contain a summary of certain points of interest emphasized by various panelists, as well as a synopsis of the panel discussions and the question and answer period which followed. This report should be read in conjunction with the special double issue of EUROPEAN TAXATION (May-June 1981) which is devoted almost entirely to the seminar and related matters, and includes:

1) an article on treaty shopping, with a particular emphasis on the efforts to curtail the use of treaty shopping schemes under the U.S.—U.K. and Netherlands—U.K. conventions;
2) the full text of the speeches addressed during the seminar by:
   a) Mr. R.A. van Gorkum, "Passing the Test for the U.K. Dividend Tax Credit: A commentary on the New Article 10(3) Subpara. (d) of the Netherlands—U.K. Double Taxation Convention".
   b) Mr. J.F. Spierdijk, "Netherlands—United Kingdom Double Taxation Convention: The New Article 10(3) Subpara. (d) — Warnings of Overkill".
   c) Mr. John F. Avery Jones, "Domicile and Residence in the United Kingdom".
   d) Mr. D.A. van Waardenburg, "The Concept of Residence under Netherlands Tax Law".
   e) Mr. Max Widmer, "Exchange of Information".
3) a tax note discussing the treatment of the concepts of residence and domicile in the Isle of Man; and
4) an article on Estate, Inheritance and Gift Tax consequences for persons moving between the United Kingdom and the Netherlands.

II. GENERAL PANEL DISCUSSION

A. A Bit of Background[1]

The first comprehensive double taxation treaty between the Netherlands and the United Kingdom was concluded in 1948. This was replaced by a new convention in 1967, and amended by a protocol in 1977 following the introduction of the imputation system into the United Kingdom taxation scheme. The protocol introduced a provision granting the dividend tax credit to recipients resident in the Netherlands. Individuals and companies owning less than 10 percent of the voting power in the company paying the dividend were entitled to a full credit, and companies owning 10 percent or more of the voting power in the company paying the dividend were entitled to a one-half credit.

Initially the U.K. stance was opposed to the credit for direct dividends paid to non-residents; however, this stance has been altered and current legislation favors the granting of the credit. In this respect, the United Kingdom is considerably less restrictive than other countries having imputation systems which do not allow the credit to non-residents, even when they are resident in a treaty partner country.

Problems arose when taxpayers resident in third countries, who were not themselves entitled to the credit, began to use Netherlands "conduit companies" so as to qualify for the U.K. dividend tax credit. The U.K. government sought a means of resolving these problems, but decided against the enactment of an additional protocol. Rather, the previous Netherlands—U.K. treaty was renegotiated, thus affording both sides an opportunity to incorporate any and all changes they desired, and also allowing the new treaty to be brought into line with the 1977 O.E.C.D. Model Double Taxation Convention.

The new treaty was concluded on November 7, 1980, and entered into force on April 6, 1981 (which, coincidentally, is also the beginning of the U.K. individual tax year). Some of the differences between the 1967 treaty — as amended by the 1977 protocol — and the new treaty, and between the O.E.C.D. Model Treaty and the new treaty, are as follows:

SOME SIGNIFICANT DIFFERENCES FROM THE 1967 TREATY/1977 PROTOCOL

(1) Under Article 2, "TAXES COVERED", the new treaty now *in*cludes the U.K. development land tax, and *ex*cludes the Netherlands capital tax.
(2) Under the "SHIPPING AND AIR TRANSPORT" article (Art. 9 in the 1967 treaty; Art. 8 in the new treaty), liability to tax is now determined on the basis of the "place of effective management", rather than on the basis of residence.
(3) Article 21, "OTHER INCOME", of the new treaty (having as its counterpart in the 1967 Treaty Art. 23, "INCOME NOT EXPRESSLY MENTIONED") has been altered so as to expressly exclude trust income from its coverage.
(4) Article 26, "DIPLOMATIC AGENTS AND CONSULAR OFFICERS", has been introduced into the new treaty so as to bring it in line with the O.E.C.D. Model.

DIFFERENCES FROM THE O.E.C.D. MODEL CONVENTION

(1) In the "BUSINESS PROFITS" article (Art. 7 in both cases), the reference in the O.E.C.D. Model to the independent method of assessment is not included in the new Netherlands—U.K. Treaty.[2]
(2) Similarly, in the "ASSOCIATED ENTERPRISES" article (Art. 9 in both cases), the reference to adjustments which is made in the O.E.C.D. Model does not appear in the new Netherlands—U.K. treaty.[3]
(3) Under the article on "DEPENDENT PERSONAL SERVICES" (Art. 15 in both cases), the O.E.C.D. provision dictates that "remunerations derived in respect of an employment exercised aboard a ship or aircraft" are taxable "in the Contracting State in which the place of effective management of the

1. The materials in this sub-section are based primarily on the speech delivered by Mrs. A.H. Smallwood of the United Kingdom Board of Inland Revenue.
2. It was suggested during the seminar that this reference to the independent method of assessment was excluded because it appeared to be an endorsement of the unitary system.
3. However, it was mentioned during the seminar that such adjustments would be made in practice.

enterprise is situated", whereas under the new Netherlands—U.K. treaty such remunerations are taxable "only in the State of which the employee is a resident".

(4) As mentioned earlier, under the "OTHER INCOME" article (Art. 21 in both cases) the Netherlands—U.K. treaty expressly excludes trust income from the scope of the article.[4]

B. The New Art. 10(3) Subpara. (d)[5]

The principal departure found in the new treaty from both the 1967 treaty/1977 protocol and the O.E.C.D. Model is Article 10, Para. 3, Subpara. (d). The text of the new subparagraph reads as follows:

"(d)(i) Notwithstanding the provisions of Subparagraphs (b) and (c) of this paragraph, no tax credit shall be payable where the beneficial owner of the dividends is a company, other than a company whose shares are officially quoted on a Netherlands stock exchange, provided that the conditions for admission to such quotation, and in particular those governing the minimum value of the shares to be admitted, the transferability and the dispersion of the shares, are in conformity with the conditions set out in schedule A to the Directive of the Council of the European Communities dated 5 March 1979 No. 79/279/EEC, unless the company shows that it is not controlled by a person or two or more associated or connected persons together, who or any of whom would not have been entitled to a tax credit if he had been the beneficial owner of the dividends.

(ii) For the purposes of this subparagraph a person or two or more associated or connected persons together shall be treated as having control of a company if under the laws of the United Kingdom related to the taxes covered by this Convention he or they could be treated as having control of it for any purpose, and persons shall be treated as associated or connected if under those laws they could be so treated for any purpose. However, where an individual is treated as having control of a company by reason only of the fact that he holds ordinary shares in the company carrying full voting and dividend rights and that individual holds not more than 10 percent of the total number of such shares in the company, the shares held by him shall be left out of account in determining whether the company is controlled by a person or two or more associated or connected persons together, who or any of whom would not have been entitled to a tax credit if he had been the beneficial owner of the dividends payable to the company, provided that not more than 25 percent of the total of such shares in the company may be left out of account."

The objective of this new provision is to prevent the granting of the U.K. one-half tax credit through the intermediary of a Dutch company to non-residents who receive dividends from a company resident in the U.K. but who are not intended to benefit from the credit provisions. The controversy which has arisen concerning Subpara. (d) stems *not* from the objective of the provision, but rather from the manner in which it is sought to achieve this objective. In other words, the objections voiced in respect of Subpara. (d) are directed against the *form* of the provision, and not against its substance.

The operation of the provision involves the application of a two-pronged test, viz.:

(1) Are the shares of the controlling Netherlands company quoted on the Netherlands stock exchange?

If the answer to that question is "no", then:

(2) Can the controlling company show that it is *not* controlled by taxpayers who are not entitled to the credit?

Thus, the ultimately decisive question is one of control — or, rather, "non-control". Although this "negative" approach (i.e. requiring a company seeking the credit to show that it is *not* controlled by unqualified taxpayers) may not be the ideal method, the treaty negotiators feel that it is the most comprehensive and workable test.

During the course of the Anglo-Dutch Tax Seminar, a number of general questions were raised regarding the Subpara. (d) approach. One area of concern was that the provision was "tailor-made" so as to apply specifically to Netherlands "conduit companies" receiving dividends from companies resident in the United Kingdom. The justification offered was that the Netherlands is *not* being singled out in this area. Rather, it is intended that this type of provision will, in the future, form part of the U.K. "standard treaty package", and will be included in treaties concluded with any other countries where it is found that routing of this kind is being practiced. The negotiation of such treaties will call for the cooperation of the other government involved, as well as for a high degree of technical expertise.

Along the same lines, i.e. by way of objection to the "tailor-made" approach of Subpara. (d), it was queried why a more general approach was not used, e.g. a kind of "safe haven" test under which companies seeking the credit have only to show that they are owned to a certain extent, say 75 percent, by Netherlands residents? It was suggested that such a general test would be preferable in that (1) it is more flexible and could be included in treaties with all countries; and (2) it relieves the taxpayer of the onerous burden of proving "non-control". The reply from the panelists representing the tax administrations was that the general approach was not used because it was inadequate for dealing with the complex and difficult subject matter involved. It was also pointed out that Subpara. (d) *does* make available one very large "safe haven", namely, the quoted company (i.e. quoted on the Netherlands Stock Exchange). And although it was not explicitly stated during the conference, it might be implied that a general "safe haven" rule was undesirable because it would allow greater opportunities for tax avoidance, and that the tax

4. The effect of this exclusion is that the U.K. loses its tax charge on non-resident beneficiaries of discretionary trusts.

5. See note 1 supra.

administrations wished to exercise a stricter control in this area.

A number of other more specific questions were raised regarding the application and interpretation of Subpara. (d). One question concerning the 10 percent and 25 percent levels established in Sub-subpara. (d)(ii) asked, firstly, whether these levels were "fair" ones and, secondly, how the tax administration planned to apply the provision in borderline cases. The panelists representing both the Dutch and U.K. tax administrations asserted that these levels were, indeed, regarded as "fair", and that they felt a good balance had been struck. It was pointed out that the results of the application of the new Subpara. (d) would be closely monitored,[6] and the two tax administrations have agreed that if the dividend provision proved unsatisfactory, negotiations would be resumed and the clause could be altered (including a readjustment of the 10 and 25 percent levels) and given retroactive application. It was also stated that in bona fide borderline cases the tax credit will be extended where reasonable, and it is anticipated that in practice the fears of "overkill" in connection with the new Subpara. (d) will not be realized. While on the one hand this seems to be an equitable solution, on the other hand it still leaves the taxpayers involved in a position of uncertainty.

Perhaps the biggest bone of contention lies in the question of the "chain of control". In other words, would control by an intermediate company which is *not* qualified for the credit break the chain of entitlement, such that the credit would be unavailable to any and all companies further down the chain? A private letter sent in February by a Member of the U.K. Board of Inland Revenue to an accountant firm in London[7] had indicated that, no, the chain would not be broken; however, the panelist representing the Inland Revenue emphasized, along with an apology, that this letter was in error and its contents had been retracted. The correct answer in the U.K. view is that, yes, each and every company in the chain must be qualified to receive the credit, and that an unqualified link at any intermediate level will break the chain of entitlement. This question was discussed at some length in the panel discussion conducted on the second day of the seminar, and is reported in greater detail in Sec. III infra.

Also in the area of the control question, it was asked what the result would be under the new Subpara. (d) if *no one* is in control? The example used was a Dutch corporation (B.V.) which is 25 percent owned by each of four different foreigners none of whom is entitled to the credit. Would the Dutch B.V. be entitled to the one-half credit? It was suggested that if such a case actually existed it should be brought to the attention of the Inland Revenue for their consideration, but that under these circumstances it would most likely be difficult for the Dutch corporation (B.V.) to qualify for the credit.

C. Company Residence: The U.K. Viewpoint[8]

One principal area of discussion during the Anglo-Dutch Tax Seminar was the U.K. test for the determination of company residence.[9] This topic was brought to the fore in light of the Consultative Document on Company Residence recently released by the U.K. Internal Revenue.[10]

The basic problem in this area is that no definition of the concept of "company residence" currently exists. The old test relied upon by the Inland Revenue, which is no longer used, was "where the central management and control abide". At present, the Inland Revenue emphasizes as an important criterion for the determination of company residence "where the company's board meetings are held". This assumes, however, that central management and control are exercised by the Board, which is not always the case since there can be many layers of management within a company.

Two reasons were cited for wanting to adopt a new test for the determination of company residence, viz.:

(1) The U.K. has become a member of the E.E.C. and the current rules are inconsistent with its obligations to other E.E.C. members; and
(2) The abolishment in the U.K. of exchange control in 1979 destroyed the spirit behind the Income and Corporation Taxes Act (ICTA) Section 482.[11] If Sec. 482 is abolished, amended or replaced, the rules for the determination of company residence will become an important tool for combating tax avoidance.

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6. In this same connection, the following reference was made in an article concerning the new Art. 10(3)(d) of the Netherlands—U.K. Treaty published in ONDERNEMING No. 19 of May 15, 1981 at 11:
"It is important that in practice it be monitored to what extent the above-mentioned limitation [under Art. 10(3)(d)] of the right to claim (one-half of) the British tax credit has more far-reaching consequences than simply the prevention of the unintended use of Netherlands holding BVs. Therefore, the VNO (Dutch Employers' Federation) requests that it be informed of concrete instances in which there is no improper use of the so-called "close company", but in which the British tax authorities have nevertheless refused to grant (one-half of) the tax credit. The VNO will contact the Ministry of Finance upon the request of the interested parties in such cases."
7. Somehow the contents of this letter were given wide circulation among the private sector.
8. The material in this sub-section is based primarily on the speech delivered by Mr. Lindsay Duncan.
9. Also discussed in this connection was the related Inland Revenue Consultative Document of about the same date on "Tax Havens and the Corporate Sector". It was suggested by representatives of the private sector that the proposals set forth in that Consultative Document are comparable to the U.S. Sub-part F legislation, although the U.K. revenue representative countered that the proposals in the consultative document were more restricted and did not go as far as the Sub-part F provisions. The main critisms of the Consultative Document on Tax Havens were: (1) that it suggests the implementation of legislation allowing the Inland Revenue to tax income which is not paid to and in no way belongs to the U.K.; (2) that point 6) of the Document, in particular, creates problems because it allows no flexibility in the case e.g. of tax holidays; and (3) that, above all, the proposals are objectionable because they are extremely arbitrary and taxpayers have no way of ascertaining their tax liability in any tax haven situation.
10. See note ** supra.
11. The text of Section 482 ICTA is reprinted in full in 21 EUROPEAN TAXATION 2 at 56.

The Consultative Document suggests a number of alternative tests that might be adopted. One suggestion was where the company's "day to day management" is carried out, which is the test currently used in the Netherlands. It was asserted, however, that this test could not easily be administered in the United Kingdom.

Another approach which might be employed is the "incorporation under domestic law" test, i.e. companies incorporated under U.K. law are subject to U.K. tax. This is the test that has already been adopted by many of the O.E.C.D. countries. However, one school of thought is that if the incorporation test is adopted in the United Kingdom it will result in an exodus out of the United Kingdom of non-resident companies. The only additional requirement to leaving the United Kingdom which did not previously exist is that the migrating company must now first obtain permission from the U.K. Treasury. Such a mass exodus would have no positive repercussions for either the companies or the Inland Revenue. The Inland Revenue will wind up in the same position in which it now finds itself, that is to say, with nothing. And the migrating companies will stand to lose even more since, although they are not subject to tax, they *are* subject to the rules and regulations of the Companies Act which provide a well-defined and regulated structure within which to operate, not to mention the sources of knowledge and expertise available in the U.K. to assist them in conducting their operations efficiently. The danger is that the companies will migrate to countries in which these conditions do not exist.

In sum, the old test for determining company residence has proved inadequate, but the proposed alternatives have met with considerable opposition. It is generally agreed that there is a definite need for a statutory definition of company residence in addition to the definition established by case law. In light of the numerous and strong objections to the Consultative Document, it will be interesting to witness what reaction they will elicit on the part of the Inland Revenue, and even more interesting to see what test will finally be adopted for the determination of company residence.

III. QUESTION AND ANSWER PERIOD

The afternoon of the second day of the seminar was devoted to a panel who answered written questions submitted by the participants. These gave rise to an interesting, and sometimes controversial, discussion between the participants and the panel members.

The panel members numbered six: three from England and three from Holland. The three English members were. Mr. R.T. Esam (Chairman), Mr. H.R. Roe, and Mr. J.D.B. Oliver; and the three Dutch were: Mr. T. Dekker, Mr. P. den Boer and Mr. N. Nobel.

1. Subject

The first question was on Article 10(3)(d)(ii) of the treaty. The text of the relevant part of this sub-subparagraph (see Sec. II.B. supra for the complete text of that section) reads as follows:

"For the purpose of this subparagraph a person or two or more associated or connected persons together shall be treated as having control of a company if under the law of the United Kingdom related to the taxes covered by this Convention he or they could be treated as having control of it for any purpose, and persons shall be treated as associated or connected if under those laws they could be so treated for any purpose."

Question:

According to Art. 10(3)(d)(ii) of the new treaty persons (i.e., individuals and companies) shall be treated as associated or connected if under the laws of the United Kingdom they could be so treated for any purpose.

Section 302(1) ICTA 1970 contains a definition of "associated *company*", whereas Section 303, Subsections (3) and (4) contains a definition of "associate" which basically refers to the relatives of an *individual*.

Is there any provision in U.K. law, according to which a company and an individual can be deemed to be associated or connected persons, as that situation is apparently not covered by either Section 302 or Section 303?

Response:

The Section which treats companies and individuals as connected is Section 533 ICTA.

2. Subject

The second question was concerned with two concepts in Dutch company taxation. The questioner wanted to know what the effect of the participation privilege (deelnemingsvrijstelling) is on fiscal unity (fiscale eenheid).

Question:

The questioner provided a concrete example when more details were requested. A U.K. company had apparently taken over a Dutch trading company, which has two subsidiaries. As the two subsidiaries are losing money, the plan is to liquidate them. How can tax relief be obtained for these losses?

Response:

The reply clearly stated that the participation privilege has nothing to do with fiscal unity. The participation privilege is only concerned with tax free dividends and capital gains between associated companies.

Fiscal unity, however, implies treatment as one single taxpayer of a parent company and its 100 percent owned subsidiary or subsidiaries and consequently the setting off of losses of a subsidiary against the profits of the parent. There would, in this case, be no problem in obtaining relief for a subsidiary's losses on the liquidation of the subsidiary. The taxpayer must be sure to liquidate, since if he merely sells the shares he will not qualify for the set-off. The shares must have been owned for a certain period of time, i.e. from the beginning of the relevant accounting period, but not necessarily for the whole of the accounting period.

Some of the conditions to be satisfied are:
1) the shares must have been held by the parent since the beginning of the parent's financial year; and
2) the losses must be made after the date of the formation of the "fiscal unit".

Note: Losses made prior to the take-over of the subsidiary by the parent are not eligible for set-off. This can provide accounting problems as to whether the losses existed on the date of the formation of the union or not.

The requirements for the participation privilege to operate were also given. The participation privilege is available, in the case of a Dutch parent and subsidiary, if the parent owns at least 5 percent of the shares of the subsidiary. If less are owned the Minister of Finance may upon request grant the participation privilege, provided that either one of the following two conditions is satisfied:
a) the parent hold the shares in the course of its normal business operations; or
b) the acquisition of the shares is of general interest.

The participation privilege is available to a Dutch parent with a foreign subsidiary if:
a) the above conditions applying to a Dutch parent/subsidiary relationship are satisfied;
b) the foreign company is *subject* to tax *similar* to the Dutch corporation tax (the rate of the tax is not important); and
c) the Dutch company does not hold the shares as a portfolio investment.

Note that in practice, a Dutch holding company in an international group of companies will always be accorded the privilege.

3. Subject

The next questioner criticised the attitude of the U.K. government in limiting the tax credit in the way employed in Article 10(3)(d)(ii) of this treaty. He claimed that it discriminates between Dutch companies, and even punishes bona fide companies. He gave the example of a Canadian parent company with a U.K. manufacturing subsidiary. In such a case the Canada—U.K. tax treaty does not afford the Canadian parent the U.K. tax credit. Before the new Netherlands—U.K. treaty, the Canadian parent could interpose a Dutch company which would have been entitled to a tax credit under the old Netherlands—U.K. tax treaty. According to the new treaty, the tax credit is not available.

Response

In response it was pointed out that the imputation system does not discriminate. The Canadian company will suffer double taxation on the profits derived by the U.K. company, but its only recourse is to a bilateral treaty between its country and the United Kingdom as it is the purpose of such treaties to solve the problem of double taxation. Such treaties are a result of negotiation and, as it is the policy of the U.K. government to grant the tax credit to non-residents in its bilateral treaties, the absence of the appropriate provision in the Canada—U.K. treaty probably evidences the reluctance on the Canadian side to concede a like benefit to U.K. residents.

It was also pointed out that there was no discrimination in a failure to grant the tax credit to a non-resident who paid no U.K. tax on his income anyway. If the recipient of the dividend was also a U.K. company, that company would suffer U.K. tax in one way or another on its profits. The U.K. resident was granted the credit to prevent U.K. tax being paid on the some profits twice. When it is accorded to a non-resident it means effectively that no U.K. corporate tax, or less in case of half the credit is being paid on that part of the U.K. profits. ACT (advance corporation tax) is only a part of the tax which U.K. companies pay on their profits.

4. Subject

On various occasions, the Netherlands Under-Minister of Finance has apparently declared that, in his opinion, the "beneficial ownership" concept in tax treaties could be used against abuse or improper use of, inter alia, "conduit companies" established in the Netherlands. In his view, the shareholders of e.g. a conduit company can be regarded as the "beneficial owners" of the income of the "conduit company", which implies that the tax authorities would be able to "pierce the corporate veil" on the basis of "beneficial ownership".

The Under-Minister once formulated his opinion as follows (in our translation):
"It is pretended (by the Netherlands 'conduit company') that the income is enjoyed by a resident of the Netherlands. If this is actually not the case, in that the 'conduit company' redistributes the income, the Netherlands tax administration is able to inform the tax authorities of the other country (i.e. the country of source) that the *beneficial owner* (emphasis added) is not a resident of the Netherlands. That is the way it works. The tax authorities of the source country can then determine whether the 'conduit company' is entitled to the benefits of the treaty provision."

Questions:

a) Do the members of the panel agree with the Under-Minister that under British and/or Dutch law in the absence of specific provisions a shareholder in a company can be deemed to be the "beneficial owner" of the company's income? If so, would that apply generally, or under special ("improper use") circumstances only?
b) If the answer to the above question is yes, could the members of the panel indicate why it was felt necessary to change the dividend article in the U.K.—Netherlands treaty by adding more specific rules against "conduit companies" to the unchanged "beneficial ownership" requirement?

Response

The U.K. members of the panel confirmed that U.K. law did not support the Dutch Under-Minister of Finance's point of view on beneficial ownership. Under U.K. law beneficial ownership cannot be transferred, and the concept cannot be used to pierce the corporate veil in the absence of specific rules.

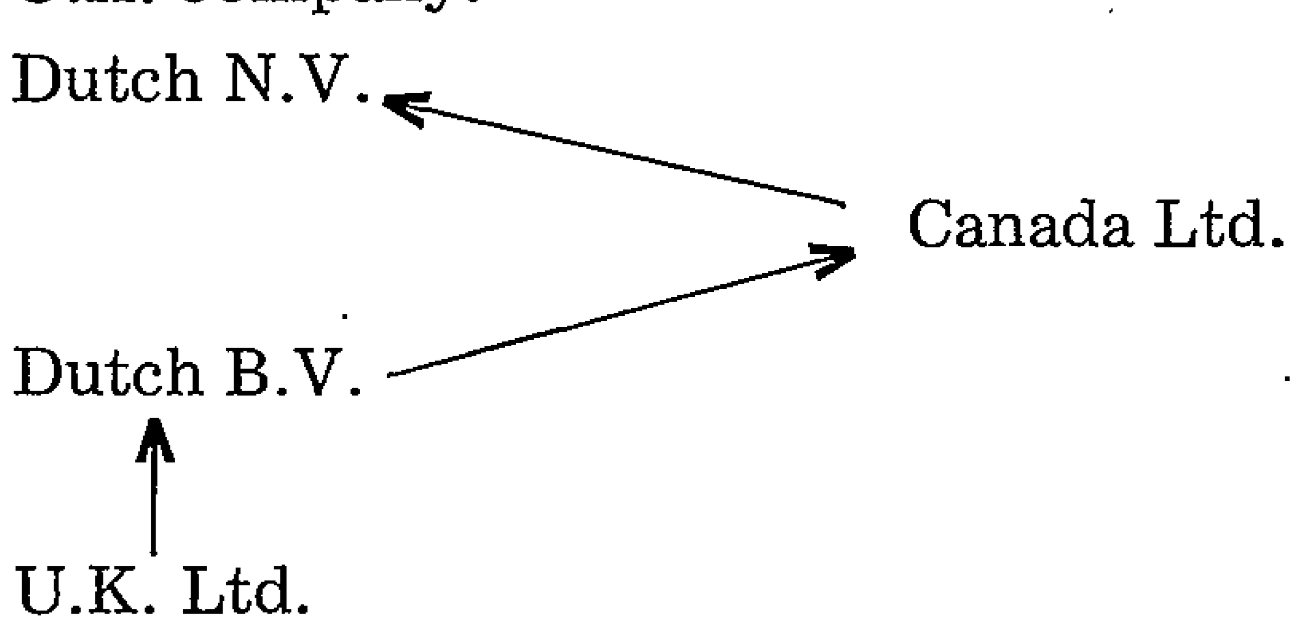
It appeared from the discussion that followed that the term beneficial owner in Article 10(3)(d) has been translated into Dutch as "uiteindelijke gerechtigde", which means the ultimate owner. This concept is decidedly different from the British concept of beneficial owner. The problem for the Dutch will be in understanding that concept. The crux of the Article 10(3)(d) provisions revolves around the words in Sub-subparagraph (i), which state:

"... no tax credit will be payable where the *beneficial owner* (emphasis added) of the dividends is a company, other than a company whose shares are officially quoted on a Netherlands stock exchange, ... unless the company shows that it is not controlled by a person ... who ... would not have been entitled to a tax credit if he had been the beneficial owner of the dividends".

It is the U.K. government who is giving the tax credit. Consequently, the two crucial terms "beneficial ownership" and "control" — which operate hand-in-hand within the context of the provision — will, in practice, be interpreted according to U.K. law, and the English version is therefore the more important.

Example

The following example was considered to illustrate how the chain of entitlement to the tax credit is broken when the beneficial owner of the dividend is controlled by a company which itself would not be entitled to a tax credit on direct receipt of the dividends from the U.K. company.



The arrows indicate the flow of dividends. The Dutch N.V. is quoted on a Netherlands stock exchange but the B.V. is not. Each company is a 100 percent subsidiary of the other.

Under U.K. law the Dutch B.V. is the beneficial owner of the dividends from the U.K. Ltd. To see whether it is entitled to the tax credit under the treaty, it must pass one of the following tests, applied in the followiing order:

1) Is it quoted on a Netherlands stock exchange?
2) Is it controlled by a company which would not itself be entitled to the tax credit in the same situation?

The Dutch B.V. fails on the first test.

Under U.K. law, the Dutch B.V. is controlled for the purposes of the second test by both the Canada Ltd. and the Dutch N.V. Although B.V. passes the second test in respect of N.V. (as a Dutch quoted company it is entitled to the tax credit), it fails in respect of Canada Ltd., since the Canada—U.K. treaty does not accord the tax credit to the Canadian corporate recipient of U.K. source dividends. Thus the chain is broken by Canada Ltd., and B.V. will not be entitled to the tax credit.

On reflection, it is obvious that if N.V. owned the shares of B.V. directly, instead of through a Canadian subsidiary, the tax credit would be available. Also, if Canada Ltd. was a mere nominee the tax credit would be payable to B.V. because, in that case, Canada Ltd. would not control B.V.

Suppose, however, that Canada Ltd. is substituted by a Bermudan company, i.e. a tax haven company. Such a situation makes it obvious why the U.K. government introduced the provision into the treaty, and the use of tax haven companies will no longer be beneficial in this type of situation.

5. Question:

During the negotiations for the treaty, was the taxation of the profits from the exploration and exploitation of the seabed and subsoil discussed?

Response:

Yes, substantial agreement was reached, but it would have held up the main correction if it was to be included. A protocol on the subject may be expected in the future.

6. Subject:

A question was raised in connection with the quotation of a company's shares on a Netherlands stock exchange, as passing this test entitles the Dutch company to claim the tax credit without having to show who controls it. It was asked whether shares included certificates.

Response:

It was not clear to the British members of the panel nor the British participants what was meant by this question, as only a company's *shares* are quoted in Britain. The following explanation was provided:

It is possible in Holland for a fund, similar in some ways to a trust, to own part or all of the shares of a company. The fund retains all the rights, e.g. voting rights, given by the shares, and issues bearer certificates which pass on a right to the income of the shares to the certificate-holders. The shares can be considered as being held in trust by the fund for the certificate-holders, who enjoy the financial rights attached to these shares. The fund may or may not be incorporated. In either case, the certificates may be quoted on the stock exchange.

The arrangement described above is commonly used by two very different types of companies, viz.:

a) Large Dutch N.V.'s (similar to public companies), such as Unilever, prevent the control of the company falling into unknown or unwelcome hands in this way. Their shares are not quoted on the stock exchange but are owned by such a fund whose certificates *are* quoted on the exchange. The fund, therefore, retains the voting power and control of the company. The company can never come under anyone else's control without its knowledge.

b) It may also be used in close companies where the shareholders cannot agree about the running of the company. Their shares may be transferred to a fund which will objectively run the company, exercising the rights of the shareholders as a group and passing on the dividend to the certificate-holders, i.e. the previous shareholders. Such certificates would, of course, not be quoted on the exchange.

In the first case, a problem can arise when the N.V. receives dividends from a U.K. subsidiary. Its shares are not quoted on the stock exchange, so it does not pass the first test in Article 10(3)(d)(i) applied to the beneficial owner of the dividends; it must therefore pass the second "control" test. If the fund is regarded as being in control of the N.V., its *certificates* are quoted on the stock exchange and so, if it was the beneficial owner it would seem that the second test is satisfied and the N.V. is entitled to the tax credit.

However, Article 10(3)(d)(i) says that the *company's shares* must be quoted. Is the fund a company? Yes, if it is incorporated. Do shares include certificates? The answer to this question is not clear. If yes, the second test is passed. If no, the question then becomes: Who controls the fund? As the certificates are bearer certificates, this is not an easy question to answer. It was hoped that the Inland Revenue would regard shares as including certificates so that the problem would be avoided. Control of the fund will not necessarily be in the hands of the certificate holders of the fund. If it is a company, the shareholders will most likely control the fund. Who will these shareholders be? The N.V. will probably hold all the shares. In which case there is a chicken and egg situation whereby the control test will be satisfied.

If the fund in this case is not incorporated, one is thrown back onto Article 10(3)(b) of the treaty which stipulates the circumstances under which other persons (including unincorporated persons) resident in the Netherlands are entitled to the tax credit on the receipt of U.K. dividends. If the fund is incorporated and its certificates are quoted on the exchange it becomes more difficult to see what the answer would be. Perhaps, it would be regarded as controlling the N.V., in which case the tax credit would be available since the fund is resident in the Netherlands. If one must look through the fund to the certificate holders the same problem of identity mentioned above arises, i.e. it is unlikely that anyone will know who the holders are. Where a private company's shares are held by a fund, the problem remains that of determining who controls the company.

An attempt was made to draw an analogy between a fund and a British trust fund. In a capital gains case dealing with a voting trust which owned company shares, the court looked through the trust to its beneficiaries and regarded them as the owners. However, the answer to the question still remains uncertain.

IV. CONCLUSION

All in all, everyone that attended the seminar would undoubtedly agree that it was a huge success, and that the purposes for which it was originally organized were not only fulfilled, but surpassed. As planned, panelists and participants alike were given an opportunity to pose their questions and express their views concerning the new treaty. In the course of the discussions, it became evident that there is a considerably widespread degree of dissatisfaction with some of the new provisons — especially the new Art. 10(3)(d) — and doubt as to whether they will prove adequate. In response to these indications of discontent, however, the representatives of the U.K. and Dutch tax administrations expressed the concern of their respective governments that these problems will be accorded the attention they deserve, and that every effort will be made to reach a workable solution. Thus, the seminar provided a forum not only for a general "airing of views", but also for the opposers and supporters of the new provisions to confront one another directly with their arguments concerning the shortcomings or merits of these measures. It is hoped that everyone came away from the seminar with at least one reaction in common, namely, that the new treaty provisions are not flawless, and that the tax administrations and taxpayers share a mutual interest in working together to discover and correct these flaws. It should be kept in mind that the U.K. Government has apparently committed itself to revising the controversial Article 10(3)(d) if and when it proves to be inequitable.

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International Tax Avoidance – The Impact on Legal Systems*

by Nathan Boidman, C.A., B.C.L., LL.B.**

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I. INTRODUCTION– THE INTEREST IN TAX AVOIDANCE?

A proper starting point is perhaps an inquiry as to what may reasonably be the interest of the *World Peace Through Law Center* in tax avoidance, which is the attempt to use the law so as to reduce or eliminate the obligation to pay tax.

A. As a catalyst for cooperative inter-governmental activities

A first interest could be that efforts to counteract tax avoidance have the effect of promoting cooperative inter-governmental activities. Much as in the case of international programs to combat criminal activities, governments (and to some extent groupings of governments organized along geographic or socio-economic lines) increasingly seek to deal with international tax avoidance, particularly as it might arise out of the operations of multinational corporations, by cooperating with each other in structuring and carrying out anti-avoidance measures. Such efforts, aimed at a common third party "adversary", certainly can be considered helpful in increasing the degree of harmonious, benign relationships between governments and in diverting governmental time, energies and resources from what might otherwise be areas of inter-government conflict.

Thus, tax avoidance could be considered in a somewhat perverse fashion to be an agent for promoting peace among governments. Such efforts have intensified over the last ten to fifteen years, perhaps proportionately to the development of other areas of inter-governmental economic cooperation and activities; examples follow.

In Strasbourg last March the *Council of Europe* held a "Colloquy" on International Tax Avoidance and Evasion. The scope of this activity was reflected in the foreword to the "Compendium of Documents" published by the Council, a portion of which reads as follows:

"*In accordance with Order 369 (1978) and Resolution 699 (1979), the Committee on Economic Affairs and Development, in liaison with the Legal Affairs Committee, organized a Colloquy on International Tax Avoidance and Evasion from 5 to 7 March, 1980 at the 'Palais de l'Europe' in Strasbourg. The main purpose of this colloquy was to study in depth the proposals made in Recommendation 833 (1978) of the Parliamentary Assembly and to enlighten parliamentary and public opinion on the complex aspects of international tax avoidance and evasion (as well as related subjects such as bank secrecy and tax havens). Approximately 200 participants, parliamentarians from member states of the Council of Europe, governmental officials, experts, representatives of inter-governmental and non-governmental organizations and journalists took part in the colloquy.*"

On 18 September 1980 the *International Fiscal Association* held an unusual session in the course of its annual meeting (which brings together 500—1000 senior governmental officials and members of the professions involved in international tax) in Paris to deal with "Recourse to Tax Havens — Use and Abuse".[1]

* Paper submitted to the 10th Conference on the Law of the World, World Peace Through Law Center. This article describes the state of law as of March 30, 1981 and therefore does not, for example, include reference to the landmark decision of the House of Lords in *W.T. Ramsey Ltd.* v. *Commissioner of Inland Revenue*.

** Tax Consultant to Courtois, Clarkson, Parsons & Tetrault.

1. The paper has been published by Kluwer and includes reports from the United Kingdom, the Netherlands, Germany, France, Japan, the United States, Switzerland and Canada.

On 12 January 1981 the United States Treasury tabled a special report on "Tax Havens and the Use by United States Taxpayers — An Overview" which would, inter alia, lead to more cooperation between governments.[2]

In its comprehensive study of the topic, the *Rotterdam Institute for Fiscal Studies* reported in "International Tax Avoidance, a Study by the Rotterdam Institute for Fiscal Studies"[3] on anti-tax avoidance measures in Belgium, France, Germany, the Netherlands, the United Kingdom and the United States. In Part Six of the study, a review is made of "collaboration between governments", citing the following cooperative intergovernmental programs:

- the first bilateral agreements for exchange of information in the 19th century;
- the first multilateral work on international tax evasion, emerging from the *League of Nations*;
- the third report on tax treaties between developed and developing countries (United Nations, New York 1972) dealing with tax fraud and international cooperation;
- various efforts of *The League of Nations* culminating in the "London Model Convention of 1946";
- the model tax conventions of the *Organization for Economic Cooperation and Development (O.E.C.D.)* in 1963 and 1977;
- the 1973 Report commissioned by the *Council of Europe* on the use and abuse of holding companies;
- the *Council of Europe* Resolution of 10 February 1975 "on the measures to be taken by the Community in order to combat international tax evasion and avoidance";
- the E.E.C. Directive on Mutual Assistance by the Competent Authorities of Member States in the field of direct taxation, December 1977, "which was intended to combat fiscal fraud or evasion or avoidance across tax frontiers";
- the 1979 O.E.C.D. study on multinational pricing;[4]
- the Nordic Convention in 1973 dealing with cooperative administration of tax law;
- the 1977 "Recommendation of the Council (of the O.E.C.D.) on Tax Avoidance and Evasion";
- in 1967 the *United Nations* established the "ad hoc group of experts on tax treaties between developed

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The Press Release respecting the meeting (A(81)8 dated 27 February 1981) reads as follows:

> "Tax inspectors and auditors met at the headquarters of the Organisation for Economic Co-operation and Development in Paris on 23-25 February 1981. This was their fourth meeting to discuss the detection of tax avoidance and evasion. These meetings form part of the regular cooperation between national tax administrations in O.E.C.D. countries carried out under the sponsorship of the O.E.C.D. 'Committee on fiscal affairs'.
>
> The theme chosen from this meeting was transfer pricing by multinational enterprises and constituted one of the follow-ups to the publication in 1979 of a report 'Transfer Pricing and Multinational Enterprises' by the O.E.C.D. Committee on Fiscal Affairs'. This report — in addition to the original publication in English and French — has now been translated or is in the process of being translated into Dutch, Finnish, German, Italian, Japanese and Spanish.
>
> The meeting was attended by some 60 tax inspectors actually engaged in auditing company accounts in O.E.C.D. countries. The focus was, therefore, on the practical aspects of detecting transfer prices which do not correspond to arm's length prices, that is, prices which could be charged between independent enterprises. Participants discussed questions related to the selection of cases for in-depth audit, transfer prices for the exchange of goods, research and development, capital end services, and the different opportunities available to tax administrations to co-operate with other countries through exchanging information, simultaneous audits or joint audits. The discussions were based on expositions by national rapporteurs drawing upon actual experience but respecting confidentiality as to the indentity of the taxpayers involved. It is intended that there should be further meetings of this type."

---

2. The report, prepared by Richard A. Gordon, Special Counsel for International Taxation, the International Revenue Service, states in a covering letter:

> "In response to your request, I am pleased to submit the enclosed report which is based on a study and an analysis of tax haven transactions, United States Internal Tax Laws applicable thereto, United States Income Tax Treaties, and the attempts of the tax administrators to deal with these transactions."

See also the article "Highlights of the U.S. Treasury Report on Tax Havens and Their Use by U.S. Taxpayers", by Victoria Tkachenko, in this issue.

3. Published by Kluwer, 1979 (project leader: Dr. J.C.L. Huiskamp; principal authors: Dr. Barry Bracewell-Milnes and Mr. M.A. Wisselink).

4. Published by Kluwer. The report is entitled "Transfer Pricing and Multinational Enterprises". In February 1981, the fourth in a series of regular meetings by some 60 tax inspectors and auditors was convened at O.E.C.D. headquarters in Paris to follow up on the 1979 Report.

and developing countries"; the group has considered programs designed to detect tax haven operations of multinationals and in 1979 published a draft double tax agreement for relationships between developed and developing countries.[5]

As well there have been efforts by the Andean Pact countries to counteract multinational intercompany pricing and licensing arrangements aimed at income reallocations from branch and subsidiary operations in South American countries.

In 1980, the O.E.C.D. published a Report on Tax Evasion and Avoidance, reflecting the views of government officials in Australia, Austria, Belgium, Canada, Finland, France, West Germany, Ireland, Italy, Luxembourg, Norway, the Netherlands, New Zealand, Spain, Sweden, Switzerland, Turkey, the U.K. and the U.S.

The *Bulletin for International Fiscal Documentation* recently reported on the activities of the Study Group on Asian Tax Administration and Research (SGATAR).[6] Between February 1971 and November 1980 ten meetings were held, at which tax avoidance and related topics were a recurring theme. For example, with respect to proceedings at the second meeting, at Jakarta in 1972 (at page 113):

"on the second topic, income tax evasion and avoidance, all participating countries agreed that this was indeed a serious problem . . ., to combat this, the developing countries need to bond themselves together . . . ."

Finally certain countries have recently developed ad hoc bilateral "simultaneous audit" programs designed particularly to detect tax haven operations of multinationals.

Thus is seen the effect of tax avoidance in bringing governments into harmonious non-adversary relationships.

B. Distortion of legal concepts and entities

The second effect of tax avoidance of possible interest to the *World Peace Through Law Center* is somewhat less benign. The methodology of tax avoidance is grounded in the accentuated use of the formalities of legal concepts and entities and formalistic, literal interpretation thereof designed to achieve the ends of tax avoidance. In other words, it is the art and purpose of the author of tax avoidance arrangements to seek not the spirit, purpose and intent of legal systems and entities, but rather the limits to which the elasticity often inherent therein can be stretched, justified by reference to highly literal and/or formalistic interpretations, which, more often than not, go beyond the contemplation of the legislator and achieve unintended results inconsistent with general legal norms and public policy.

The incidence of such misuse or abuse of legal entities or concepts abounds. Consider, for example, the incongruous results of a resident of a tax haven country being able to reduce tax on income derived from a high tax jurisdiction by the expediency of forming a letter-box corporation "base" in a third, "stepping-stone" country having a treaty with the country of source; the entire arrangement turns on the right of incorporation, separate legal personality of companies and literal reading of the relevant tax treaty. As we shall see, courts in some countries move to counteract such activities by invoking discretionary doctrines such as "sham" or "agency". The difficulty, however, is that in the absence of widespread and consistent conceptualization, recognition and application of such doctrines, tax avoidance objectives will often be achieved by unintended use of legal concepts and entities.

C. Distortion of normal commercial relations and judicial approaches

A third area of concern or interest in tax avoidance for the *World Peace Through Law Center* could be the tendency that tax avoidance distorts normal commercial relationships and procedures and to some extent the manner in which courts interpret and apply relevant laws in respect thereto. The interplay of these two concerns can be considered by delineating commercial transactions into three groups.

First, there are transactions entered into without regard to the consequential tax results, that is "non-planned" transactions. In such cases, devoid of tax avoidance motive, a court in applying relevant tax law uses usual "rules of interpretation" of tax law and, in the usual fashion, there will presumably be no reason to deviate from consistent patterns of application.

The second category is transactions which, although entered into primarily for business or commercial purposes, are "structured" in order to achieve the best consequential tax results. Here the "tax avoidance" motive arises. In such a case a court not only brings to bear orthodox "rules of interpretation" of tax statutes but also may be required to consider judicial doctrines such as step transaction, form versus substance, etc. in uncovering the true legal significance of the transaction for tax assessment purposes. Furthermore, in the application of "rules of interpretation" there can be a tendency in such cases to alter evolved patterns or theories (in the particular jurisdiction) as to the role of "strict" or "literal" rules of interpretation versus more "contextual" or "liberal" rules of interpretation in respect to tax statutes.

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5. The International Fiscal Association published, as a seminar paper delivered at the 1979 Congress in Compenhagen, the "The United Nations Draft Model Double Taxation Convention Between Developed And Developing Countries (Unofficial draft to be considered at its 8th Meeting in December 1979 by the group of experts on Tax Treaties Between Developed and Developing Countries)" (Kluwer). The draft was finalized in 1980, and as noted in 35 *Bulletin for International Fiscal Documentation* (1981) at 138, both English and French versions are available. The treaty is analyzed by Prof. Stanley S. Surrey in Vol. 5 (1980) of the Selected Monographs on Taxation, a joint publication of the Harvard Law School International Program and the International Bureau of Fiscal Documentation.

6. "An Experiment in Regional Tax Cooperation — PART I"; Angel Q. Yoingco (Executive Director, National Tax Research Center, Manila, Philippines) and Sutadi Sukarya (Director-General of Taxes, Ministry of Finance, Jakarta, Indonesia); 35 *Bulletin* (1981) at 110.

Finally, there are transactions which have no independent economic significance, being carried out simply to achieve an apparent tax avoidance result. In these cases a greater burden will be placed on the judicial "doctrines" with perhaps a more definite alteration of the manner in which a court selects between strict and literal rules of interpretation. This class of transaction can have two distinctive faces: first, the internal reorganization which does not even purport to create or change relationships with third parties;[7] second, the area of the "tax shelter" where ostensibly new economic relationships are created, but which on closer examination reveal that no such thing has occurred. An example is the various tax shelters based on acquiring property (the cost of which may be deducted against other sources of income) at inflated prices and financed by non-recourse obligations with the only real economic impact being a reduction of the tax liability, the true patrimony of the taxpayer not being otherwise affected. In Canada and in some other countries both the legislative and judicial response has been to reject such plans — see, for example, the Canadian movie film shelter case *Mandel* v. *The Queen* ((1978) D.T.C. 6518) and the recent changes under the Internal Revenue Code of the United States prohibiting the use of most forms of non-recourse debt in tax shelters.

D. Effect on business ethics and morality

A fourth area of interest for the *World Peace Through Law Center* arising out of tax avoidance schemes is the possible effect on the general level of social and business community ethics and morality. Although this is dealt with in some greater detail below, for introductory purposes it should suffice to note that the oft quoted dictum in *CIR* v. *Duke of Westminister* ((1936) A.C. 1)[8] stems from an earlier and less complex era when laissez-faire capitalism was more acceptable and widespread and, perhaps more importantly, when the tax struggle was often between a private individual seeking to protect his property from the grasp of the tax collector, rather than under today's conditions of the industrialized welfare State and the faceless multinational corporation which is often subjected to a multitude of socially imposed strictures to exhibit "good corporate citizenship", holding, inter alia, tax avoidance procedures to be socially unacceptable behaviour.

II. TAX AVOIDANCE VERSUS TAX EVASION

The distinction between tax avoidance and tax evasion should be clear, the former comprising, at worst, highly creative, artificial but open uses of business organization relationships and legal entities, the latter based on clandestine, covert and non-disclosed transactions. For example, under the Canadian Income Tax Act, Section 239 provides as follows:

"*(1) Every person who has*

(a) made, or participated in, assented to or acquiesced in making of, false or deceptive statements in a return, certificate, statement or answer, filed or made as required by or under this Act of Regulation,

(b) to evade payment of a tax imposed by this Act, destroyed, altered, mutilated, secreted or otherwise disposed of the records or books of account of a tax payer,

(c) made, or assented to or acquiesced in the making of, false or deceptive entries, or admitted, or assented to or acquiesced in the omission, to enter a material particular, in records or books of account of a tax payer,

(d) willfully, in any manner, evaded or attempted to evade, compliance with this Act or payment of taxes imposed by this Act, or

(e) conspired with any person to commit an offence described by paragraphs a to d

is guilty of an offence and, in addition to any penalty otherwise provided, is liable on summary conviction to :

(f) a fine of not less than 25 percent and not more than double the amount of the tax that was sought to be evaded, or

(g) both the fine described in paragraph (f) and imprisonment for a term not exceeding two years.

(2) Every person who is charged with an offence described by subsection 1 may, at the election of the Attorney-General of Canada, be prosecuted upon indictment and, if convicted, is, in addition to any penalty otherwise provided, liable to imprisonment for a term not exceeding five years and not less than two months."

This type of provision should provide for clear demarcation between civil tax avoidance disputes and criminal tax evasion prosecution. For similar provisions under the Internal Revenue Code of the United States see, inter alia, Sections 7201 — 7217.

However, the distinction in concept and in law between pure tax avoidance and tax evasion blurs when one considers, first, penal sanctions which are often imposed by a taxing statute for transgressions devoid of evasion "mens rea", such as negligence or innocent misrepresentation, that is, non-willful defaults, and, second, the characterization and treatment to be accorded so-called "sham" transactions. In the words of Lord Diplock in *Snook* v. *London and West Riding* ((1067) 1 All. E.R. 518) a sham means:

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7. *Newstead (Inspector of Taxes)* v. *Frost*, 1980 S.T.C. 123 (H.L.).

8. *CIR* v. *Duke of Westminister* (1936) A.C. 1 at 19-20:

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

See also *Ayrshire Pullman Motor Service* v. *IRC* (1929), 14 T.C. 754 at 763:

"No man in this country is under the smallest obligation, moral or other, so as to arrange his legal relations to his business or to his property as to enable the internal revenue to put the largest possible shovel into his store."

"acts done or documents executed by the parties to the 'sham' which are intended by them to give third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create."

The inherent clash between, on the one hand, open disclosure inherent in a sham transaction and, on the other hand, the defined objective (of a "sham") of misleading the tax authorities or court makes it difficult to assign such transactions as between the avoidance class and the evasion class. It would appear that in most countries, other than perhaps the United States, the tax systems and courts to date have treated sham arrangements as comprising matters of civil dispute and not having criminal tax evasion status.[9]

Governmental pronouncements can be helpful in making the distinction between evasion and avoidance. Consider, for example, Information Circular No. 73–10R2 issued in 1978 by the Canadian Department of National Revenue which considers acceptable tax avoidance planning to comprise:

"*. . . cases in which a taxpayer, in seeking a beneficial tax result, has merely selected a certain course of action that is either clearly provided for or not specifically prohibited in the law and had implemented that decision in a real way. Indeed the Department does not view itself as having any special responsibility in respect of any form of tax planning that consists of a genuine arranging of one's affair openly and within the framework of the law so as to keep one's taxes to a minimum.*"

On the other hand, the Department will attack:

"*. . . those [transactions] where the taxpayer has apparently circumvented the law,* without giving rise to a criminal offense, *by the use of a scheme, arrangement or device, often of a complex nature, the main or sole purpose of which is to defer, reduce or completely avoid the tax payable under the law. Usually a series of transactions is involved which do not truly reflect what is actually happening; and sometimes the avoidance is accomplished by shifting the liability to tax to other tax payers not at arm's length in whose hands the tax payable is reduced or eliminated.*"[10] (emphasis added)

It is clear that in the latter excerpt Revenue Canada is referring to the third category of transaction described earlier or the sham transaction as defined by Lord Diplock as not comprising tax evasion, notwithstanding that it will attack such arrangements on a civil dispute basis, as comprising unacceptable tax avoidance.

III. TAX AVOIDANCE – ETHICS AND MORALITY

The view of the Department of National Revenue cited above could be considered by some to reflect a rather modest standard of tax compliance ethics or morality and seemingly quite consistent with the policy adopted by the courts in *Duke of Westminister* and *Ayrshire Pullman Motors* (supra). This perhaps had its genesis in the approach to interpreting tax law advocated by the House of Lords in the 19th century in the famed dictum in *Partington* v. *Attorney-General* ((1869) L.R. 4 H.L. 100 at 122):

"As I understand the principle of all fiscal legislation it is this: if the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of a statute".

The mechanical approach to applying tax law suggested by this rule clearly undermines the establishment of a high standard of morality or ethics in tax planning. To be sure this rule of strict or literal interpretation does not generally govern the interpretation of revenue statutes today. For example, in Canada the Interpretation Act specifically provides for "broad liberal" interpretation of every statute although the actual approach of Canadian courts varies, ranging from *Partington* (supra), to the rule of the Interpretation Act.[11, 12]

The question often arises of whether a court is to read into taxing statutes the need for a "business purpose" in a transaction or a series of transactions, particularly where there is an obvious tax avoidance motive. Such a doctrine is highly developed in the United States but less so in other countries such as Canada and the United Kingdom. In Canada there is a great deal of vacillation on the issue. Consider for example *Foreign Power Securities Corp. Ltd.* v. *M.N.R.* 66 D.T.C. 5022 (Exchequer Court of Canada, 1966):

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9. In *Regina* v. *Myers et al.* ((1977) D.T.C. 507), non-disclosure of the income of a Swiss company by a Canadian financial writer was held to be tax evasion and not merely tax avoidance. The taxpayer argued the propriety of non-disclosure on the basis that the Company was a "non-resident", hence its income exempt from Canadian Tax.

10. Revenue Canada expressed its view of tax evasion in IC 73-10R2 as follows:

> "Tax evasion is the commission or omission of an act knowingly with the intent to deceive so that the tax reported by the taxpayer is less than the tax payable under the law, or a conspiracy to commit such an offense. This may be accomplished by the deliberate omission of revenue, the fraudulent claiming of expenses or allowances, and the deliberate misrepresentation, concealment or withholding of material facts."

11. Section 11 of the Interpretation Act, R.S.C. 1970, c. I-23, provides that:

> "Every enactment shall be deemed remedial and shall be given such fair, large and liberal construction and interpretation as best insures the attainment of its object."

12. In a dissenting judgement in a 1980 Supreme Court decision involving a succession duty tax avoidance scheme, *Frank M. Covert, John S. Jodrey and the Canada Permanent Trust Company* v. *The Minister of Finance of the Province of Nova Scotia*, issued 18 July 1980, the Honorable Mr. Justice Dickson made the following statment respecting the contention by the taxpayer that a taxing statute is to be strictly construed:

> "If the submissions made on behalf of the appellants as to

"There is indeed no provision in the Income Tax Act which provides that, where it appears that the main purpose or one of the purposes for which any transaction or transactions was or were affected was the avoidance or reduction of liability to income tax, the court may, if it thinks fit, direct that such adjustments shall be made as respects liability to income tax as it considers appropriate so as to counteract the avoidance or reduction of liability to income tax which would otherwise be affected by the transaction or transactions. The only authority of this character conferred by the statute is conferred on Treasury Board by Section 138."

This rule has been confirmed, rejected and reconfirmed in an ad hoc and inconsistent pattern ever since. For example, in 1976 in *M.N.R.* v. *Leon* (76 D.T.C. 6299) the Federal Court Appeal Division held that a management company utilized by an executive to render services to his employer was to be disregarded on the basis of lacking a business purpose.[13] On the other hand, the same Court later in 1976 in *Produits LDG Products Inc.* v. *The Queen* (76 D.T.C. 6349) upheld the taxpayer's use of an employee pension fund to achieve tax savings, and rejected the assertions of the tax authorities that the arrangements comprised an undue avoidance of tax without business purpose.

The latter (traditional) attitude of the courts continued in cases such as *Alberta and Southern Gas Co., Ltd.* v. *The Queen* (76 D.T.C. 6362), *Esskay Farms Ltd.* v. *The Queen* (76 D.T.C. 6010) and *Massey Ferguson Ltd.* v. *M.N.R.* (75 D.T.C. 6529), with exceptions for certain tax haven operations considered to be manifestly sham in their substance and nature such as *Dominion Bridge Company Limited* v. *The Queen* (75 D.T.C. 5150 and 77 D.T.C. 5367), *Spur Oil* v. *M.N.R.* (80 D.T.C. 6105) and *Natural Retreats of Nova Scotia Ltd.* v. *M.N.R.* (79 D.T.C. 391). The latter cases were considered to be abusive and capable of being dealt with by the orthodox concept of piercing the corporate veil, a variant of Lord Diplock's "sham" approach.

One would have thought that the uncertainty of the role of business purpose had been resolved by the Supreme Court of Canada in a 1980 decision in *Campbell* v. *The Queen* (80 D.T.C. 6239) where in upholding the right of a doctor to assign fees to a hospital corporation, the court distinguished a previous contrary decision by specifically focussing on the business purpose for the arrangement (at page 6242):

"*A prime consideration for Heald J. was the judgement of Cattanach J. in* Kindree... *which he found to be indistinguishable from the present case. It is my view that the* Kindree *case is readily distinguishable. Although then, as here, a doctor incorporated a company of which he became a salaried employee and there, as here, the relevant provincial legislation did not envisage the practice of medicine by a corporation, but the finding in the* Kindree *case was that there was no real change in manner in which the doctor conducted his practice after incorporation from the manner in which it was previously conducted. In short, I take the finding to amount to a conclusion that the incorporation of the company was a mere facade .... That is not so in this case.*"

However a subsequent decision of a lower court earlier this year appears to be contrary to the dictum of the Supreme Court in *Campbell* (supra) and would seem to perpetuate the lack of judicial support for the establishment of a business purpose test as the foundation of a firm and reasonably high standard of ethics or morality in tax planning. In *Daly* v. *The Queen* (81 D.T.C. 5025) the Federal Court, Trial Division stated (at page 5027):

"One other matter was raised on these appeals and is referred to. It was pleaded and submitted that there was no valid business purpose .... As to this, it should be noted that there is no statutory basis for the proposition that John J. Daly had the onus of establishing that the incorporation of a management company and the causing of that management company to enter into a contract for management services with a third party was to achieve a bona fide business purpose .... and, therefore, in the absence of a charging provision in the Income Tax Act, importing this business purpose requirement, in my view, there is no such onus. As to this, further, the dichotomy of opinion in respect to this so called 'business purpose test' in the cases in the Courts perhaps may be resolved by confining the decisions to the facts of these cases."

In the United States it appears that the courts have set a higher standard of ethics or morality in tax planning and

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the proper principles to be applied in constructing fiscal legislation, simply mean that it is impermissible to bring to the task of construing a fiscal statute a bias in favour of the Crown, then I am in entire accord ....

If on the other hand, the submissions of the appellant mean that there are special principles of construction governing the interpretation of fiscal legislation, or that a Court must uncritically and supinely accept the form of the transaction, blind as to what is actually happening, then, with respect, I disagree ....

A Court should ask — what would the words of the statute be reasonably understood to mean by those governed by the statute? Unnatural or artificial constructions are to be avoided.

The correct approach, applicable to statutory construction generally, is to construe the legislation with reasonable regard to its object and purpose and to give it such interpretation as best insures the attainment of such object or purpose ....

Although a Court is entitled, in the case of fiscal legislation as with other enactments, to look to the purpose of the Act as a whole, as well as to the particular purpose of the given section it must *still respect the actual words* which express the legislative intention."

In support of the restriction implicit in the previous paragraph Mr. Justice Dickson cites the Privy Council in *Corporation of the City of Toronto* v. *John Russell* ((1908) A.C. 493):

"Their lordships are more of the opinion that, since the main and obvious purpose and object of the legislature in passing the Act ... was to validate sales made for arrears of taxes ... the statute should, *where its words permit*, be construed so as to affect that purpose and attain that object." (emphasis added)

13. The Federal Court of Appeal in *Leon* states (at 6302) as follows:

"In my view for the respondents to be successful in this appeal, they must establish a bona fide business purpose in the transaction, which on the evidence in these cases, they have failed to do .... If the agreement or transaction lacks a bona fide business purpose, it is a sham."

tax compliance; it is generally conceded that a transaction devoid of a business purpose or substantial economic effect can be disregarded by a court. However the record may not be entirely consistent in the United States either. For example in *Gregory* v. *Helvering* (69 F. 2d. 809 (2 D) Cir. 1934, Aff'd, 293 U.S. 465 (1935)), Judge Learned Hand stated:

"We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the law, does not lose its immunity, because it is actuated by a desire to avoid or, if one choose, to evade taxation since anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one's taxes."[14]

Reflective of the main thrust of the U.S. approach was the attitude of a U.S. court in a treaty abuse case involving the professional boxer Ingemar Johansson who sought to avoid U.S. taxes by utilizing a Swiss service corporation. In the case *Johansson et al.* v. *U.S.* (336 F. 2d 809; or 64-2 U.S. T.C. 93907) the court said (at 93909 and 10):

"Scanart, S.A. [Johansson's company] had no legitimate business purpose but was a device which was used by Ingemar Johansson as a controlled depositary and conduit by which he attempted to divert, temporarily, his personal income, earned in the United States, so as to exempt taxation thereon by the United States."

In considering ethics and morality in tax avoidance or tax planning arrangements there are several other factors which can be assessed. For example, one can refer to the trilogy of types of transactions referred to earlier (those structured without tax law in mind, those structured with tax law in mind but having independent economic significance and those structured for no other purpose than to achieve a tax savings) or to the effect of high, confiscatory tax rates (see Part VI below) or to the insight which may be gained by considering two distinct types of adversary tax encounters.

First, there is the traditional taxpayer versus government struggle over tax dollars, comprising the main focus of the comments in this paper; however, as well, one can give thought to the tug of war over taxation revenues which can take place at intergovernmental levels, in particular between developed and developing countries. Considerations, ethical, moral, economic, etc., play what role in tax treaty arrangements between developing and developed countries? To what extent are multinational corporations pawns in such a struggle, the developing countries (as reflected by the model treaty published by the United Nations referred to earlier) seeking to apply source of income rules and rights and rates of taxation as will give the largest slice of the tax dollars to the host country, which is normally the developing country in the developed-developing country context; on the other hand, the home country (generally the developed country) usually seeks to obtain for its multinationals tax concessions from the host country in order to increase its share of the tax by reducing the amount of credits that it must allow for foreign taxes. For example, in a typical double tax agreement between two developed countries the country of source (the host country) will allow interest, royalties and other charges to flow to the home country at rather low and in some cases nil tax rates. The result will be to shift the tax burden (and revenue) from the host country to the home country, enriching the treasury of the latter at the expense of the former. Also "tax sparing" measures will generally not be recognized, meaning that if the host country grants incentive tax concessions (reductions) to a multinational, the home country will effectively neutralize the effects of the concession by not granting a notional tax credit for the incentive tax reduction.

Under all of Canada's new or renegotiated treaties with, for example, the United Kingdom, Switzerland, France, Italy and the United States, withholding taxes on interest are at 15 percent and royalties at 10 percent (which may be compared to the 1977 O.E.C.D. model which calls for 10 percent in the case of interest and 0 percent in the case of royalties). To this extent, Canada as a net importer of capital and exporter of interest, dividends and royalties takes steps similar to those advocated by the developing countries to prevent multinational corporations (and overly generous tax treaties) from unduly shifting revenues from its own coffers to that of a foreign government. The approach advocated in the draft model treaty between developing and developed countries[15] favours taxation in the host country; examples of this are as follows:

— *Unlike the O.E.C.D. Model which would place a maximum withholding tax on dividends, Article X of the draft treaty merely refers to "a certain percentage to be established through bilateral negotiations".*

— *Again, in respect of interest payments, Article XI of the draft merely stipulates that any restriction on withholding tax is one that would be established by bilateral negotiations.*

— *With respect to royalties, Article XII unlike the O.E.C.D. Model which would preclude any withholding tax provides only that any restriction on the withholding rate would be "established through bilateral negotiations".*

— *Whereas most bilateral treaties and the O.E.C.D. Model would preclude host country taxation of capital gains realized on property other than immovables, paragraph 5 of the draft would permit the host country to tax gains from the sale of shares "representing a substantial participation in the company which is a resident of the state".*

— *Generally Articles V and VII of the draft seek the widest possible allocation of business profits to the host country and the narrowest possible scope for exemption.*

14. In *Fraser Companies, Limited* v. *The Queen* (81 D.T.C. 5051) a Canadian Court almost 50 years later reiterated Mr. Justice Hand's statement in the following words (at page 5060):

"I know of no provision in the Income Tax Act nor any moral obligation that, if courses are open to a taxpayer which if followed would result in no tax being exigible or if one course would attract a lessor tax than another, dictates that the taxpayer must select the course which attracts a tax or the maximum tax."

15. As noted in footnote 5, a final version was issued in 1980.

These inter-governmental relationships can hardly be seen to differ from those between individual taxpayer and government in the struggle over tax dollars, with the ethics or morality of the developed countries indicated to some extent by their treaty relationships with developing countries. Although to date the record is rather thin and considerable time will be required to assess fully tax morality and ethics at the inter-governmental level, it is sufficient to note that both the U.S. and Canada decline to recognize the "tax sparing" principle (mentioned above) in their treaty arrangements with developing countries.

IV. TAX AVOIDANCE – METHODOLOGY

Tax avoidance comprises those structures and arrangements designed and implemented either to improve the tax results of a legitimate business transaction (the second type of transaction previously mentioned) or achieve a reduction of existing tax liability without effecting any significant economic change or undertaking (the third category). A brief review of the methodology of tax avoidance follows.

A. Intercompany transactions

In the multinational corporate context, tax avoidance usually takes the form of improper charges (prices) for goods or services rendered by a member of the corporate group situated in a low taxing jurisdiction to a member situated in a high taxing jurisdiction. While such transactions may well have a legitimate business purpose, particularly for multinationals engaged in integrated operations, the quantum of such charges often is or is capable of being manipulated to achieve a tax advantage. Revenue authorities often make such a presumption where the payer is in a high taxing jurisdiction, the recipient in a low or no tax jurisdiction. The problem is particularly acute where there is an absence of readily available, independently determinable arm's length pricing (comparable arm's length prices) to evaluate the propriety of the particular intercompany charge.[16]

Prices for transfer of inventory between related parties, financing charges, those in respect of royalties, rents and management services and in respect of the provision of non-proprietary know-how and other industrial technology are part of this class.

A variation of this arises where an enterprise carries on business in another jurisdiction through a branch and intra-company charges and accounting allocations are then the focal point of possible tax avoidance manipulations.

Some industries have been singled out as potentially (or actually) extreme examples of such procedures. In Canada the pharmaceutical industry is under close government audit at present.

B. The use of corporations

Single purpose corporations can form part of tax avoidance plans in a variety of situations. In a purely domestic context the substantial tax rate differential between income received by a corporation and an individual is often the incentive to interpose a corporation in the commercial relationship which otherwise would be directly between an individual and a third party. Or in those countries where corporations are entitled to such an incentive as low rates of tax on a first level of income, use of multiple corporations to affect a tax savings may arise.

In the international context and dealing strictly with income tax avoidance, properly stated (that is, not dealing with the improper clandestine use of corporations to effect tax evasion or perhaps to effect proper avoidance of estate, inheritance and other non-income tax levies), the use of corporations often arises in one or two situations. First, a corporation, foreign to the home country, may achieve a proper but significant tax deferral or avoidance, although most countries today — such as Canada, the United States, Japan, Germany and France, and in the near future the United Kingdom — have mechanisms to disregard in certain circumstances the existence of separate foreign corporations for purposes of levying domestic income taxes. The second major use of corporations in the international tax avoidance context usually revolves around attempts to benefit from third country treaties, for example, the well known use of Dutch Antilles corporations in respect of certain investments and business operations into and with the United States.

C. Trust

Trusts can serve purposes similar to that of corporations in either the domestic or the international context. For example, where taxation turns on residence and residence of the trustee is attributed to the trust, a foreign or third country trust can be used to either defer or avoid home country taxation or achieve benefits of tax treaty relief with third countries.

D. Third (stepping-stone) countries

Where the home country does not have a suitable treaty with the host country (of investment or business operations), the investor may seek to use (abuse?) a treaty which a third country has with the host country, such arrangements also requiring favourable domestic tax treatment in the third (stepping-stone) country in order that the overall taxes be lowered. Particularly with respect to the United States, which traditionally has had some of the highest domestic withholding tax rates on payments made to foreign investors, the use of structures involving the Netherlands — U.S. or the Netherlands Antilles — U.S. treaties has common currency.

Third countries might also be used as a base to carry on business operations in a high taxing jurisdiction which provides exemption for transitory business operations under a treaty but does not under purely domestic law. For example, under Section 253 of the Canadian

16. See footnote 4 respecting the O.E.C.D. Report on "Intercompany Pricing and the Multinational Enterprise".

Income Act a non-resident business enterprise would be liable to Canadian tax by merely offering goods for sale in Canada through an agent and notwithstanding the absence of any permanent place of business in Canada. However, such liability would be eliminated under double tax agreements which require the existence of a "permanent establishment" before Canadian taxation could arise. Thus a business enterprise based in a country which does not have a treaty with Canada would seek if possible to carry on its Canadian operations from a treaty base.

Surprisingly, high taxing countries can often serve as a stepping-stone country by reason of particular interaction between domestic tax laws and treaty provisions. As an example, under Section 861(a)(1) and (2) of the Internal Revenue Code, a U.S. corporation which derives less than 20 percent of its gross revenue from U.S. sources can pay interest and dividends to third country shareholders or lenders free of the standard U.S. 30 percent withholding tax. Therefore it may be possible for a tax haven based company to utilize the United States as a stepping-stone into high tax countries such as Canada, although modern treaties, including the recently renegotiated treaty between Canada and the United States, often contain anti-avoidance provisions to deal with such arrangements. The latter approach is particularly seen in treaties with countries whose tax systems include tax haven type provisions and are thus likely "stepping-stones".

E. Use (abuse) of treaties

As noted, the use of treaties in the context of third (stepping-stone) countries can be a foundation of tax avoidance arrangements. Treaties can also be used directly between a home country and a host country to achieve tax minimization. There are no particular patterns in this area, each case depending upon the particular facts, the domestic laws of both countries involved and particular provisions of the relevant treaty.

Normally the purpose of a bilateral tax treaty is to prevent double taxation and to provide a means of allocating tax revenues between the two jurisdictions — not to provide the basis to lower overall taxes. But as an example of the unusual situations that can arise, consider that a Canadian corporation which carries on business operations directly in a third country with which Canada has a treaty would, at best, be subject to full Canadian taxation but none in the other country. However, by reason of Canada's "foreign affiliate" rules the conduct of the business operations through a subsidiary formed in the host country, with which Canada has a treaty, can lead to exemption from Canadian tax upon repatriation of the operating profits and, to the extent that lower taxes arise in the foreign country by reason of its own domestic law, overall tax savings will be achieved.

In the direct host country — home country context, treaties can be used to reduce tax in situations where there are write-offs available for home country purposes only, by taking steps to isolate tax to the home country by reason of the provisions of the treaty. Thus, while a corporation carrying on business through a permanent establishment in a treaty country will normally be liable to full tax in that country, it may be possible to reorganize the operations so as to achieve the same level of economic activity but without using a "permanent establishment", thereby isolating tax to the home country and reducing overall tax through use of the home country "write-offs".

F. Role of tax residence

As indicated earlier, some countries base taxation of world-wide income on residence or place of incorporation of companies, leading to the use of non-resident corporations or trusts owned by residents of the home country in order to defer and in some cases escape taxes entirely in respect of foreign investments and business undertakings.

On a more direct approach, individuals resident in high taxing jurisdictions may seek expatriation. And, subject to a few exceptions the most notable of which is the United States, continued citizenship in the absence of ordinary residence will not maintain the basis for general liability to the home country tax system. However, establishing residence in a tax haven or low taxing jurisdiction for tax avoidance purposes may not be entirely legal where residence ties and involvements with the home country are maintained. Or issue can arise where substantial vacation time or business "sojourning time" is spent in high taxing jurisdictions. Disputes in this area arise particularly where the individual involved does not have a fixed, family based, living pattern in any particular place, perhaps is unmarried or married without dependent children, in semi-retirement or retirement and spends considerable time in more than one jurisdiction.

G. Tax shelters

Tax shelters contemplate investments in capital assets often in leveraged financing situations which under the domestic law of a particular country afford immediate or fast "write-off" against all sources of income, not merely the income from the particular investment. Although the domestic tax laws which permit such arrangements are usually designed to encourage and provide incentive for desired investment activity, unexpected avoidance (abuse) is often sought through the use of aggressive leveraging and non-recourse financing and revenue guarantee techniques. For example, consider the acquisition of a tax shelter at a cost of $100,000 where the investor pays $10,000 in cash and assumes a $90,000 non-recourse balance of sale, due without interest at the end of, say, ten years and is entitled to immediate 100 percent write-off with tax savings at the 50 percent tax rate. In such circumstances the taxpayer can "manufacture" a $40,000 cash flow profit. Even if one assumes reasonable financing charges on the balance of sale, taxpayers liable to tax rates in the 70 percent area will usually profit, even if the investment produces no revenue, by reason of inflationary devaluation of the real amount of the balance of sale.

Furthermore, even if discounted cash flow analysis would militate against the investment, the psychological appeal of immediate tax savings often motivates high-taxed individuals to follow such a course of action.

H. Family income splitting arrangements

Corporations and trusts are often used to split currently taxable income among members of a family so as to achieve multiple use of the law rates in progressive tax rate schedules. The particular arrangements will depend upon the rules in the particular country. In this area perhaps more than any other the "rules of the game" are constantly changing, with the tax legislator and the tax court moving to close loopholes and opportunities as quickly as they are designed and implemented by individuals and their advisors.[17]

V. TAX AVOIDANCE – GOVERNMENT RESPONSE

In response to tax avoidance plans and procedures, governments have three basic tools, aside from administrative surveillance and enforcement:
— statutory provisions;
— judicial doctrines applied by the courts;
— double tax agreements.

With respect to administration and enforcement, reference should be made back to Part I of this paper.

A. Statutory provisions

Tax statutes such as the Income Tax Act of Canada and the Internal Revenue Code of the United States have by now established firm rules designed to counteract much of the avoidance techniques described in the preceding section.

1. With respect to intercompany transactions

With respect to intercompany transactions, and by way of example, under Sections 67, 69 and 245 of the Income Tax Act of Canada (I.T.A.) unreasonable charges made to Canadian subsidiaries by foreign parent or affiliated companies can be denied as a deduction in computing taxable income of the Canadian subsidiary. Furthermore such excess or unreasonable charges can be subject to a 25 percent withholding tax pursuant to Part XIII of the Income Tax Act. Similar provisions from part of the tax laws of most of the western industrialized countries, the effectiveness thereof usually being more a question of the surveillance of the tax authorities than the scope and operation of the statutory provisions.

2. With respect to the use of corporations

With respect to the use of corporations and again by way of example, under Sections 247(2) and 256 of the Income Tax Act multiple use of low corporate rates of tax for certain Canadian controlled private corporations in respect of active business income would be denied to companies controlled by the same person or group of persons. Similar results will arise under the Internal Revenue Code.

Where a Canadian would seek to shelter foreign source passive income through the use of a foreign corporation, Canada's "Foreign Affiliate Property Income" (F.A.P.I.) rules under Sections 91 to 95 will often give rise to attribution of undistributed income of the foreign corporation to the Canadian shareholder which would thereby be subject to Canadian tax as though the income were earned directly. Similar rules exist in countries such as the United States, Germany, Japan, and France and apparently are being considered in the United Kingdom.[18]

3. With respect to the use of trusts

With respect to trusts, the aforementioned "FAPI" rules can defeat a tax deferral or avoidance arrangement based on utilizing a trust controlled by non-Canadian trustees (see Sections 91 through 95 and in particular Section 94, I.T.A.). Again, comparable provisions exist in other countries.

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17. Revenue Canada lists instances of tax avoidance arrangements in IC 73-10R2 as follows:

"59. Some of the complex tax avoidance schemes designed to circumvent the law, which the Department has investigated and will continue to have under review, involve the use of one or more of the following:
(a) Tax haven companies and trusts used to
  i) divert revenue from sales and services,
  ii) inflate purchases,
  iii) inflate expenses,
  iv) divert investment income,
  v) hide investments.
(b) Loss companies acquired for the purposes of diverting profits from existing businesses. Under the law it is possible in certain circumstances to reduce taxes on business profits by selling a business to a loss company. However, some taxpayers try to achieve the same results by buying up a loss company and diverting profits to it without transferring the business.
(c) Exempt entities used to defer unduly or completely avoid tax on business profits or other income actually earned by a taxpayer, such as:
  i) retirement savings plans,
  ii) deferred profit savings plans,
  iii) shareholder pension plans,
  iv) foreign business corporations.
(d) Appropriations to shareholders by
  i) giving notes of doubtful value to the company,
  ii) payment of insurance by the company,
  iii) stranger companies acting as agents or nominees,
  iv) dividend-stripping,
  v) offshore companies.
(e) Artificial deductions by corporations or individuals in respect of
  i) shareholder pension plans,
  ii) deferred profit sharing plans,
  iii) supplementary unemployment benefit plans,
  iv) interest on loans to buy shares or insurance.
(f) Income splitting to reduce tax rates by
  i) limited partnerships,
  ii) multiple corporations".

18. The U.K. proposals would tax U.K. parent companies on income of foreign subsidiaries "where arrangements are made or transactions entered into with the object of avoiding tax".

4. With respect to tax residence

As far as those who would seek to utilize tax residence as a means of avoiding tax, Canada has a number of specific rules which can undermine such arrangements. For example, an individual who spends more than 183 days in Canada would be deemed to be a resident for the entire year except in a year where he either took up or gave up ordinary residence (see Sections 114 and 250(3), I.T.A.). As well, case law "residence syndrome" rules could result in an individual being held resident even if he is not physically present in Canada.

Canada will tax the world-wide income of a corporation which is formed outside of Canada but which is managed and controlled by Canadian residents (Section 250(3), I.T.A.).

5. With respect to tax shelters

With respect to tax shelters, Section 245(1), I.T.A. would deny deductibility for expense which "artificially reduces" income otherwise subject to tax. Section 67(1) provides for the non-deductibility of "unreasonable expenses".

6. Other types of anti-avoidance provisions

In addition, in Canada there are several other broadly worded anti-avoidance provisions. For example, under Section 245(2) tax may arise "where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatever is that a person confers a benefit on a taxpayer". Furthermore, a provision (Section 246) which has yet to be invoked could cast a net over any tax avoidance schemes:

"*Where the Treasury Board has decided that one of the main purposes for a transaction or transactions effected before or after the coming into force of this Act was improper avoidance or reduction of taxes that might otherwise have become payable under this Act, . . . the Treasury Board may give such directions as it considers appropriate to counteract the avoidance or reduction.*"

Comparable or analogous provisions may often be found in the statutory law of the United States and some of the other industrialized countries.

Finally, with respect to anti-avoidance provisions under the Canadian Income Tax, a complete review thereof would require reference to, inter alia, the surplus stripping provisions of Section 247(1), the appropriations and benefits to a shareholder provisions of Section 15, the indirect payment provisions of Section 56, the artificial reduction of capital gain provisions of Section 55, and Part XIII which incorporates some of the foregoing with respect to non-residents as well as a host of other less evocative provisions designed to exact a high degree of compliance for purposes of the Income Tax Act, such as mechanical thin capitalization rules in respect of loans to Canadian corporations by related non-residents, per Section 18(4).

B. Judicial doctrines and approach to tax avoidance

1. The business purpose test

As already noted, the use of a business purpose test in Canada has gained some foothold in the past ten years and one would think that the 1980 decision of the Supreme Court in *Campbell* (supra) would in fact have unequivocally imported that doctrine into the Canadian law; but, as noted earlier, lower courts appear not to interpret the decision in such an embracing fashion.

2. Substance over form

The traditional doctrine of substance over form in tax avoidance matters will often apply as it does in other areas of legal determination. The court will seek to give effect to the substance of a transaction to determine the applicable tax law rather than its particular legal form.

The issue can arise in such diverse activities as leasing arrangements which seek to allocate to a financier certain tax write-offs which might not otherwise be usable by the lessee if he chose to purchase rather than lease. Other applications may arise in the context of characterizing entities. For example, under U.S. laws, the question of co-ownership versus partnership or partnership versus taxation as a corporation can be a frequent issue. The landmark decision of the U.S. Supreme Court in *Morrissey* v. *Commissioner* (296 U.S. 344 (1935)) has been codified under Regulations, Section 301.7701-2, pursuant to Section 7701 of the Internal Revenue Code where an attempt will be made to determine whether an unincorporated association has sufficient "corporate characteristics" so as to render it liable to U.S. tax as a corporation notwithstanding its lack of formal incorporation. In Canada, attempts to cloak employment as self-employment, partnership as co-ownership or vice versa, sale-financing as lease or vice versa, or financings as partnerships or vice versa can all be recharacterized under the substance over form doctrine.

Finally in this area are cases which would treat the profit on the sale of shares, normally taxed as capital asset, as ordinary income where the sale was an alternative to the sale of inventory by the company.[19]

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19. According to an article by William J. Baillie in the *Alberta Law Review* (Volume XVIII, No. 2 at page 237), the role of the doctrine in Canada is not free from doubt. Mr. Baillie concluded, according to the editor's introductory note:

> ". . . the 'so called' doctrine of 'the substance' is inconsistent with the fundamental philosophical principles of our legal system and that the doctrine had not been accepted by the Courts as part of our law".

However, as Mr. Baillie noted, the decision of the Supreme Court of Canada in 1954 in *Dominion Taxi Cab Association* v. *M.N.R.* (54 D.T.C. 1020) stated:

> ". . . in considering whether a particular transaction brings the parties within the terms of the Income Tax Act its substance rather than its form is to be regarded".

Perhaps the author's formulation of the doctrine of "the substance" (as being: "if the purpose of a transaction is tax avoidance, the legal environment which a taxpayer creates for himself may be disregarded and another less favourable legal environment from the point of view of the taxpayer may be substituted by the Minister of National Revenue for the purpose of assessing the taxpayer's liability for tax in respect of a particular transaction") differs from that of "substance over form" as discussed above.

3. Sham (agency and piercing the corporate veil)

As already mentioned, sham in the sense of Lord Diplock in *Snook* v. *London and West Riding* (supra) can be invoked by a court to ignore or recharacterize a transaction or a step in a transaction.

Closely associated is the concept of piercing the corporate veil where the use of a corporation is considered to have no independent legal significance or viability. Thus, for example, in *Dominion Bridge Company Limited* v. *The Queen* (supra) the use of a trans-shipment company by a Canadian manufacturer for the purposes of skimming profit upon the importation of raw materials failed on the basis that the captive or trans-shipment company was to be disregarded, its operations and profits to be considered part of those of the Canadian taxpayer.

Again closely associated with the basic concept of sham is that of agency as invoked by the U.S. Tax Court in the famed *Aikens*[20] case where an attempt to utilize a Honduras corporation to take advantage of the then existing U.S. — Honduras income tax convention failed on the basis that the Honduras company was not the owner of the debt instrument upon which interest was being paid from the United States, rather it was a collecting agent for the true beneficial owner, a company situated in a tax haven country which did not have a tax treaty with the United States.

A good example in Canada of the application of Lord Diplock's definition of sham was seen in *Susan Hosiery Ltd.* v. *M.N.R.* (69 D.T.C. 5346) where the court dismissed the tax effects of establishing and immediately thereafter collapsing an employee pension plan stating that "it [the pension plan] mascaraded as an employee's pension plan but was nothing of the sort", the parties having no desire to have a pension plan but merely the tax advantages related to the pension plan. Presumably the decision would have been different had the pension plan remained in existence even if the prime motivation was to enjoy the benefits of the tax law related thereto. Such a finding would be consistent with that of the U.S. Tax Court in the *Perry Bass*[21] case where, notwithstanding the admitted tax motivation of establishing a Swiss corporation, the U.S. court upheld the propriety of the arrangement holding that it (the court) ought to disregard "the personal purpose of a taxpayer in creating a corporation" provided that all necessary steps were taken to cloak the corporation with ongoing commercial viability.

4. Step transactions

A doctrine closely associated with substance over form is that of a step transaction where a court may disregard a step designed simply to achieve a tax result in the course of carrying out an otherwise ordinary commercial transaction. However, in one of the few Canadian cases specifically on point, the court rejected the step transaction doctrine: in *Esskay Farms Ltd.* v. *The Queen* (76 D.T.C. 6010) the taxpayer interposed a trust company in the course of selling land to a municipality in order to achieve instalment-sale treatment, the municipality being unable to transact except on a cash basis. Revenue Canada attempted to ignore the tax effects of interposing the trust company but the arrangement was upheld by the court. A similar finding for the taxpayer arose in the *Massey Ferguson Ltd.* v. *M.N.R.* case (supra) and the *Fraser* case discussed elsewhere.[22] [23]

It seems that the step transaction doctrine plays a greater role in other courts such as those in the U.S. than in Canada, at least to the present.

5. Consideration of improper documentation

Finally, another type of doctrine which the courts might bring to bear on tax avoidance transactions is the mechanism of applying a stiff test or standard to the degree of compliance by the taxpayer with formality and proper preparation and execution of documentation. Thus, the courts, instead of seeking to defeat tax avoidance with some of the more broadly based and stated principles noted above, may lean towards seeking a decision for the tax collector by close examination of the attention to contractual and property law requirements. In the 1970s the Department of National Revenue successfully assessed three tax avoidance arrangements based on the use of trusts, alleging before the court that the trusts were not properly constituted and therefore never came into existence (see *Leon (1964) Limited* v. *The Queen* (74 D.T.C. 6451); *Kingsdale Securities Co. Limited* v. *The Queen* (74 D.T.C. 6674) and *Gate Paper Products Limited* v. *The Queen* (75 D.T.C. 5203)).

C. Treaties

In dealing with international tax avoidance, modern double tax agreements employ three effective mechanisms to prevent abuse or misuse of treaties, particularly in the third (stepping-stone) country situations described earlier.

First, most modern treaties provide that preferential withholding tax rates apply only to the extent that the recipient is also the beneficial owner thereby, serving to prevent the use of stepping-stone countries through mere nominee arrangements. Although one would think that the "beneficial owner" test might also strike at a conventional common law trust this is not so, at least in the case of the new U.S.—Canada treaty. The U.S. Treasury has stated in its Technical Explanation there-

20. *Aikens Industries Inc.* v. *C.I.R.* 56 T.C. 925.
21. *Perry Bass* v. *C.I.R.* 50 T.C. 595.
22. For *Fraser*, see footnote 14.
23. *Antonie Guertin Ltd.* v. *Her Majesty, The Queen* (81 D.T.C. 5045), a 1981 decision of the Federal Court, Trial Division, is a good example of a successful tax avoidance plan which ostensibly could have fallen on the basis of sham as utilized in the *Susan Hosiery* case or the step transaction doctrine, which perhaps can be expressed as doing indirectly that which you cannot do directly. The Court accepted, as a deductible expense, salaries paid to employees who immediately made deductible charitable gifts to a foundation which re-lent the funds to the employer company. Such gifts if made directly by the employer would not have been deductible by reason of a 20 percent of income donation limitation. Obviously, the variable content which Courts can give these doctrines can lead to a great deal of uncertainty as to permissible as opposed to impermissible tax avoidance schemes.

of that a trust otherwise considered resident in a State will be considered a beneficial owner for purposes of treaty relief provisions.

Secondly, in regard to the use of companies formed in third (stepping-stone) countries, many new treaties will deny a reduction in withholding rates when income items are paid to a corporation resident in the other treaty country if more than a specified percentage of the shares of the corporation is owned by third country persons and the corporation does not pay regular business tax rates on the subject income. See, for example, Section XXIX (6) of the new Canada—U.S. Treaty.[24]

Thirdly, modern treaties provide for both a broad range of exchange of information as well as substantial discretion to the tax authorities to mutually interpret the treaty, including as in the case of the new Canada—U.S. Treaty the right to define terms otherwise undefined in the Treaty (see Article XXIV (3)(d) of new U.S.—Canada Treaty). Also the right given the country seeking to impose the tax to unilaterally interpret undefined terms by reference to its own domestic tax laws can serve to reduce tax avoidance planning.[25]

VI. SUMMARY AND CONCLUSIONS

In summary, tax avoidance could be said to be a natural instinct of investors and business enterprises but the combined effect of domestic statutory provisions, treaty provisions, judicial doctrines and the emerging cooperative enforcement efforts between nations in exchanging information and dealing with tax avoidance and evasion presents formidable obstacles.

Undoubtedly the weight of the governmental response in the past ten to fifteen years in each of thse areas has served to substantially reduce the opportunities and incidence of tax avoidance.

Presumably, however, those countries with excessively high tax rates will continue to be subjected to constant attempts by taxpayers and their advisers to seek new ways of reducing or eliminating taxation. It would seem that only a reduction of the overall tax burden to levels perceived to be reasonable and non-confiscatory will lead to true elimination of tax avoidance activities. In this context the experience in the U.S. of the 50 percent maximum tax on earned income appears to work well and to have eliminated much tax avoidance planning in respect to qualifying earned income. President Reagan's tax cut program tabled in Congress in March 1981, which would reduce the highest personal tax rate to 50 percent, should serve to enhance this trend.

In summary, it would seem that the effectiveness of government initiatives against tax avoidance would be optimized by concomitantly reviewing and where necessary modifying the overall income tax burden, in particular as it applies to those exposed to the worst and the highest of current tax tystems. This would reduce the degree to which tax laws encourage undesirable distortion of commercial transactions and abuse of legal systems, concepts and entities.

24. Under the renegotiated U.K.—Netherlands Treaty signed in 1980, Dutch companies owned by third country residents will not be entitled to the half credit for U.K. Advance Corporate Tax (ACT) otherwise available. The interaction of Canadian and Dutch domestic law, the Dutch—Canadian treaty and the current Dutch—U.K. Treaty has rendered the Netherlands a favorite "stepping-stone" for Canadian-owned operations in the U.K.

25. In 1962 Switzerland adopted unique, unilateral anti-treaty abuse legislation. The Federal decree of 14 December 1962 imposes punitive taxation on a Swiss company which has been availed of to exploit Switzerland's tax treaty network. This is accomplished by withholding certification for claiming of treaty benefits from other countries and the manner in which the company's income and distributions to its shareholders are taxed.
Article XXII of the recently ratified treaty between Belgium and Switzerland contains anti-abuse provisions which are formulated with regard to the Federal decree of 14 December 1962 of Switzerland.

Some Problems of Tax Policy in Developing Countries

By Nizar Jetha*

I. INTRODUCTION

Interest in the study of tax policy in developing countries seems to have waned in recent years.[1] *Greater concern with income distribution, and the accompanying shift of attention from taxation to public expenditures, is probably the main reason for this. The transience of many conclusions of tax theory and the pessimism about prospects for tax reform may also have discouraged research on tax structures of developing countries. Interest in tax policies of developing countries declined at a time when the theory of taxation was undergoing major transformation.*[2] *Not surprisingly, therefore, there is now uncertainty and confusion about the desirability of many tax practices. This paper reviews selected aspects of tax policy in developing countries in light of recent ideas, and concludes with some thoughts on future research. Specifically, taxation of personal and corporate incomes, indirect taxes, taxation of agricultural incomes and capital taxation are discussed.*

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II. PERSONAL INCOME TAXATION

A. General

Implicit in the tax strategy recommended to developing countries by economists is the assumption that the structure of economies and administrative capacity severely constrain the use of personal income taxation. The basic strategy is well summarized by Musgrave and Musgrave.[3] According to them, given the impediments to a broad-based income tax, the importance of "luxury" consumption in total income, and the concentration of private savings in very high income brackets, the "key to development finance appears to lie in progressive consumption taxation". They would supplement this tax by a progressive property tax on residences to deal with housing consumption. Finally, the complete replacement of progressive income and wealth taxation by progressive consumption taxation is not considered desirable, and a proper balance between the three taxes is urged. Due and Friedlaender also favor high reliance on a progressive consumption tax: they view such a tax as providing the progression which in developed countries is provided by income taxes.[4]

While this broad strategy is difficult to fault, few developing countries levy the kind of income and wealth taxes that it seems to postulate. Lack of political will has constrained the evolution of income taxes in line with general economic development, and few countries levy wealth taxes. Thus, the circumstances in which heavy reliance on consumption taxes could be tolerated do not often exist. This section comments on the appropriateness of certain income tax practices; taxation of capital is discussed briefly in a later section.

B. Simplicity

The income tax structure of many developing countries is not substantially different from that inherited on independence, when the proportion of the local population paying taxes was small, and the tax structure was, quite understandably, tailored to the needs of the expatriate civil servant.

* World Bank, Washington, D.C. I am indebted to Robert Burns, Angelo Faria and Carol Meyer Johnson for comments on an earlier draft. The responsibility for the views expressed is entirely mine.

1. The date of publication (second edition) of Alan R. Prest's influential *Public Finance in Underdeveloped Countries* (London: Weidenfeld & Nicholson, 1972) is indicative.
2. Comparison of Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw Hill, 1959) and Anthony B. Atkinson and Joseph E. Stiglitz, *Lectures on Public Economics* (New York: McGraw Hill, 1980) will reveal the changes in the methodology and conclusions of the theory of taxation that have taken place over the past two decades, and especially during the 1970s.
3. Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (New York: McGraw Hill, 1980).
4. John F. Due and Ann. F. Friedlaender, *Government Finance* (Homewood, Illinois: Richard D. Irwin, 1977).

The tax structures continue to embody a wide range of allowances and are often far too complicated in relation to the available tax personnel and the educational background of the majority of taxpayers. Some countries have even retained allowances for a large number of dependents and for education, with the tax benefit under the latter often related to actual costs; the operation of such allowances is very time consuming and costly. A simpler structure, embodying allowances only for the taxpayer, the spouse and children, and perhaps some tax relief for saving, could release the manpower needed for improving the overall working of the income tax. It might even be fairer since the danger of overpayment by those who can neither understand the tax structure nor afford the services of accountants would be reduced.

C. Exemption of the poor

Those with insufficient income to meet the basic needs for food, shelter and clothing have rarely come under the scope of income taxation in developing countries. Exemption levels have been high relative to per capita incomes (often unrealistically so) in most countries, and they have been raised periodically to compensate for the effects of inflation. However, with the world economy plagued by high rates of inflation and developing countries relying more and more on indirect taxes, there is now a need to review the relationship between poverty levels and income tax exemptions more carefully and frequently than in the past. Yet few countries calculate poverty levels for households of different size on a regular basis.

D. Deductions versus credits

The replacement of exemptions by credits seems to have preceded an understanding of all its ramifications.[5] The popularity of the measure is not surprising. It is politically attractive since it can be presented as a measure that would remove an unintended benefit conferred on the wealthy. The measure also has appeal from the viewpoint of administration since the task of projecting revenues is made simpler; unlike the cost (in terms of revenue foregone) of exemptions, that of credits does not depend on taxpayers' marginal tax rates. Some countries have replaced single, married and child allowances by credits. Recent thinking suggests that the wrong kind of deductions may have been converted into credits.

Due and McLure argue that the most appropriate way of refining the concept of income is through deductions.[6] Costs of earning income, and allowances for family size are included in this category. Although deductions will give a less progressive tax structure than credits, this factor is not considered relevant for arriving at a definition of taxable income. Credits, on the other hand, are seen as the most suitable way of favoring specific expenditures on the grounds that there is no rationale for relating tax relief for such purposes to taxpayers' marginal tax rates. Deductions for consumption expenditures are not as important in developing countries as in the developed. The main deductions in developing countries under the second category are for certain forms of saving, discussed below. While there cannot be hard and fast rules concerning the relative roles of deductions and credits, the case made by Due and McLure is sufficiently persuasive to deserve thought in developing countries contemplating a changeover from deductions to credits.

E. Encouragement of saving

Many developing countries give tax inducements for certain forms of personal saving. The main incentives relate to investment in owner-occupied housing, pension and provident funds and life insurance.[7] Low rates of personal saving in many developed countries have provided a strong impetus to research on the taxation of income from capital, notably in the United States. What conclusions have been reached? What relevance do they have for the tax treatment of saving in developing countries?

Research has proceeded along three main lines. The most critical question that has been asked is whether a reduction in the taxation of capital income combined with increased taxation of consumption or of labor income so as to keep the tax yield constant would raise private saving. It turns out that the effect on the rate of private saving under these conditions is theoretically indeterminate.[8] This means, for example, that theory cannot predict the effect on saving of a shift from direct to indirect taxation. The issue can, therefore, be only resolved empirically. In this connection, effort has been made to determine the relationship between private saving and real after-tax return on capital. A recent study found a significant relationship,[9] but the result is still controversial.[10] Finally, the welfare cost[11] of the taxation of capital income has begun to be studied more

5. Note that a deduction reduces tax liability by the amount of the deduction times the marginal tax rate whereas a dollar of tax credit reduces tax liability by a dollar. The replacement of exemptions by credits benefits taxpayers in lower income groups with large families and reduces the differential in tax liability of households of different size at higher incomes.

6. John F. Due, "Personal Deductions", in Joseph A. Pechman, ed., *Comprehensive Income Taxation* (Washington, D.C.: The Brookings Institution, 1977), pp. 37-65. See also comments by Charles E. McLure, Jr., pp. 69-74.

7. The incentives in many developing countries are similar to those in the United Kingdom. For a description of the incentives for savings in the United Kingdom and a discussion of their effects on the composition of personal wealth and structure of the capital market, see J.A. Kay and M.A. King, *The British Tax System* (Oxford: Oxford University Press, 1980).

8. The reason for the indeterminacy is that while a higher after-tax return on saving would induce some to save more, others might save less because a given future consumption may now be purchased with lower saving. See Martin Feldstein, "The Rate of Return, Taxation and Personal Savings," *The Economic Journal*, vol. 88, no. 351, September 1978, pp. 482-487.

9. Michael J. Boskin, "Taxation, Saving and the Rate of Interest," *Journal of Political Economy*, vol. 86, no. 2, pt. 2, April 1978, pp. S23-S28.

10. E. Philip Howrey and Saul H. Hymans, "The Measurement and Determination of Loanable-Funds Saving", *Brookings Papers on Economic Activity*, 3: 1978, pp. 655-685.

11. The welfare cost of taxation is the loss of real income due to tax-induced distortions in the allocation of resources.

carefully.[12] The main conclusion that has emerged is that the taxation of capital income, by distorting the choice between present and future consumption, may inflict a substantial welfare loss, even if private saving is not responsive to the net return on capital. An innovative feature of the recent work is that it allows for the possibility that reduced revenues from the taxation of capital income may have to be made up by taxes that may also distort the allocation of resources, although in different ways. Reliable research on the empirical questions touched upon in this paragraph is sparse in both the developed and developing countries.

Opinions will differ on whether the present state of knowledge justifies substantial tax incentives for saving. Be that as it may, recent work has certainly clarified the considerations that have to be borne in mind in formulating tax incentives for saving. The most basic point is that the form and extent of tax incentives must recognize that the sole purpose of a preferential treatment of capital income is to raise the real net-of-tax return on net private saving or certain major forms of private saving. Another consideration is that the calculations of welfare cost are not supposed to and nor do they take account of the effect on income distribution. There is therefore a continuing need to assess the implications of changes in the taxation of capital income for income distribution, specifically, tax relief must not be too generous for the rich. Though these points may appear self-evident, tax practice does not seem to have taken adequate account of them. The tax incentive for life insurance provides a good illustration. The incentive normally has three features: premiums are deductible fully or partially; the investment income from life funds is taxed at a preferential rate; and proceeds from life policies are not taxable, provided policies have run for a specified number of years. The deductibility for premiums raises the net-of-tax return for all taxpayers, but it does not raise it equally: the higher the marginal rate of tax, the greater the increase in the rate of return. There cannot be any rationale for this. If the rate of return on life policies is to be raised by the same percentage for all taxpayers, then the tax relief should take the form of a tax credit.

The tax credit approach is not applicable to retirement schemes because the primary purpose of such schemes is to change the timing of tax payments rather than to exclude income from the tax base, although this is not always the case in practice. The tax treatment of private pension and provident funds does not diverge too widely from that suggested by theory.[13] For the funds satisfying specified conditions, both employer and employee contributions are deductible and interest is accumulated tax free, but benefits are taxable, except for the part that may be commuted into a lump sum. However, the treatment of public social security schemes is more generous in most developing countries and needs to be reviewed. The employer contribution is deductible but the employee contribution is generally not deductible; all benefits are exempt from taxation. Since initially the rates of contribution were low and the maximum rate was reached at modest incomes, there was much to be said for this arrangement on administrative grounds; taxing relatively small lump sums from a large number of persons would have been very cumbersome. The situation has changed in recent years. Strapped for domestic financial resources, many countries have steadily raised the rates of contributions as well as the income level for the maximum rate, with the result that the relatively rich now benefit substantially from the generous tax treatment of public social security schemes. This is especially so where the employee contribution is deductible.

F. Treatment of owner-occupied housing

The tax treatment of owner-occupied housing has been widely criticized in developed countries. The subsidy implied by the exclusion of imputed rent from taxable income and the deductibility of mortgage interest has been considered undesirable: it benefits the rich more, since the subsidy increases with the marginal rate, and it encourages inefficient use of housing, not to mention the construction of luxury housing. Since in most developing countries, the ownership of nontraditional housing tends to be more concentrated and the resources available for housing investment are more limited, the adverse effects are probably also more serious. Yet most, if not all, developing countries emulate the tax practice of developed countries, most of which exempt imputed rent.[14]

The taxation of net imputed rent should be administratively manageable in many developing countries, especially if it is coordinated with property taxes. Neither the taxation of net imputed rent nor the elimination of the mortgage interest relief may be politically feasible, however. Given then that some subsidy for home owners is unavoidable, what form should it take? The replacement of the deduction by a tax credit for mortgage interest would be preferable.[15] This will ensure that the cost of home loans is subsidized at the same rate for all taxpayers. Moreover, a tax credit may be more consistent with the social philosophy of many countries since tax benefits received by persons in lower income groups (i.e., those with marginal tax rates below the rate at which tax credit is given) would actually increase.

12. Martin Feldstein, "The Welfare Cost of Capital Income Taxation," *Journal of Political Economy*, vol. 86, no. 2, pt. 2, April 1978, pp. S29-S31.

13. The problem of the proper tax treatment of retirement schemes is discussed in Musgrave and Musgrave (1980), pp. 354-356.

14. United States, the United Kingdom, France, Australia, Canada and New Zealand exempt the notional income from owner-occupied dwellings, but such income is taxable in some European countries, including Germany, the Netherlands, Belgium, Luxembourg, Italy and Denmark. See J.R.M. Willis and P.J.W. Hardwick, *Tax Expenditures in the United Kingdom* (London: Heinemann, 1978), ch. 5.

15. Some implications of replacing deductions by credits in the United States are examined in Harvey S. Rosen, "Housing Decisions and the U.S. Income Tax: An Econometric Analysis," *Journal of Public Economics*, vol. 11, no. 1, February 1979, pp. 1-24.

III. CORPORATE TAXATION

Economists' attitudes concerning company taxation have turned full circle. At one time, the predominant view was that a company was no more than the totality of shareholders and that at least the companies' distributed profits should be taxed at the relevant marginal tax rates of shareholders. Then it became fashionable to argue that companies and their shareholders were different entities and a separate corporation tax was justified. Now, once again, the maximum possible integration of corporate and personal taxes is in favor. These turnarounds have left tax administrators in many developing countries bewildered.

The present case for full integration (or the administratively more manageable partial integration) is based on economic considerations rather than on philosophical attitudes and deserves attention in developing countries.[16] Two questions need to be asked. What arguments have been put forward for integration in developed countries? Are those arguments equally valid for developing countries?

Some of the major inequities and inefficiencies associated with the separation of corporate and personal income taxes, which would be reduced or eliminated even by partial integration, are as follows:[17]

(a) violation of horizontal and vertical equity. The former is due to the overtaxation of dividend incomes relative to other incomes, whereas the latter arises because the extent of overtaxation falls as the marginal rate of income tax increases.

(b) distortion between corporate and noncorporate activities. The higher taxation of corporate incomes in relation to noncorporate incomes diverts resources from the corporate to the noncorporate sector. Many studies have found the welfare cost of the resulting misallocation of capital to be significant.[18]

(c) distortion between future consumption and present consumption. Taxation of capital income, by reducing the net return on saving, increases the price of future consumption in terms of present consumption. The distortion will be the more important where capital incomes bear higher taxes than labor incomes. A recent study (see footnote 12) has found the welfare cost of the distortion from this source to be as high as under (b).

(d) bias in favor of retained earnings. Retentions are encouraged since dividends bear higher taxation.

(e) bias in favor of debt finance. Debt finance is encouraged at the expense of equity finance, since interest payments are deductible from gross profits whereas dividends are part of corporate profits.

All these factors will be relevant for formulating corporate tax policies in developing countries, although the significance of each factor will vary with individual circumstances. The case for some form of integration seems strong on equity grounds. In contrast, the welfare cost of the distortion between future and present consumption may not be a matter for serious concern in many developing countries. Where capital gains and property taxes are nonexistent or inadequately developed, savings receive a generous tax treatment and where large employer and employee contributions to national provident funds prevail, capital income may not be more highly taxed than labor income. This is probably the situation in most developing countries. Only a careful balancing of various factors can, therefore, indicate the magnitude of benefits that are likely to flow from a change in corporate tax policy. This is made more difficult by a dearth of empirical studies on the quantitative significance of the effects of taxation in developing countries.

One possible consequence of eliminating or reducing the discrimination in favor of retained earnings would need especially careful consideration in countries with low rates of saving and underdeveloped capital markets. In such countries, a crucial question is: would the lower corporate saving, caused by higher distributions, be offset by higher personal saving or result in a decline in the overall private saving? This problem does not seem to have received attention in developing countries, but a recent study for the United States concludes that the removal of tax incentives for corporate retentions is likely to reduce the rate of private saving.[19]

IV. INDIRECT TAXATION

A. General

A major recent advance in public finance has been the development of theories of optimal taxation.[20] Some of the conclusions of these theories are at variance with traditional prescriptions. The central conclusion in the area of indirect taxation, to be elaborated later, is that

16. The term "partial integration" here denotes that only corporations' distributed profits would be taxed at the relevant marginal rates of taxpayers. Where tax is deducted at source from dividends, dividends gross of the tax deducted would be part of the shareholder's taxable income but the tax already deducted would be credited against his total tax liability. "Full integration" normally refers to the taxation of corporations' total profits at the relevant marginal rates of shareholders.

17. These factors are discussed in detail in Charles E. McLure, Jr., "Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals," *Harvard Law Review*, vol. 88, January 1975, pp. 532-582, and Martin Feldstein and Daniel Frisch, "Corporate Tax Integration: The Estimated Effects on Capital Accumulation and Tax Distribution of Two Integration Proposals," *National Tax Journal*, vol. XXX, no. 1, March 1977, pp. 37-52.

18. The welfare cost is due to the movement of capital from higher productivity applications in the more highly taxed sector to lower productivity applications in other sectors. See Arnold C. Harberger, "Efficiency Effects of Taxes on Income from Capital," reprinted in *Taxation and Welfare* (Boston: Little, Brown and Company, 1974), pp. 163-170.

19. The conclusion follows from the finding that undistributed corporate profits have no direct influence on consumption. See Kul B. Bhatia, "Corporate Taxation, Retained Earnings and Capital Formation," *Journal of Public Economics*, vol. 11, no. 1, February 1979, pp. 123-134.

20. A simple account of the optimal tax theory will be found in David F. Bradford and Harvey S. Rosen, "The Optimal Taxation of Commodities and Income," *American Economic Review*, vol. 66, no. 2, May 1976 (Papers and Proceedings, 1975), pp. 94-101.

an optimal structure of indirect taxation will not in general imply a uniform rate of taxation on all commodities. This is in sharp contrast to the traditonal view, which considered a single ad valorem rate on all commodities to be neutral (nondistortionary). While research on the empirical investigation of the theory, albeit under simplified assumptions, has already begun in developed countries,[21] the ramifications of the theory for developing countries remain to be explored. This section discusses the theory of optimal commodity taxation in a specific context — the problem of reconciling different sets of indirect tax structures implied by theories of optimal taxation and effective protection. In addition, it discusses the taxation of sumptuaries, and of intermediate and capital goods, where tax practices frequently appear to be inconsistent with notions of equity and efficiency, respectively.

B. Effective protection and optimal indirect taxation

Prescriptions on the reform of indirect taxes tend to fall short of what is needed for policy purposes. Trade theory, concerned with the avoidance of unnecessary inefficiencies in production, suggests a set of nominal tariffs. On the other hand, fiscal theory, concerned with the avoidance of unnecessary inefficiencies in consumption, suggests a different set of nominal tariffs. This gives rise to the problem of reconciling the two sets of tariffs. Can they be reconciled? To my knowledge, the only satisfactory solution is fraught with administrative difficulties. Let us retrace our steps and look at the matter in a little more detail.

The notion of effective protection is widely known. It is the effective rates of tariff, and not the nominal rates, which determine the allocation of resources in production. Effective rates of protection take account of nominal rates of tariff on products, the relative shares of various inputs utilized in production and the nominal rates of tariff on those inputs. The basic purpose is to correct the nominal rate on the product for the nominal rates on inputs and to define protection in relation to value added rather than gross value.[22] The main point which is relevant for our purposes is that a uniform structure of effective protection, which is frequently thought desirable for productive efficiency, would call for highly complicated and disparate nominal rates of tariff.

The crucial assumption underlying the optimal tax theory is that not all commodities can be taxed; leisure, for one, cannot be taxed. The optimal tax theory poses a simple question: which structure of commodity taxation will minimize the welfare loss, given that not all commodities can be taxed and that a specified amount of revenue must be raised? The answer, somewhat loosely, is that taxes should be set at levels that would result in an equal proportionate reduction of demand for each taxable good. In other words, the relative pattern of demand must be kept unchanged. Without going into the details of the solution, in which optimal taxes depend on direct and cross price elasticities, it should be clear that since direct and cross price elasticities of different goods will vary widely, the price increases (and consequently the tax rates) needed to secure an equal proportionate reduction of demand for each good will also vary widely. Equity considerations can be introduced into the framework of optimal taxation, but at the cost of greater complexity. One complication that would be introduced is that revenue requirements would affect not only the absolute tax rates but also relative tax rates. We need not, however, be concerned with such complications here. All that need be noted is that a complex structure of commodity taxation, incorporating a wide range of tax rates, would be required if revenues are to be raised in a way that minimizes the welfare loss caused by taxation.

Corden brings out the main problem very clearly:

"There are a number of qualifications to the simple uniform effective protection idea. First, nonuniform nominal rates are needed to yield uniform effective rates. This means that there will be distortions in the pattern of consumption of manufactures. The aim of the exercise is to foster domestic production of manufactures uniformly, not to discourage consumption nonuniformly. In principle, the argument for uniformity applies as much on the consumption side as on the production side. But on the consumption side it is nominal rates that matter, and on the production side, effective rates. Consumption distortion affects not only final consumers but also manufacturing industries themselves, which are consumers of manufactured inputs . . . Given the uniformity objective, the conclusion is that there are two incompatible ideals. One is uniformity of effective rates, which is important in terms of the pattern of production, the other is uniformity of nominal rates, important in terms of the pattern of consumption. In practice some kind of compromise is probably best. A system of uniform nominal rates might be used, to be modified later in cases where very nonuniform effective rates result. Alternatively, a roughly uniform effective system could be used initially and then modified to smooth out nominal rates, avoiding excessive nonuniformities in nominal rates."[23]

As explained, modern theories of taxation suggest that a system of uniform nominal rates would distort the pattern of consumption.[24] More importantly, reconciliation of the different structures of nominal rates

21. See, for example, Angus Deaton, "Equity, Efficiency and the Structure of Indirect Taxation," *Journal of Public Economics*, vol. 8, no. 3, December 1977, pp. 299-312.

22. In the simplest case, where there is only one manufactured input, the rate of effective protection on the final product may be derived as follows:

$$e = \frac{t - zr}{1 - z}$$

where e = the rate of effective protection; t = the nominal rate of tariff on the product; r = the nominal rate of tariff on the input; and z = the relative share of the input in a unit of the product. Taking t = 0.62, r = 0.10 and z = 0.20, gives

$$e = \frac{0.62 - (0.20)\,(0.10)}{1 - 0.20} = \frac{0.60}{0.80} = 0.75,$$

or an effective rate of protection of 75 percent.

23. W.M. Corden, "Trade Policies," in John Cody and others, eds., *Policies for Industrial Progress in Developing Countries* (Washington, D.C.: The World Bank, 1980), pp. 74-75.

24. Corden recognizes this in his more technical writings. See W.M. Corden, *Trade Policy and Economic Welfare* (Oxford: Clarendon Press, 1974), pp. 70-75.

suggested by considerations of production and consumption through *ad hoc* adjustments would not be satisfactory. In the slippery world of the second-best, common sense may not lead up the right alley.

The conflict discussed here would not arise if production subsidies can be used. Then, the sole purpose of indirect taxation would be revenue, and desired protection could be granted through subsidies. Any set of nominal tariffs considered to be optimal could be levied on final goods and, provided equivalent excises were imposed on domestic production, the indirect tax structure would be completely free of protective effects. Such a system could bring as much revenue as a system where indirect taxes performed both revenue and protective functions, but it would be much more difficult to operate.[25] This may be the main reason why subsidies have not been widely used for protective purposes.

The rates of protection in developing countries vary too widely to be justified on any reasonable grounds for differential protection. In view of this, the evaluation of protection in terms of the effective rates has a major contribution to make toward a more rational industrial development. But further guidance on the harmonization of the conflicting requirements of efficiency in production and consumption is clearly needed.[26]

C. Sumptuary taxes

Tax structures of most developing countries are characterized by relatively high tax rates on tobacco and alcoholic beverages. Frequent hikes in taxes on these commodities are often justified in budget speeches in terms of medical, social and moral considerations, but expediency may be the main explanation for heavy sumptuary taxation: because the consumption of tobacco and alcoholic beverages is widely diffused throughout the population, a few more cents on a packet of cigarettes or a bottle of beer bring substantial revenues. Finance ministers seldom dwell on the equity implications of a steadily rising level of sumptuary taxes.

McLure and Thirsk have made a valuable contribution to the literature on tax policy in developing countries by highlighting the consequences of sumptuary taxes for income distribution. Their review of empirical evidence confirms the impression that both price and income elasticities for tobacco and popular alcoholic beverages are low. It follows that taxes on these commodities are regressive. A related implication where low-income households spend a high fraction of their income on these commodities is that heavy taxation of sumptuaries may leave insufficient resources for meeting the basic needs. The main conclusion is best expressed in the words of the authors:

"*. . . in virtually all developing countries indirect taxes on tobacco products and alcoholic beverages are very high and constitute an important source of tax revenue. We contend that this state of fiscal affairs is undesirable (experience demonstrates that literally speaking, it is not "intolerable"), judging from the recent worldwide surge of interest in income distribution, "social justice", equity in taxation, etc. Sumptuary taxes fail to achieve their commonly stated ends — discouragement of consumption of potentially harmful products — and render attainment of the equity goals of society more difficult. The policy conclusion we reach is that developing countries should place less reliance upon these taxes — in relative terms over time, if not immediately and in absolute terms.*"[27]

Governments genuinely interested in income distribution need to review their policies on sumptuary taxes. Their task would be eased by further research on price and income elasticities of demand for tobacco and alcoholic beverages in developing countries. It is surprising how little research has been done in this area; of the 44 studies surveyed in the paper cited above, only 13 referred to developing countries. Future research needs to pay greater attention to the relative shares of income spent on sumptuaries at various income levels, the relationship between the variability of price data and estimates of price elasticities, and the plausibility of a constant income elasticity assumption.

D. Taxation of capital and intermediate goods

There has been a trend toward the imposition of indirect taxes on intermediate and capital goods for revenue purposes. These taxes start out at low rates but grow progressively as governments discover the revenue potential of small across-the-board upward adjustments. Advice on this subject has sometimes been confusing. Does the taxation of intermediate and capital goods for revenue purposes make sense?

The clearest discussion on the tax treatment of intermediate goods is perhaps to be found in Little and Mirrlees:

"*. . . the primary intention of taxation being, normally, to restrain private consumption, indirect taxes are best imposed on the sales of final consumers' goods. Where possible the taxation of intermediate goods should be avoided. The only point of taxing intermediates is really to raise the price of those consumers' goods which use them. It is much better to tax these latter goods directly, for this does not result in producers trying to minimize the use of those inputs which happen to be taxed.*[28] *There can admittedly be administrative reasons*

25. A lucid discussion of the case for production subsidies for industrial development in developing countries will be found in Ian Little, Tibor Scitovsky and Maurice Scott, *Industry and Trade in Some Developing Countries: A Comparative Study* (London: Oxford University Press, 1970).

26. Some of the implications of optimal taxation in open economies are explored in Partha Dasgupta and Joseph E. Stiglitz, "Benefit-Cost Analysis and Trade Policies," *Journal of Political Economy*, vol. 82, no. 1, January/February 1974, pp. 1-33. Most discussions of optimal taxation assume a closed economy.

27. Charles E. McLure, Jr. and Wayne R. Thirsk, "The Inequity of Taxing Iniquity: A Plea for Reduced Sumptuary Taxes in Developing Countries," *Economic Development and Cultural Change*, vol. 26, no. 3, April 1978, pp. 487-488.

28. This does not apply when a value added tax is used because a producer purchasing taxable inputs can deduct all taxes previously paid against his tax liability. In consequence, all intermediate goods are effectively exempt under a value added tax.

for taxing the input of a material into a consumption good: this arises, for instance, when the producers of the input are relatively few and large, while those of the consumption good are small and many. But before doing so, the end-uses of the intermediate, and the possibilities open to producers to use other inputs instead, should be carefully considered."[29]

Import tariffs on intermediate goods, whether for revenue or protective purposes, would discourage the flow of resources to export industries in countries which primarily rely on tariff for protective purposes. An export is protected not by a tariff but by an export subsidy. Therefore, if the increased costs resulting from tariff on inputs are not offset through export subsidies, export industries would face negative effective protection. Since most industries producing for the home market normally receive some positive effective protection through tariff, the overall effect would be to favor production for domestic consumption over that for export. This is a further reason for avoiding indirect taxes on intermediate goods for revenue purposes as far as possible. While many countries refund duties paid on inputs utilized in production, the negative rates of effective protection frequently found for exports suggest that, for one reason or the other, the duties may not be fully refunded.

Revenue duties on capital goods are also not desirable for similar reasons. Taxation of capital goods is sometimes recommended as a means of correcting the distortion in the relative prices of capital and labor, which may arise due to minimum wage legislation, strong unions and a host of other reasons. This approach will reduce the relative price of labor, but it would also tend to raise the cost of production. Instead, subsidization of wage costs should be considered despite its greater administrative complexity.

V. AGRICULTURAL TAXATION

Squeezing resources from agriculture to promote industry used to be a major objective of development strategy. Now rapid agricultural development is considered essential for satisfactory growth, improved income distribution and generation of sufficient opportunities for gainful employment. The change in perception concerning the role of agriculture in economic development has yet to be reflected in agricultural taxation in many developing countries.

Few countries have admittedly been willing to pay the political and administrative cost of effective land taxation. On the other hand, export taxes, levied primarily for revenue purposes or to depress the domestic price of the main staple or a raw material for a major industry, place a heavy burden on smallholders in many countries.[30] Not only do farmers become liable to export taxes at incomes that are far below the exemption levels for income taxes, but their tax liability is several times greater than the liability of other taxpayers for income taxes at similar incomes.

The conventional wisdom that smallholders are not responsive to prices is being seriously questioned. There is some evidence that even in the least developed countries, the supply elasticity of smallholder production is sizable.[31] The probable supply response of smallholder production, combined with the high taxation of agricultural exports relative to other activities, is bound to distort the allocation of resources. Unfortunately, very limited research has been done on the welfare cost of distortions introduced by export taxes in developing countries.

VI. CAPITAL TAXATION

Interest in the taxation of capital, which surged in the years following the publication of Nicholas Kaldor's *An Expenditure Tax*, has subsided in recent years.[32] Only limited progress seems to have been made in this area. Comprehensive capital gains taxes and net worth taxes of any kind are rare, and even the effectiveness of estate duties is severely circumscribed by the absence or inadequacy of gifts taxes. Taxes on real property (land or buildings) and on realized gains from such property have come to feature in tax structures of many countries, however. These taxes vary a great deal from country to country, partly reflecting the lack of consensus on the appropriate structure of property taxes in developing countries.[33]

Taxation of urban real estate (land and buildings) has many advantages over the taxation of land alone. For one thing, since developing countries do not in general have the capacity to prepare annual valuations and since frequent increases in tax rates are not politically feasible, the inclusion of buildings in the tax base would better meet the need for higher revenues. As new construction takes place, the tax base and revenues would expand in tandem. This is an important consideration since few local authorities have sufficient independent sources of revenues. Second, except in countries at very

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29. I.M.D. Little and J.A. Mirrlees, *Project Appraisal and Planning for Developing Countries* (London: Heinemann, 1974), p. 76. Dasgupta and Stiglitz (1974) show that in the context of optimal taxation the conclusion requires the assumption of 100 percent taxation of pure profits (which arise under competitive conditions when there are decreasing returns to scale). The relaxation of this assumption greatly complicates the results derived from theories of optimal taxation in both closed and open economies.

30. For an interesting analysis of the effects of taxes on rice exports in Thailand, see Edward Van Roy, "The Pursuit of Growth and Stability through Taxation of Agricultural Exports: Thailand's Experience," *Public Finance*, vol. 23, no. 3, 1968, pp. 294-313.

31. In many small island economies of the South Pacific, the number of coconuts farmers pick up and the number they consume, and consequently the quantity of copra available for export depends on export prices. For evidence on Solomon Islands, see G.J. Eele, "Indigenous Agriculture in the Solomon Islands," Development Studies Monograph no. 11 (Canberra: The Australian National University, 1978), pp. 46-71.

32. Nicholas Kaldor, *An Expenditure Tax* (London: Allen & Unwin, 1955).

33. See Roy W. Bahl, ed., *The Taxation of Urban Property in Less Developed Countries* (Madison: University of Wisconsin Press, 1979).

early stages of development, there is likely to be more market evidence concerning built-up property than for vacant land. In such circumstances, the division of the value of a property between land and buildings will be more or less arbitrary. Third, further tax concessions for owner-occupied housing, given the considerable advantages conferred through income taxes, seem undesirable.

Why then do a large number of countries impose site value taxes or tax buildings at a lower rate than land? Many economists support site value taxation on the grounds that it would discourage the holding of idle land. The importance of this consideration seems to have been exaggerated where property taxes are confined to urban areas. The conclusion Sir John Hicks reached in reviewing this matter is of interest:

"We are accordingly brought back to the central argument for site value taxation, its effect on the inducement to building development. It is often maintained that a rate on land plus buildings is a net disincentive to building; and since building is a part (usually an essential part) of economic growth, the tax is an obstacle to economic growth. But it is not clear that this is the right way of putting the matter. The services that are provided out of the rates are usually demanded in greater quantities when there is more building; the cost of these services should be reckoned as part of the social cost incurred when a new building is put up. That is done (admittedly in no more than a very rough manner) when buildings are rated. If buildings are exempted from rates, what is being done is to give a net encouragement (if you like, a subsidy) to building in general. Though there are some sorts of buildings which may very well deserve some encouragement, a blanket encouragement to all sorts of buildings seems hard to justify. Once again, one has to challenge the assumption, concealed in the terminology adopted, that every building is an 'improvement'."[34]

VII. CONCLUDING REMARKS

We have discussed a number of problems of tax policy in developing countries which could benefit from further study. For it to be directly relevant for tax reform, research might usefully proceed along three lines. First, comparative studies of tax structures, which seem to have fallen into disfavor, need greater attention. Second, implications of recent developments in the theory of public finance for developing countries need to be explored. Third, empirical investigations of the economic effects of taxation, which have tended to be neglected, need to be established as an integral part of research into tax policy in developing countries. Without a revival of interest in the study of taxation in developing countries, the gap between the state of tax theory and tax practices would continue to widen.

34. John R. Hicks, "Unimproved Value Rating — The Case of East Africa", in *Essays in World Economics* (London: Oxford University Press, 1959), pp. 243-244.

INDONESIA:
Anti-Tax Avoidance Measures

by Jap Kim Siong

I. INTRODUCTION

The Indonesian corporate income tax law denies interest, royalties, and any other payments as business expenses if it is believed that the contracts giving rise to such payments are not made in accordance with the methods usually followed in business practice (i.e. the arm's length basis.[1]

The Law on the Tax on Interest, Dividends and Royalties of 1970, as amended (hereinafter "IDR tax") imposes, inter alia, a withholding tax of 20 percent on royalty payments. The Explanatory Memorandum to the Bill (No. 2942 to Law No. 10 of 1970) states that the Indonesian Government thought it expedient to introduce the IDR tax. It was put forward that foreign enterprises transferred patents, licenses, trademarks, designs or models, plans, trade secrets and other similar rights, and rented equipment and tools for industry, trade and science to enterprises in Indonesia for which some sort of remuneration generally designated as royalties was received. The Explanatory Memorandum considers such royalty payments as profits derived through indirect operations in Indonesia. Therefore it was believed reasonable that royalties should be subject to tax in the same manner as interest and dividends.[2] In practice, the assessment and collection of the IDR tax on royalties for the use of trademarks, patents, licenses, models or designs, etc. may be difficult where there is no written contract specifying the amount of the royalty payment to the non-resident enterprise. To solve this problem the Indonesian tax authorities have fixed a deemed royalty payment on a case by case basis where no royalty payments are specified in written agreements between an Indonesian and a foreign enterprise, and any liability to pay such royalty to the foreign enterprise is denied by the Indonesian enterprise. This article is to provide an overview of those new anti-tax avoidance measures.

The IDR Tax Law provides that the IDR tax is levied on the proceeds in whatever name or form derived from patent, license, trademark and other rights, and from the leasing of industrial, commercial and scientific equipment and tools.

The Law further sets out examples of taxable royalties, which include:

(a) the use of, or the right to use, patents, licenses, trademarks, designs or models, plans, secret formulas, processes, copyrights of literary, artistic or scientific works, including cinematographic work;
(b) the use of, or the right to use, industrial, commercial and scientific tools and equipment;
(c) the obtaining of data and information on business enterprises and investments in general, and on experience in the fields of industry, commerce and science in particular.[3]

In plain words, the term "royalties" is in practice interpreted rather broadly and may include: charter fees; remuneration for feasibility studies, rentals from the leasing of equipment; fees for the use of technical know-how; royalties for the exploitation of Indonesian natural resources such as oil, gas and minerals.[4]

II. ANTI-TAX AVOIDANCE MEASURES

A. Imported movie films

Importers of foreign movie films into Indonesia have to pay the IDR tax *before* the films can be imported and distributed in Indonesia in accordance with the procedures set out in the Joint Circular by the Director General of Taxes and the Director General of Radio and Television Films dated March 28, 1978 No. KEP - 266/PJ.2/1978 - 11/KEP/DIRJEN/RTF/1978.[5]

IDR Tax on imported foreign cinematographic films

Type of films imported	*Amount of royalty per meter of film for each title*	*IDR tax on royalty per meter of film (20 percent)*
1. Films for children of all ages	Rp. 250	Rp. 50
2. Cultural and educational films	Rp. 500	Rp. 100
3. Non-action films	Rp. 750	Rp. 150
4. Action films	Rp. 1,000	Rp. 200

Official exchange rate: US$ 1.00 = 615 Indonesian Rupiahs (Rp.)

B. Foreign ships chartered by Indonesian enterprises

Indonesian enterprise which charter ships owned by foreign shipping companies have to withhold IDR tax from the charter fees paid to the foreign shipping companies.

The effective rates of this IDR tax, which is a final tax, are:

— voyage charter	3 percent
— time charter	2.5 percent
— bareboat charter	2 percent

1. Article 5, Paragraph (2), Number 3, in conjunction with Article 9, Paragraph (1) of the Corporation Tax Ordinance 1925, as amended.
2. See: Jap Kim Siong, "Tax Incentives and Income Tax Liability of Foreign Business Enterprises Operating in Indonesia as Affected by the 1970 Amendment Laws", in 26 *Bulletin for International Fiscal Documentation* (March 1972) at 105-113.
3. Article 1, Letter (d), in conjunction with Article 3(c) of the Tax Law on Interest, Dividends and Royalties of 1970.
4. See: "Pengertian royalty" (The concept of royalty) in *Berita Pajak* (Tax News), Jakarta, No. 691, dated May 4, 1981 at 30-32, 41.
5. See: "Pengertian overriding royalty, hubungan dan aspek-aspeknya" (The concept of overriding royalty and its related aspects) in *Berita Pajak*, No. 694, dated May 25, 1981 at 23-30.

The IDR tax must be withheld by the payor of the charter fee, so that the foreign shipping company bears the tax. The payor is obliged to pay the tax withheld over to the Treasury in conformity with Circular No. SE - 08/PJ.222/1979 dated April 11, 1979. [6]

C. Soft drink industry

The Head Office of the Directorate General of Taxes, when investigating the royalty payments for the use of trademarks in the soft drink industry, found that the royalties paid were incorporated into the purchase price of the concentrates bought by the bottling enterprise in Indonesia from foreign soft drink companies. In his Circular No. SE - 03/PJ.222/1979 dated February 1, 1979, the Director General of Tax has instructed the Heads of the Regional Directorates General of Taxes and the Heads of Tax Inspections in Indonesia to apply the following rules: [7]

(1) Where the amount of the royalty payment for the use of the trademark is not known owing to the lack of any written contract specifying the amount of the royalty payment, the deemed royalty is:
- for the calendar year 1978 and earlier years: 26.12 percent of the purchase price of the concentrate;
- for 1979 and following years: 25 percent of the purchase of the concentrates.

(2) The IDR tax is withheld at the moment of payment for the concentrate by the purchaser using the trademark (in accordance with the provisions of the IDR tax law 1970).

(3) The withholding tax is an advance tax and is creditable against the IDR tax when the tax authorities have completed their investigations.

In other recent circulars issued by the Director General of Taxes, the tax administration is instructed to levy and collect the IDR tax from Indonesian agents, distributors, assemblers and manufacturers who sell foreign designed products if there is no written contract specifying the amount of royalty payable to foreign enterprises. In such cases, the deemed royalties paid by the Indonesian enterprise have been fixed as follows:

1. Pharmaceutical industries

Three percent of the sales price of the medicine sold in Indonesia. The effective rate of the IDR tax is thus 0.6 percent of the total sales price (No. SE - 31/PJ.222/1979 dated October 17, 1979). [8]

2. Automobiles

2.5 percent of the sales price in Indonesia for agents, distributors, assemblers and manufacturers of foreign automobiles having licenses to sell then in Indonesia. The effective rate of tax is thus 0.5 percent of the total sales price (No. SE - 7/PJ.222/1981 dated March 14, 1981). [9]

3. Motorcycles (including scooters)

2.5 percent of the sales price in Indonesia for agents, assemblers, and manufacturers of foreign motorcycles (including scooters) having licenses to sell them in Indonesia. The effective rate of tax is 0.5 percent (No. SE - 12/PJ.222/1981 dated April 2, 1981). [10]

4. Electronic and electrical appliances

Three percent of the sales price in Indonesia for assemblers of foreign electronic and electrical appliances (such as televisions, radios, refrigerators, washing machines, cassette recorders, radio telecommunication receivers, air conditioners, calculators, fluorescent lamps, sewing machines, generators, etc.) in Indonesia having licenses to sell them in that country. The effective rate of tax is 0.6 percent (SE - 8 PJ.222/1981 dated March 14, 1981). [11]

The tax must be paid at the moment the products are sold. The royalty payments are not considered a business expense and are therefore not deductible in computing the taxable profit of the enterprise involved.

These rules apply from April 1, 1981 through December 31, 1982.

III. CONCLUDING REMARKS

Under the anti-tax avoidance measures the deemed royalty payments are not deductible as a business expense. In other words, they are not deductible in computing the taxable profits of the enterprise paying the deemed royalty.

Only those royalty payments can be deducted as business expenses which are evidenced by written contracts and documents, provided the contracts have been concluded on an arm's length basis.

In general, the enterprise paying the royalty must withhold the IDR tax from the royalty payments and pay the tax to the Treasury. The tax, therefore, is borne by the licensor. For resident licensors, the IDR tax withheld is an advance tax which is creditable against the ultimate individual or corporate income tax liability. The result is that royalty payments which are deductible from the payor's profits, i.e. those which are evidenced and on an "arm's length" basis, are taxed at the level of the *recipient* (licensor). For non-resident recipients, the IDR tax withheld for the royalty is, in essence, a final tax. In other words, it is a separate tax. [12]

The situation is different for royalty payments which are *not* deductible as business expenses. Such royalties are not considered as profits for the recipient resident in Indonesia, meaning that the recipient is exempt from corporation tax and also from the IDR tax. The overall effect is that there is no national double taxation of royalties. Only the resident paying company is in fact

6. For the text of the Circular see: *Berita Pajak*, No. 585, dated April 23, 1979 at 38.
7. *Berita Pajak*, No. 575, dated February 12, 1979 at 30.
8. *Berita Pajak*, No. 612, dated October 29, 1979 at 34.
9. *Berita Pajak*, No. 686, dated March 30, 1981 at 30.
10. *Berita Pajak*, No. 691, dated May 4, 1981 at 34.
11. *Berita Pajak*, No. 686, dated March 30, 1981 at 31.
12. Article 9 of the Tax Law on Interest, Dividends and Royalties 1970.

taxed, because the royalties are not deductible as business expenses, and the result is that the tax is levied at the payor's (licensee's level).[13]

Since the anti-tax avoidance measures prevent the deduction of *deemed* royalty payments from the payor's profits and provide that the IDR tax be levied on deemed royalties, this would seem to imply that there *is* national double taxation at the level of the resident paying enterprise. The Circulars do not prescribe that the IDR tax must be borne by the non-resident recipient, nor do they state that the IDR tax, if borne by the resident payor, is not an advance tax. Consequently, they do not prohibit the IDR tax from being creditable against the ultimate individual or corporate income tax liability of the resident payor. It is, therefore, assumed that the IDR tax is creditable against the income tax of the resident payor. Thus, the result is that these deemed royalties are exclusively taxed at the resident payor's level, so that there is again no double national taxation.

13. But compare to: *"Taxes and Investment in Asia and the Pacific"*, Part Indonesia, Section Taxes.

Conference Diary

NOVEMBER 1981

Management Centre Europe: Managing and Developing Foreign Subsidiaries (including: tax in international operations), Brussels (Belgium), November 4-6 (English).

Management Centre Europe: Leasing (including: tax aspects of leasing), Brussels (Belgium), November 23-25 (English).

Management Centre Europe: Captive Insurance Companies (including: tax considerations), Brussels (Belgium), November 23-25 (English).

DECEMBER 1981

Investment and Property Studies: Overseas companies, setting up, uses and practices (including: tax efficient finance for overseas operations; successful use of tax havens; double tax agreements; personal taxation of international executives) (Seminar), London (United Kingdom), December 2 (English).

Management Centre Europe: International Cash Management (including: international tax aspects in cash management), London (United Kingdom), December 7-9 (English).

FEBRUARY 1982

Business Perspectives Ltd.: 7th International Tax Conference (including: developments in legislation and practice in U.S.A., U.K., Canada, Australia and the Far East as they affect companies and individuals with world wide interests; and tax problems involved in investment in Mexico and the Caribbean area). Mexico City (Mexico), February 1-5 (English).

JUNE 1982

The Inter-American Center of Tax Administrators (C.I.A.T.): XVIth General Assembly on the basic subject: Tax evasion and tax compliance, Asunción (Paraguay), June (date unknown yet) (Spanish).

SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada), September 12-16 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Business Perspectives Ltd., 11 Alexander Place, London SW7 2SG, United Kingdom.

Inter-American Center of Tax Administrators (C.I.A.T.), Executive Secretary of C.I.A.T., P.O. Box 215 zona 1, Panamà.

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

Institute for International Research, 70 Warren Street, London W1P 5PA, United Kingdom.

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4, United Kingdom.

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

U.S.A.: Foreign Tax Credit – Temporary Regulations

The document reproduced below contains temporary regulations setting forth the requirements for the creditability of foreign taxes against U.S. income tax. They apply to taxable years ending after June 15, 1979 unless the taxpayer elects to apply earlier regulations.

Supplementary information: Background

This document contains temporary and proposed income tax regulations under Sections 901 and 903 of the Internal Revenue Code of 1954. The amendments set forth the requirements for the creditability of foreign taxes against a person's U.S. income tax liability. They are issued under the authority contained in Section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

A notice of proposed rulemaking relating to the creditability of foreign taxes under Sections 901 and 903 was published in the FEDERAL REGISTER on June 20, 1979 (44 FR 36071). Many interested parties have commented on this proposal. These comments have been taken into account in the drafting of the temporary and proposed regulations contained in this document.

Explanation of Provisions:

Section 901 allows to taxpayers a credit against U.S. income tax liability for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States." Section 903 provides that the term "income, war profits, and excess profits taxes" includes "a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States."

Income taxes:

Under Paragraph (a) of Section 4.901-2, the standard for determining whether a foreign charge is an income tax is the U.S. income tax. Thus, a foreign charge is an income tax if and only if: the charge is not compensation for a specific economic benefit within the meaning of Paragraph (b); and the charge is based on realized net income within the meaning of Paragraph (c); and the charge follows reasonable rules of taxing jurisdiction. A foreign charge may meet these requirements even if the provisions of the law of the foreign country imposing the charge differ substantially from the income tax provisions of the Internal Revenue Code. A foreign charge does not follow reasonable rules of taxing jurisdiction if liability for the charge is clearly related to the availability of a credit for the charge against income tax liability to another country.

Under Paragraph (b)(1), a foreign charge imposed only on persons that do not receive any specific economic benefit from the foreign country is not compensation for a specific economic benefit. A foreign charge imposed on persons that receive any specific economic benefit from the foreign country is presumed to be compensation for a specific economic benefit. Under Paragraph (b)(2), this presumption is rebutted if: the same charge is also imposed on income of persons that do not receive any specific economic benefit; the amount of charge paid by persons that receive the specific economic benefit is not significantly increased over what this amount would be if such persons were, instead, subject to an income tax imposed on income of persons that do not receive the specific economic benefit; or it is demonstrated that no significant part of the charge is compensation for the specific economic benefit received.

Under Paragraph (b)(3), a person upon which a charge is imposed receives a specific economic benefit if the person receives an economic benefit that, in general, is not being received by persons upon which the charge is not being imposed. The term "economic benefit" includes a good, a service, a fee or other payment, or a right to use or extract property that the government owns or controls.

Under Paragraph (c)(1), a foreign charge is computed on the basis of realized net income if any only if it meets the realization, gross receipts, and net income requirements. Under Paragraph (c)(2), a foreign charge meets the realization requirement if it is imposed, without substantial deviation, upon the occurrence of: realization events in the U.S. sense; events subsequent to U.S. realization events; or events that are the transfer or processing of readily marketable property (but only if the foreign country does not impose any charge with respect to the same amounts upon the occurrence of another event). Under Paragraph (c)(3), a foreign charge meets the gross receipts requirement if it is imposed, without substantial deviation, on the basis of: gross receipts; or, in certain specified circumstances, gross receipts computed under a method that is designed to produce an amount that is not greater than fair market value and that, in fact, produces an amount that approximates, or is less than, fair market value. Under Paragraph (c)(4), a foreign charge meets the net income requirement if the base of the charge is computed, without substantial deviation, by reducing gross receipts by the costs attributable, under reasonable principles, to such gross receipts. A special rule is provided for cases in which certain persons subject to the charge may elect periodically to compute a portion of the base of the charge under another method. In addition, certain gross foreign charges imposed on items of income specified in Section 871(a) or 881(a) need not meet the net income requirement if the foreign country makes a resonable distinction between income that is subject to the gross charge and income that is subject to tax on a net basis.

In lieu of taxes:

Under Paragraph (a) of § 4.903-1, a foreign charge is a tax in lieu of an income tax, and thus is considered a creditable income tax for purposes of Section 901, if and only if: the charge is not compensation for a specific economic benefit within the meaning of § 4.901-2(b); the charge follows reasonable rules of taxing jurisdiction within the meaning of § 4.901-2(a)(1)(iii); the charge meets the substitution requirement as set forth in Paragraph (b); and the charge meets the comparability requirement as set forth in Paragraph (c).

Under Paragraph (b), a foreign charge meets the substitution requirement if the charge is clearly intended, and in fact operates, as a charge imposed in substitution for, and not in addition to, an income tax otherwise generally imposed. Under Paragraph (c), a foreign charge meets the comparability requirement unless it is reasonably clear that foreign law imposing the charge is structured, or in fact operates, so that the amount of liability of persons subject to the charge will generally be significantly greater, over a reasonable period of time, than the amount for which such persons would be liable if they were subject to the income tax otherwise generally imposed. Under Paragraph (d), an income tax is otherwise generally imposed by a foreign country if the country imposes an income tax or a series of separate income taxes (within the meaning of § 4.901-2) on significant amounts of income.

Pursuant to Paragraph (e)(5), a foreign tax credit may be allowed, under Section 903, if payment of a charge that is compensation for a specific economic benefit discharges a person's liability for an otherwise creditable charge.

Amounts paid or accrued by the taxpayer:

A credit is allowed under Sections 901 and 903 only for the amount of income tax (or in-lieu-of tax) that is paid or accrued by or on behalf of the taxpayer. Paragraph (f) of § 4.901-2 provides special paid-or-accrued rules in the case of refunds, subsidies, liability for more than one charge, noncompulsory amounts, contested liability, interest and penalties, and amounts for which consideration is received. Under Paragraph (g), income tax is paid or accrued by or on behalf of a person if foreign law imposes legal liability for income tax on that person. Special rules are provided for taxes paid on combined income and taxes paid by the payor of income.

Comments and requests for a public hearing:

Before adopting as final regulations the temporary and proposed regulations contained in this document, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

Drafting information:

The principal author of these regulations is Daniel Horowitz of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Adoption of regulations.

Accordingly, §§ 1.901-2 and 1.903-1 are deleted, a new Part 4, Temporary Income Tax Regulations Relating to the Creditability of Foreign Taxes, is added to Title 26 of the Code of Federal Regulations, and the following temporary regulations are adopted:

Reg. § 4.901-2

(TD 7739, filed 11-12-80.)

Income, war profits, or excess profits taxes paid or accrued.

(a) Definition of income, war profits, or excess profits tax

(1) In general. Section 901 allows a credit for the amount of any income, war profits, or excess profits tax ("income tax") paid or accrued by or on behalf of the taxpayer to any foreign country. Whether a charge imposed by a foreign country ("foreign charge") is an income tax is determined independently for each separate foreign charge. Each separate foreign charge will be considered either to be an income tax or not to be an income tax, in its entirety, for all persons subject to the charge. The standard for determining whether a foreign charge is an income tax is the U.S. income tax. Thus, a foreign charge is an income tax if and only if —
(i) The charge is not compensation for a specific economic benefit within the meaning of Paragraph (b) of this Section;
(ii) The charge is based on realized net income within the meaning of Paragraph (c) of this Section; and
(iii) The charge follows reasonable rules regarding source of income, residence, or other bases for taxing jurisdiction.

A foreign charge may meet these requirements even if the provisions of the law of the foreign country ("foreign law") imposing the charge differ substantially from the income tax provisions of the Internal Revenue Code. A foreign charge does not follow reasonable rules of taxing jurisdiction if liability for the charge is clearly related to the availability of a credit for the charge against income tax liability to another country.

(2) Other rules. Paragraph (d) of this Section contains rules describing what constitutes a separate foreign charge. Paragraphs (f) and (g) of this Section contain rules for determining the amount of income tax paid or accrued by or on behalf of the taxpayer. Paragraph (h) of this Section defines the term "foreign country."

(b) Compensation for a specific economic benefit

(1) General rule. A foreign charge imposed only on persons that do not receive any specific economic benefit from the foreign country is not compensation for a specific economic benefit. A foreign charge imposed on persons that receive a specific economic benefit from the foreign country is presumed to be compensation for a specific economic benefit. This presumption is rebutted only as provided in Paragraph (b)(2) and (4) of this Section.

(2) Same or similar charges. A foreign charge imposed on persons that receive a specific economic benefit is not compensation for a specific economic benefit if —
(i) The same charge is also imposed on income of persons that do not receive any specific economic benefit from the foreign country;
(ii) The amount of the charge paid by persons that receive the specific economic benefit is not significantly increased over what this amount would be if such persons were, instead, subject to an income tax imposed by the foreign country only on income of persons that do not receive the specific economic benefit; or
(iii) It is demonstrated that no significant part of the charge is compensation for the specific economic benefit received.

(3) Definitions — (i) Specific economic benefit. A person upon which a charge is imposed receives a specific economic benefit if and only if the person receives an economic benefit that, in general, is not being received by persons upon which the charge is not being imposed. The term "economic benefit" includes a good, a service, a fee or other payment, a right to use, acquire or extract resources, patents, or other property that the foreign country owns or controls, or a discharge of a contractual obligation. The term does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.
(ii) Control of property. A foreign country controls property to which it does not hold legal title if the country exhibits substantial indicia or ownership with respect to the property, for example by regulating the quantity of property that may be extracted and the price at which it may be disposed of.
(iii) Receiving a benefit. A person is considered to receive a specific economic benefit from a foreign country if another person receives a specific economic benefit from the foreign country and that other person —
(A) Is owned or controlled, directly or indirectly, by the same interests that own or control, directly or indirectly, the first person; or
(B) Engages in business transactions with the first person under terms and conditions such that the first person receives, directly or indirectly, some portion of the value of the specific economic benefit.

(4) Pension, unemployment, and disability fund payments. A foreign charge imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some similar purpose, is not compensation for a specific economic benefit if the amount of charge imposed on each individual is not computed on a basis reflecting the characteristics of that individual. A foreign charge is, however, not considered an income tax if it is imposed with respect to any period of employment or self-employment that is covered under the social security system of the foreign country in accordance with the terms of an agreement entered into pursuant to Section 233 of the Social Security Act.

(c) Realized net income

(1) In general. A foreign charge is computed on the basis of realized net income if and only if it meets the realization, gross receipts, and net income requirements as set forth in Paragraph (c)(2), (3) and (4) of this Section.

(2) Realization — (i) In general. A foreign charge meets the realization requirement if it is imposed, without substantial deviation, upon the occurrence of events that —
(A) Result in the realization of income under the income tax provisions of the Internal Revenue Code;
(B) Occur subsequent to events described in Paragraph (c)(2)(i)(A) of this Section; or
(C) Occur prior to events described in Paragraph (c)(2)(i)(A) of this Section, but only if the events are the transfer or processing of readily marketable property (within the meaning of Paragraph (c)(2)(iii) of this Section).
Paragraph (c)(2)(i)(C) of this Section applies only if the foreign country does not impose any charge with respect to the same

amounts upon the occurrence of another event (other than a distribution or a deemed distribution of such amounts).
(ii) Different taxable entity. A foreign charge meets the realization requirement if it is imposed, but only once, on amounts that meet the realization requirement with respect to a person that, under foreign law, distributes or is deemed to distribute such amounts.
(iii) Readily marketable property. Property is readily marketable if it —
(A) Can be sold on an open market without further processing; or
(B) Is exported from the foreign country; and
is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year, or is held primarily for sale to customers in the ordinary course of business.

(3) Gross receipts. A foreign charge meets the gross receipts requirement if it is imposed, without substantial deviation, on the basis of —
(i) Gross receipts; or
(ii) Gross receipts computed under a method that is designed to produce an amount that is not greater than fair market value and that, in fact, produces an amount that approximates, or is less than, fair market value, but only in the case of —
(A) Transactions with respect to which it is reasonable to believe that gross receipts may not otherwise be clearly reflected; or
(B) Situations to which Paragraph (c)(2)(i)(C) of this Section (relating to a transfer or processing of readily marketable property) applies.

(4) Net income. — (i) In general. A foreign charge meets the net income requirement if the base of the charge is computed, without substantial deviation, by reducing gross receipts by —
(A) Expenses and capital expenditures ("costs") attributable, under reasonable principles, to such gross receipts; or
(B) Costs computed under a method that is designed to produce an amount that is not less than costs attributable, under reasonable principles, to such gross receipts and that, in fact, produces an amount that approximates, or is greater than, such costs, but only in the case of transactions with respect to which it is reasonable to believe that costs may not otherwise be clearly reflected.
(ii) Formulary base. Notwithstanding Paragraph (c)(3) and (4)(i) of this Section, a foreign charge meets the gross receipts and net income requirements if the base of the charge is computed by reducing gross receipts by costs as described in Paragraph (c)(4)(i) of this Section except that certain persons subject to the charge may, under foreign law, elect periodically to compute a portion of the base of the charge under another method.
(iii) Charges on fixed or determinable income. Notwithstanding Paragraph (c)(1) of this Section, a foreign charge need not meet the net income requirement if and only if —
(A) It is imposed, without substantial deviation, on items of gross income specified in Section 871(a) or 881(a) (or on such items of gross income reduced by specified amounts); and
(B) Foreign law makes a reasonable distinction, based on the degree of contact that the foreign country has with the recipient of the income or with the activities or assets that generate the income, between items of income that are subject to the charge and such items of income that are subject to a charge computed by reducing realized gross receipts by costs as described in Paragraph (c)(4)(i) of this Section.

(d) Separate charges

(1) In general. Whether separate charges are imposed by a foreign country depends upon the structure of foreign law. Charges are separate if they are separately computed under foreign law as provided in Paragraph (d)(2), (3), or (5) of this Section, or if foreign law contains particular industry provisions described in Paragraph (d)(4) of this Section.

(2) Separate bases. Foreign law imposes a separate charge on each separate base if a separate rate of charge is applied to each base or a flat rate is applied to bases that are combined. If a progressive rate of charge is applied to bases that are combined, foreign law imposes a single charge on the aggregate of the bases. A separate base may consist of a particular type of income (such as interest income or income derived by a particular class of persons) or nonincome amount (such as wages paid) identified by foreign law. Identified types of income or nonincome amounts constitute one base only if costs related to one type may reduce the other types. If no deduction for costs is permitted, each identified type of income or nonincome amount is a separate base, regardless of whether the types are aggregated for purposes of applying a rate of charge.

(3) Separate rates. Foreign law imposes separate charges if separate rates of charge are applied to the same base.

(4) Particular industry. If foreign law imposing a charge contains provisions that significantly increase the liability only of persons engaged in a particular industry or industries, and if those provisions would prevent the charge from being an income tax if persons engaged in the industry or industries were the only persons subject to the charge, then foreign law imposes a separate charge on persons engaged in the industry or industries.

(5) Contractual modifications. If foreign law imposing a charge is modified by contracts entered into by the foreign country, then foreign law imposes a separate charge on persons that are parties to substantially similar contracts with the country.

(e) Examples.

The following examples illustrate the application of Paragraphs (a), (b), (c), and (d) of this Section.

Example (1). Country X imposes separate 30 percent charges on interest, dividends, and royalties paid by residents of country X to residents of the United States or of country A, B, C, D, or E, that are not engaged in trade or business in country X. Interest, dividends, and royalties paid to residents of other countries are exempt from tax by country X. Like the United States, countries A, B, C, D, and E each allows its residents to claim a credit against the income tax otherwise payable to it for income taxes paid to other countries. Because the 30 percent charge is imposed by country X only on residents of countries which allow a credit for taxes paid to other countries, liability for the charge is clearly related to the availability of a credit for the charge against income tax liability to another country. As a result, under Paragraph (a)(1)(iii) of this Section, the charge does not follow reasonable rules of taxing jurisdiction and is not an income tax.

Example (2). Country X imposes a 25 percent charge on royalties. Country X has a patent license agreement with D, a corporation organized in the United States. Country X and D agree, as part of the patent license, that the 25 percent charge will be imposed on royalties due from country X to D only to the extent of the amount available to D as a credit against D's U.S. income tax liability. Under Paragraph (d)(5) of this Section, country X imposes a separate charge on D. The liability for this charge is clearly related to the availability of a credit for the charge against income tax liability to another country. As a result, under Paragraph (a)(1)(iii) of this Section, the charge does not follow reasonable rules of taxing jurisdiction and is not an income tax.

Example (3). Country X imposes a 55 percent charge on the realized net income of corporations owned by nonresidents. These corporations are engaged in various businesses in country X including mineral extraction. Country X owns all mineral resources located within the country and licenses private persons to extract those minerals. Country X does not retain a share of the minerals extracted by licensees or receive a separately computed royalty from licensees. The law of country X imposing the 55 percent charge does not distinguish significantly between persons extracting minerals and other persons that do not receive any specific economic benefit in determining gross receipts, allowing deductions for expenses and recovery of capital (including depletion), permitting losses from one activity to offset income from other activities, applying rates of charge, or in any other manner. With respect to both licensees and others, the charge is not compensation for a specific economic benefit under Paragraph (b)(2)(i) of this Section.

Example (4). The facts are the same as in example (3), except that country X imposes different rates of charge on the realized net income of various corporations as follows:

Industry	*Rate of charge*
Manufacturing	45 percent
Technical services	35 percent
Construction	30 percent
Mineral extraction	45 percent

In addition, country X imposes a 25 percent charge on interest paid by residents of country X to corporations not engaged in business in country X. The 25 percent charge and the charge imposed on persons engaged in manufacturing are income taxes. For purposes of Paragraph (b)(2)(ii) of this Section, the charge on gross income of corporations not engaged in business in country X cannot be compared with a charge on corporations engaged in business in country X. The charge on mineral extraction can, however, be compared to the charge imposed on corporations engaged in manufacturing in country X. Thus, the charge imposed on corporations engaged in mineral extraction is not compensation for a specific economic benefit under Paragraph (b)(2)(ii) of this Section.

Example (5). The facts are the same as in example (3), except that corporations engaged in a business other than mineral extraction are subject to a 35 percent charge on realized net income if they are closely held and to a 55 percent charge on realized net income if they are widely held. Both of these charges are income taxes. Corporations engaged in a business other than mineral extraction are both widely and closely held. Corporations engaged in mineral extraction are subject to a separate 55 percent charge on realized net income whether they are widely or closely held. The latter charge is not compensation for a specific economic benefit under Paragraph (b)(2)(ii) of this Section.

Example (6). The facts are the same as in example (3), except that realized net income in excess of $1,000,000 is subject to a rate of 70 percent. Most corporations engaged in mineral extraction in country X have realized net income significantly in excess of $1,000,000. Other corporations never have an amount of realized net income significantly in excess of $1,000,000. The charge imposed on corporations engaged in mineral extraction, which varies from 55 to 70 percent, is a separate charge under Paragraph (d)(4) of this Section because the 70 percent rate significantly increases the liability only of persons engaged in mineral extraction. This charge is presumed to be compensation for a specific economic benefit under Paragraph (b)(1). This presumption is rebutted only if it is demonstrated that no significant part of the charge is compensation for the specific economic benefit received by corporations engaged in mineral extraction.

Example (7). Country X imposes a 45 percent charge on the realized net income of all corporations doing business in country X. Corporations engaged in the extraction of mineral resources owned by country X pay an additional charge of 40 percent of the same base as the 45 percent charge. In computing the base of each of these charges, no deduction is allowed for the amount of the other charge. The fact that no such deduction is allowed significantly increases the amount of each charge paid by corporations engaged in mineral extraction over what this amount would be if such corporations were subject to the 45 percent charge on the basis of realized net income (that is, if a deduction for the 40 percent charge were allowed). The 40 percent charge and the 45 percent charge imposed on corporations engaged in mineral extraction are separate charges under Paragraph (d)(3) and (4), respectively, of this Section. Each is presumed to be compensation for a specific economic benefit under Paragraph (b)(1). This presumption is rebutted only if it is demonstrated that no significant part of the charge is compensation for the specific economic benefit received by corporations engaged in mineral extraction. The 45 percent charge imposed on other corporations is a separate charge that may be an income tax.

Example (8). Country X imposes a 40 percent Corporate Tax on the realized net income of foreign corporations engaged in the extraction of minerals owned by country X. These corporations are also subject to a Branch Profits Tax of 10 percent imposed on the same base as the 40 percent charge. Other foreign corporations are subject to the Corporate Tax at a rate of 30 percent and to the Branch Profits Tax at a rate of 20 percent. The 20 percent charge and the 30 percent charge are income taxes. Because the overall burden on corporations engaged in mineral extraction is the same as that on other foreign corporations, neither of the charges imposed on corporations engaged in mineral extraction is compensation for a specific economic benefit under Paragraph (b)(2)(ii) of this Section.

Example (9). Country X imposes an 80 percent charge on the realized net income of corporations engaged in the extraction of mineral resources owned by country X and on several other corporations. Country X also imposes a 40 percent charge on the realized net income of all corporations engaged in business in the country that are not subject to the 80 percent charge. Most corporations engaged in mineral extraction in country X have realized net income in excess of $10,000,000. The other corporations subject to the 80 percent charge generally have less than $100,000 of realized net income. Paragraph (b)(2)(i) of this Section does not apply because the income of corporations not engaged in mineral extraction that are subject to the 80 percent charge is so insignificant that no meaningful comparison can be made between the amount of charge imposed on such persons and the amount of charge imposed on persons engaged in mineral extraction. The 80 percent charge is presumed to be compensation for a specific economic benefit under Paragraph (b)(1) of this Section. This presumption is rebutted only if it is demonstrated that no significant part of the charge is compensation for the specific economic benefit received by corporations engaged in mineral extraction.

Example (10). Country X imposes a 46 percent charge on the realized net income of corporations engaged in the extraction of minerals owned by country X. Country X imposes no income tax on other persons. The 46 percent charge is presumed to be compensation for a specific economic benefit under Paragraph (b)(1) of this Section. This presumption is rebutted only if it is demonstrated that no significant part of the charge is compensation for the specific economic [benefit] received by corporations engaged in mineral extraction.

Example (11). Country X owns all the subsoil mineral resources within country X and retains privately owned corporations to provide the services of extracting and marketing such minerals for country X in return for a fee. Country X generally imposes a 30 percent charge on realized net income of corporations. The rate of charge for mineral service corporations is, however, 60 percent. Under Paragraph (b)(3)(i) of this Section, the fee paid to the mineral service corporations is a specific economic benefit provided by country X to these corporations. The charge imposed on these corporations is presumed to be compensation for a specific economic benefit under Paragraph (b)(1) of this Section.

Example (12). Country X allows resident individuals to deposit amounts of earned income in a "retirement savings account" ("RSA") and claim a deduction for the deposit in computing taxable income under its income tax. When amounts are paid out of a RSA, country X subjects those amounts to a separate charge of 20 percent. The RSA does not meet the standards of an Individual Retirement Account set forth in Section 408(a) and no deduction would be allowed under Section 219(a)(1) for the deposits. Because the charge is imposed only on the occurrence of an event (withdrawal) that occurs subsequent to an event that results in realization under the income tax provisions of the Internal Revenue Code, the charge meets the realization requirement under Paragraph (c)(2) of this Section.

Example (13). Country X imposes on all individuals a charge that is similar to the individual income tax provisions of the Internal Revenue Code except that taxable income is defined to include imputed rental income from owner-occupied housing and unrealized appreciation of investment property. The charge meets the realization requirement under Paragraph (c)(2) of this Section because the charge is imposed, without substantial deviation, upon the occurrence of events described in Paragraph (c)(2)(i)(A).

Example (14). Country X imposes on all individuals a charge that is similar to the individual income tax provisions of the Internal Revenue Code. In addition, country X imposes a separate charge on imputed rental income from owner-occupied housing. No other amounts are included in the base on which the latter charge is imposed. The latter charge does not meet the realization requirement because it is not imposed, without substantial deviation, upon the occurrence of events described in Paragraph (c)(2)(i) of this Section.

Example (15). Country X imposes a separate charge on corporations engaged in the extraction and processing of petroleum. The base of the charge is "gross proceeds" reduced by costs. "Gross proceeds" is defined as actual gross receipts from sales plus the value (determined on an arbitrary basis) of petroleum "used" by the corporation. Petroleum is "used" by the corporation, if the petroleum is consumed in powering the vehicles or machines employed by the corporation in extracting or processing petroleum. In country X, "used" petroleum is likely to be an insignificant portion of total extracted petroleum. Despite the fact that the base of the charge includes "used" petroleum valued on an arbitrary basis, the charge meets the realization and gross receipts requirements under Paragraph (c)(2) and (3) of this Section because it is computed, without substantial deviation, on the basis of realized actual gross receipts.

Example (16). Country X imposes a separate charge on petroleum extraction income. The base of the charge is "gross proceeds" reduced by costs. "Gross proceeds" is defined as gross income from sales of extracted petroleum plus the fair market value of unsold petroleum transported from the well-head and delivered for processing. The charge meets the realization requirement under Paragraph (c)(2)(i)(A) and (C) of this Section because it is imposed upon the occurrence of sales and transfers (transport) and the transported petroleum is readily marketable property. In addition, the charge meets the gross receipts requirement under Paragraph (c)(3)(i) and (ii)(B) of this Section.

Example (17). Country X imposes a separate charge on the excess of fair market value over costs of readily marketable minerals removed from a mine. Country X imposes another separate charge on realized net income of corporations. Included in the base of this charge are proceeds from sales of minerals, including minerals subject to the former charge. The former charge does not satisfy the realization requirement under Paragraph (c)(2)(i) of this Section because country X imposes a charge with respect to the same income upon the disposition of the same minerals.

Example (18). Country X imposes a Corporation Tax on realized net income. Country X also imposes a tax on dividends paid to shareholders resident outside of country X by corporations organized in country X, and a Branch Profits Tax on corporations organized under the law of another country. The Branch Profits Tax is imposed when realized net income is remitted to home offices outside of the country X. The Branch Profits Tax meets the realization requirement under Paragraph (c)(2)(ii) of this Section.

Example (19). Country X imposes a charge on the net gain of petroleum companies and another charge on the net gain of other companies. Net gain of petroleum companies is determined when petroleum is sold or exported, whichever occurs first. Country X's Tax Board uses a set price in determining net gain derived from both sales and exports of petroleum. The set price is a weighted average based on reported prices for arm's-length sales of country X petroleum and comparable petroleum from other countries under long and short term contracts and on the "spot market." The set price takes into account transportation costs, delivery time, payment time and prices for petroleum products. The set price is determined retroactively every 4 months by the Tax Board and is applied to sales and exports that took place during that period. The set price is in fact nearly equal to the fair market value of substantially all the petroleum sold and exported by companies subject to the charge. With respect to companies other than petroleum companies, country X uses actual gross receipts in computing net gain. It uses the set price for petroleum companies because the Tax Board believes that the gross receipts of petroleum companies are not otherwise clearly reflected. Since the exported petroleum is readily marketable property, the realization requirement under Paragraph (c)(2) of this Section is met. In addition, the charge meets the gross receipts requirement under Paragraph (c)(3)(ii)(A) and (B) of this Section.

Example (20). Country X imposes a charge on the "value" of exported petroleum. The "value" of such petroleum is deemed to be the "spot-market" price although a significant portion of exported petroleum is sold to related and unrelated persons under long term contracts at arm's-length prices substantially below the "spot market" price. The charge does not meet the gross receipts requirement under Paragraph (c)(3) of this Section because the "value" of petroleum used by country X is an amount determined under a method that is not designed to produce an amount that is not greater than fair market value.

Example (21). Country X uses a set price in imposing a charge on the net gain of petroleum companies. The set price is equal to 102 percent of the fair market value of the petroleum. The charge does not meet the gross receipts requirements under Paragraph (c)(3) of this Section because it is computed under a method that is not designed to produce an amount that is not greater than fair market value.

Example (22). Country X imposes a charge on business income which is computed by deducting costs from realized gross receipts. However, country X limits the amount of costs which may be deducted to 80 percent of gross receipts. Costs incurred in deriving gross receipts in country X frequently exceed 80 percent of such receipts. The charge does not meet the net income requirement under Paragraph (c)(4) of this Section.

Example (23). Country X imposes a charge on realized gross business receipts. The legislative history of the charge indicates that the rate was reduced to make up for the fact that deductions were not allowed. The charge does not meet the net income requirement under Paragraph (c)(4) of this section.

Example (24). Country X imposes a charge on the realized gross receipts, less allowed deductions, derived by domestic and foreign persons from business activities conducted within country X. Country X allows deductions for all costs except royalties paid to a related person, interest exceeding certain limits paid to a related person by a person other than a financial institution, social security tax payments to other countries, and general administrative costs incurred by home offices outside country X. Despite the disallowance of the costs described above, country X's charge satisfies the net income requirement under Paragraph (c)(4)(i) of this Section because it is computed, without substantial deviation, by reducing gross receipts by costs.

Example (25). Country X imposes a 40 percent charge on realized net income of all corporations that have offices in country X, including corporations that maintain a headquarters office to provide management services for related corporations. Country X allows a person subject to this charge to elect every 2 years to calculate its realized net income from headquarters management services by way of a formula rather than by subtracting costs from gross receipts. The formula provides that realized net income from such services is deemed to be a specified multiple of the costs of providing the services. This amount is added to the amount of any other realized net income and the 40 percent rate of charge is applied to the sum of the amounts. The charge imposed by country X meets the gross receipts and net income requirements pursuant to Paragraph (c)(4)(ii) of this Section.

Example (26). Country X imposes a charge on the realized net income of individual residents of the country. A resident individual that does not engage in commercial activity within country X may elect annually to calculate his income from sources without country X either by reducing realized gross receipts by costs or under a formula. The formula provides that taxable income is deemed to be a specified multiple of the rental value of the individual's residence. This amount is added to his income from sources within country X and the rate of charge is applied to the sum of the amounts. The charge imposed by country X meets the gross receipts and net income requirements pursuant to Paragraph (c)(4)(ii) of this Section.

Example (27). Country X imposes an income tax on income derived from manufacturing operations in Country X. Province A of country X imposes a charge on gross receipts, less deductions, derived from manufacturing operations in province A. No deduction is allowed in computing the province A charge for the country X income tax. Notwithstanding the failure to allow a deduction for the portion of the income tax that is attributable to manufacturing operations without province A, the province A charge may meet the net income requirement under Paragraph (c)(4) of this Section because this portion is not a cost attributable to gross receipts subject to the province A charge. Notwithstanding the failure to allow a deduction for the portion of the country X income tax attributable to manufacturing operations within province A, the charge may meet the net income requirement because the failure of a charge to allow the deduction of an income tax imposed on the same gross receipts is not a substantial deviation within the meaning of Paragraph (c)(4)(i).

Example (28). Country X imposes a 25 percent rate of charge on interest, dividends, and royalties paid by residents of country X to persons that are neither residents of, nor, in the case of foreign persons, "established" in, country X. The law of country X allows non-resident financial institutions to operate in the country only through "representative offices." The functions of a "representative office" are limited by law to solicitation of customers for its home office or branches outside country X, advertising for its home office, performance of credit analyses on prespective borrowers, and the transmission of information between prospective borrowers and the home office. Deposits from residents of country X may not be accepted by such respresentative offices. A representative office cannot legally bind the non-resident financial institution. Loans must be recorded outside the country. Non-resident financial institutions doing business in country X through representative offices are not considered to be "established" in country X and interest paid to them by residents of country X is subject to the 25 percent charge. Interest paid to resident financial institutions is subject to a 50 percent charge on realized gross receipts reduced by costs. The 25 percent rate of charge as applied to interest is a separate charge under Paragraph (d)(2) of this Section and need not meet the net income requirement pursuant to Paragraph (c)(4)(iii).

Example (29). The facts are the same as in example (28), except that certain non-resident financial institutions have been granted the right to open branches in country X and to perform all normal banking activites within country X. Financial institutions that exercise this right are considered "established" in country X and are subject to the 50 percent charge on realized net income attributable, under reasonable principles, to the establishment. The interest received by such financial institutions that is not attributable to such an establishment is subject to the 25 percent gross charge. The 25 percent charge need not meet the net income requirement pursuant to Paragraph (c)(4)(iii) of this Section.

Example (30). The law of country X requires that loans made to residents of country X by non-residents be recorded and executed outside the country. There are no other restrictions on the activities that non-residents can perform within country X. A separate charge of 25 percent is imposed on gross interest paid by residents of country X to non-residents. The 25 percent charge is not excused from the net income requirement of Paragraph (c)(4) of this Section by Paragraph (c)(4)(iii) because country X does not make a reasonable distinction, based on the degree of contact of the recipients of the interest or the activities or assets that generate the interest, between interest income that is subject to the 25 percent charge and interest income that is subject to a charge on realized gross receipts reduced by costs. The 25 percent charge does not meet the net income requirement because the base of the charge is not computed, without substantial deviation, by reducing gross receipts by costs that may be incurred by lenders.

Example (31). Country X imposes a charge computed on the basis of realized gross receipts reduced by costs on residents of country X and on non-residents that have a permanent establishment within country X. Country X also imposes a 20 percent charge on the gross amount of fees paid by residents of country X for technical services performed within or without the country by non-residents that have no permanent establishment within country X. A non-resident has a permanent establishment within country X if it has a place of business in the country for a period of more than 1 year. Pursuant to Paragraph (a)(1)(iii) of this Section, the 20 percent charge may be an income tax notwithstanding the fact that country X determines the source of personal services income on the basis of the residence of the payor. Pursuant to Paragraph (c)(4)(iii) of this Section, the 20 percent charge need not meet the net income requirement.

Example (32). Country X imposes a 50 percent charge on the "net gain" of corporations engaged in a trade or business in country X. In calculating "net gain," deductions are allowed for all business expenses. In addition, corporations subject to the charge are permitted to amortize capital expenditures over a reasonable period. Country X does not permit related corporations to file consolidated returns. It does, however, permit a carryover of losses from the period in which the losses are incurred to other periods. Country X requires that each oil well within the country be operated by a separate corporation. Otherwise country X imposes no restrictions on whether businesses may operate as a single corporation. As a result, foreign persons wishing to engage in the extraction of oil within country X typically form several corporations, each of which operates a different well. Country X does not own or control the petroleum resources in country X. The provision of foreign law precluding the filing of consolidated returns significantly increases the liability only of corporations engaged in the extraction of oil because country X requires each oil well to be incorporated separately and it can reasonably be expected that oil wells will frequently not be profitable. Extraction corporations that incur costs with respect to an oil well that does not produce revenues will never be able to recover those costs. Therefore, the 50 percent charge as it applies to corporations engaged in the extraction of oil is considered a separate charge under Paragraph (d)(4) of this Section. That charge does not satisfy the net income requirement under Paragraph (c)(4)(i) of this Section because it is likely that the aggregate of the basis of the charge imposed on the profitable members of a group of related corporations engaged in the extraction of oil will frequently be significantly greater, over a reasonable period of time, than the excess of the aggregate gross receipts of the entire group of related corporations over the costs attributable, under reasonable principles, to those gross receipts. The 50 percent charge, as it applies to other industries, is a separate charge and may be an income tax with respect to other corporations that are subject to it.

Example (33). The facts are the same as in example (32), except that country X does not require that each oil well within the country be operated by a separate corporation. Instead, it requires that persons engaged in unrelated lines of business conduct each line of business through a separate corporation. Thus, a person wishing to engage in the extraction of oil within country X and to invest in a resort hotel in country X is required to conduct each activity through a separate corporation. Even though country X does not permit the filing of consolidated returns by related corporations, country X's charge meets the net income requirement under Paragraph (c)(4)(i) of this Section.

Example (34). Country X generally imposes a 45 percent charge on the realized net income of corporations doing business in country X. However, the law of country X provides that in the case of a corporation engaged in mining operations, a separate 35 percent charge is instead imposed on the excess of the gross receipts over costs attributable to each specified ore body. Thus, losses from one specified ore body may not offset gains from another specified ore body or from other activities and losses from other activities may not offset gains from specified ore bodies. Losses attributable to one taxable year may be carried forward and used in subsequent taxable years. Country X owns the mineral resources in country X. Corporations engaged in mining operations often also are engaged, in country X, in related activities such as processing or refining. The realized net income from these activities is subject to the 45 percent charge. It is demonstrated that it is likely that these related activities are profitable over a reasonable period of time. It is also demonstrated that due to the nature of the expenses involved in mining ore in country X, the scope of the mining areas encompassed within ore bodies, the value of country X ore, and the prospects for the recovery of ore, the aggregate of the basis of the separate charges imposed with respect to each profitable specified ore body will rarely, if ever, be significantly greater, over a reasonable period of time, than the excess of the aggregate of gross receipts from all specified ore bodies over all costs attributable, under reasonable principles, to those gross receipts. The charge imposed with respect to each specified ore body satisfies the net income requirement under Paragraph (c)(4)(i) of this Section.

Example (35). A charge imposed by the law of country X is not based on realized net income. A, a U.S. person, represents to the Internal Revenue Service that the law of country X is administered, with respect to A, in a manner such that in practice the charge is based on realized net income. Notwithstanding this representation, the charge is not an income tax because it does not meet the standard set forth in Paragraph (a)(1)(ii) of this Section under the law as well as in practice.

Example (36). Country X imposes a charge on all interest paid by residents of country X to lenders, regardless of whether the lenders are commercial or whether they are residents of, or operate within, country X. Country X's law does not specifically identify separate classes of taxpayers or types of interest. Under Paragraph (d)(2) of this Section, country X imposes one charge on interest income. The charge does not meet the net income requirement of Paragraph (c)(4)(i) of this Section. It is not excused from meeting this requirement by Paragraph (c)(4)(iii) because no interest is subject to a charge computed by reducing realized gross interest by costs as described in Paragraph (c)(4)(i).

Example (37). The facts are the same as in example (36) except that country X's law does specifically identify residents and non-residents as separate classes. Under Paragraph (d)(2) of this Section country X imposes separate charges on interest paid to residents and non-residents. However, the charge on non-residents is not excused from meeting the net income requirement by Paragraph (c)(4)(iii) of this Section because interest paid to residents is not subject to a charge computed by reducing realized gross interest by costs as described in Paragraph (c)(4)(i).

Example (38). Country X imposes a single rate of charge on the sum of an individual's wages and gross business income. The wage income and the business income each constitute a separate base under Paragraph (d)(2) of this Section because these amounts are identified by foreign law and no deductions are allowed for costs. Since a flat rate of charge is applied to the sum of the bases, the charge on each base is a separate charge. Accordingly, under Paragraph (a)(1) of this Section, the determination of whether the charge on gross business income is an income tax is made independently of the determination of whether the charge on wages is an income tax.

Example (39). Country X requires persons to pay an amount equal to 25 percent of a specified base and another amount equal to 15 percent of the same base. Country X imposes two separate charges under Paragraph (d)(3) of this Section.

Example (40). The facts are the same as in example (39), except that the 15 percent rate is applied to the specified base reduced by the amount of the first charge. Country X imposes two separate charges under Paragraph (d)(2) of this Section.

Example (41). Country X imposes a charge on realized net income except that no deduction or other allowance is granted for mineral royalties paid or accrued. The disallowance of a mineral royalties deduction significantly increases the liability only of persons engaged in mineral extraction. If such persons were the only persons subject to the charge, the charge would not be an income tax because it would not satisfy the net income requirement under Paragraph (c)(4) of this Section. Country X imposes a separate charge on persons engaged in mineral extraction under Paragraph (d)(4) of this Section.

Example (42). The facts are the same as in example (41), except that the deduction disallowed applies only to royalties paid or accrued for the right to extract gold ore. Country X imposes a separate charge on persons engaged in gold ore extraction under Paragraph (d)(4) of this Section.

(f) Amount of income tax paid or accrued

(1) In general. A credit is allowed under Section 901 for the amount of income tax (within the meaning of § 4.901-2(a)(1)) that is paid or accrued to a foreign country, subject to the provisions of this Paragraph (f). The amount of income tax paid or accrued is determined separately for each taxpayer.

(2) Refunds. An amount is not income tax paid or accrued to a foreign country to the extent that it is reasonably certain that the amount will be refunded. It is not reasonably certain that an amount will be refunded if the amount is a reasonable approximation of final income tax liability to the foreign country.

(3) Subsidies — (i) General rule. An amount is not income tax paid or accrued to a foreign country to the extent that —
(A) The amount is used directly or indirectly by the country to provide a subsidy by any means (such as through a refund or credit) to the taxpayer; and
(B) The subsidy is determined directly or indirectly by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the taxpayer.
(ii) Indirect subsidies. A foreign country is considered to provide a subsidy to a person if the country provides a subsidy to another person that —
(A) Is owned or controlled, directly or indirectly, by the same interests that own or control, directly or indirectly, the first person; or
(B) Engages in a business transaction with the first person, but only if the subsidy received by such other person is determined directly or indirectly by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the first person with respect to such transaction.

(4) Multiple charges — (i) General rule. If a person or one or more related persons are liable to a foreign country for one or more charges that are not income taxes in addition to an income tax, an amount is income tax paid or accrued to a foreign country only to the extent that the total of all amounts paid or accrued to the country exceeds the amount for which the person or persons would have been liable to the country if the person or persons were not liable for any income tax. This Paragraph (f)(4) applies even if liability for the income tax and liability for the charges that are not income taxes are attributable to different taxable years.
(ii) Offsetting charges. If under foreign law —
(A) Liability for an income tax can be reduced by the amount of a charge that is not an income tax;
(B) Liability for a charge that is not an income tax can be reduced by the amount of an income tax; or
(C) The total amount of liability is the greater of the amount of an income tax or the amount of a charge that is not an income tax;
then an amount is income tax paid or accrued to a foreign country only to the extent that the income tax exceeds the other charge.
(iii) Simultaneously determined amounts. If liability for an income tax and liability for one or more charges that are not income taxes are computed so that their sum cannot be less than a third amount that is not an income tax, then an amount is income tax paid or accrued to a foreign country only to the extent that the income tax exceeds the third amount.
(iv) Advance corporation taxes. If, pursuant to foreign law that partially or fully integrates corporate and shareholder taxation, liability of a corporation for an amount, imposed with respect to a distribution of the corporation's profits ("advance amount"), reduces liability of the corporation, or a related corporation, for an income tax imposed on corporate profits, whether or not distributed, then the corporate income tax is paid or accrued in the taxable year for which it is imposed and the advance amount is not paid or accrued to the extent such amount reduces the corporate income tax. The amount of corporate income tax paid or accrued is reduced to the extent the advance amount is paid or credited to shareholders of the distributing corporation.

(5) Noncompulsory amounts. An amount is not income tax paid or accrued to a foreign country to the extent that the amount exceeds liability under foreign law for income tax. An amount does not exceed such liability if —
(i) The amount of such liability is determined; and
(ii) All effective and practical remedies are exhausted;

in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax conventions) so as to reduce, over a reasonable period of time, such liability. An interpretation or application of foreign law is not reasonable if there is actual or constructive notice that the interpretation or application is likely to be erroneous. A remedy is effective and practical only if it is reasonable to believe that the potential reduction in liability would justify the expenses of pursuing the remedy. A person need not alter its form of doing business or its business conduct to reduce its liability under foreign law for income tax.

(6) *Contested amounts.* An amount may be income tax paid or accrued to a foreign country notwithstanding the fact that liability for the amount is contested.

(7) *Interest and penalties.* An amount is not income tax paid or accrued to a foreign country to the extent that the amount discharges a liability for interest, fines, penalties, or any similar obligation.

(8) *Consideration.* An amount is not income tax paid or accrued to a foreign country to the extent of the fair market value of consideration received explicitly in exchange for the amount. Unless it is demonstrated otherwise, the fair market value of the consideration will be considered to be equal to the amount exchanged for the consideration.

(9) *Examples.* The following examples illustrate the application of this Paragraph (f).

Example (1). The law of country X provides that 25 percent of the amount of a person's "income tax liability" to that country will be refunded to that person after 5 years. The amount to be refunded is not income tax paid or accrued under Paragraph (f)(1) and (2) of this Section.

Example (2). The law of country X requires a resident of country X that pays interest to a non-resident to withhold and pay over to country X 25 percent of such interest. A tax convention between the United States and country X provides that interest paid by a resident of country X to a resident of the United States is subject to a maximum rate of charge of 10 percent and that such charge is an income tax. The excess over the 10 percent rate is refunded to the U.S. resident after the end of the taxable year. Under Paragraph (f)(1) and (2) of this Section, the excess of the amount withheld over the 10 percent rate is not income tax paid or accrued.

Example (3). Country X imposes a 30 percent charge on interest paid by its residents to non-resident lenders. This charge is withheld by resident borrowers and paid over to country X. Country X refunds to borrowers a subsidy equal to 20 percent of the interest paid. Because the subsidy is based on the interest paid, it is determined by reference to the base used to compute the income tax imposed on the non-resident lender. Under Paragraph (f)(3)(ii)(B) of this Section, the subsidy is considered to be provided to the non-resident lender since it is provided to a person (the borrower) that engaged in a business transaction with the lender and is based on the amount of income tax imposed on the lender with respect to this transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by a resident borrower from interest payments to a non-resident lender is not income tax paid or accrued under Paragraph (f)(3)(i) of this Section.

Example (4). Country X grants a "rebate" to each province of country X of a specified percentage of the income tax paid in the prior year to country X by the electric company in the province. Each province may decide the manner in which it will use the rebate. Province A uses the rebate to pay an allowance to each person that is a customer of the electric company in province A during the year the allowance is paid. The allowance is based on the amount of electricity used by the customer in that year. Country X regulates electric utility rates and does not vary them to reflect the allowance paid to customers. Country X is not considered to provide a subsidy to the electric company in province A under Paragraph (f)(3) of this Section because the allowance paid to a customer is not based on the amount of income tax imposed on the electric company with respect to its transaction with that customer.

Example (5). A is an accrual basis U.S. corporation doing business in country X. The general law of the country X provides that income tax due to country X for any taxable year must be paid by the end of the next taxable year. Country X and A agree by contract that A is not required to pay the income tax due for calendar year 1980 until December 31, 1984. A is not required to pay interest to country X on the unpaid income tax. The fair market value of the use by A in 1982, 1983, and 1984 of the amount of A's 1980 income tax liability is a subsidy determined by reference to the amount of income tax imposed on A by country X. Under Paragraph (f)(3)(i) of this Section, the amount of income tax otherwise accrued by A for 1980 is reduced by the amount of this subsidy. No additional amount of income tax is paid or accrued when the amount due is paid.

Example (6). Country X imposes an income tax on persons engaged in a trade or business in country X. In addition, country X requires petroleum companies to pay a royalty. Petroleum companies are allowed to deduct the amount of the royalty in computing net income subject to the income tax. The tax is then determined by applying the generally applicable tax rules and rates in country X. The amount of royalty imposed by country X is determined in such a way that the sum of the royalty and the amount of the net income tax on petroleum companies equals an amount which is based on a percentage of the gross value of petroleum production. Under Paragraph (f)(4)(iii) of this Section, the amount of the income tax paid or accrued is zero.

Example (7). Country X owns all mineral resources within country X and licenses corporation A to extract such minerals. Corporation A is permitted to sell the minerals to B a related corporation at fair market value. Corporation B is required under the law of country X to sell the same minerals within country X. Country X imposes an income tax on A's realized net income under the generally applied rates and provisions of its corporate income tax. Country X imposes a separate charge on B that is not an income tax. This charge is computed so that the sum of the amount of income tax imposed on A and the amount of charge imposed on B equals an amount based on a percentage of the gross value of the minerals sold by B. Under Paragraph (f)(4)(i) and (iii) of this Section, the amount of income tax paid or accrued by A is zero.

Example (8). The tax system of country X grants individuals that receive a dividend from a country X corporation a credit for a portion of the income tax paid by the corporation. When a country X corporation pays a dividend, it is required to make an advance payment equal to a specified percentage of the amount of the dividend. The advance payment, under the law of country X, may offset the country X income tax liability of the distributing corporation or related country X corporations. In 1973, A, a country X corporation, pays a dividend to B, its U.S. parent corporation, and also makes the associated advance payment. Neither A nor any of its related corporations is liable for any country X corporate income tax for 1973. In 1974 pursuant to country X law, the entire advance payment made by A in 1973 reduces the liability of C, a related corporation, for the country X corporate income tax for 1974. The advance payment is not income tax paid or accrued by A. Instead, the corporate income tax for 1974 is paid or accrued by C under Paragraph (f)(4)(iv) of this Section.

Example (9). A, a corporation organized and doing business solely in the United States, owns all of the stock in B, a corporation organized in country X. A and B deal extensively with each other. A reasonable interpretation of country X's income tax provisions requiring that transactions between related persons be at arm's length would allocate $100,000 of income to B and $100,000 to A in 1978. Instead, A and B allocate $10,000 of income to A and $190,000 to B. This allocation is not consistent with a reasonable interpretation of the law of country X. The Internal Revenue Service does not audit the 1978 tax return of A. The amount paid or accrued to country X by B that is attributable to the improperly allocated $90,000 exceeds legal liability and is not income tax paid or accrued under Paragraph (f)(5) of this Section.

Example (10). A, a corporation organized and doing business solely in the United States, owns all of the stock in B, a corporation organized in country X. Country X has in force a tax convention with the United States. The convention provides that the profits of related persons shall be determined as if the persons were not related. A and B deal extensively with each other. A and B, with respect to a transaction between them, allocate $30,000 of income to A and $70,000 of income to B. Subsequently, the Internal Revenue Service reallocates $20,000 of income from B to A under the authority of Section 482 and the convention. This reallocation constitutes notice that the interpretation of country X's law and the tax treaty is likely to be erroneous. B does not seek a refund from country X and does not establish that its liability to country X was determined in a manner consistent with a reasonable interpretation of country X's law and the tax convention. The amount paid to country X by B that is attributable to the reallocated $20,000 exceeds legal liability and is not income tax paid or accrued under Paragraph (f)(5) of this Section.

Example (11). C, a U.S. corporation doing business in country X, pays an income tax consistent with what appears to be a reasonable interpretation of the law of country X. A court in country X subsequently holds that corporations organized outside country X are entitled to a deduction not claimed by C. The statute of limitations of country X has not expired. C does not follow the procedural provisions of the law of country X allowing it to claim a refund in a country X court, although the expenses of doing so are small in relation to the potential country X tax savings. An amount equal to the refund that C could have received from country X exceeds legal liability and is not income tax paid or accrued under Paragraph (f)(5) of this Section.

Example (12). D, a U.S. person doing business in country X, is subject to the country X income tax. D determines its 1977 country X income tax liability in a manner that is consistent with a reasonable interpretation and application of the law of country X. After D files its country X return for 1977 and pays to country X the amount shown as due thereon, D files a claim for refund for 1977 in order to claim a deduction for certain additional business expenses on its return. Under the law of country X it is not clear that the deductions claimed by D in requesting the refund are allowable. Under Paragraph (f)(5) and (6) of this Section, the original income tax payment made by D to country X may be income tax paid or accrued notwithstanding the fact that D has filed a refund claim. However, if D obtains a refund, D must, pursuant to § 1.905-3(a), immediately notify the Internal Revenue Service of the refund.

Example (13). A is a U.S. person doing business in country X. In computing its income tax liability to country X, A calculates its depreciation on the basis of a reasonable asset life that is longer than the shortest life permitted by country X. Under Paragraph (f)(5) of this Section, the use of such asset life by A does not result in a payment in excess of legal liability for the income tax since the use of a shorter asset life would not reduce, over a reasonable period of time, A's income tax liability to country X.

Example (14). A is a citizen of the United States and a resident of country X. Country X imposes no tax on gains from the sale of investment property. A travels to country Y, which imposes a 10 percent charge on such gains, to sell investment property. A had no significant purpose for doing so other than to avoid the rule of Section 904(b)(3)(C). Under Paragraph (f)(5) of this Section, the amount paid by A to country Y is not income tax paid or accrued because A has altered his conduct to incur unnecessary liability to country Y.

Example (15). Country X imposes an income tax on all individual residents of the country. Such a resident may elect, 3 months after the close of the taxable year, to calculate his income from sources without country X either by reducing realized gross receipts by costs or under a formula. A and B are U.S. citizens resident in country X. A elects to calculate his income from sources without country X by reducing gross receipts by costs even though the use of the formula would produce a lesser amount of income. B elects to calculate such income under the formula even though the use of realized gross receipts reduced by costs would produce a lesser amount of income. The amount paid or accrued to country X by A and B that results from their electing to use the method that produces a greater amount of income exceeds legal liability and is not income tax paid or accrued under Paragraph (f)(5) of this Section.

(g) Taxpayer

(1) In general. Income tax is paid or accrued by or on behalf of a person if foreign law imposes legal liability for income tax on that person and income tax is paid or accrued under Paragraph (f) of this Section.

(2) Taxes paid on combined income. In the case of an income tax imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and its subsidiaries) that are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such person for the amount of the income tax attributable to its portion of the base of the tax under foreign law, regardless of which person actually pays the tax.

(3) Taxes paid by payor of income. Foreign law is considered to impose legal liability on a person that realizes an item of income specified in Section 871(a) or 881(a) for an income tax paid or accrued by or on behalf of the payor of such income if —
(i) The payor has the right under foreign law to withhold the amount of the tax from such income;
(ii) The payor does not have the right under foreign law to reduce by part or all of the amount of the tax withheld any other liability imposed on the payor by foreign law; and
(iii) The person that realizes such income does not have the right under foreign law to recover from the payor the amount of the tax withheld.

(h) Definition of "foreign country"

For purposes of this Section, the term "foreign country" includes any foreign state or possession of the United States, or political subdivision or agency or instrumentality thereof. The term "possession of the United States" includes Guam, Puerto Rico, and the Virgin Islands.

(i) Effective date.

This Section shall apply to taxable years ending after June 15, 1979, unless the taxpayer chooses to apply this Section to taxable years ending on or before such date. If a revenue ruling in effect on November 13, 1980 is inconsistent with this Section, then, notwithstanding this Section, a taxpayer may choose to apply such ruling for any taxable year ending on or before December 31, 1980.

Reg. § 4.903-1

(TD 7739, filed 11-12-80.)

Taxes in lieu of income taxes.

(a) In general.

Section 903 provides that the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits ("income tax") otherwise generally imposed by any foreign country or any possession of the United States. A charge is a tax in lieu of an income tax if and only if —
(1) The charge is not compensation for a specific economic benefit within the meaning of § 4.901-2(b);
(2) The charge meets the substitution requirement as set forth in Paragraph (b) of this section;
(3) The charge meets the comparability requirement as set forth in Paragraph (c) of this Section; and
(4) The charge follows reasonable rules of taxing jurisdiction within the meaning of § 4.901-2(a)(1)(iii).
The amount of a tax in lieu of an income tax that is paid or accrued by or on behalf of the taxpayer is determined under

§ 4.901-2(f) and (g) by treating the tax in lieu of an income tax as an income tax.

(b) Substitution.

A foreign charge meets the substitution requirement if the charge is clearly intended, and in fact operates, as a charge imposed in substitution for, and not in addition to, an income tax otherwise generally imposed.

(c) Comparability.

A foreign charge meets the comparability requirement unless it is reasonably clear that foreign law imposing the charge is structured, or in fact operates, so that the amount of liability of persons subject to the charge will generally be significantly greater, over a reasonable period of time, than the amount for which such persons would [be] liable if they were subject to the income tax otherwise generally imposed.

(d) Otherwise generally imposed.

An income tax is otherwise generally imposed if the country imposes an income tax or a series of separate income taxes (within the meaning of § 4.901-2) on significant amounts of income.

(e) Rules of application.

For purposes of applying Paragraph (a) of this Section the following rules apply.

(1) The charge need not be imposed because of administrative difficulty in determining the base of the income tax otherwise generally imposed.

(2) All the income derived by persons subject to the charge need not be exempt from the income tax.

(3) The base of the charge may be gross income, gross receipts or sales, or the number of units produced or exported; the base of the charge need not bear any relation to realized net income.

(4) Paragraph (a) of this Section is applied independently to each separate charge (within the meaning of § 4.901-2(d)) imposed by the foreign country (within the meaning of § 4.901-2(h)). Each separate foreign charge will be considered either to be a tax in lieu of an income tax or not to be such a tax in its entirety for all persons subject to the charge.

(5) If —
(i) Payment of a charge (including the "third amount" referred to in § 4.901-2(f)(4)(iii)) that is compensation for a specific economic benefit discharges a person's liability for —
(A) An income tax imposed on significant amounts of income of persons to which this Paragraph (e)(5) does not apply; or
(B) A tax in lieu of such an income tax; and
(ii) Foreign law requires the income tax or the tax in lieu of the income tax to be separately stated and computed;
Then, subject to § 4.901-2(f) (other than § 4.901-2(f)(4)(i), (ii), and (iii)) and (g), the person pays or accrues an amount of tax in lieu of an income tax equal to the amount of liability referred to in Paragraph (e)(5)(i)(A) or (B) of this Section.

(f) Examples.

The following examples illustrate the application of this Section.

Example (1). Country X imposes an income tax on significant amounts of business, investment, and personal services income derived from within country X by foreign persons and corporations owned by foreign persons. Country X does not impose an income tax on nationals of country X or corporations owned by such nationals even though those persons also derive significant amounts of business, investment, and personal services income from within country X. Under Paragraph (d) of this Section, the income tax of country X is otherwise generally imposed.

Example (2). Country X imposes separate income taxes on income from: investments (30 percent rate of tax); business activities (45 percent rate of tax); and personal services (40 percent rate of tax). Under Paragraph (d) of this Section, the separate income taxes constitute an income tax otherwise generally imposed.

Example (3). Country X imposes separate charges, at different rates, on significant amounts of realized net income from investments, petroleum operations, and other business activities. The rate applicable with respect to petroleum operations is substantially in excess of the rates applicable to investments and other business activities. Those engaged in petroleum operations are extracting oil owned by country X. The charges on other business activities and investment are income taxes. Country X enters into a contract with D, a domestic corporation, to substitute a charge on gross petroleum income for the otherwise applicable charge on realized net petroleum income. The charge on gross petroleum income will, over a reasonable period of time, approximate in amount the charge imposed on realized net income from petroleum operations. Under Paragraph (d) of this Section, Country X has an income tax otherwise generally imposed. However, under Paragraph (a)(1) of this Section and § 4.901-2(b), the charges on gross petroleum income and on realized net income from petroleum operations are each presumed to be compensation for a specific economic benefit. Therefore, the charge paid by D is presumed not to be a tax in lieu of an income tax.

Example (4). Country X imposes a 40 percent tax on realized net income of persons doing business in country X. Persons in the insurance business may elect instead to be subject to a 5 percent charge on a formulary base. The 5 percent charge does not meet the net income requirement under § 4.901-2(c)(4)(i) or, because it is a charge separate from the 40 percent tax on realized net income, under § 4.901-2(c)(4)(ii), and thus is not an income tax. However, the 5 percent charge meets the substitution requirement under Paragraph (b) of this Section.

Example (5). Country X imposes a tax on realized net income of all persons engaged in business in country X other than persons engaged in the banking business. Country X also imposes a gross receipts charge (deductible from realized net income) on persons engaged in business in country X including persons engaged in the banking business. The gross receipts charge does not meet the substitution requirement under Paragraph (b) of this Section because it is imposed in addition to, and not in substitution for, the tax on realized net income.

Example (6). Country X imposes a 30 percent tax on significant amounts of realized net business income. Persons engaged in the shipping business are required to pay the greater of this income tax or 8 percent of gross receipts. The gross receipts charge does not meet the substitution requirement under Paragraph (b) of this Section because it is imposed in addition to, and not in substitution for, the income tax. Thus, the gross receipts charge is not a tax in lieu of an income tax.

Example (7). Country X imposes an individual income tax and a corporate income tax. Persons subject to the individual income tax are also liable for a minimum charge equal to a stated percentage of the rental value of their residence. The minimum charge does not meet the substitution requirement under Paragraph (b) of this Section because it is imposed in addition to, and not in substitution for, the individual income tax and because it is not clearly intended as a charge imposed in substitution for the corporate income tax.

Example (8). Substantially all business income, other than income derived by insurance companies, is subject to one of several separate income taxes. Insurance companies are subject to a charge on gross premiums. Income derived by insurance companies is not specifically exempted from the application of any of the income taxes although none, by its terms, applies to such income. The charge on gross premiums meets the substitution requirement under Paragraph (b) of this Section because it is clearly intended, and in fact operates, as a charge imposed in substitution for, and not in addition to, the income taxes.

Example (9). A significant portion of the business income derived within country X is subject to one of several separate income taxes. Insurance companies are subject to a charge on gross premiums. Income derived by insurance companies is not specifically exempted from the application of any of the income taxes although none, by its terms, applies to such income. Income derived by insurance companies was subject to an income tax by country X until that income tax was repealed by the legislation that enacted the charge on gross premiums. The charge on gross premiums meets the substitution requirement under Paragraph (b) of this Section because it is clearly intended, and in fact operates, as a charge imposed in substitution for, and not in addition to, the income taxes.

Example (10). Country X imposes a 40 percent charge on the realized net income of corporations engaged in various businesses in country X including mineral extraction. Country X owns all mineral resources located within the country and licenses private persons to extract those minerals. Country X imposes an 80 percent charge on the "posted price" of minerals sold by a licensee. Posted price is equal to 105 percent of the amount realized on the sale. A licensee's liability for the 80 percent charge is reduced by the 40 percent charge. The law of country X imposing the 40 percent charge does not distinguish significantly between persons extracting minerals and other persons that derive significant amounts of income and do not receive any specific economic benefit in determing gross receipts, allowing deductions for expenses and recovery of capital (including depletion), permitting losses from one activity to offset income from other activities, applying rates of charge, or in any other manner. The excess of the 80 percent charge over the 40 percent charge is allowed as a deduction in computing the 40 percent charge by the law of country X. That is, the amount of the 40 percent charge imposed on a licensee is always equal to (G-C-K) (R) / 1-R.'R' is the rate of the charge (.40) imposed on persons that derive significant amounts of income and do not receive any specific economic benefit. 'G' is the gross receipts of the licensee. 'C' is the costs attributable to those gross receipts. 'K' is the amount of the 80 percent charge imposed on the licensee. The 80 percent charge is presumed not to be an income tax or a tax in lieu of an income tax pursuant to § 4.901-2(b)(1). The 40 percent charge is an income tax under § 4.901-2(a)(1), but is not considered paid or accrued by a licensee under § 4.901-2(f)(4). Under Paragraph (e)(5) of this Section, a licensee pays or accrues an amount of tax in lieu of an income tax equal to the amount of the 40 percent charge imposed on the licensee (subject to § 4.901-2(f) (other than § 4.901-2(f)(4)(i), (ii), and (iii)) and (g).

Example (11). The facts are the same as in example (10) except that the 80 percent charge is imposed on realized net income and the excess of the 80 percent charge over the 40 percent charge is not allowed as a deduction in computing the 40 percent charge imposed on persons engaged in mineral extraction. Thus, the amount of this 40 percent charge is one-half of the amount of the 80 percent charge. If the excess were allowed as a deduction, the amount of this 40 percent charge would be only approximately one-sixth of the amount of the 80 percent charge. Under § 4.901-2(d)(4) and (b)(1), the 40 percent charge imposed on licensees is presumed to be a separate charge that is compensation for a specific ecnomic benefit because the failure to allow the excess (a cost of extracting minerals that is not an income tax) as a deduction significantly increases the amount of the 40 percent charge paid by licensees over what this amount would be if they were subject to the 40 percent charge imposed on others, which charge allows the deduction of costs of doing business. Thus, the 40 percent charge imposed on licensees is presumed not to be an income tax or a tax in lieu of an income tax. Therefore, unless the presumption is rebutted, pursuant to § 4.901.2(a)(1) and Paragraphs (a) and (e)(5) of this Section, no tax in lieu of an income tax is paid or accrued by any licensee.

Example (12). The facts are the same as in example (10) except that the law of country X does not require the 40 percent charge to be separately computed and stated. The law of country X does state that the 80 percent charge is, to an unspecified extent, in lieu of the 40 percent charge imposed on persons that are not engaged in mineral extraction. Pursuant to Paragraphs (a) and (e)(5) of this Section, no tax in lieu of an income tax is paid or accrued by any licensee.

Example (13). The facts are the same as in example (12) except that, in computing the 40 percent charge, a person that is not engaged in mineral extraction qualifies for an additional deduction equal to one-third of its realized net income. Licensees do not qualify for this deduction. Under § 4.901-2(4) and (b)(1), the 40 percent charge imposed on licensees is presumed to be a separate charge that is compensation for a specific economic benefit, because the failure to qualify for the additional deduction significantly increases the amount of the 40 percent charge paid by licensees over what this amount would be if they were subject to the 40 percent charge imposed on others. Thus, the 40 percent charge imposed on licensees is presumed not to be an income tax or a tax in lieu of an income tax. Therefore, unless the presumption is rebutted, pursuant to § 4.901-2(a)(1) and Paragraphs (a) and (e)(2) of this Section, no tax in lieu of an income tax is paid or accrued by any licensee.

Example (14). The facts are the same as in example (13), except that licensees do qualify for the additional deduction. Licensee A, however, does not claim this deduction in computing its liability for, and payment of, the 40 percent charge. A receives no refund, subsidy or consideration within the meaning of § 4.901-2(f)(2), (3), or (8) and discharges no liability for interest, fines or any similar obligations within the meaning of § 4.901-2(f)(7). Under Paragraph (e)(5) of this Section, A pays an amount of tax in lieu of an income tax equal to the amount of the 40 percent charge imposed on A reduced, pursuant to § 4.901-2(f)(5) by the amount of the 40 percent charge that is attributable to the additional deduction that A did not claim.

Example (15). Country X imposes an income tax on corporations engaged in business in country X other than corporations engaged in mineral extraction. Country X owns all mineral resources located within the country. Corporations engaged in mineral extraction are subject to two charges neither of which is an income tax. Each charge, considered separately, may meet the requirements of Paragraph (a) of this Section. However, if the aggregate of the two charges were considered to be a single charge, the aggregate charge would not meet the requirement of § 4.901-2(b)(2)(ii) or Paragraph (c) of this Section. A taxpayer may establish which of the two charges is the tax in lieu of an income tax and may only claim a foreign tax credit for that charge.

(g) Effective date.

This Section shall apply to taxable years ending after June 15, 1979, unless the taxpayer chooses to apply this Section to taxable years ending on or before such date. If a revenue ruling in effect on November 13, 1980 is inconsistent with this Section, then, notwithstanding this Section, a taxpayer may choose to apply such ruling for any taxable year ending on or before December 31, 1980.

IRELAND:
Supplementary Budget 1981

Extracts from the Financial Statement submitted by the Minister for Finance, Mr. John Bruton, T.D., on July 21, 1981

REVENUE

The action taken in reducing spending which I have just outlined is very substantial, especially in the circumstances of a mid-year adjustment. It has had the effect of reducing the amount of taxation which would otherwise have had to be raised. But the scale of our problem is such that tax measures must still be significant.

We cannot have recourse to income tax for two reasons. Firstly, the Government's commitment is to a reduction in the burden of taxation on the ordinary worker combined with a special tax credit for the spouse. It would be quite inconsistent with this commitment to impose new burdens on the income taxpayer. Secondly, income tax changes cannot be introduced in the middle of a tax year because of the nature of the tax system and the method of calculating taxable incomes. It is for this reason that, as was always envisaged, I will implement the Government's tax reform proposals, including the £9.60 tax credit for spouses and the new augmented child benefit, from the beginning of the next income year.

For similar reasons it is not possible to have recourse to capital taxes in a budget introduced at short notice. Measures of capital taxation are of their nature complex and, if drafted with insufficient care, can have unintended adverse effects on the economy as a whole. The Government are, as indicated in our Programme, undertaking a review of capital taxation with special reference to non-productive capital.

We are therefore compelled, whatever might be our wish otherwise, to rely today for the most part on indirect taxation.

Value-added tax

My main proposal in this regard is for an increase in the present 10 percent VAT rate to 15 percent with effect from 1 September next. This rate band covers by far the major share of expenditure liable to VAT and accordingly must be looked to in a situation where additional revenue is needed urgently. 15 percent as the main VAT rate will still stand comparison with the corresponding VAT rate in most countries in Western Europe. This measure will, it is estimated, yield £28.2 million this year and £188.5 million in 1982. In connection with this change, I should say that I am providing that the effective 3 percent VAT rate on building, which is related statutorily to the 10 percent rate, will remain unchanged; and that, because of the importance of agriculture to national production and exports, the flat-rate VAT refund for farmers will be raised to 1.5 percent in order to offset the consequent increase in VAT on farm inputs.

I will refer later in my Statement to the Government's commitment to provide a VAT relief for agricultural contractors.

Excise duties

In reviewing the levels of excise duties, I have taken into account the fact that the new 15 percent VAT rate will apply to the main excisable goods from 1 September.

Beer

I am proposing a duty-based increase of 2p in the retail price of the pint of beer, to take effect immediately. This is expected to bring in extra revenue of £5.3 million this year and £14.5 million in 1982. This increase, together with the VAT change on 1 September, will make for a total tax increase of 5p to 6p on the pint of beer.

Spirits

An immediate duty-based increase of 2p in the retail price of a glass of spirits is proposed. This is expected to yield £2.5 million in 1981 and £4.5 million in 1982. Combined with the VAT change on 1 September, a total tax increase of 8p to 9p would be expected in the class of spirits.

Wine

I propose to increase by 10p the duty-based element in the retail price of a bottle of wine, to have immediately effect. The increase will be pro rata for stronger wines, and for sparkling wines it will be 20p per bottle. The yield is estimated at £0.8 million in 1981 and £1.6 million in 1982. For a bottle of wine at present costing £3, a total tax increase of 24p would result from this additional tax together with the VAT change on 1 September.

Cigarettes and tobacco

The duty-based tax on twenty cigarettes will be increased immediately by 4p, estimated to yield £5.4 million in 1981 and £13.1 million in 1982. There will be a pro rata tax increase on tobacco. This tax increase, together with the VAT change on 1 September, will result in an aggregate tax increase of 8p on 20 cigarettes.

Petrol, road diesel, liquid petroleum gas (LPG) used in motor vehicles

I am very conscious of the contribution to the balance of payments deficit by expenditures related to motor vehicles, particularly motor vehicle fuels. Accordingly I propose to supplement the VAT-related increases by immediate duty increases representing 4p per gallon on petrol, 4p per gallon on road diesel and 8p per gallon on liquid petroleum gas used in motor vehicles. Combined with the proposed VAT change on 1 September, total tax increases of approximately 13.4p on petrol and 12p on road diesel will be involved. These duty increases will yield £6.2 million in 1981 and £14.0 million in 1982. I am arranging that the existing rebate for handicapped drivers will be increased so that the excise duty increase now will not affect them.

Private motor vehicles

The purchase of private motor vehicles, which reached record levels earlier this year, represents a large element in the balance of payments deficit. While the VAT change proposed will apply to such purchases, the Government are not satisfied that the impact will be adequate having regard to the serious balance of payments position. I propose accordingly to increase the excise duty on private motor vehicles, including motorcycles, from 40 percent to 50 percent with immediate effect. The revenue yield is estimated at £8.5 million in 1981 and £32.3 in 1982.

Road tax

The abolition by the previous Government of road tax on almost all cars not only narrowed the tax base but ran counter to all balance of payments and energy considerations. I propose therefore to reintroduce road tax on cars of 16 horse power and under with effect on and from 1 September at the rates in force in July 1977. As a result of the restoration of road tax, the annual registration charge on these vehicles will be repealed for renewals on and from 1 September. I am also increasing the road tax on cars exceeding 16 horse power by £2 per horse power. These changes will bring in £8 million in 1981 and £27.5 million in 1982.

I should say at this point that I will come later in my Statement to the Government's commitment to provide a measure of relief on industrial fuel oil.

Stamp duties

I turn now to stamp duties.

I propose to increase the stamp duty on cheques from 3p to 5p and to impose a new stamp duty of £5 on credit cards issued by banks and on charge cards issued by international companies. I am also increasing the stamp duty chargeable on transfers of property between associated companies from a nominal rate of 50p to an ad valorum rate of 2 percent. These changes will come into effect shortly. They will yield an extra £0.65 million this year and £2.5 million in 1982.

Banks

The Government's Programme includes provision for a temporary levy on the banks pending the completion of the review of the taxation system affecting banks. I have consulted the Central Bank and have received representations from the Associated Banks about this proposal. I have come to the conclusion that a levy to yield £5 million in 1981 would be an appropriate contribution from the banking sector. In arriving at this amount, I have attempted to strike a balance between what could be regarded as reasonable in view of the need for additional revenue and what would be a prudent charge on the banks. This measure will require legislation and, subject to this, it is intended that the levy will be payable on 1 December next. The method of assessment of individual banks will be decided after consultation with the Central Bank.

Prices

The Government would be anxious that price increases consequent on today's taxation proposals should be fully justified and, in the case of items subject to price control, price increases must be notified and, where appropriate, await the making of new maximum price orders. These will be made by the Minister for Industry, Commerce and Tourism who will determine the appropriate size and timing of increases.

These price increases will of course be reflected in the Consumer Price Index. Because of the delayed nature of some of the tax increases, the immediate effect on the Index will be slight—less than one percent of the August quarter. The full effect of the tax increases will be approximately 3 perccent. I shall be announcing later measures which will fully protect the weaker sections of the community against this price rise.

The Government would impress on the House and on the community at large that increases in taxation are unavoidable if we are to make a serious attempt to meet the cost of our day-to-day public services. It would be unrealistic to expect or to pretend that the process of phasing down a current deficit of the present scale could be a painless experience for the community. I have already referred to the need for moderation in income trends. All the more so, it would be unrealistic and indeed self-defeating for the community to attempt to compensate through higher incomes for these tax increases. I cannot sufficiently stress the fact that this would merely give a new impetus to the spiral of inflation with consequent losses in employment.

...

Taxation incentives

The dominant objective in the Government's taxation programme is the reform of the income tax code including the introduction of a tax credit system. Because of the administrative problems associated with income tax changes in mid year, this reform must necessarily await the beginning of the next income tax year for its implementation. The social insurance and health contribution changes which form part of this reform will come into effect at the same time.

In the meantime other taxation changes in the Programme are being implemented.

Industrial fuel oil

There is a commitment in the Programme to reduce by 50 percent the tax increase on industrial fuel oil imposed in the 1980 Budget. This tax increase was 5 pence a gallon and, in accordance with the commitment, the tax will be reduced by 2½ pence a gallon from 1 December next on purchases by manufacturing industry of oils in the Residual Fuel Oil category. The reduction will cost £½ million this year and £6 million in 1982.

Small businesses - VAT

I wish to assist small business in some way through the tax mechanism. There is limited scope at this time because of the cost implications. I will however increase the present registration thresholds for VAT purposes and I would hope to make provision for this in the Finance Bill.

VAT on agricultural contractors

The Government wish to encourage and maintain agricultural contracting services throughout rural areas. On foot of our commitment in this regard, I propose to reduce the effective VAT rate on agricultural contractor charges to 3 percent with effect from 1 September 1981.

Profit sharing

A further commitment in the Government Programme relates to the exemption from income tax of shares given by companies to their workers under profit sharing arrangements. Other European countries have made considerable progress in promoting the financial involvement of workers in their firms. I am anxious that we should move forward in this area with the minimum of delay. I am, therefore, having this matter examined urgently.

O.E.C.D.: RECOMMENDATION OF THE COUNCIL CONCERNING A STANDARDIZED FORM FOR AUTOMATIC EXCHANGES OF INFORMATION UNDER INTERNATIONAL TAX AGREEMENTS *

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 Recommendation of the Council of 11th April, 1977, concerning the Avoidance of Double Taxation [C(77)40(Final)] and the Model Convention set out in the Annex thereto (Model Convention for the Avoidance of Double Taxation with respect to Taxes on Income and Capital);

Having regard to the Recommendation of the Council of 21st September, 1977 on Tax Avoidance and Evasion [C(77)149 (Final)];

Considering that most double taxation conventions signed by Member countries follow Article 26 of the Model Convention referred to above in providing for co-operation between the competent authorities of the Contracting States, in the form of exchanges of information necessary for carrying out the provisions of the convention or of their domestic laws concerning taxes covered by the convention;

Considering that exchanges of information should be encouraged as an effective form of administrative assistance for a better implementation of domestic tax laws;

Considering that differences in languages and format used for automatic exchanges of information create obstacles for tax administrations in using information received, and therefore reduce the effectiveness of this form of assistance;

Considering that the use by all Member countries of a form with uniform lay-out and content would remove these obstacles irrespective of the language used, would make such exchanges more effective and make it easier for Member Countries to agree, under bilateral or multilateral conventions, upon such a form of exchanges of information, both in the OECD area and in relations with non-Member countries;

RECOMMENDS

That Governments of Member countries use the OECD standardized form annexed hereto when making automatic exchanges of information under bilateral or multilateral conventions.

* Adopted by the Council on May 5, 1981 under the written procedure [C(81)58; C/M(81)7]. The present document is cited under [C(81)39 final].

ANNEX

Information provided under exchange of information arrangements

NAME OF ORIGINATING COUNTRY ____________ YEAR ______

CODE OF ORIGINATING COUNTRY ____________

PART I NAME AND ADDRESS OF RECIPIENT OF INCOME

1. RECIPIENT (Beneficial owner)	2. AGENT OR INTERMEDIARY (if beneficial owner not known)
1a Name (last, first, middle initial, if an individual)	2a Name (last, first, middle initial, if an individual)
1b Taxpayer identification number in residence country: in originating country:	2b Taxpayer identification number in residence country: in originating country:
1c Mailing address: Number and street City, state or province, postal zone Country	2c Mailing address: Number and street City, state or province, postal zone Country
1d Code for residence country: *	2d Code for residence country: *

PART II NAME AND ADDRESS OF PAYER OF INCOME

3. ACTUAL PAYER	4. AGENT OR INTERMEDIARY (if actual payer not known)
3a Name (last, first, middle initial, if an individual)	4a Name (last, first, middle initial, if an individual)
3b Taxpayer identification number in originating country:	4b Taxpayer identification number in originating country:
3c Mailing address: Number and street City, state or province, postal zone Country (if other than originating country)	4c Mailing address: Number and street City, state or province, postal zone Country (if other than (originating country)

PART III TYPE OF RECIPIENT AND PAYER

5a Enter code for type of recipient (see below):

5b Enter code for type of paper (see below):

Codes for type of recipient and payer:

01 Individual
02 Corporation
03 Partnership
04 Business organization other than corporation or partnership
05 Government or International Organisations
06 Other (please specify)
07 Unknown

* Code ISO 3166.

PART IV INCOME AND TAX

Type of income (numbers refer to articles of the OECD Model Income Tax Convention so they are not necessarily consecutive)	(A) Date of payment* day month year	(B) Gross amount paid**	(C) Rate of tax withheld (%)	(D) Amount of tax withheld**	(E) Amount (if any) of tax refunded	(F) Date of refund day month year
6. Real property income, total						
a Agriculture						
b Natural resource royalties						
c Other leasing						
7. Business profits						
10. Dividends, total						
a To parent corporation						
b Other						
11. Interest, total						
a On securities						
b On other indebtedness						
12. Royalties, total (other than for natural resources)						
a Patents, trademarks, etc.						
b Copyrights						
c Other						
13. Capital gains						
14. Remuneration for independent personal services						
15. Wages and salaries (other than for government services)						
16. Directors' fees						
17. Earnings of artists and athletes						
18. Pensions, annuities, alimony						
19. Remuneration for government services, total						
a Wages and salaries						
b Pensions						
c Other						
21. Other (Specify)						
a						
b						
c						

PART V OTHER TRANSACTIONS BY THE NON-RESIDENT TAXPAYER

22. Type and amount of transaction
   - a Real property — Purchase price of property acquired ______ Sale price of property disposed of: ______
   - b Securities (stocks, bonds, etc.) — Purchase price of property acquired ______ Sale price of property disposed of: ______
   - c Bank accounts — Balance at end of year ______
   - d Loans (mortgages, etc.) — Amount of loan received or granted ______
   - e Other property — Specify type and value acquired ______ Specify type and value disposition: ______

* Or the applicable period

** If in foreign currency, indicate currency code used (ISO 4217/1977)

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Angel Q. Yoingco:

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Portugal: Taxation of Business Profits

by Dr. Manuel Pires *

I. A GENERAL OVERVIEW OF THE PORTUGUESE TAX SYSTEM

The Portuguese tax system is a composite system made up of taxes on income, on gifts and inheritances (non-periodic general taxation) and on expenditure.

The income taxation system itself is equally a composite one, considering that it presents a whole series of schedular taxes [1] levied on different kinds of income (income from immovable property, income from labour, profits from agriculture and income from forestry and cattle-raising activities, business profits, income from movable capital and capital gains and, in addition, a complementary tax on "total" income, i.e. Portuguese-source income (resident and non-resident taxpayers) [2] and foreign-source income (resident taxpayers),[3] after deduction of Portuguese schedular taxes and foreign taxes. Capital gains are not subject to the complementary tax.

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I. A general overview of the Portuguese tax system
II. Scope of the article
III. Taxation on business profits proper
IV. Taxation of income from the mere application of capital
V. Capital gains tax
VI. Taxation on the entire income of companies
VII. Substitute inheritance tax
VIII. Stamp duty

II. SCOPE OF THE ARTICLE

The present survey shall be limited to a discussion of the taxes on income derived by businesses (including income from movable capital), on capital gains and on "total" income and also the substitute inheritance tax and the stamp duty.

III. TAXATION ON BUSINESS PROFITS PROPER

Profits attributable by law to the even occasional exercise of a commercial or industrial activity are liable to *industrial tax*.

After it has been established that a commercial or industrial activity is exercised, the determination of taxable profits depends on whether the enterprise is resident in Portugal or not. In this respect, the place where the company's *head office* or *effective management* is situated is decisive. The effective management generally corresponds to the top management of the enterprise, namely to the performance of the functions of the board of directors or, in the case of private limited companies, the functions of their management.

Companies with their head office or effective management in Portugal (resident companies) are liable to industrial tax on the entire amount of profits wherever they may arise, i.e. taxation is levied on a world-wide basis, except for profits derived through a permanent establishment (i.e. any fixed place of business through which the business of the enterprise is wholly or partly carried on) in Macau, in which case such profits are excluded from taxation in Portugal.

Companies without a head office or effective management in Portugal (non-resident companies) are liable to industrial tax only when a permanent establishment, i.e. a branch, an agency, a representative or any other form of permanent representation, or any commercial or industrial installation, exists in Portugal. Tax is then levied on profits derived within the country. This provision is, however, interpreted by the tax administration in the sense that the "principle of attractive force of the permanent establishment" does not apply.

In addition to the fact that resident enterprises are taxed on world-wide income and non-residents only on business income derived in Portugal through a permanent establishment, the computation of taxable profits

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1. *Editor's note:* See for the concept of schedular taxes: Prof. Sylvain R.F. Plasschaert, "The Definition of Statutory Net Income in Schedular and Global Income Tax Systems", 32 Bulletin for International Fiscal Documentation 201 (May 1978).

2. Companies with neither head-office nor effective management in Portugal are not subject to the complementary income tax.

3. Legal persons, other than companies, (resident or not), are only liable to complementary income tax concerning income subject to Schedular Taxes.

also depends on whether the taxpayer falls under Group A or B. [4]

Group A comprises, for example, joint stock companies, cooperative societies and partnerships limited by shares. Also falling under Group A are trading companies (sociedades comerciais, or sociedades civis sob forma comercial) whose capital exceeds 3,000 contos [5] and any other taxpayer whose taxable business income was, on the average, more than 300 contos a year during the years preceding the tax year in question. Resident companies deriving profits from abroad and non-resident companies deriving business income from Portuguese sources are always included in Group A.

The other taxpayers are in Group B. [6]

The distinction is relevant in two manners:
Taxpayers in Group A are taxed on the assessable profit which is derived from the effective profit as shown in the enterprise's financial records (assessable profit is not necessarily the same as accounting profit) and taxpayers in Group B are taxed on profits which they are presumed to have obtained.

Another difference with regard to taxation of taxpayers in Groups A and B is that taxpayers in Group A are liable to industrial tax not only on profits from their commercial or industrial activity but also on income of any other kind (except in case of an exemption, such as income liable to agricultural tax), unlike taxpayers in Group B who are liable to industrial tax only on profits derived from a commercial or industrial activity.

Such a difference is not to be disregarded, considering the difference in industrial tax rates and other schedular tax rates which means that income derived by companies in Group A is more heavily taxed than if such income were derived by other entities.

As a matter of fact, income which is not business profit derived by taxpayers in Group A is taxed first under the corresponding schedular tax (thus, income from the mere application of capital is liable to tax on income from movable capital, income from real property to tax on income from immovable property etc.) and then it is again subject to industrial tax.

The resulting double taxation is, however, eliminated through one of the following methods:
(a) an effective exemption from industrial tax by means of a deduction of the amount of the "non-bsuiness" income from net income computed for purposes of the industrial tax up to the amount thereof. This is, for instance, the case for dividends received from a participation in a company during the accounting year;
(b) the credit of the amount of such schedular taxes (e.g. tax on income from real property or tax on income from movable capital) against the industrial tax up to the amount of the industrial tax levied on such income.

Considering the level of the industrial tax rates (they are in most cases higher than those of the other schedular taxes), the method used is significant.

At present, the industrial tax rates are 30 percent of taxable income up to 1,000 contos, 36 percent on that portion of income over 1,000 contos up to 5,000 contos, and 40 percent on that portion of income over 5,000 contos. In other words, the rate of the industrial tax is progressive [7] and as stated before they are higher than the general rates of the other schedular taxes.

IV. TAXATION OF INCOME FROM THE MERE APPLICATION OF CAPITAL

Income derived from the mere application of capital is liable to tax on income from movable capital.

The tax is divided into two sections — A and B — according to the method of taxation chosen by the legislator: by way of assessment of the income received (Section A) or by way of withholding at source by the payer, who must deduct tax from the amount attributable to the recipient (Section B).

Section A includes, inter alia, interest on ordinary loans.

Section B includes, inter alia, dividends paid by joint stock companies and partnerships limited by shares to their shareholders, and profits made available to participants in trading companies and "civil companies under commercial form", interest on bonds and debentures, even if such securities can be converted into shares, and interest on deposits with banks and other persons legally authorized to accept money on deposit as well as interest on ordinary loans made by the shareholders of or participants in companies to these companies.

In case profits are placed at the disposal of members of trading companies and "civil companies under commercial form" (not joint stock companies and partnerships limited by shares) but are not collected by them at the end of the year in which such profits were placed at their disposal, the company must also withhold the tax.

As fas as profits are concerned, the fact giving rise to taxation is their being placed at the disposal of shareholders or participants, and not the mere attribution thereof by any organ of the company to its shareholders or participants, as was formerly the case, or their payment.

With regard to interest on bonds and debentures and interest on deposits for a fixed period, the fact giving rise to schedular tax is their maturity. In respect of interest on ordinary loans and other advanced credits granted by shareholders of or participants in companies to those companies, the interest is not subject to the schedular tax at the moment of maturity, but upon approval of the profit and loss account or placing of income at the disposal of those entitled thereto before the closing of accounts, irrespective of their formal approval.

4. There is also a Group C, but this group comprises very small businesses, which will be disregarded in this article.
5. 1 Conto = 1,000 Escudos.
6. See footnote 4.
7. The tax is augmented by a "derrama" (local tax) for the municipalities up to 10 percent thereof — the revenue of which is allocated to the accomplishment of any urgent improvements to be made within the area of the respective local authority — as well as by a surcharge within the districts of Viana do Castelo and Aveiro for the respective Autonomous Board of Ports with rates of 2.67, 7, 9 and 10 percent according to administrative subdivisions.

Income on which the tax is levied is either real or presumed income, as in the case of interest on loans and other advanced credits made by shareholders or participants to their companies as well as income (interest or presumed interest) from profits not drawn up by the end of the year during which they were made available. In such cases, it is assumed by law (iuris et iure presumption) that interest is due at an annual rate of at least 5 percent.

Nevertheless, such presumption shall not apply to income from 1977 to 1981.

In order that income may be liable to tax under Section B, it is necessary that the person paying the income (interest) be a resident of or have his effective management in Portugal, or its payment (as a charge) be attributable to a permanent establishment situated therein.

The rates of tax on income from movable capital are proportional, although they are not identical for every kind of income. The general rate is 30 percent but in case of profits distributed to shareholders or participants of companies the tax rate is 18 percent, for debenture interest 12 percent, and for interest on deposits for a fixed period of time 18 percent. (Section B interest).

Several reasons can be given for this diversity of tax rates.

In addition to the fact that the general tax rate of 30 percent meets the requirement in the sense of making a distinction between income from different sources (thus, taxation of income derived from the mere application of capital shall be more burdensome than, for example, taxation of income from work), some distinctions have been made, taking into account, the need to favour bonds and debentures in order not to influence negatively their market value and the mitigation of economic double taxation in the case of dividends and other distributions of profits.

In case of profits made available by companies to their shareholders or partners out of profits that have been subjected to industrial tax (see III), the shareholders of or the participants in the company are liable to tax on income from movable capital on the amounts placed at their disposal, so that double taxation occurs with different taxable persons: companies and its shareholders or participants.

In order to eliminate or to mitigate this economic double taxation several methods may be used, the most important of which are the splitting rate method (taxation of distributed profits at a rate much lower than that of undistributed profits) and the credit method (from tax levied on income of members a deduction is made of a portion or, less common, the whole amount of the tax levied on the business profits).

Under the first method double taxation is mitigated at the company level, whereas under the latter, a procedure adopted by most E.E.C. countries, although it has not been the subject of any communitary guidance [8] — such elimination or mitigation is operated at the level of the shareholders of the company.

Portuguese law has not adopted any of the above methods; neither does it adhere to the *classical methods*, where no distinction is made either *at the company level* — between taxation on distributed profits and on undistributed profits — or *at the level of the shareholders* of the company, to the extent they are taxed on profits placed at their disposal as well as on any other income. As a matter of fact, in Portugal *at the company level* — as we will see below — undistributed profits are taxed at higher rates, although it does not apply the splitting rate method between taxation on distributed profits and undistributed profits; *at the level of shareholders of companies*, profits placed at their disposal are taxed at a rate which is lower than the general rate of tax on income from capital (18 instead of 30 percent).

V. CAPITAL GAINS TAX

The Portuguese capital gains tax is not levied on capital gains, in general, but only on certain gains, specified in the law. For the purpose of this article the following transactions which are liable to tax on capital gains are important: increase in capital of resident joint stock companies, or partnerships limited by shares and companies with limited liability (sociedades per quotas) through the incorporation of reserves or the issue of shares.

Liable to this tax are shareholders who derive gains liable thereto, without prejudice of the requirement of the withholding by the company. The rate is 12 percent and it is applied to 50 percent of the incorporated reserves and of the difference between the actual value of the shares issued by reason of the increase of capital and the issue price.

VI. TAXATION ON THE ENTIRE INCOME OF COMPANIES [9]

Complementary income tax (Section B) is levied on the entire income of companies. Nevertheless, only companies having their head office or effective management in Portugal are liable to this tax (for the definition of effective management, see III).

The entire income is the sum of the following:
— income from rural and urban real property;
— income from agriculture;
— business profits;
— income from movable capital.

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8. There is, however, a proposal for a Council Directive in this respect which was submitted to the Council on July 23, 1975 (COM (75) 392 final).

9. Individuals are subject to the complementary income tax (Section A) on their total world-wide income. This income includes business income, income from employment and independent work, income from immovable property and income from movable capital, e.g. dividends and interest. Schedular taxes paid are deductible.
The rates of the complementary income tax are progressive from 4 to 70 percent for married taxpayers and from 4.8 to 80 percent for unmarried taxpayers. The maximum rate is levied on income in excess of 1,400,000 escudos (approximately $23,500).

However, from the amount of the above-mentioned income are deducted (1) profits distributed to, or placed at the disposal of, the shareholders or participants in relation to the year in which the tax refers, i.e. the year following that in which the profits are made, and (2) corresponding schedular taxes.

Therefore, it could be said that complementary income tax is levied only on undistributed profits, in so far as it concerns companies. That is why under IV it was stated that, *at the company level*, undistributed profits are liable to higher taxation, to the extent they are liable to complementary income tax in addition to industrial tax.

Tax rates are progressive as follows:

Taxable income (contos)	Rate (%)
Up to 120	6
On that part of profits between 120 and 1,200	8
On that part of profits between 1,200 and 6,000	10
On that part of profits over 6,000	12

Nevertheless, such tax rates are doubled in the case of holding companies, i.e. those companies whose activities are limited to the management of property or values held for investment, as well as those which also exercise other activities, when the profits or gains resulting from such property or values reach an average in the last three years of more than 50 percent of the average of their total profits or gains for the same period of time.

Reference must be made to the complementary income tax scheme applying to bond and debenture interest.

Interest on registered bonds and debentures is liable to complementary income tax in the same manner as any other income liable to tax on income from movable capital. With regard to interest on bearer bonds and debentures, a distinction must be made according to whether the respective holder has or has not registered such securities with the issuing entity (or in certain cases, with its permanent representative on Portuguese territory) for tax purposes.

If registration has been made, tax on such interest is levied as in the case of interest on registered bonds or debentures, that is to say, together with other income. If there is no such registration of bearer bonds or debentures the respective holder is unknown and tax is levied by withholding complementary income tax at source at a 24 percent rate on the amount of interest, after deduction of the tax on income from movable capital, so that the effective rate on the gross amount of interest is 21.12 percent.

VII. SUBSTITUTE INHERITANCE TAX

Owing to difficulties of controlling the taxation of gifts and inheritances bearer securities, a small annual tax has been established. This is the substitute inheritance tax. Considering the influence that the tax system may exercise upon quotation of securities, both registered securities and bearer securities issued by entities having their head office in Portugal are liable to tax. The tax rate is 5 percent on the gross amount of interest. This tax is also withheld at source.

The above system ceased to apply to dividends as from 1977, owing to the fact that such shares are now obligatorily liable to registration at the head office of the issuing entity or to deposit with a credit institution.

VIII. STAMP DUTY

Whenever dividends, interest or income of any other kind are paid on registered shares or bonds or debentures, then the so-called registration stamp duty shall be due, deducted each year from the payments made.

The rate of the stamp duty is five per thousand of the market value of securities.

In case registered securities are converted into bearer securities, or vice versa, a stamp duty shall be due at variable rates depending on the nominal value of such securities.

With regard to the so-called receipts stamp, a rate of two per thousand applies to the amount after deduction of any sum having the nature of a tax.

Attempts to Restructure the Philippine Income Tax and Recent Developments

By Dr. Angel Q. Yoingco *

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I. INTRODUCTION – GOALS OF INCOME TAXATION

Income taxation in developed as well as in developing economies is generally regarded as a policy instrument capable of salutary fiscal and non-fiscal effects. The experiences of highly industrialized countries have adequately demonstrated the relatively large capacity of income tax to raise revenue with which to finance government's development plans; promote wealth redistribution; bring about resource allocation; achieve economic stability; and secure other socioeconomic and welfare goals.

A. Income tax and revenue-raising

The major sources of revenue in the Philippines are: (1) business, occupation and sales tax; (2) import duties; (3) income taxes; and (4) specific taxes. Business, occupation and sales taxes constituted 21.3 percent of the total national government revenue from taxation during the year 1979. Import duties accounted for 21.2 percent, the income taxes represented 20.1 percent and specific taxes, 14.2 percent. In terms of revenue potential therefore, income taxes, both at the personal and corporate levels, only ranked third as a major source of government revenue. Between the personal and corporate income taxes, the former has been more productive of revenue, accounting for at least 10.6 percent of total national government tax revenue as opposed to 9.5 percent for the latter.

This has not always been the case as personal income tax collections have lagged behind those derived from corporate income tax. Personal income tax collections as a percentage of the national government tax revenues stood at 6.84 percent in 1970, 8.07 percent in 1973 and 9.60 percent in 1976. Those of corporate income tax were 17.43 percent in 1970, 20.07 percent in 1973, and 14.78 percent in 1976. Apparently, the individual income tax base has been eroded or manipulated to some extent relative to the corporate income tax base, thereby accounting for the former's law percentages during the years mentioned. The rise in personal income tax as a proportion of total tax revenues in recent years evidences the revenue generating potentials of a properly structured and implemented income tax system, especially at the personal level.

During the years 1972-1976, income taxes were 2.51 percent of gross national product, and 24.8 percent of total tax collections. In the same period, the averages for some 63 developing countries (as per *IMF Staff Papers*) [1] were 4.77 and 26.6 percent, respectively.

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1. Alan A. Tait, et. al., "International Comparisons of Taxation for Selected Developing Countries, 1972-76", *IMF Staff Papers*, Vol. 26, No. 1 (March, 1979).

B. Income tax and wealth redistribution

Furthermore, income taxes levied at progressive rates are also effective as a redistributive tool. They are expected to reduce the concentration of wealth in the hands of a few and promote the equalization of benefits therefrom. In this connection, Philippine personal income tax rates range from 3 to 70 percent for individuals; and, generally, 25 and 35 percent, for corporations, plus an additional tax of 10 percent for close corporations. But due to the regressivity of the tax system in the Philippines, wealth redistribution through income taxes is hardly noticeable.

C. Income tax and allocation of resources

Much is also expected from income taxation in providing direction to the allocation of resources. The use of income exemptions (exemption from capital gains if proceeds are invested in certain activities) and of preferential income tax treatment (lower tax rate for educational institutions) illustrates how the involvement of private enterprise in preferred or desired areas of undertakings can be solicited or influenced. Conversely, the unproductive use of resources can be deterred through heavy or confiscatory income tax rates (a surtax on undue accumulation of surplus, as in the case of corporations).

D. Income tax and economic stability

Economic stability and other socioeconomic and welfare goals are equated with the built-in flexibility of the income tax and the package of exemptions and preferential treatments accorded by the same to certain enterprises. Thus, in times of prosperity during which people usually have too much spending capacity, the income tax allows a government to collect more and in the process reduce spending power as in the long run it leads to inflation. In times of depression during which taxpayers may not have much spending power, the income tax may (although with some fiscal sacrifice) help reduce tax liabilities through liberal deductions and exemptions. With reduced tax liabilities, the spending power of taxpayers is enhanced.

II. PROBLEMS OF THE PHILIPPINE INCOME TAX SYSTEM

A. Complexity of income tax administration

Given the variety and diversity of roles that income taxation plays in the attainment of policy objectives, it is not surprising that its administration has been guarded with much zealousness and rapt concern by the taxing powers. Quite often, however, this zealousness and concern translate themselves into far too many complicated rules and regulations which render tax administration unwieldy and thus dissipate the capability of income tax to achieve its *raison d'être*. Wittingly or unwittingly, in our eagerness to use income tax to achieve policy desiderata, a number of refinements, over the years, have been introduced into the system which have complicated rather than simplified tax administration (sophisticated rules and regulations for dealing with deductions and exemptions).

B. Discretion in the determination of allowable deductions

Through the system of deductions (generous or otherwise), a wide latitude of discretion on the part of the taxpayer and/or tax officer has been allowed. Thus, the income tax base is subjected to undue erosion. Consequently, the revenue potential of the tax is impaired.

On average, deductions for fixed income earners add up to 46 percent of gross income. With personal exemptions, accounting for 26 percent of gross income, only 28 percent is left as taxable income.

C. Uniform treatment of different types of income

The income tax system does not generally distinguish between types of incomes. Thus earned or employment income and incomes from business are treated in a similar way to income from capital investment. Such treatment does not recognize the fact that wage or employment and business income is generally earned through mental exertion and physical effort which is not usually the case with income from capital.

It is in this light that efforts have been made, time and again, and more persuasively during the years of martial rule, to reform the Philippine income tax system. Some of these reforms sought to correct flaws found within the structure in order to make it more responsive to economic vagaries. Laws were promulgated to enhance the progressivity of the income tax, simplify its administration and enable it to conform with the socioeconomic and welfare aspirations of Philippine society. Likewise, the adoption of a scheme of a final withholding tax on passive income, income from capital and the imposition of a schedular capital gains tax on capital gains from real estate transactions are efforts to introduce distinctions between the taxation of different types of income.

III. CABINET BILL NO. 34

The most ambitious efforts to restructure the Philippine income tax are to be found, however, in Cabinet Bill No. 34 filed in the Interim Batasang Pambansa (IBP) or Parliament last year (1980). Its main thrust is the adoption of schedular taxation of income with the gross income tax concept proposed to apply in the case of employment income. The Bill is also premised on a policy desire to simplify the administration of the Philippine income tax in order to make it productive in yield. To attain these considerations, the IBP Committee on Finance commissioned its sub-committee on taxation to devise a gross income tax scheme to replace the existing income tax approach. The sub-committee considered various proposals based on studies conducted by the NTRC-BIR Study Group.[2] In May 1980, the Committee on Finance agreed to adopt the proposal which calls for a schedular approach to taxing incomes. This proposal epitomizes the policy consideration to make not merely piecemeal revision or partial reform, but rather to effect an overhaul of the entire income tax system through the possible adoption of another approach to income taxation in the Philippine frontiers.

While generally the trend in income taxation is towards the global approach as it is deemed to be the more effective way of achieving progressivity, Philippine experience says otherwise. Thus, a preference for schedular taxation for more effective compliance and collection, and probably more revenue in the long run, has been synthesized even at the expense of global progressivity. After all, if income tax compliance and tax collection can be improved, it will also be easier to achieve equity and progressivity by the introduction of this type of income tax. Besides, there is also a growing sentiment among some tax practitioners that the Philippines should not have started at all with a global income tax (considering its many ramifications and complexities) patterned on the U.S. income tax system, especially when economic and non-economic conditions do not parallel those of the model. Thus, without belittling the merits of a global income tax, the idea of a schedular income tax has been endorsed by parties interested in achieving other policy goals and also keeping in mind such issues as revenue, equity and progressivity.

Phases. With this orientation, the proposal has been subdivided into four phases, as follows:

Phase I — taxation of employment income;
Phase II — taxation of income from business, professions and analogous activities;
Phase III — taxation of corporate income;
Phase IV — taxation of passive and other income.

Objectives. The proposal seeks the attainment of the following objectives:

1. to simplify income tax administration;
2. to reduce discretion in the determination and allowance of deductions on the part of taxpayer/tax officer;
3. to rationalize income tax treatment of different types of income.

A. Employment income

The schedular taxation of employment income (that is, income arising from employer-employee relations) in the first phase is a marked departure from the global income tax system that is currently in force. Included in this category are the following types of incomes: (1) salaries, wages, compensation, emoluments and honoraria; (2) bonuses; (3) allowances, except cost of living allowances mandated by law; (4) fringe benefits in cash and in kind; (5) fees (director's fees and the like); (6) taxable pensions; and (7) other similar sources of income.

No deduction of expenses shall be recognized in this phase except for personal and additional exemptions or allowances. The proposed rates applicable range from 3 to 50 percent and with wider income brackets, thus resulting in a relatively much reduced tax liability (particularly for those opting for optimal standard deductions) compared to the present steeply graduated scale of 3 to 70 percent with narrower income brackets.

1. Adoption of a gross income taxation concept on employment income

A great number of employees in a developing country like the Philippines do not earn much. For the most part, they belong to the lower income brackets but ironically, pay relatively more under a net income tax scheme. The reason for this is that this group of taxpayers does not have many items of expense which they can deduct from their employment income to be able to reduce or avoid their tax liabilities. These taxpayers generally resort to the optional standard deduction (10 percent of gross income) in computing their tax liability and have no elbow room to escape the full brunt of the income tax. On the other hand, some employees with larger incomes or with multiple sources of income are able to reduce their tax liabilities quite effectively. Sometimes, they even find themselves in comfortable tax brackets, that is, below the 10 percent or within the 3 percent tax rate, which is already very low compared with prevailing rates in other ASEAN countries.[3] It is for this reason that a preference for a gross income tax has been put forward. Under this approach, employment income will be taxed at the gross level at relatively lower rates and deductions are eliminated. These features are expected to reduce the liability to income tax of employees who make use of the optional standard deduction as opposed to those who use itemized deductions. They also help to simplify the tax administration for employment income.

2. Adoption of a schedular income tax approach

The schedular income tax approach is an offshoot of the adoption of gross income taxation on employment income. Since the rates applicable to this source have been lowered, the same treatment cannot be applied to business income or the income of professionals, the latter being allowed to remain taxable on their net income. Thus, a low schedule of rates for employment income and another schedule for business/professional income resulted in schedular taxation.

3. Personal and additional exemptions

In line with policy considerations to extend relief from

2. NTRC or National Tax Research Center and BIR refers to the Bureau of Internal Revenue.
3. Comparative Table on Individual Marginal Income Tax Rates of ASEAN Countries

Country	Marginal rates (in percent) Lowest rate	Highest rate
Indonesia	10	50
Malaysia	6	50
Philippines	3	70
Singapore	5	55
Thailand	7	60

the ill effects of inflation, personal and additional exemptions, which were last adjusted in 1959, are to be increased as follows:

Personal circumstances	*From* ₱	*U.S.$*	*To* ₱	*U.S.$*	*Change* %
Single	1,800	233.16	2,500	323.83	39
Single, head of family	3,000	388.60	4,000	518.13	33
Married	3,000	388.60	5,000	647.67	67
Dependents	1,000 each but not exceeding four	129.53	2,000 each but not exceeding three	259.07	100

These amounts are to be applied prospectively so that all other dependents who qualified prior to the proposal shall still be allowed at ₱ 1,000 each. In case of multiple marriages recognized as valid under the Code of Muslim Personal Laws of the Philippines, a Muslim taxpayer may be entitled to an additional exemption for qualified dependents up to five or a maximum of ₱ 10,000 (U.S.$ 1,295.34).

4. Indexation scheme

To further contain the onslaughts of inflation, indexation of personal exemptions at intervals of 3 or more years is proposed. Indexation is an inflation adjustment mechanism which links the income tax system to an index which is taken as representative of the prevailing rate of inflation. Under inflation, indexation implies a widening of tax brackets in money terms as well as restoring the real value of personal allowances. The scheme is practised in countries such as Canada, Denmark, the Netherlands, Switzerland and Brazil, to name a few. The motive for indexation, therefore, under the proposal is to increase exemptions between 10 and 50 percent based on the percentage increase of the consumer price index or an appropriate indicator as an anti-inflationary device.

5. Withholding scheme/filing

To ensure administrative simplicity and convenience, a final withholding tax for employment income derived from only one source and the filing of a simplified tax form is proposed.

Under the present system, fixed income earners undergo untold hardships and inconveniences ranging from a much too detailed income tax return form to forming queues in order to be able to file their tax returns. Considering that this group of taxpayers cannot bear a heavy tax burden and that they are already a captive sector, then it is but fair that this group be spared the rigors that usually accompany tax filing by a final withholding scheme.

The proposal is to adjust the withholding tax rates on wages to approximate the actual tax due.

Withholding and filing is proposed as follows: For an employee receiving employment income from one employer and for a husband and wife both of whom receive income from the same employer, the withheld tax shall be considered *final* income tax payments. A simplified income tax form or information return shall be filed with the employer, who in turn forwards the return to the BIR on or before 15 March each year.

For all other employees, i.e. employees receiving wages from multiple employers and husband and wife employed by two different employers, the employee shall be subject to withholding tax at each level of employment. Filing as in the present law shall be maintained whereby the employee files a tax return directly with the BIR which shall make corresponding adjustments either for refund or additional payment.

B. Business income and income from professions

The taxation of business income or income from professions has long been a thorny area in the history of the Philippine income tax system. Some of the problems engendered by the present system of net income tax on these types of income are: (1) injudicious erosion of the tax base through a scheme of deductions which gives elbow room to the taxpayers to exaggerate their deductions and claim excessive expenses; (2) under-declaration or non-declaration of income which cannot easily be checked under a global approach; (3) difficulty of covering all taxable persons, especially professionals and operators of single proprietorships; and (4) negotiation and discretion as to the substantiation of deductions gives too much discretionary power and occasion for haggling to tax officers and taxpayers.

Be that as it may, no major change is proposed in the determination of the tax base of those deriving income from business, profession and similar activities in recognition of the costs of producing such income, an argument which, if ignored, is feared will cause ominous repercussions for industries vital to economic growth. Deductions, however, for this category of taxpayer are restricted to those which are business cost-related, in order to do away with unwarranted tax base erosion. More specifically, the following deductions shall not be subject to further restrictions: (1) ordinary and necessary business expenses, except entertainment, travel and promotional expenses; (2) interest; (3) losses; (4) payments to employees' pension trust funds, (5) depreciation; (6) depletion; and (7) taxes.

Further restrictions by means of a permissible ceiling on entertainment, travel and promotional expenses are recommended as these are deductible items which have been regarded as being highly susceptible to manipulation and, by experience, these are the items usually claimed by high income earners. The sum of these three expense items may be deductible as follows: (1) to the extent of not more than 2 percent of gross income without investigation or (2) to the extent of not more than 20 percent of gross income per industry subject to investigation (excess amounts shall be disallowed).

Bad debts are deductible subject to further restrictions that are presently applied to interest, i.e. these shall be disallowed if sustained in transactions entered into between certain parties, e.g. between members of a family.

Under the proposal, persons receiving professional income, can use the optional standard deduction of 10 percent of the gross income without a maximum limit.

The tax rate applicable to this category ranges from 5 to 60 percent, a schedule which is less burdensome than the existing rates (3 to 70 percent) to soften the impact of some limitations on deductions.

C. Corporate income

Relatively speaking, corporate income taxation is less fraught with problems than the personal income taxation of self-employed businessmen and professionals. However, there are also gray areas in the corporate income tax structure which if left unbridled might give rise to certain economic and non-economic repercussions. For instance, there is the matter of tax base maneuvers through excessive claims of certain deductions. There is also the urgency of making the corporate income tax rates more progressive and, therefore, more capable of producing increased revenue. And then there is the nagging question of whether or not the tax system should be neutral on the choice of corporate forms, that is whether the corporation is organized as a close or public corporation. (See Table 1.)

Restrictions applicable to deductions under the second category are extended to corporate taxpayers in order to minimize tax base erosion. The 5 percent development tax currently imposed on close corporations (a number of which are related to multinationals) is proposed to be repealed and integrated with the prevailing corporate income tax rates, that is, 30 percent for taxable income not exceeding ₱100,000 (or U.S.$ 12,953.37) and 40 percent on the excess. The repeal of the development tax is the beginning of a neutral policy on corporate form. However, its integration with the general rates is expected to make the corporate tax structure more progressive as a recompense for the revenue loss resulting from such repeal.

Corporations enjoying incentives under the Tax Code or under special laws shall continue to do so. Non-resident corporations will continue to be taxed on the basis of gross income for reasons of administrative simplicity.

D. Passive income

The last category of income covers passive and other types of income, such as interest, dividends, royalties and the like. These types of income have not been taxed effectively for some time as they may be easily under-declared or not declared at all. The tax authority, on the other hand, is not able to verify the income sources for one reason or another (secrecy of corporate books, unless there is an authority for examination thereof).

Under this proposal, all passive income is to be subject to a final tax under a withholding scheme in order to simplify its treatment and to tax effectively the recipients of such income at the source point, thus preventing instances of tax evasion. The tax rates would differ depending on government policies, and are set at 10, 15 and 20 percent, with certain exceptions. Thus, interest on savings deposits and dividends received by individuals would be given preferential treatment as against other receipts of passive income. Also, passive income received by pensioners who are at least 65 years old and have no other source of income except their passive investment would also be treated leniently. The proposal is to subject this group of taxpayers to the 3 to 50 percent tax rates applicable to earned income provided that the effective rate shall in no case be higher than that applied to passive income. The reason for this special treatment is to provide relief to pensioners during their old age.

This approach, however, still puts a premium on passive income and, therefore, negates the object of rationalizing the taxation of different types of income. (See objective No. 3 of Cabinet Bill No. 34.) The very much lower tax rates of 10, 15 and 20 percent definitely put individuals receiving income from capital in a more favored situation than those receiving income from employment. The situation is further aggravated by the fact that passive income earners usually belong to higher income brackets than wage earners. The better approach would be to strike a balance between the bottom and top individual income tax rates and use this as a basis for taxing passive income.

IV. OVERALL EFFECTS OF CABINET BILL NO. 34

The proposed restructuring of the Philippine income tax system including a gross income tax concept for employment income is expected to achieve the following:

1. *Administrative simplicity* — This is attainable through schedular taxation and gross income taxation of employment income as it: (a) does not recognize deductions, thus eliminating the administrative problems of verifying deductions; and (b) adopts a final withholding tax scheme and simplified filing for employment income.

Likewise, the imposition of a final tax on passive incomes makes simple their taxation and is deemed to reach effectively the taxpayers at source.

2. *Reduction of discretion and prevention of collusion* — This is attainable through the use of restrictions and/or ceilings on certain deductible items.

3. *Rationalization of taxation of different types of income* — This is to be achieved through the simplified taxation of employment income and schedular taxation for certain types of income. Some incomes that are generally not declared may now be taxable.

4. *Effective taxation of passive incomes* — This is to be achieved by the use of a final withholding tax at source.

5. *Softening the effects of inflation* — This is achieved through reliefs in the form of increases in personal and additional exemptions and indexation.

TABLE 1

Comparative table on corporate tax rates of ASEAN countries

Country	Taxpayer	Tax base	Tax rate	
Indonesia	Corporations domiciled in Indonesia	Global taxable profit	*For domiciled and non-resident corporations in Indonesia*	
	Corporations not resident in Indonesia	Domestic taxable profit	First Rp. 25 million of taxable profit	% 20
			Next Rp. 50 million of taxable profit	30
			Balance of taxable profit	45
	Cooperative association	Global taxable profit	*For cooperative associations*	
			First Rp. 10 million of taxable profit	25
			Next Rp. 25 million of taxable profit	5
			Balance of taxable profit	10
Malaysia	Resident companies	Income from sources within and outside Malaysia		40
	Cooperatives (registered in Malaysia)	Income from sources within and outside Malaysia		5 to 40
	Non-resident entities	Income from within Malaysia		40
Philippines	Domestic corporations	Net income derived from all sources within and outside the Philippines	*For domestic and resident foreign corporations*	
			Net income not over ₱ 100,000	25
	Resident foreign corporations	Net income derived from all sources within the Philippines	Net income in excess of ₱ 100,000	35
	Non-resident foreign corporations	Gross income received from all sources within the Philippines		35
	Note: A ten percent (10%) corporate development tax is also imposed on domestic and resident foreign corporations which qualify as closely-held corporations.			
Singapore	Resident and non-residents	Net income from sources within and outside Singapore	Flat rate	40
Thailand	Domestic juridical companies or partnership	Net profit		35
	Foreign companies carrying on business in Thailand	Net profit		35
	Foreign companies carrying on international transport business	Gross receipts		1
	Foreign companies not carrying on business in Thailand	Net income	For interest income paid to a juridical company or partnership carrying on banking, insurance or similar business	10

6. *Promotion of progressive and equitable aspects of income taxation* — The proposal is strong on the equitable aspects of income taxation as they greatly benefit employees in the low income brackets. These are employees presently using the optional standard deduction who represent around 65 percent of total taxable fixed-income filers in 1978. These filers are concentrated in income brackets below ₱ 14,000 (US$ 1,813.47) annual gross income. On the other hand, the group of taxpayers using itemized deductions represents around 35 percent of total taxable fixed-income filers. With the proposal, employees under the optional standard deduction scheme will enjoy a tax reduction. Those using the itemized deductions will experience increases in tax liability, all of which should be interpreted as making the tax system more equitable, which

is a basic norm of income taxation.

The proposal also reflects the desire to inject progressive features into the tax system. This is achieved by the tax increasing as income rises as in the case of employees, professionals and businessmen.

The problem of non-declaration or under-declaration of taxable income may still persist. However, with fewer problems in the area of deductions, tax authorities may now effectively grapple with this problem-area.

Revenue loss may be expected to result from: (1) the application of lower tax rates to employment income; (2) the restructuring of tax rates for individuals with business incomes: (3) the shift from a global to a schedular approach; and (4) the increase in exemptions.

On the other hand, possible revenue gains may arise from (1) the increased corporate tax rates and (2) the adoption of a final tax on passive incomes.

On balance, it is hoped that the gains in administration will, in the long run, offset the losses resulting from the initial implementation of the proposal.

V. RECENT DEVELOPMENTS (PD 1773, issued on January 16, 1981)

The task of restructuring the Philippine income tax system has not been a very easy one. Cabinet Bill No. 34, for all intents and purposes, has met with criticism and opposition. In the meantime, however, the government has deemed it fit that reforms be introduced into the income tax system as palliative or curative measures.

With this framework of objectives, Presidential Decree No. 1773 (issued on January 16, 1981) has adopted certain provisions of Cabinet Bill No. 34. More specifically, the reforms introduced by PD No. 1773 are as follows.

A. Personal and additional exemptions

Personal circumstances	*1980*		*CB 34*		*Change*	*PD 1773*		*Change*
Single	₽ 1,800	U.S.$ 233.16	₽ 2,500	U.S.$ 323.83	39%	₽ 3,000	U.S.$ 388.60	67%
Single, head of family	₽ 3,000	U.S.$ 388.60	₽ 4,000	U.S.$ 518.13	33%	₽ 4,500	U.S.$ 582.90	50%
Married	₽ 3,000	U.S.$ 388.60	₽ 5,000	U.S.$ 647.67	67%	₽ 6,000	U.S.$ 777.20	100%
Dependents	₽ 1,000 each but not exceeding four		₽ 2,000 each but not exceeding three		100%	₽ 2,000 each but not exceeding four		100%

The generous increase in exemptions under PD 1773 is highly erosive of tax revenue. One particular aspect of this increase, however, is the equitable treatment of single and married persons. Under the old system, married persons who were able to file separate returns enjoyed a greater exemption than those who filed a joint return. This was so because, by filing separately, each of the taxpayers was able to claim ₽ 1,800 (US$ 233.16) or ₽ 3,000 (US$ 388.60), depending on his/her particular circumstances. With PD 1773, this situation has been corrected and it is hoped that there will be more encouragement to file joint returns on the part of married persons as the exemption is now on a per capita basis.

The new rates of exemptions are among the highest in the ASEAN countries (see Table 2).

B. Indexation

Adjustments in personal and additional exemptions once every three years, upon recommendation of the Minister of Finance — based on, inter alia: (1) movements in consumer price indices; (2) minimum wage levels; and (3) bare subsistence levels — have been provided as a counter measure to inflation and to increase the significance of income tax relief granted especially to small income earners. With the adoption of indexation, it is expected that each level of income will continue to be taxed at approximately the same rate as in the base year. In effect, tax relief elements are strongly injected into the system.

C. Optional standard deduction

The standard deduction which is in lieu of itemized deductions is now without any absolute maximum amount limit except the percentage retained at 10 percent. Prior to this, taxpayers were allowed a standard deduction equivalent to 10 percent of gross income or ₽ 5,000, whichever was less. With the amendment, it is hoped that itemizing taxpayers would switch to the standard deduction thus eliminating the need for examination and simplifying the tax administration.

D. Itemized deductions

Itemized deductions are still recognized, but the Minister of Finance, upon recommendation of the BIR Commissioner, is now empowered to prescribe limitations or ceilings for any of the itemized deductions allowed by law. The use of this power is intended to reduce abuses especially in the matter of tax base manipulations through excessive and often unsupported deductions.

TABLE 2

Personal exemptions granted to individual resident taxpayers by country, by type and by the amount of exemption in the ASEAN countries

Country	Type of exemption	Amount of exemption		U.S.$
Indonesia	*Basic exemption (for residents and non-residents)*			
	1. Each taxpayer	Rp. 240,000		384
	2. Each legal spouse	Rp. 240,000		384
	3. For each member of the family and adopted children who are 21 years old or younger for whom the taxpayer is fully responsible, up to the maximum of 5 persons	Rp. 120,000 for each dependent		192
Malaysia	*For residents in Malaysia*			
	1. Relief for individuals	M$ 5,000 M$ 60 rebate		2,158 25.91
	2. Wife's relief	M$ 2,000 M$ 30 rebate		863.60 12.94
	3. Children's relief	1st child	M$ 800	345.44
		2nd child	M$ 700	302.26
		3rd child	M$ 600	259.08
		4th child	M$ 500	215.90
		5th child	M$ 400	172.72
		Retarded child	M$ 400 each	172.72
	4. Allowance for children educated abroad	Four (4) times the normal deductions allowed as children's relief		
	5. Insurance premiums and approved employee provident fund contribution	The aggregate amount of payments or contributions or both subject to a maximum of M$ 3,500		1,511.30
	Non-resident relief			
	1. Non-resident citizens	The difference between the tax chargeable on the individual at the non-resident rate and the tax that would have been charged on that income had he been a resident.		
	2. Non-residents who are not citizens	The difference between the tax charged on the pension or pensions and employment income at the non-resident rate and the tax that would have been charged had the taxpayer been a resident.		
Philippines	1. Personal exemption	₱ 3,000 if single or legally separated ₱ 6,000 if married ₱ 4,500 if head of family		388.85 777.70 583.27
	2. Additional exemption for qualified dependents	₱ 2,000 for each qualified dependent (the number of dependents must not exceed four)		259.23
Singapore	*Resident citizens*			
	1. Personal relief for single individuals or married persons legally separated from their spouses including relief for maintenance of parents and grandparents	S$ 8,500		3,995
	2. Personal relief for married persons including relief for maintenance of parents and grandparents	S$ 11,500		5,405
Thailand	1. For a single individual or married couple	7,000 baht for the taxpayer 7,000 baht for the taxpayer's spouse 3,000 baht for each lawful or adopted child		350 350 150
	2. An estate	6,000 baht		300
	3. Unincorporated partnership or body of persons	7,000 baht for each partner but shall not exceed 14,000 baht in total		350
	4. Dividend	Amount actually received by not exceeding 10,000 baht or 5,000 baht		500 or 250

Dollar Conversion (as of March 6, 1981).
Indonesia – 1 Rp. =.0016¢; Malaysia – 1 M$ = .4318¢; Singapore – 1 S$ = .47¢; Thailand – 1baht = .0500¢.

Source: Department of Economic Research Central Bank.

E. Liability of corporations to development tax

The corporate development tax has been upgraded from 5 to 10 percent. It shall not apply, however, to open corporations, banks and non-bank financial intermediaries. A possible repercussion of this amendment is the dampening effect that it may have on foreign investors who are usually organized as close corporations, the target of the development tax.

F. Passive income as approved under PD 1739 and PD 1800

PD 1739 (issued September 17, 1980) and PD 1800 (issued January 11, 1981) imposed final withholding taxes at source on passive income, except royalties. These are designed to achieve administrative simplicity and effective taxation of passive income. The new rates are as follows:

Individuals	*Interest*	*Dividends*	*Royalties*
Citizens and resident aliens	15%, if from savings deposits.	15%	15%*
	20%, if from time deposits and deposit substitutes.		
	All other interest is taxable as part of gross income subject to the usual 3-70% tax rates.		
Aliens not engaged in trade or business	30%	30%	30%
Corporations			
Domestic	15%, if from savings deposits.	10%, if inter-corporate	15%*
	20%, if from time deposits and deposit substitutes.		
	All other interest is taxable as part of gross income subject to the usual 25 and 35% tax rates.		
Non-resident foreign	35%, if from sources within the Philippines.	35%, if there is no tax sparing provision	35%**
	15%, if from foreign loans.	15%, if there is a tax sparing provision	
Offshore banking units	10%, on loans to residents		
Depository banks under expanded foreign currency deposit system	10%, on foreign currency granted to residents.		

* Not final.
** Final.

The amendments, however, tend to favor the rich as their income is now subject to much lower tax rates compared to the steep progression of the 3 to 70 percent tax rates applicable to other incomes. With these new rates, the progressive element of the income tax system is also weakened (see Table 3).

VI. CONCLUSION

As can be noted, some of the amendments under PDs 1773, 1739 and 1800 render certain provisions of Cabinet Bill No. 34 academic, such as the increase in personal and additional exemptions, the indexation scheme, the limitations or ceilings on itemized deductions and the imposition of final withholding tax at source for passive incomes.

Be that as it may, an ideal income tax system remains a much sought after target. This attitude is, of course, inevitable considering the high level of expectation that is pinned on the income tax system as a final and non-fiscal instrument.

Thus, the remaining features of Cabinet Bill No. 34 which are worth salvaging should still be given consideration. The adoption of the gross income concept on fixed or employment income would to a significant extent simplify administration and reduce the discretions given to the taxpayer and the tax authority.

TABLE 3

Tax treatment of passive incomes in ASEAN countries

Country	Interest	Dividends	Royalties
INDONESIA *			
Individual	Lumped with other income but subject to a 20 percent withholding tax which could be credited against the individual's income tax.	Lumped with other income but subject to a 20 percent withholding tax which could be credited against the individual's income tax.	20 percent of the proceeds — the taxpayer is the entity providing such proceeds. The tax can be credited against the individual's income tax.
Corporation	Lumped with other incomes but subject to 20 percent withholding tax which could be credited against the corporation's income tax. Interest paid to a foreign creditor is subject to a final tax of 10 percent.	Lumped with other incomes but subject to a 20 percent withholding tax which could be credited against the corporation's income tax.	20 percent of the proceeds credited against the corporation's income tax.
MALAYSIA *			
Individual	Taxable as part of gross income. Interest received from the National Savings Bank not more than M$1,400 or not more than M$600 from savings accounts with any commercial banks are exempt from tax.	Taxable as part of gross income.	Taxable as part of gross income for income more than M$3,000. Income up to M$3,000 is exempt. Royalties received by non-residents are subject to 15 percent withholding tax.
Corporation	Taxable as part of gross income.	Taxable as part of gross income.	Taxable as part of gross income on income of more than M$3,000. Income up to M$3,000 is exempt.
	Interest received from the National Savings Bank not more than M$1,400 or not more than M$600 from savings accounts with any commercial banks are exempt from tax.	a) Dividends received by corporations are treated as part of gross income. But when a resident company distributes its profits to shareholders by way of dividends, the shareholders are taxed on the gross dividends, and the income tax paid by the company is fully passed on to shareholders as credit. b) Dividends received by foreign shareholders from resident companies are subject to a 40 percent withholding tax. c) Dividends received by cooperative societies are exempt from income tax.	
PHILIPPINES			
Individual			
a) Citizens and resident aliens	15 percent final tax if from savings deposits. [1] 20 percent final tax if from time deposits and deposit substitutes. [1] Interest other than derived from above is taxable as part of gross income subject to 3-70 percent on the part of recipients.	15 percent final withholding tax on dividends. [2]	15 percent withholding tax creditable against the recipient's income tax. [2]
b) Aliens not engaged in trade or business.	30 percent final withholding tax.	30 percent final withholding tax.	30 percent final withholding tax.
Corporation			
a) Domestic and resident foreign corporation.	15 percent final tax if from savings deposits. [3] 20 percent final tax if from time deposits and deposit substitutes. [3] Interest other than enumerated above is taxable as part of gross income subject to 25-35 percent.	10 percent final tax if received from a domestic corporation liable to tax under the Code. (Provided that interest paid or incurred on indebtedness abroad shall be allowed as deduction from intercorporate dividends to compute the 10 percent if such loans was incurred to provide funds for investment in a domestic corporation.) [4]	15 percent withholding tax creditable against the recipient's income tax. [5]

Country	Interest	Dividends	Royalties
b) Non-resident foreign corporation not engaged in trade or business.	35 percent on interest incomes from sources within the Philippines. 15 percent tax on interest on foreign loans.	35 percent final tax if there is no tax sparing provision. 15 percent tax if there is a tax sparing provision.	35 percent final withholding tax.
c) Offshore banking units	10 percent final withholding tax on interest income from loans granted to residents.		
d) Depository banks under the expanded foreign currency deposit system.	10 percent final withholding tax on interest income from foreign currency loans granted to residents.		
SINGAPORE **			
Individual	Taxable as part of gross income. The tax deducted at source is allowed as a credit against individual income tax. Interest payable to non-residents is taxed at 40 percent on gross income at time of payment.	Taxable as part of gross income. The tax is allowed to be credited against income tax.	Taxable as part of gross income assessed at gross less any allowable deductions.
Corporation	Taxable as part of gross income and assessed at gross. Tax deducted at source is allowed as a credit.	Taxable as part of gross income and assessed at gross less allowable deductions.	
THAILAND **			
Individual	Received before 1983 — 10 percent of gross amount of interest. Received after 1983 — interest is added to gross income and taxable at income tax rates.	Taxable as part of gross income. Dividends received from listed companies not exceeding 10,000 baht — exempt; excess (up to 400,000 baht) — 30 percent is exempt. Dividends not exceeding 5,000 baht received from other Thai juridical companies or partnerships exempt; excess (up to 200,000 baht) — 15 percent is exempt.	Royalties are treated as ordinary income and are not subject to deduction. A 20 percent deduction is allowed for a patent however, but not exceeding 20,000 baht.
Corporation	Received before 1983 — 10 percent of gross amount of interest. Received after 1983 — interest is added to gross income and taxable at income tax rates.	Dividends received by a registered company from a Thai limited company, a listed company or a mutual fund are not included as revenue. Any other Thai company is required to include as revenue only one-half of the dividends received from a Thai company.	Taxable as part of gross income. If a recipient is a non-resident company, royalties shall be subject to withholding tax at the rate of 25 percent of the gross amount.

* Source: Tax Systems of Selected Countries in Asia and the Pacific, Project study of SGATAR, Prepared by the Republic of the Philippines, National Tax Research Center, November 1980.

** Source: Tax Systems of Selected Countries in Asia and the Pacific, November 1980.

1. PD 1739 (issued September 17, 1980).
2. PD 1800 (issued January 16, 1981).
3. Provided by PD 1739 (issued September 17, 1980).
4. Provided by PD 913 (issued March 29, 1976).
5. Provided by PD 1800 (issued January 16, 1981).

The New International Debate on Expenditure Tax: An Assessment

by G.Thimmaiah*

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I. BACKGROUND

In the idea of an expenditure tax is as old as the science of economics. It has been repeatedly discussed as an alternative to income tax but without any decisive impact on policy makers. In the 1970s, a new debate on the desirability of introducing the expenditure tax emerged in several developed countries, notably in Sweden, the U.K. and the U.S.A. There are several reasons for this latest revival of interest in the expenditure tax. The inflationary trend which engulfed the entire western world severely affected taxpayers when the increase in their nominal incomes pushed the lower slab income tax payers upwards into the higher slabs. Besides, business firms and the corporate sector could not plough back savings from their own sources to undertake new investments and, as a result, productivity suffered. Further, the type of income tax which has been operating in most developed countries has its own defects which added to the dissatisfaction of taxpayers and the frustration of tax administrators. All these problems required not merely ad hoc tax reforms but also fundamental long term changes in the tax structures. Perhaps the most vocal discussion on the need to reform the income tax structure and to consider the possibility of introducing an expenditure tax has been going on in the U.S.A. As far back as 1921, Congressman Ogden L. Mills was reported to have proposed a tax on spending. Later, in 1942, the Secretary of the Treasury, Mr. Morgenthau, proposed a spending tax in the U.S.A. In 1974, the Advisory Commission on Intergovernmental Relations (ACIR) prepared an information report on the expenditure tax. [1] In 1975, the Secretary of the Treasury, William E. Simon, suggested basic reforms of income tax; at his suggestion, *Blueprints for Basic Tax Reform* [2] were prepared in 1977 in which expenditure was proposed as an alternative to either a comprehensive income tax or the presently operating income tax.

In Europe, the *Swedish Government Commission on Taxation* initiated a detailed study on a progressive expenditure tax as an alternative to income tax in 1976. [3] In England, the Institute of Fiscal Studies appointed a Committee [4] in 1976 under the chairmanship of J.E. Meade to examine the structure of direct taxes and to suggest required reforms. This Committee produced an elaborate proposal for an expenditure tax in 1978. All these reports considered an expenditure tax as a feasible alternative to the existing income tax as well as to the ideal but impracticable Haig-Simons comprehensive income tax. [5] This revival of interest in expenditure tax deserves close scrutiny to understand afresh the problems and prospects of expenditure tax in both developed and developing countries.

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1. *The Expenditure Tax: Concept, Administration and Possible Applications* (ACIR, Washington, D.C., March 1974).
2. Department of Treasury, January 17, 1977.
3. *Progressive Expenditure Tax — An Alternative?* (Stockholm, 1978). Professor Sven-Olof Lodin, the athor of this Swedish study, has also published a summary of the Swedish proposal in *Intertax*, Nos. 11-12, 1978 and No. 1, 1979.
4. *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Prof. J.E. Meade* (George Allen and Unwin, London, 1978).
5. It is called "comprehensive income tax" because Robert M. Haig (in "The Concept of Income — Economic and Legal Aspects", *The Federal Income Tax* (Columbia University Press, New York, 1929)) defined taxable income as "the money value of the net accretion to one's economic power between two points in time"; Henry C. Simons (*Personal Income Taxation* (Chicago, 1938), p. 128) also defined it as "the algebraic sum of (1) the market value of rights exercised in consumption; (2) the change in the value of the store of property rights between the beginning and end of the period in question". Hence the concept has come to be associated with their names.

II. HISTORICAL PERSPECTIVE

The idea of an expenditure tax is traced to the writings of Thomas Hobbes, [6] though the proposal to exempt savings from income tax is found in the writings of J.S. Mill, Alfred Marshall and A.C. Pigou in England and Luigi Einaudi in Italy. [7] However it was Irving Fisher [8] of the United States who put forward in 1937 a proposal for a more practicable expenditure tax which was published in 1942. [9] Until that time, the expenditure tax was conceived as a tax on consumption, but the difficulty of imposing a tax on individual consumption makes it administratively impracticable, although in terms of economic logic it is rated a better tax than the income tax. It was Irving Fisher who for the first time showed that this administrative problem could be overcome by deriving the expenditure tax base from income in terms of aggregate economic entities. This was a major breakthrough in designing a practicable expenditure tax. In 1947, William Vickrey [10] suggested a spending tax for the U.S.A., either as a supplementary tax to the then existing progressive income tax in the middle income ranges or as a complete substitute for the income tax on all income slabs except the highest. Expenditure tax shot into academic prominence and attracted world-wide attention after the publication of Nicholas Kaldor's book in 1955. [11] From then onwards, the expenditure tax has been seriously considered by many governments in both the developed and the developing world.

It should be mentioned here that although an administratively practicable expenditure tax was expounded as early as 1937 by Irving Fisher, it did not catch the attention of the policy makers, mainly because of the unfavourable economic situation at that time in the western world: during the 1930s all these countries were reeling under the impact of the great depression. The depression called for expansion of aggregate expenditure and since private expenditure was considered inadequate to utilise the then existing productive capacity, public expenditure was expected to expand to fill the gap. The expenditure tax was believed to curb private consumption, and was therefore considered an inappropriate fiscal policy tool for initiating economic recovery during depression. Thus the first proposal for an expenditure tax was born at an inauspicious time and hence faced infant mortality. After this sad demise, the expenditure tax was reborn in the 1950s when Kaldor became its foster father. Kaldor's proposal was not sympathetically considered either by the British Royal Commission on Taxation of Profits and Income, before which he presented it, or by the British Government, because of their ignorance about the nature of the proposed expenditure tax. Undaunted by this failure to sell the expenditure tax at home, when called upon to achieve the Governments of India and Ceylon on tax reforms Kaldor sold his expenditure tax there. He recommended that the expenditure tax be introduced as a supplementary tax along with moderate rates of income tax. He also recommended that it be an integral part of an "integrated direct tax system" to curb tax evasion and to reduce the inequality of income and wealth. Thus in India he recommended retaining a progressive income tax with a maximum marginal rate of 45 percent, an expenditure tax, an estate duty, a gift tax, a capital gains tax and a wealth tax, all operating simultaneously. But because the Government of India could not implement it in the way he recommended and also because the bureaucracy could not establish the expenditure tax base in the way suggested by Irving Fisher, it became a consumption tax based on the declared consumption of individuals. This made the tax unpopular, administratively complicated and, in terms of yield, unproductive. The tax was abolished in 1962 but reintroduced in 1964 and finally abolished in 1966. With this demise, the first practical experiment after its second birth came to an end. In the 1970s, the American *Blueprints*, the Swedish proposal and the Meade Committee proposal revived international interest in the expenditure tax. These proposals have also started an international debate which deserves critical assessment.

III. JUSTIFICATION FOR THE EXPENDITURE TAX

Of several justifications [12] for the expenditure tax, at

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6. See Nicholas Kaldor, *An Expenditure Tax* (George Allen and Unwin, Ltd., 1955), pp. 11-15.
7. Ibid., pp. 11, and 79-80.
8. "Income in Theory and Income in Taxation in Practice", *Econometrica*, January 1937, and "A Practical Schedule for an Income tax", *The Tax Magazine*, July 1937.
9. Irving Fisher and Herbert W. Fisher, *Constructive Income Taxation* (New York, 1942).
10. *Agenda for Progressive Taxation* (The Ronald Press Co., New York, 1947). However, he slightly modified his suggestion in a subsequent paper and recommended "... to reform the income tax at least as applied to upper bracket tax payers, so as to provide full inclusion of capital gains and losses and some form of averaging and... to adopt a spending tax for upper bracket tax payers" ("Expenditure, Capital Gains and the Basis of Progressive Taxation", *The Manchester School of Economic and Social Studies*, January, 1957, p. 24).
11. Op. cit.
12. These are mainly peace time justifications. It is interesting to know that Milton Friedman justified the expenditure tax (spending tax) during World War II to achieve (i) maximum total output as well as that required for war, (ii) efficient allocation of scarce consumer goods available for civilian consumption and (iii) a smooth economic transition to the post-war situation by using accumulated savings ("The Spending Tax as a Wartime Fiscal Measure", *American Economic Review*, March 1943, p. 62).
William Vickrey also justified a spending tax during war for the following reasons: "There is a case of a different order to be made, not discussed by Kaldor, for a temporary expenditure tax to be applied at a time of great general shortage of consumer goods, as during a war, or other emergency period. In this case the tax is specifically not expected to continue after the emergency is over, or at least only at much lower rates, so that deferment of expenditure not only defers the tax, but reduces the applicable rate, and the incentive for individuals to save, at least temporarily, is greatly enhanced. In such contexts the argument for the expenditure tax is much stronger than it is for a permanent tax; indeed it can be considered as a form of graduated generalized rationing. One could even argue that the possibility of such emergency use would be a reason for using the tax in normal times in order to have the administrative machinery ready for the emergency" ("Expenditure, Capital Gains and the Basis of Progressive Taxation", *The Manchester School of Economic and Social Studies*, Jan. 157, pp. 7-8).

least one is as old as the idea itself: income tax amounts to double taxation of savings and hence discourages savings. This allegation against income tax was first made by J.S Mill, although it was modified by Alfred Marshall and A.C. Pigou and became a very fashionable argument against income tax. However, on close examination this is an exaggeration, as pointed out by Raja Chelliah.[13] Because income tax first taxes the income earned/received in a particular year, and savings or investments are made from that income, the income which flows from those savings and/or investments will be taxed and not the original savings themselves. Therefore, it is far from true to say that income tax is "double taxation of savings". However, what happens in practice is that under an income tax regime, if there is a wealth tax or an inheritance or gifts tax, this would amount to double taxation of past accumulated savings though not in the same year. Thus income tax taxes the savings which were already included in income; when savings are accumulated and become wealth in the future, that is taxed in later years under the wealth tax or inheritance tax. But even this is not double taxation of savings in the same year. And this kind of integrated taxation is based on equity considerations which are relevant even under an expenditure tax regime as will be shown below.

An important argument in favour of an expenditure tax is that, for a fast growth of productivity, high rates of savings and capital formation are required. Self-financing is necessary for business and the corporate sector to undertake new investment and to improve productivity. In an inflationary situation, the cost of borrowing becomes discouragingly high and, under the income tax regime, a plough-back of savings is made impossible; hence an expenditure tax would encourage self-financing and promote savings in developed as well as developing countries. This is the argument put forward by the American *Blueprints*, the Swedish proposal and the Meade Committee. Thus it is interesting to know how the tide has turned; namely, in the 1930s when the expenditure tax was first proposed, over-saving was considered an economic malady and an expenditure tax hence ruled out as an inappropriate remedy as it was feared to kill the patient. But by the 1970s, the lack of adequate savings became a malady and hence an expenditure tax has been advocated to encourage savings in both the household and corporate sectors.

Yet another argument for expenditure tax advanced in the three proposals mentioned above is that the inflationary situation has created serious problems for income tax payers and for the business and corporate sectors. Income tax cuts into the capital structure of companies through the capital gains tax, reduces the flow of funds in the corporate sector and imposes a heavy burden of tax on individuals whose nominal incomes shift them to higher brackets on account of inflation. An expenditure tax is therefore advocated as a solution to those problems created by inflation. It is argued that an expenditure tax automatically indexes incomes for inflation. This argument is open to dispute. It is possible that capital gains may receive more favourable treatment under an expenditure tax than under income tax in an inflationary situation, but it is difficult to believe that expenditure tax would automatically index for changes in the real value of income from other sources.

All three proposals, which have unanimously advocated expenditure tax, have recommended it with a view of also achieving other objectives of tax reform. For instance, the American *Blueprints* emphasise three objectives of tax reform, namely, equity, simplicity and efficiency. In other worlds, the American *Blueprints* have tried to examine the alternative proposals for reforming the existing income tax with a view to making the direct tax structure of the U.S.A. more equitable, easier to understand and to justify, and more conducive to the efficient operation of the private economy. The Meade Committee has maintained that its proposals aim at providing incentives and achieving economic efficiency, distributional equity, simplicity and low cost of administration and compliance. More or less the same objectives are kept in view by the Swedish proposal. Thus all three countries' proposals for an expenditure tax have examined it both as a supplementary tax and as a tax supplanting income tax from the viewpoint of the abovementioned objectives of tax reform. They also happen to be the essential characteristics of any good tax system. This means that in all these countries their respective direct tax systems have lost these characteristics; hence, these proposals assume that, among other things, if an expenditure tax is introduced the necessary characteristics will be restored to their direct tax systems.

IV. SCOPE OF THE PROPOSALS

The three proposals examined the weaknesses of the existing income tax in the respective countries, and against this background the American *Blueprints* and the Meade Committee proposed a comprehensive income tax and an expenditure tax as alternatives whereas the Swedish proposal did not directly examine a comprehensive income tax and expenditure tax as alternatives. The American *Blueprints* examined the comprehensive income tax and a full-fledged expenditure tax as alternatives and came to the conclusion that it is very difficult to administer the comprehensive income tax even though it is the ideal way of taxing income. Hence the *Blueprints* opted for an expenditure tax. The Meade Committee examined the relative merits of the comprehensive income tax, the universal expenditure tax, and the two-tier expenditure tax, and recommended the two-tier expenditure tax to start with on the grounds of administrative feasibility, with a gradual phased switch over to the universal expenditure tax. The Swedish proposal recommended conversion of the present progressive income tax into a proportional income tax with a 30 percent rate, and the introduction of a progressive expenditure tax (along with the proportional income tax) on expenditures which exceed 30,000 kroners. Therefore, all three proposals have opted for an expenditure tax not merely as an "economically efficient" substitute but also as an administratively feasible tax as compared to the comprehensive income tax.

13. "Case for an Expenditure Tax", *Economic and Political Weekly* (Bombay), January 26, 1980, pp. 158-174.

V. TAX BASE

Expenditure tax was originally known under other names: American authors used the term "spending tax" and British authors used the term "consumption tax". But it was Nicholas Kaldor who called it an expenditure tax. There are certain valid reasons for calling the tax on consumption base an expenditure tax. Traditionally, the tax on consumption has been in the form of commodity taxes which assume the form of indirect taxes. They include excise duties, turnover tax, sales tax and value added tax. Conceptually such a tax, though a tax on consumption, is not neutral between different forms of consumption as the rates of tax differ from commodity to commodity depending upon their nature and importance. Even the value added tax assumes the form of a consumption base tax. Several problems are therefore associated with the measurement of consumption for the purpose of direct taxation and it is this difficulty which leads to the administrative unpopularity of the expenditure tax. Realising this drawback, Irving Fisher suggested the derivation of consumption through income by deducting savings from gross income. Thus the technical aspect of a consumption base tax was conceptually solved. In this form, the tax will be neutral between different commodities and different consumption units. It is as universally applicable for all consumption as is an income tax. Therefore, it was rightly designated an expenditure tax since the expenditure is derived in the aggregate sense by deducting aggregate savings from aggregate income. Consequently, the total expenditure is the tax base in the case of an expenditure tax. However, the Meade Committee examined different forms of expenditure tax, namely: (i) the expenditure tax adjustment of the income base, (ii) the value added method and (iii) the hundred percent capital allowance method. The expenditure tax adjustment of the income base is called the universal expenditure tax and the remaining two are called two-tier expenditure taxes. Under the universal expenditure tax, the tax base is estimated in the following way: all personal income (such as wages, salaries, dividends, interest, rent, profits and royalties) plus all capital receipts (like realisation of capital assets, amounts borrowed, receipts of repayment of past loans, reduction in money balances) plus all windfall earnings (like inheritances, gifts received and lottery earnings) are added and considered as total income. From this total income are deducted non-consumption outgoings (such as for acquisition of assets, the amount of money lent, repayment of past loans, increase in money balances, payment of interest on money borrowed). What remains is the tax base for the universal expenditure tax. Even in the case of a two-tier expenditure tax, where it is suggested that it take the form of a surcharge on incomes above a particular limit, the tax base would be the same, except that income tax paid will be deducted from the tax base. In the case of the American *Blueprints*, for purposes of the expenditure tax (also called consumption base tax or cash flow tax), all income minus all positive and negative changes in net worth are taken into account. In other words, all receipts of income such as wages, salaries, gross business receipts, pensions, gifts and inheritances, all forms of public assistance, alimony and withdrawals from qualified accounts, loans and proceeds from asset sales, *minus* gross business expenses, gifts made, deposits in qualified accounts, repayments of loans, and proceeds of asset purchases, make the consumption base almost equivalent to the comprehensive income tax base without requiring an actual tally of the purchases of consumption goods and services. The earlier-mentioned experiments with expenditure tax in India and Ceylon considered the actual amount spent by individuals on goods and services as the tax base. Proof of purchases through vouchers or bills was required which was very difficult to obtain; hence the measure became administratively unpopular. Precisely for this reason, namely, difficulty of enforcement, it could not yield adequate revenue and became unproductive. But the proposed expenditure tax base tries to overcome this problem. The Swedish proposal worked out the tax base for an expenditure tax on the basis of cash receipts, such as regular income, proceeds from the sale of investment assets, legacies, gifts, loans, lottery prizes and the like plus all dissavings such as reduction of bank deposits, reduction of claims, loans, minus all outgoing deductible amounts like accumulated outlays for the acquisition of income, outlays for investment yielding activities and also new savings in bank deposits, increases of claims and repayment of loans. The net amount constitutes the individual tax base for the expenditure tax. Thus, as against the existing income tax which is based on the principle of ability to pay, the progressive expenditure tax is based on the principle of standard of living of the family or the individual as the tax base. The expenditure tax, as discussed in the three proposals, becomes a tax on standard of living. Kaldor justifies expenditure as a better index of taxable capacity. This is supposed to indicate the ability to pay better than mere income. However, this argument does not stand close scrutiny in terms of economic logic as income is always a better index of economic ability by the mere fact that income is of a greater magnitude than expenditure at higher levels of income.

VI. EXEMPTIONS AND DEDUCTIONS

All three proposals have examined the items of savings and other allowances to be deducted from the total income to arrive at expenditure as the tax base. While all receipts of income in various forms become part of total income, all items of saving such as bank deposits, life insurance premia, stocks and shares become part of deductions. Ticklish problems arise, however, in regard to assets like housing, life insurance funds, durable consumer goods, borrowing and "lumpy" (meaning substantial amounts of money to be paid in one amount) items of expenditure such as education and health. The investment in housing is usually large, and if it is allowed to be deducted in one year, the tax base may become negative. Similarly, if the amount borrowed for housing is added to the income base and if the tax is levied on "lumpy" expenditures incurred on education and health, the amount of tax would be prohibitively high. Therefore, several suggestions have been made by the three proposals to overcome these problems. One suggestion is to add the annuity or mortgage payments on houses each year as deductible savings. Another suggestion is to take the rental value of the house. In regard to expenditure on education, if we treat it as an investment in human capital formation, then it should be deducted from the tax base. This is consistent with the philosophy of the expenditure tax which is supposed to exempt all savings and investment. If the same logic is used, then expenditure on health becomes a depreciation or maintenance cost of human capital, but if it is exempted on such economic theoretical grounds it erodes the tax base enormously. It is precisely for this reason that the Swedish proposal suggested that deductible items of savings should be identified purely on practical considerations and not on the basis of economic theory. So in such cases suggestions are made to allow some limits up to which they are exempted. Another suggestion made by the Swedish proposal is to give allowances, e.g. child allowance for education and health, so that "lumpy" expenditures are reduced to reasonable levels. In the case of interest, if the amount borrowed is used for capital formation, it should be treated as part of investment income and hence be exempted. But this violates the principle of equity and therefore it has to be taxed separately as income from capital. In the case of durable consumer goods, the Meade Committee suggested that some of the smaller consumer goods of daily use may be exempted from taxation as it is administratively difficult to cover them.

However, other high priced durable consumer goods such as TV sets, stereo sets, refrigerators, motor cars, etc., will have to be taken into account for purposes of taxation by adding the annuity payment if they are purchased on credit. If they are purchased with cash, the "lumpy" amount may be averaged over the life span of the assets. For the purpose of distinguishing items of savings and durable consumer goods which qualify for deductions, all three proposals suggested a more or less similar administrative procedure. The Meade Committee suggested classifying the assets into registered and unregistered assets. All registered assets should be included as savings deductible from income and all unregistered assets (which include small cash, small household articles and the like) may be left out of both the tax base and the tax deduction. For this purpose, the Swedish proposal suggested that registration of such items as bank deposits, financial assets, houses, motor vehicles, refrigerators, etc., be made compulsory. The American *Blueprints* made a similar distinction between qualifying and non-qualifying accounts which correspond to registered and unregistered classification. However, it is necessary to recognise the practical problems involved in neatly classifying all the assets for purposes of tax deduction. The Meade Committee tried to get over this problem by suggesting that all assets whose market value appreciates over time should be classified as registered assets. But this principle fails to help the tax authorities during periods of stable and falling prices. The Swedish proposal, on the other hand, suggested that for purposes of identifying savings for tax deduction, economic logic should be relegated to the background and administrative feasibility should be the determining factor. The Swedish proposal recommended consideration of the principle of "income yielding asset" as deductible when purchased and to be added to the tax base when sold.

Thus the expenditure tax, while making it possible to arrive at aggregate expenditure as the tax base by deducting aggregate savings from aggregate income, creates the problem of a negative tax base and an excessive tax base because of the need to take into account "lumpy" expenditures and capital assets. The three proposals attempted to solve these problems though not successfully. The solutions are only indicative and not conclusive.

VII. UNIT FOR TAX PAYMENT

In all three proposals the recommended unit of tax payment is the family, including husband, wife and minor dependents. If the family is considered as the tax paying unit, then, unless proper provisions are made for income splitting, there will be hardship for earning couples. Therefore the Meade Committee suggested the following guiding principles for the tax treatment of individuals and families: (i) the decision to marry or not to marry should not be affected by tax considerations; (ii) families with the same joint resources should be taxed equally, and (iii) the tax system should be fair between families which rely upon earnings and families which enjoy investment income.[14] The same view is taken by the American *Blueprints* which suggested two guidelines: (i) families of equal size with equal incomes should pay equal taxes; and (ii) the total tax liability of two individuals should not change when they marry. The Meade Committee suggested partial income splitting and partial quotient methods to levy expenditure tax on families to satisfy these criteria.

VIII. EQUITY OF THE EXPENDITURE TAX

With expenditure as the tax base, families with more children and other dependents are compelled to spend more, and hence larger families will be more highly taxed than smaller families whose expenditure may be limited and who can afford higher savings. Besides, the expenditure tax discriminates against income from employment or labour and falls lightly on income from capital or wealth. This, in other words, suggests that the expenditure tax discriminates against income from labour and hence fails to satisfy the neutrality criterion of the optimal taxation theory.[15] Thus the expenditure

14. Op. cit., p. 377.
15. The theory of optimal taxation is a new attempt to design income taxation (and also commodity taxation) with a view to achieving both economic efficiency (or neutrality or absence of excess burden) and equity, simultaneously, by deriving appropriate rate schedules. According to this theory, income tax, in order to be efficient, should have a linear rate schedule (moderately progressive rates). This requirement makes income tax an effective tool of achieving equity in tax burden. Therefore, it is suggested that "it would be good to devise taxes complementary to the income tax, designed to avoid the difficulties that tax is faced with" (J.A. Mirrlees, "An Exploration in the Theory of Optimum Income Taxation", *Review of Economic Studies*, April 1971, p. 208). Hence, the expenditure tax may be considered as

tax creates both efficiency and equity problems. It fails to be an efficient tax because it is not meutral (i) between labour income and capital income and (ii) between consumption and savings. Furthermore, income tax is neutral between consumption and savings, both different forms of savings and different forms of consumption. Hence it can be made to satisfy, at least theoretically, the criterion of horizontal equity, namely, those who earn/receive the same amount of income should pay the same amount of tax irrespective of the pattern of its allocation between consumption and saving. But the expenditure tax violates the criterion of horizontal equity by taxing heavily those who spend more than those who save, given the same level of income. It also fails to satisfy vertical equity because it falls heavily on larger families and relatively lightly on smaller families. Since the size of the family is inversely related to level of income, the expenditure tax makes rich people pay proportionately less of their income as expenditure tax whereas poor people will be compelled to pay proportionately more because at the lower end most of their income is consumed. The Swedish proposal attempted to solve this equity problem by suggesting a wealth or inheritance tax on the one hand and by fixing a higher exemption limit by allowing child allowances for large families on the other. The American *Blueprints* tried to solve this problem by fixing a higher exemption limit. But the Meade Committee did not bother to tackle this problem, except that from the point of view of equity it suggested a supplementary wealth or inheritance tax. This question of inequity still remains an unresolved issue as far as the expenditure tax is concerned. In fact in an attempt to get over this problem by suggesting an alternative or a supplementary wealth tax or inheritance tax, the three proposals are exposed to the criticism of being inconsistent with the philosophy of an expenditure tax whose main concern is encouraging capital formation by exempting savings. [16] Though the rate structure proposed for the expenditure tax by the American *Blueprints* vis-à-vis the existing income tax rates shows that the expenditure tax becomes slightly more progressive as compared to income tax, this may be due to the suggested hypothetical rate structure. Therefore, the real issue is not merely to chose the appropriate rate structure in order to make the expenditure tax progressive, but also to design the tax in such a way as to achieve horizontal as well vertical equity. [17]

IX. THE ECONOMIC STABILIZATION ISSUE

It has already been mentioned above that the expenditure tax proposal was not accepted during the depression years because of its problable anti-economic recovery impact. Similarly, it became a popular tax proposal in the 1970s because it was considered a potential fiscal tool to curb inflation by reducing consumption expenditure. This stabilising aspect of the expenditure tax was not considered by the American *Blueprints*, except to state that since the American economy lags in capital formation to increase productivity, the expenditure tax would encourage savings and capital formation. But the Swedish and the Meade Committee proposals have taken into account the stabilisation potential of expenditure tax. According to the Swedish proposal, in a period of inflation a rise in the rates of the expenditure tax would serve the purpose of reducing aggregate demand by reducing private consumption. Reducing the rates of tax will encourage expansion of aggregate demand in times of recession. But when the income from employment goes on losing its real value in an inflationary situation, if expenditure tax rates are raised across the board, a heavier burden will be imposed on the poorer sections who depend upon income from labour. This means that although it is possible to use the expenditure tax as an anti-cyclical fiscal tool, such use will conflict with vertical equity considerations. As a fiscal policy tool for stabilisation, raising the tax rates during inflation will no doubt bring down expenditure, but if that revenue is used by the government either for its own spending or for repayment of debts, then the contractionary effect of high tax rates will be offset by the expansionary activity of government spending. During a recession, if expenditure tax is cut lo leave more money in the hands of the people, the expansionary effect will not be as much as if the government increases expenditure, because the expansionery effect of government expenditure is much more than that of private expenditure. Therefore, the compensatory financial characteristics of the expenditure tax are not all that certain. However, it would help encourage savings and capital formation in the long run.

No doubt the expenditure tax may be neutral between different forms of consumption but it will not be neutral between different forms of savings. It should be mentioned in this context that none of the early proponents of an expenditure tax made any distinction between productive and unproductive savings from the point of view of society. If such a distinction is not followed, then the expenditure tax becomes neutral between different forms of savings. However, in recent years such a distinction has been felt to be desirable. Accordingly, all three proposals suggest, and rightly too, some form of discrimination against undesirable savings. If this suggestion is accepted, the expenditure tax can-

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one of such complementary taxes to achieve equity. But the expenditure tax itself creates problems of "excess burden" and inequity. See David F. Bradford and Harvey S. Rosen, "The Optimal Taxation of Commodities and Income", *American Economic Review*, May 1976, and A. Sandmo, "Optimal Taxation — An Introduction to the Literature", *Journal of Public Economics*, January 1975.

16. Dr. Barry Bracewell-Milnes has maintained in this context that "There is a contradiction at the heart of the Meade Report, because the Committee could not decide whether, how or where saving should be taxed more or less heavily than spending" ("The Meade Report and the Taxation of Capital", *British Tax Review*, No. 1, 1979, p. 40).

17. However, as compared to indirect taxes on commodity consumption, direct tax on expenditure is considered a better way of achieving equity. In this context Chelliah has observed that: "It would be a far better method to restrict the consumption of the rich through a direct tax on expenditure and simultaneously reduce the rates of taxes on commodities in general, so that many of them would come within the reach of the common people" (op. cit., p. 169).

not be neutral between different forms of savings. This can be justified on the basis of planned non-neutrality.[18] Further, the expenditure tax, by substituting the expenditure base for an income base at higher levels of income, reduces the disincentive effect of marginal tax rates on higher incomes. This would reduce the distortion effect of direct tax on the choice between work and leisure. However, it has now been accepted that planned non-neutrality of taxation is necessary to achieve certain broader economic and social policy goals. Hence, the expenditure tax cannot be disqualified on the ground of its possible allocational distortion effect.

X. REVENUE IMPLICATIONS

Whenever a new tax is proposed in place of an existing one, the first condition which the new tax is expected to satisfy is that it should not result in any loss of net revenue yield to the government. Keeping this revenue implication in view, all three proposals have examined the revenue impact of introducing an expenditure tax in place of the existing income tax. The American *Blueprints* contended that there would be no loss of revenue if a progressive expenditure tax were introduced in place of the present income tax. And it even went to the extent of arguing that the yield might increase in the long run because savings and investment would be encouraged by the expenditure tax, thus generating more income and thereby enhancing the tax base. But the Meade Committee, which examined the revenue aspect in detail, put the loss at a considerable amount if housing is left out of the tax base. This divergence in conclusions may be attributed to different forms of expenditure tax proposals and different forms of income tax operating at present in those two countries. The Swedish and the Meade Committee proposals, however, though similar in form, arrived at different conclusions in regard to revenue impact: a loss of revenue in the immediate future if the expenditure tax replaces the existing income tax. But in the long run, the yield may increase as the administration becomes easy. If in the long run expenditure tax replaces income tax, and a supplementary tax on wealth or inheritances is levied, then it is doubtful if the yield could be much higher through the "Laffer curve" effect[19] than under the present direct taxes regime. This is mainly because the tax base under the expenditure tax is necessarily smaller than that under income tax, unless expenditure rates are set higher than under income tax in the short run and/or the tax base expands in the long run, so that revenue from expenditure tax will be lower than under income tax. The revenue aspect is therefore very much connected with both rate structure and administrative feasibility of the tax. This leads us to the problem of tax evasion under an expenditure tax regime.

XI. TAX EVASION

Of the three proposals, the Swedish proposal examined this issue in broader perspective. It maintained that "*the possibilities of avoidance are considerably more limited than in the case of income tax, since all income is taxed equally. The loss of revenue owing to tax avoidance should therefore be substantially reduced. Tax fraud can never be entirely prevented. But there is reason to believe that the scope for fraud is less in the case of expenditure tax than it is in income tax.*"[20] However, the scope for tax evasion is equal if not greater under the expenditure tax. For instance, if a loan for investment in an income yielding asset is deducted from the tax base, taxpayers may declare their loans as investments to reduce tax liability. But in actual practice they may use the funds for consumption. Further, borrowing may be so "timed" as to reduce the tax liability without actually incurring any net debt liabilities. In order to avoid this possibility, the tax rate should be lower than the rate of interest on borrowing. This would affect the tax yield in the short run. Similarly, if higher exemption limits are inevitable on "lumpy" expenditure, it is possible to convert most of the normal expenditure into "lumpy" expenditure. Further, it is possible to evade expenditure tax through barter transactions of goods without subjecting them to registration transfers, and by fals valuation of goods.[21] Hence, the expenditure tax in order to be evasion-proof requires full computerisation of all assets, financial transactions and capital transfers of the taxpayers. Thus cross checking and updating of such information virtually every year becomes an integral part of administering the expenditure tax.

XII. ADMINISTRATIVE PROBLEMS

Expenditure tax has been considered a "utopian" idea by such economists as Alfred Marshall, A.C. Pigou and J.M. Keynes, mainly on the ground of its administrative impracticability. But Irving Fisher attempted to change this misconceived notion by making the base an aggregate remainder of income minus savings. Even after that simplification, the failure of the expenditure tax in India and Ceylon created scepticism in the minds of those who might otherwise be supporters of an expenditure tax. However, the American *Blueprints* tried to convince the sceptics by suggesting the minimum necessary modifications in the existing income tax self-assessment form and in other procedures. The Swedish proposal also contended that the present procedures for income tax administration may also be sufficient for implementing a progressive expenditure tax. However, the Meade Committee raised certain doubts about the administrative feasibility of expenditure tax in the U.K. The Commit-

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18. See for details on this concept, G. Thimmaiah, "Tax Reform in India — An Evaluation of the Indirect Taxation Enquiry Committee (1977-78)", 33 *Bulletin for International Fiscal Documentation*, February 1979.

19. This refers to the incentive effect of the tax rate cut on the private sector, which will generate a higher GNP which in turn expands the tax base and enables the government to collect more revenue even at lower rates of tax. This "Laffer curve" effect has been advanced in the U.S.A. as a part of "Reaganomics".

20. Sven-Olof Lodin, *Intertax*, No. 1, 1979, p. 37.

21. See for further details, Kenyon E. Poole, "Problems of Administration and Equity under a Spending Tax", *American Economic Review*, March 1943, pp. 63-73.

tee thought that taxpayers will feel the initial burden of educating themselves about the two-tier expenditure tax. In order to make it administratively simple, taxpayers should be made to accept the self-assessment procedure. This is considered a precondition for successful implementation of expenditure tax in the U.K. This may be possible in a country like England where voluntary tax compliance is surprisingly high. Even so, Professor A.R. Prest [22] observed that the Meade Committee tried to justify the expenditure tax by comparing its hypothetical merits with the actual demerits of the presently operating income tax in U.K.

The controversy on the administrative aspect of the expenditure tax has been aptly summed up by Chelliah: "*The administrators usually contend that it would be considerably more difficult to administer an expenditure tax than an income tax. In putting forward this contention, they implicitly compare the present form of income tax with the full-fledged expenditure tax. Economists favouring the expenditure tax on the other hand argue that it is almost impossible to administer an equitable form of income tax; in saying this they have in mind the comprehensive income tax which they contrast with the expenditure tax.*" [23] The position which emerges from the new international debate on expenditure tax is a compromise: it is possible to combine the best features of the existing income tax with the practicable advantages of the expenditure tax to improve the direct tax system in developed as well as developing countries. This would suggest the emergence of an income-cum-expenditure tax in these countries in the near future. But in countries like India, where tax evasion has become a common practice, administration of an expenditure tax requires adequate preparation for both the administration and prospective honest taxpayers.

XIII. RELEVANCE OF AN EXPENDITURE TAX FOR A DEVELOPING ECONOMY

The three international proposals which recommended an expenditure tax have not been unanimous on the pattern of its actual introduction. For instance, the American *Blueprints* recommended the expenditure tax as an alternative to the existing income tax in the U.S.A., whereas the Meade Committee and the Swedish proposal suggested that the expenditure tax first be introduced in the form of a surcharge at higher levels of income, converting the present progressive income tax into a proportional income tax. However, the Meade Committee recognised the initial administrative problems involved in implementing such a proposal and also the problem of educating the public in regard to the combined operation of a proportional income tax and a progressive structure of expenditure surcharge above a particular level of expenditure. It should be mentioned here that levying a surcharge on higher levels of expenditure by retaining moderate rates of progressive income tax at all levels was first recommended by Kaldor. The Meade Committee and the Swedish proposals have only revived Kaldor's proposal with certain modifications. However, the Meade Committee suggested a universal expenditure tax in a phased manner, that is, it recommended the introduction of a two-tier expenditure tax to start with, then replacing the income tax by a universal expenditure tax.

Expenditure tax was introduced in India from April 1, 1958 on the recommendation of Nicholas Kaldor. It was levied along with income tax. Kaldor recommended moderate rates of income tax with a maximum rate of 45 percent on income, but steeply progressive expenditure tax rates as shown in Table. 1. But the government of India levied high marginal rates of income tax (up to 90 percent) and also high rates of expenditure tax. However, the expenditure tax was applicable only to those income tax assessees whose income exceeded 60,000 Rs. per annum. Further, the administrative procedure introduced to assess the expenditure tax required the spenders to declare their total consumption and submit vouchers or bills in support of it. Though the government of India accepted the expenditure tax as a desirable tax policy measure for reducing tax evasion and conspicuous consumption, the Indian bureaucracy did not accept it wholeheartedly and hence throttled the experiment by creating administrative complica-

22. He observed that "the Committee is a little inclined to play the old game of comparing an imperfect present (income tax) with a perfect future (expenditure tax) without the comparison to be valid" ("The Meade Committee Report", *British Tax Review*, No. 6, 1978, p. 191). However, Alan T. Peacock has given just the opposite interpretation for the Committee's justification of expenditure tax. He has observed that: "In fairness to the Committee, however, it must be emphasised that it has not committed the fallacy of comparing an imperfect existing income tax with some ideal hypothetical alternative" ("Do we need to Reform Direct Taxes", *Lloyds Bank Review*, July 1978, p. 36). But in all fairness to both, A.R. Prest's statement is nearer the truth. In fact, Nicholas Kaldor also resorted to the same old game when he advocated an expenditure tax. Professor R.A. Musgrave, in his review of Kaldor's book *An Expenditure Tax*, observed that "Kaldor holds that it is much simpler to devise a proper concept of spending than a proper concept of income. However, in his highly stimulating discussion, he seems to overstate the difficulties of the income tax and to understate those of the spending tax.... The proof of the pudding, of course, is not in comparing a perfect income tax with a perfect spending tax, but in comparing both as they turn out in practice. Again Kaldor tends to overstate the administrative difficulties of improving the income tax while understating those involved in the spending tax" (*American Economic Review*, March 1957, pp. 201-202).

23. Op. cit., p. 163. William Vickrey has rightly observed that: "In this area, more than in most, there is a sharp distinction to be drawn between considerations that would apply to the comparison of theoretically perfect taxes of the various types and those that would apply to the taxes as actually administered.... On the other side even less tolerable is the reverse error of ignoring the difficulties of the present system merely because they are somehow being lived with, while making the most of all of the difficulties, real or imagined, associated with the new.
Evenhanded comparison of two taxes in terms of imperfect practice is difficult, however, not only because imperfection is always more complex than perfection but because the nature of the imperfections to be encountered in practice is difficult to predict, particularly with respect to the new law. As a first approximation, therefore, it is helpful to compare a reasonably perfected income tax with an equally idealized expenditure tax" (*The Manchester School of Economic and Social Studies*, January, 1957, pp. 1-2).

TABLE 1

Rate structure of the expenditure tax which operated in India

Rate structure suggested by Nicholas Kaldor		Rate structure introduced by the Government of India in 1958-59		1964-65	
Taxable Expenditure (Rs.)	*Rate of tax (%)*	*Taxable Expenditure slab (Rs.)*	*Rate of tax (%)*	*Taxable Expenditure slab (Rs.)*	*Rate of tax (%)*
		Up to 10,000	10	Up to 36,000	Nil
		Between 10,001 and 20,000	20	Between 36,001 and 48,000	5
Up to 10,000	Nil	Between 20,001 and 30,000	40	Between 48,001 and 60,000	7.5
Up to 12,500	25	Between 30,001 and 40,000	60	Between 60,001 and 72,000	10
Above 50,000	300	Between 40,0001 and 50,000	80	Between 72,001 and 84,000	15
		Above 50,000	100	Above 84,000	20

Note: The Bill levying the expenditure tax was introduced in the Indian Parliament on May 15, 1957; the tax became operative from April 1, 1958. It was discontinued from April 1, 1962, but reintroduced on April 1, 1964 and finally abolished from April 1, 1966.

TABLE 2

Revenue yield from the expenditure tax and number of expenditure tax payers in India

Year	*Revenue yield (Rs. million)*	*Yield from expenditure tax as percent of total tax yield of the country*	*Number of expenditure tax payers*
1958-59	6.9	0.10	421
1959-60	8.9	0.11	553
1960-61	10.5	0.12	789
1961-62	9.6	0.09	807
1962-63	4.2	0.04	348
1963-64	0.9	0.01	042
1964-65	3.8	0.02	367
1965-66	3.5	0.02	599

Source: O.P. Chawla, *Personal Taxation in India (1947-70)* (Somaiya Publications Pvt. Ltd., Bombay, 1972), pp. 156.

tions. Consequently the revenue yield was poor (see Table 2) and the administration became a muddle. Hence the tax was abolished. Expenditure tax faced the same fate in Ceylon.

However, in the light of the new international debate on expenditure tax, there are suggestions in India to introduce some elements of expenditure tax into the presently operating progressive income tax. In most countries the income tax is a mixed form of tax on income as well as on expenditure. That is, the taxable base is income minus certain forms of savings and hence is a tax on consumption and on certain unapproved savings, such as bank deposits in India. The suggestion made in India is that the income tax should be converted into an expenditure tax by allowing socially desirable savings to be deducted after taking into account all forms of income. For instance, Raja Chelliah [24] has suggested the following tax base to make the present income tax a more comprehensive income-cum-expenditure tax: gross total income as computed for income tax plus gifts, interest received on post office savings and fixed deposits (which are exempted now up to 3,000 Rs.), plus agricultural income (which is indifferently levied), and realised capital gains and all other casual income, minus taxable gifts made, net contributions to provident funds, compulsory deposits required to be kept by the income tax payers, life insurance premia, minus the increase in net worth at previous year's prices minus taxes on capital gains, wealth and on income. The proposal does not recommend whosesale replacement of the existing income tax by an expenditure tax, mainly because expenditure is not accepted as a better measure of taxable capacity and has its own administrative complications which may adversely affect the revenue yield.

In India it is easy to justify the expenditure tax, as it is derived from income tax, because some of the arguments against expenditure tax in developing countries may not hold good for India. For instance, the expenditure tax is opposed in the west on the ground that it would hurt large families much more than small families; although large families have to spend more, they spend a relatively smaller proportion of their income than poor families, and hence the tax will be regressive. But this argument does not hold good for India because the Indian national policy has been to limit the size of the family through the family planning programme. If the families whose total income and expenditure exceed the exemption limit face higher rates of expenditure tax because they spend more, it will act as a further disincentive to large families in India. Further, the concentration of wealth in India has been increasing as a result of widespread tax evasion resulting in black money operations. This has been flowing into lavish consumption, urban real estate and gold. The expenditure tax when introduced should disallow any expenditure on luxury durable consumer goods, on gold, investment in urban land (except one approved plot per family for building a house for own living), and in agricultural land (not intended for own cultivation). This would discourage socially undesirable savings. Besides these, expenditure on all durable luxury consumer goods like cars, TV sets, stereo sets, refrigerators, etc., should be included in the tax base. The past accumulation of black money has already become a "fund" and the future accumulation will manifest itself in "flow". The expenditure tax may not be able to tax the black money which is in "fund". This will have to be covered by estate duty, wealth tax and gift tax. However, if all gifts made in the form of jewellery, luxury durable consumer goods and real

24. Op. cit., p. 171.

estate in the past five to ten years are included as part of the expenditure tax base by averaging the amount, even this fund part of the black money may be brought under the expenditure tax. In the case of future flow of black money, all expenditure incurred on these items will automatically come under the expenditure tax. To that extent, the expenditure tax will go a long way in reducing black money. In order to achieve this kind of tax base computation, registration of all such purchases and computerising the information will become a necessary part of tax administration.

No doubt there will be some opposition to the expenditure tax in India on the grounds of its past failure. The past failure, however, was mainly due to the way it was implemented by a disinterested bureaucracy. Therefore, if the expenditure tax is designed technically by deriving the expenditure from total income by deducting desirable savings, then no additional assessment authority will be required. The present income tax department will be able to assess and collect the tax. As far as the revenue from an income-cum-expenditure tax is concerned, it should be more than what is realised under income tax if it is implemented in the way suggested. Raja Chelliah has proposed a progressive expenditure tax to supplement the existing progressive income tax without reducing the present income tax rates. His proposed rate structure and my modified rate structure may be seen in Table 3. It may be observed that he has treated the family as the unit for expenditure tax payment without making provision for splitting the expenditure of married couples. This would impose undue hardship on married earners. Hence, it would be better to treat individuals as a tax unit for tax payment, though the common exemption limit may be fixed for individuals as well as for a family. Further, Chelliah has suggested a very low exemption limit for a family. I would suggest that the exemption limit be fixed at 40,000 Rs. in view of the inflation factor and not at 20,000 Rs. as suggested by Chelliah. In fact the income tax exemption limit itself has been raised to 15,000 Rs. in 1981-82. It has been suggested by the international proposals that the expenditure tax come into operation at higher levels of income tax, and the exemption limit be fixed at two and half times the exemption limit of income tax. Also the overall rates would increase moderately and not steeply because of the operation of a progressive income tax. Confiscatory rates do not work in practice as they create tax resistance and hence evasion, through a "vicious circle of tax evasion" as pointed out by Kaldor.[25] Besides, it is necessary to decide what forms of savings and investment should be encouraged and what forms of savings discouraged. In the west the proponents of an expenditure tax did not bother to distinguish between socially desirable and socially undesirable savings. It was only Kaldor who mentioned this distinction in passing. Such a distinction may not be relevant in developed countries but it is relevant in a developing country like India where scarce resources have to be allocated among competing social ends. This is the reason I suggested above that investment in gold and real estate should not be considered deductible.

TABLE 3

Chelliah's rate structure and my modified rate structure of supplementary expenditure tax for India

Slab of taxable expenditure (Rs.)	*Raja Chelliah's suggested rate (% of taxable expenditure of family)*	*My modified rate on individual assessees (% of taxable expenditure)*
First 20,000	Nil	Nil
Next 20,000	7.5	Nil
Next 20,000	10	10
Next 20,000	15	15
Next 20,000	20	20
Next 50,000	30	25
Next 50,000	40	35
Above 200,000	50	40

Source: Op. cit., p. 171.

Expenditure tax will go a long way to meeting the social need of reducing lavish consumption of a few, and wide inequalities of property and wealth in India. Wide inequalities of consumption and wealth are increasing in the urban area and if a tax on expenditure is introduced it will tend to minimise them and the original integrated direct tax system will fully revert to its effective operation to reduce widespread tax evasion and thus reduce wide inequality of income and wealth.

The time is opportune now to bring the expenditure tax back into the direct taxes armoury in India. It has the support of intellectuals and policy advisers of the leading democratic countries of the west. Incidentally, this was absent when the expenditure tax was introduced in 1958, and in fact policy advisers were antagonistic to the very idea of the expenditure tax. Hence, the expenditure tax needs only acceptance on the part of policy makers in India, for bureaucracy can be roped in once the government makes up its mind.

25. *Indian Tax Reform: Report of a Survey* (The Department of Economic Affairs, Ministry of Finance, Government of India, New Delhi, 1956), p. 5.

The 1981 Income Tax Changes in the Republic of South Africa

by Dr. Erwin Spiro

While the Minister of Finance, Mr. Owen Horwood, had described in his Budget speech in March last year the government's broad economic policy for the period ahead as one of growth from strength, he arrived in his Budget speech, delivered on August 12, 1981, at the conclusion that the present situation called for a budgetary policy of consolidation and adjustment — consolidation of the enormous economic gains made during the recent upward cyclical phase and adjustment to the adverse impact on the South African economy of the set of conditions created by the prevailing world recessionary tendencies, the abnormally high interest rates in the United States and elsewhere, the spectacular appreciation of the U.S. dollar and the sharp decline in the gold price. In present circumstances it did not seem to the Minister to be in the best interest of South Africa to finance the deficits from direct tax sources by increasing the income tax or reimposing loan levies. The impact of inflation leading to higher incomes and thereby pushing earners into higher income tax brackets — so called fiscal drag — must, however, not be overlooked. It is against this backgroung that the following changes must be understood.

I. STRUCTURAL INCOME TAX REFORMS

Fringe benefits

The new basis for the determination of the value of remuneration in kind and the treatment of certain allowances will be phased in over the next two years, commencing on March 1, 1982, and March 1, 1983, respectively. The proposals as finally drafted will be submitted to Parliament, it is hoped, during the present session.

Final P.A.Y.E. deduction system

It is proposed to relieve, with effect from March 1, 1982, individual taxpayers with taxable incomes of not more than R 7,000 per annum from the necessity of rendering income tax returns where such incomes are derived entirely or almost entirely from salaries or wages, the P.A.Y.E. deductions from their earnings then being regarded as the full settlement of their tax liability. The deduction allowed from the earnings of married women will be increased from R 1,200 to R 1,600, the increased deduction to be spread over two years, allowing R 1,400 with effect from March 1, 1981.

Phasing out of separate taxation of Blacks

After consultation with and subject to the approval of the governments of the various Black national states the final phasing-out of the taxation of Blacks, in terms of the Black Tax Act of 1969, will be effected as from March 1, 1982, by subjecting the incomes of all individual taxpayers to tax in terms of the Income Tax Act, 1962, under the jurisdiction of one tax authority. Table I shows the present taxation of Black people.

TABLE I (BLACKS)

Where the taxable income does not exceed R 1,800, no income tax is due.

Taxable income in R		*Rate*	
Exceeds	*Does not exceed*	*Fixed amount in R*	*+ . . R for each completed amount of R 30 by which the taxable income exceeds the amount in col. 1*
1,800	2,100	nil	0.24
2,100	3,120	2.40	0.72
3,120	4,140	26.88	1.68
4,140	5,160	84.00	2.40
5,160	6,180	156.60	3.12
6,180	7,200	271.68	3.36
7,200	8,220	385.92	3.84
8,220	9,240	516.48	4.80
9,240	10,260	679.68	5.28
10,260	11,280	859.20	6.24
11,280	12,300	1,071.36	6.72
12,300	13.320	1,299.84	7.68
13,320	14,340	1,560.96	8.16
14,340	15,360	1,838.40	8.88
15,360	16,380	2,140.32	9.60
16,380	17,400	2,466.72	10.32
17.400	18,420	2,817.60	10.80
18,420	19,440	3,184.80	10.80
19,440	20,460	3,552.00	10.80
20,460	21,480	3,919.20	11.04
21,480	22,500	4,294.56	11.04
22,500	23,520	4,669.92	12.00
23,520	24,540	5,077.92	12.00
24,540	25,560	5.485.92	12.72
25,560	26,580	5,918.40	13.20
26,580	27,600	6,367.20	13.68
27,600	28,020	6,832.32	13.92
28,020	–,——	7,027.20	14.40

Donations to educational institutions
It is intended to extend the current tax concession in regard to donations to universities and colleges to certain other educational institutions as well.

Undesirable practices in leasing agreements
There will be proposals to curb certain undesirable practices which have appeared in leasing agreements whereby the cost of the asset is artificially increased in order to allow the lessee to reap the benefit of bigger investment allowances on the inflated costs.

II. ONGOING TAX REFORMS

Relief to the aged
All taxpayers who are 70 years and older will be given an additional rebate of R 80 with effect from the tax year which commenced on March 1, 1981. Persons in this age group will consequently not become liable for income tax until their income, after the deduction of medical expenses, exceeds R 5,000 per annum compared with R 4,000 per annum at present.

Lump sum payments by an employer to an employee
The tax-exempt amount of lump sum payments received by an employee from his employer by way of bonus, gratuity or compensation upon retirement due to the attainment of the retiring age or due to old age, ill-health or other infirmity will be increased from R 15,000 to R 20,000 with effect from March 1, 1981. The portion of the lump sum remaining after the deduction of the exempt amount will be subjected to tax at the taxpayer's average rate of tax applicable to his other income and not at the marginal rate which would otherwise have applied.

Relief to parents who maintain children suffering from physical and mental disability
Parents who maintain a child or stepchild, who due to physical or mental disability is unable to maintain himself, who is wholly or partially dependent for his maintenance upon the parent and has not himself become liable for income tax will be granted an allowance equal to so much of the expenditure as the Commissioner for Inland Revenue is satisfied was necessarily incurred by the parent in consequence of the child's physical or mental disability, but subject to a maximum of R 1,200 per tax year.

Phasing-out the requirements with regard to purchased breeding stock
Contrary to other livestock, purchased breeding stock must at present be brought into account at the end of the tax year at cost price and not at standard values where the cost of such an animal exceeds the minimum amount laid down for that class of livestock in the Income Tax Act, the farmer then being entitled to write off the purchase price over a period of four years. This requirement will be phased out over two years with effect from the year of assessment which commenced on March 1, 1981, after which all classes of livestock will be treated similarly for tax purposes.

TABLE II (WHITES, COLOUREDS AND INDIANS)

Where the taxable income does not exceed R 6,000, a flat 8 percent rate applies

Taxable income in R		*Rate*	
Exceeds	*Does not exceed*	*Fixed amount in R* +	*. . percent of the amount by which the taxable income exceeds the amount in col. 1*
6,000	7,000	480	10
7,000	8,000	580	12
8,000	9,000	700	14
9,000	10,000	840	16
10,000	11,000	1,000	18
11,000	12,000	1,180	20
12,000	13,000	1,380	22
13,000	14,000	1,600	24
14,000	15,000	1,840	26
15,000	16,000	2,100	28
16,000	18,000	2,380	30
18,000	20,000	2,980	32
20,000	22,000	3,620	34
22,000	24,000	4,300	36
24,000	26,000	5,020	38
26,000	28,000	5,780	40
28,000	30,000	6,580	42
30,000	32,000	7,420	44
32,000	34,000	8,300	46
34,000	36,000	9,220	47
36,000	38,000	10,160	48
38,000	40,000	11,120	49
40,000	–,––	12,100	50

Undistributed profits tax
The plough-back of 35 percent allowed to public companies in respect of their dividend income will be increased to 50 percent.

Incentive allowances
The machinery and building investment allowances provided for in the Income Tax Act will be extended for a further two years, i.e. up to June 30, 1985.

Tax-free shares of building societies
The rates on tax-free shares of building societies are increased from 8.25 percent to 8.75 percent. Simultaneously the limit on tax-free indefinite period shares is raised from R 10,000 to R 20,000 per taxpayer.

III. RATES OF INCOME TAX (NORMAL TAX) (NON-BLACK TAXPAYERS)

Persons other than companies
Persons other than companies are, in respect of the tax-

able income derived in the year of assessment ending on February 28, 1982, or June 30, 1982, whichever is applicable, subject to normal income tax at the rates contained in Table II, with a maximum basic marginal rate of 50 percent and with the addition, in the case of unmarried persons, of a 20 percent surcharge on the tax. The maximum rate is reached where the taxable income exceeds R 40,000 in the case of married persons and R 28,000 in the case of unmarried persons.

Companies

The rates for companies in respect of taxable income derived in the Republic of South Africa in the year of assessment, that is the financial year ending during the twelve-month period from April 1, 1981 to March 31, 1982, are as follows:

(i) taxable income derived ortherwise than from mining: 40 cents per R 1. A surcharge of 5 percent of such tax is to added to such tax. The effective rate is thus 42 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;

(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;

(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;

(iv) taxable income derived from mining operation 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.

IV. 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 33⅓ 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.

In next issues:

Indirect tax harmonization: The case of LAIA?
— by *Carlos A. Longo*

Taxation of individuals in the People's Republic of Yemen
— by *Ahmed Abdulla Al-kadi*

Impact of tax liability in Nigeria
— by *A.C. Ezejelue*

The financing of the Southern Region and other regional governments of the Sudan
— by *John F. Due* and *Jean M. Due*

OECD:

THE IMPACT OF CONSUMPTION TAXES AT DIFFERENT INCOME LEVELS

In OECD Member countries as a whole, around 90 percent of revenue receipts are derived from three sources: (i) taxes on income and profits; (ii) social security contributions and payroll taxes; (iii) consumption taxes (i.e. taxes on goods and services). Annexed Table 1 shows that in 1978 consumption taxes represented on average just over a quarter of OECD revenues and that between 1965 and 1978 there was a decline in the share of consumption taxes in all OECD Member countries. Since 1978, various statements of government intentions and increases in rates of consumption taxes suggest that this trend has come to an end.

Among the various reasons why governments allowed a relative decline in consumption taxes is the widely-held belief that such taxes are regressive. It is on this issue that the first of a new series of technical OECD monographs concentrates.[1] It analyses, through the use of sample surveys, the impact of the two most important kinds of consumption taxes (value-added taxes and excises on alcoholic drinks, petrol and tobacco), on married couples without children and with two children, in seven countries.[2]

A number of limitations are discussed, the main ones being:

- the report has to deal with the first round impact of these taxes, not their final incidence, since there is no unanimity about how these taxes are finally shifted;
- the sample surveys have inherent limitations including the fact that highest and lowest income groups are under-represented and consumption habits are not always reliably reported, especially regarding consumption of alcohol and tobacco;
- the tax may be considered as a proportion of income or of expenditure; and there are advocates of both approaches. When treated as a proportion of spending it tends to be mildly progressive, but when seen in terms of income it is roughly proportional.
- since different years and different methods are used, it has not been possible to make comparisons between the seven countries.

Yet some interesting, and not generally appreciated conclusions do emerge, as regards the value-added tax. In all seven countries the impact of the value-added tax burden varies very little over the income range covered, whether measured as a percentage of income or expenditure. Measurement against an income base produces more variable results as between countries, sometimes becoming progressive at lower and regressive at higher income levels. Thus, there is no support for the traditional view that value-added taxes are regressive, even though the pertinent question is what is their relative propgressivity in relation to income and payroll taxes.

Conclusions are more tentative regarding the impact of excises on alcoholic drinks, tobacco and petrol, since the distribution of tax paid, over the income range considered, fluctuates considerably in most countries and the report has to conclude that although it is often said that excises are more regressive than VAT, the data presented in this report neither support nor refute this hypothesis.

An Annex to the report gives detailed tables of the consumption tax systems rates and yield of all OECD Member countries. Annexed Table 2 (Table B in the report) provides an example.

1. Under the title "The impact of Consumption Taxes at Different Income Levels" (OECD, June 1981). The new series is called "OECD Studies in Taxation" (and the second volume, which analyses the distribution of taxpayers under income tax schedules in eighteen OECD countries, is expected to be published towards the end of 1981).
2. Belgium, Finland, France, Germany, the Netherlands, Norway, and the United Kingdom.

TABLE 1

Tax revenue as percentage of total taxation

Country	Income and Profits Tax Heading 1,000(1)			Social Security Heading 2,000(1)			Consumption tax Heading 5,100(1)		
	1965	1978	Change in percentage points	1965	1978	Change in percentage points	1965	1978	Change in percentage points
Australia	50	54	3	-	-	-	30	2	- 6
Austria	26	27	1	25	31	6	36	3	- 4
Belgium	28	41	13	31	30	- 0	35	2	- 9
Canada	39	45	6	6	12	6	35	2	- 9
Denmark	46	54	8	5	1	- 4	38	36	- 2
Finland	44	48	4	8	10	2	43	39	- 4
France	16	18	2	34	42	8	38	30	- 8
Germany	34	36	2	27	34	7	31	25	- 6
Greece	10	15(2)	5	27	28(2)	1	47	39(2)	- 8
Ireland	26	34	8	6	14	8	49	46	- 3
Italy	18	29	11	34	41	7	37	25	- 1
Japan	40	40	0	19	29	10	26	15	- 11
Luxembourg	36	48	12	32	28	- 4	23	17	- 6
Netherlands	36	33	- 3	31	37	6	27	24	- 3
New Zealand	61	68	7	-	-	-	26	22	- 4
Norway	43	41	- 2	12	18	6	41	37	- 4
Portugal	27	22	- 5	20	30	10	40	37	- 4
Spain	25	24	- 1	28	50	22	41	21	- 20
Sweden	54	45	- 11	12	27	14	30	22	- 8
Switzerland	38	43	5	22	30	8	28	19	- 9
Turkey	25	48	13	14	15	1	49	30	- 19
United Kingdom	37	41	4	15	18	2	31	25	- 6
United States	46	46	0	16	25	9	19	15	- 4
Average OECD	35	40	5	19	24	6	35	27	- 8

1) These heading numbers refer to the OECD List of taxes – see publication referred to above.
2) 1977 figures.
Source: Revenue Statistics of OECD Member countries 1965-1979, OECD, Paris, 1980.

TABLE 2

Standard general consumption tax changes between 1968 and 1979(1)

Figures shown are in all cases percentages of the value *exclusive* of the tax itself

	April 1968	1968-9	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Australia	12½; 25; 2½ wholesale sales	15; 25; 2½	15½ 27½; 2½									
Austria	5.5 cascade					16 VAT (also 8)			18 (also 8)		1/78 18 (also 8; 30)	
Belgium	7 cascade			1/71 18 VAT (also 0; 6; 14; 25)							1/78 16 (also 6; 25)	
Canada (Federal)	12 manufacturer sales									20.25		
Denmark	10 VAT	4/68 12½	6/70 15					10/75 9¼(3)	3/76 15(3)	10/77 18	10/78 20¼	
Finland	12.4 IR(2)									1/78 16.28		
France	16 2/3 VAT (also 6; 13; 20)	12/68 19 (also 7; 15; 25)	1/70 23 (also 7½; 17 2/3; 33 1/3)			1/73 20 (also 7; 17; 2/3; 33 1/3)				1/77 17.60 (also 7; 33 1/3)		
Germany	10 VAT (also 5)	7/68 11 (also 5½)									1/78 12 (also 6)	7/79 13 (also 6½)
Greece	7 production or sales											
Ireland	2½ retail and 5 wholesale sales	2½ retail plus 10 or 15 wholesale	5 retail plus 10 or 15 wholesale		11/72 1637 VAT (also 0; 5)	9/73 19.50 (also 20)			3/76 20			3/79 10 20 & 0
Italy	4 cascade					1/73 12 VAT (also 6; 18)		1/75 12 (also 6; 18; 35)	5/76 also 9 12/76 also 1; 3	2/77 14 (also 1; 3; 6; 9; 12; 18; 35)		
Luxembourg	5 cascade		1/78 8 VAT (also 4)	1/71 10 (also 2; 5)								
Netherlands	6 cascade	1/69 12 VAT (4)		1/71 14 (4)		1/73 16 (4)			10/76 18 (4)			
New Zealand	various wholesale sales	20 to 30 and zero to 20 for certain goods						exempt to 10, 20, 40; 20 to 30, 40, 50 for certain goods	exempt to 10, 20 to 30 or 40 for certain goods			
Norway	13.64 retail sales		1/70 20 VAT									
Portugal	7 and 20 wholesale sales		7; 12; 20				7; 15; 25		10; 20; 30; 40	10; 20, 30 & 50 (additional 20%)		7/79 15; 30; 45; 75 (additional 20%)
Spain	1.5 cascade											
Sweden	11.11 retail sales	1/69 11.11 VAT		17.65			4/74 13.64(3) 19/74 17.65			20.60		
Switzerland	3.6 retail or 5.4 wholesale sales				4; 6		4.4; 6.6	5.6; 8.4				
United Kingdom	12.5; 20; 33.1/3; 50 wholesale sales			11.25; 18; 30; 45	11.25; 18; 25	4/73 10 VAT (also 0)	11/74 8 (also 0; 25)		4/76 8 (also 0; 12.5)			6/79 15 (also 0)

1) There are no such general consumption taxes in Japan and, at Federal level, in the United States.

2) At retail stage the tax is levied on the value added.

3) Temporary reduction.

Bangladesh - BUDGET 1981-82

Extracts from the Budget Speech pronounced by Mr. Mohammad Saifur Rahman, Minister of Finance on June 6, 1981.

A comprehensive description of the tax system of Bangladesh is contained in our publication: Taxes and investment in Asia and the Pacific.

...

INCOME-TAX

35. One of the chief problems of income-tax in our country is the rigidity and narrowness of the tax base caused by the evasion and avoidance of tax by a section of potential tax-payers wholly remaining outside the tax system. This was also the finding of the Taxation Enquiry Commission. Although efforts to widen the tax base are being continuously made, yet it is felt that without adequate public cooperation, substantial improvement in this respect may not be possible. In order, therefore, to broaden the tax base through public participation, relieve the assessees of the requirement of compliance with the troublesome procedural formalities and help liquidate the backlog of assessments, it is proposed to introduce the scheme of self-assessment for income-tax.

36. The salient features of the scheme are that all persons as defined in the Income-tax Act, excluding limited companies and their directors, partnership firms which have applied for registration but not yet been registered, contractors/suppliers/indentors, who submit returns showing income above the exemption limit and upto Tk. 25,000 will be entitled to the benefit of the scheme. This restriction will not, however, apply to persons more than 80 percent of whose total income is derived from salaries. Assessees deriving income from business, profession or vocation would be required to submit copies of the trading, profit and loss account and the balance sheet along with the returns. In cases where accounts are not maintained, statements showing the particulars of income and expenditure as well as of assets and liabilities as prescribed under the Income-tax Act will have to be submitted. Assessees with business income will have to declare at least 10 percent higher income than that of each preceding year. Returns showing losses or lesser income than that of the latest assessment year will not be entitled to the benefit of the scheme. All assessees, new and old, will be entitled to self-assessment. The scheme shall apply not only to all assessments for the year 1981-82 and subsequent years but also the earlier years where assessments are pending, if the assessees submit returns or revised returns for those years showing correct higher income and pay the tax on the basis of such returns by the 15th September, 1981. New assessees having business income with capital up to Tk. 100,000 may avail of the benefit, provided that they declare income of not less than ¼ th of the capital investment. In such cases no enquiry into the source of investment will be made. In other cases, any concealment of income or assets shall disqualify a person under the scheme and will be penalised up to five times the tax sought to be evaded. Assessments completed under the scheme can be reopened without any time limit, if they involve concealment of income or assets.

37. A considerable evasion of tax takes place in the area of imports particularly under the Wage Earning Scheme. Oftentimes it becomes difficult to trade out the actual importers. In order to meet the problem and facilitate the timely collection of tax, it is proposed, in accordance with the recommendation of the Taxation Enquiry Commission, to provide for deduction of income-tax at the rate of 2.5 percent on the C&F value exceeding Tk. 100,000 of all imports including those under the Wage Earning Scheme save and except foodgrains, fertiliser, POL, plant and machinery and imports under industrial licences. The tax will be allowed as credit against the liability of the relevant assessment year.

38. On similar grounds as stated before it is proposed to deduct income-tax at source @ 10 percent on the commission receipts of all indentors.

39. Considerable amounts of expenses are now incurred by and on behalf of business houses and establishments and charged to their respective expense accounts. The verification of the genuineness of the charges often raises controversies with the tax authorities. In order to reduce the scope of such disputes and restore discipline and accountability in the keeping of accounts as well as restrain tax evasion through the guise of expense account, it is proposed that expenses incurred on behalf of business houses and establishments under the expense account should not be allowed if such expenses do not bear the excise stamps in cases of sales and services liable to excise duty.

40. Some nationalised concerns have been the beneficiaries of substantial cash subsidy from the Government over the years. In their accounting system, however, these concerns show the subsidies as capital receipts while carrying forward the entire amount of their business losses, if any, over the years as admissible under the Income-tax Act. This gives undue advantage to these concerns and is detrimental to the interest of revenue. I accordingly propose that the loss of any business concern to the extent of cash subsidy receipt from the Government shall not be allowed to be adjusted against its profits and/or carried forward.

41. Under Section 46(5A) of the Income-tax Act, the Deputy Commissioner of Taxes may recover the tax by issuing a notice requiring any person from whom money is due or may become due to the assessee. If, however, such a person fails to pay the tax as notified by the Deputy Commissioner of Taxes, there is no legal provision for recovering the tax from the person. In order to remove the lacuna in law and facilitate the recovery of tax, it is proposed to provide for treating such a person as a defaulter of tax payment with all its attendant consequences.

42. There is a requirement for obtaining clearance certificate from the income-tax authorities for registration of documents in connection with the transfer of immovable properties. A considerable evasion of tax takes place through the understatement of the value of such properties. There is, however, no penal provision for the offence of such understatement of the properties. It is accordingly proposed to provide for penalty in cases of such understatement.

43. Under the existing rules the accounts of a partnership firm with turnover exceeding Tk. 500,000 or net assets over Tk. 100,000 are required to be audited by chartered accountants, although in the case of a private limited company such a requirement applies only if a company's capital exceeds Tk. 2,000,000. It is accordingly proposed to do away with the discrimination and provide for a uniform requirement of audit of accounts of partnership firms and private limited companies alike with capital in excess of Tk. 1,000,000.

44. I would now turn to proposals for reliefs and concession. Under the present tax-holiday scheme, expansion units of the existing industrial undertakings are not eligible for tax-holiday. This would hinder the development of industrial undertakings and inhibit economic growth. It is accordingly proposed to extend the benefit of tax-holiday also to new and identifiable expansion units of the existing tax-holiday concerns.

45. Repair charges in respect of house property income are now allowed @ 1/6th of the bona fide annual value of such property. Having regard to the higher cost of building materials these days as well as the fact that residential buildings unlike commercial buildings are not eligible for depreciation allowance, it is proposed, to enhance the allowance for the cost of repairs of residential houses from 1/6th to 1/5th of the bona fide annual value of such properties.

46. Advance tax under Section 18A of the Income-tax Act is now required to be paid by persons with income exceeding Tk. 20,000. With the proposed upward revision of the exemption limit of income-tax, it is also proposed to raise the minimum limit of income for advance payment of tax to an amount exceeding Tk. 25,000.

47. At present wealth statements are statutorily required to be furnished along with the income-tax returns of assessees having income exceeding Tk. 20,000. In order to relieve the lower income group of assessees from such compulsions, it is proposed to make such requirement obligatory in the case of assessees whose income would exceed Tk. 25,000.

48. In order to relieve inflationary effects, the exemption limit of casual and non-recurring receipts is proposed to be raised from Tk. 2,000 to Tk. 2,500.

49. Interest on securities is now exempt from tax upto Tk. 5,000. In order to promote savings through the banking system as well, I propose to exempt bank interest upto a sum of Tk. 3,000 from tax subject to the overall exemption limit of Tk. 5,000 for interest on securities and debentures as provided in the existing law.

50. At present pension income is totally exempt from tax whereas gratuity receipt in excess of 65 percent or Tk. 36,000, whichever is less, suffers tax. Considering the hardship of retired persons, it is proposed to enhance the exemption limit to Tk. 48,000 or 65 percent of gratuity, whichever is less.

51. The allowance for perquisites is now restricted to 50 percent of an employee's salary or Tk. 50,000, whichever is less. Having regard to the rising cost of such perquisites particularly of rent and conveyance expenses, it is proposed to enhance the limit of such admissible perquisites to Tk. 60,000 or 50 percent of his salary, whichever is less.

52. Salaried employees oftentimes suffer the rigour of tax particularly in an inflationary situation. In order to relieve their hardship, I propose the following enhancement in the limits of certain allowances and prequisites:

The existing conveyance allowances of Tk. 1,500, Tk. 1,800 and Tk. 3,600 are enhanced to Tk. 1,800, Tk. 2,400 and Tk. 4,200 respectively. Similarly, the existing exemption limits of Tk. 900, Tk. 2,400 and Tk. 3,000 are raised to Tk. 1,200, Tk. 3,000 and Tk. 3,600 respectively.

Tax exemption for house rent allowance receivable in cash is proposed to be raised from Tk. 1,200 p.m. or 30 percent of the basic salary to Tk. 1,800 or 50 percent of the basic salary, of an employee, whichever is less.

While allowing enhanced benefits for conveyance and house rent allowances, we are not, however, unmindful of the tendencies of business houses and establishments to provide costly and lavishly furnished accommodations to their employees. In order to curb such wasteful expenditure and tax avoidance, I propose to raise the rate of taxing perquisites for furnished and unfurnished accommodation from 15 and 10 percent of an employee's salary to 20 and 15 percent respectively.

53. The existing limit of investment allowances at 30 percent of the total income of an assessee or Tk. 30,000 does not seem to provide enough incentive to the maximum marginal savers. In order therefore to promote higher investment particularly by marginal savers it is proposed to raise the limit of investment from Tk. 30,000 to Tk. 35,000 or 30 percent of the total income. For this purpose, the full amount of Provident Fund contribution and insurance premia will be taken into account. Of the other investments, an initial sum of Tk. 5,000 *plus* sixty percent of the balance will be allowed.

54. It is understood that besides the income remitted under the Wage Earning Scheme, there is considerable income earned abroad by the residents in Bangladesh. In order to encourage the remittance of such business profits and commission into Bangladesh, it is proposed to tax them @ 30 percent or the personal rate of the remitter, whichever is less.

55. Prior to July, 1980, a non-resident's income in taxable territories used to suffer a flat rate of tax at 30 percent which was actually the income-tax rate applicable to a company. Owing to the integration of income-tax and super-tax in the Finance Act of 1980, however, the non-resident's income-tax rate became 60 percent. In order to promote foreign investment in Bangladesh, it is proposed to reduce the non-resident's income-tax rate to 30 percent, as before.

56. The present exemption limit of income up to Tk. 12,000 seems to need some upward revision in view of the present inflationary situation. In order to give some relief to the lower income group of persons it is accordingly proposed to raise the general exemption limit from Tk. 12,000 to Tk. 15,000.

57. It may be mentioned here that the Government provides a lot of subsidy to the agricultural sector in various forms. But the tax return from this sector is negligible, although the major share of the GDP is contributed by it. For these reasons and also in view of the enhancement of the general exemption limit, there is hardly any justification for the continuance of the special exemption of Tk. 3,600 for agricultural income which is accordingly proposed to be withdrawn.

58. In view of the upward revision of the exemption limit, the total income in the case of presumptive assessments is now proposed to be determined at Tk. 20,000 in place of Tk. 15,000 as at present.

59. The existing rates of our direct taxes have been alleged to be excessive contributing to tax evasion and creation of black money. There seems to be some truth in the allegation. Although there is no empirical evidence that the reduction in tax rates yields higher returns of income, yet many people hold the same view. In fact, there is of late a tendency in many countries to reduce tax rates. Considering these is also the fact that the real income of persons is getting eroded by inflation, I propose to reduce the rates of all direct taxes and restructure the rate schedules with lower incidence of tax. I hope this will restrain the tendency to tax evasion, and provide incentive to assessees to disclose their true and higher income. This is also expected to have a salutary effect on private savings, investment and employment.

60. In the case of personal income-tax, the revision will result in tax reduction by about 14 percent across the board. For example:

Taxable income	*Tax at existing rate*	*At proposed rate*	*Reduction*	*PC.*
Taka.	*Taka.*	*Taka.*		*%*
(1) 40,000	*10,000*	*8,500*	*1,500*	*15*
(2) 60,000	*19,000*	*16,500*	*2,500*	*13.1*

61. Industrial companies are now to pay income-tax @ 50 and 55 percent of their income depending on their use of indigenous raw materials. Since this leads to certain discrimination amongst the industrial companies some of whom have necessarily to fall back on imported raw materials, I propose to reduce the rate of tax to 50 percent in the case of those companies which now have to pay tax @ 55 percent of their income.

62. In the case of wealth tax, gift tax, and estate duty also the tax burden is proposed to be substantially reduced by liberal exemptions and restructuring of rate schedules. Although in terms of revenue, the receipts from these taxes in the past have never exceeded even half a crore, the mere presence of these taxes has proved a hindrance to the declaration of correct income and assets by assessees, besides tending to retard economic growth. In view of these considerations and also for inflationary adjustment, I propose as follows.

WEALTH TAX

63. Self-occupied houses now rank for exemption up to the value of Tk. 1,000,000. Considering the hardship of persons of smaller and limited means of income in the present inflationary days, it is proposed to raise the exemption limit of such houses from Tk. 1,000,000 to Tk. 1,500,000.

64. In order to build up a favourable investment climate in the private sector of the economy, it is proposed to exempt unit certificates issued by the Investment Corporation of Bangladesh upto the value of Tk. 200,000.

65. The existing schedule contains too many hair-splitting rates. I accordingly propose to reduce the rates from 8 to 5 only and apply the maximum rate of 2 percent on net wealth exceeding Tk.5,000,000 as against the present marginal rate of 2.5 percent on net wealth exceeding Tk. 3,500,000.

66. It often appears that the total of the income-tax and wealth tax takes away the lion's share of the tax-payer's income. This acts as a serious disincentive to his work effort and initiative. Accordingly, I propose that the total incidence of income-tax and wealth tax should in no case exceed 60 percent of a tax-payer's total income.

GIFT TAX

67. On the introduction of the Gift Tax Act in 1963, an assessee could for a year make a tax-free gift of a value up to Tk. 100,000 to his real sons, daughters, father and mother. There is some justification for allowing such tax-free gifts to one's kith and kin in-asmuch as the gifts help create self-reliance and initiative in them by providing an initial capital. Hence, I propose that a tax-payer will be allowed to make tax-free gifts up to a value of Tk. 300,000 for once in life to his real sons, daughters, father and mother.

68. Gifts made in the form of dowry on the occasion of the marriage of an assessee's real daughter are now exempt upto Tk. 50,000. In order to curb the pernicious social evil of the dowry system, I propose to withdraw the exemption.

69. In view of the steep inflation over the years, the old rate structure of 1963 is proposed to be revised so as to bring down the maximum rate from 30 to 20 percent on the value of taxable gifts exceeding Tk. 3,500,000 as against Tk. 1,800,000 as at present.

ESTATE DUTY

70. The value of a residential house up to Tk. 1,000,000 is now exempt from estate duty. Considering the present inflationary situation, I propose to raise exemption limit of a residential house up to a value of Tk. 2,000,000.

71. In order to promote saving and investment, I propose to exempt the unit certificates issued by the Investment Corporation of Bangladesh upto the value of Tk. 200,000, provided that such certificates were held continuously for 3 years by the deceased person.

72. The present rate structure of estate duty containing as many as 12 slabs with the maximum marginal rate of 50 percent on the value of an estate exceeding Tk. 5,000,000 seems to be unduly complicated and punitive in character. I therefore propose to simplify the rate schedule with only 5 slabs reducing the maximum marginal rate of 50 to 25 percent on the value of an estate exceeding Tk. 5,000,000.

URBAN IMMOVABLE PROPERTY TAX

73. The Urban Immovable Property Tax Act of 1957 of the erstwhile Provincial Government needs to be updated and brought in line with the provisions of the Central Income-tax Act. The National Board of Revenue is taking steps in this behalf to rationalise the procedure of assessment and collection of the tax by framing necessary rules within its power. I now propose to amend the Urban Immovable Property Tax Act to provide for penalty equal to the sum of the unpaid tax in case of default in the payment of tax. Further, the rate schedule is proposed to be revised to reduce the tax rate from 5 and 3 to 4 and 2 percent, respectively, for let out and self-occupied houses, respectively.

FOREIGN TRAVEL TAX

74. At present Bangladeshi nationals holding dual or multiple passports do not pay the Foreign Travel Tax by showing non-Bangladeshi passports only. In order to remove the lacuna of law in this behalf, I propose to amend the definition of a Bangladeshi national to include the category of persons who have permanent residence in Bangladesh or own property or business in Bangladesh or enjoy other facilities not available to foreign nationals.

SALES TAX

76. At present sales tax is a general levy on all goods with specific exemptions for selected goods. This scheme of general taxation in respect of domestically produced goods has given rise to much confusion and misunderstanding in the minds of the tax-payers. In order, therefore, to remove any doubt and uncertainty in the state of law and facilitate tax collection, it is proposed to change the present system to specific liability in respect of certain goods and general exemption in respect of all other goods. I also propose to reduce the rate of sales tax from 20 to 10 percent on a number of such goods. Thus from now only 30 items of locally manufactured goods are proposed to be liable to sales tax out of which only 12 items will be taxed @ 20 percent and the rest at the reduced rate of 10 percent. The proposed change in the system of sales taxation of the domestic manufactures is intended to simplify and rationalise the system, reduce the cost and the prices of goods, promote savings and investment, and provide relief to the common man. Imported goods will however continue to be taxed in the existing manner and the rates with all exemptions.

COURT FEES ACT, 1870

77. The rates of court fees have virtually remained unchanged since 1960. Apart from the fact that the cost of administering the Court Fees Act has gone up necessitating a revision of the rates, simplification and rationalisation of the rate structure in regard to court fees is also considered necessary. This was also suggested by the Taxation Enquiry Commission. Accordingly it is proposed to substitute the existing schedules by simple and rationalised rate schedules.

STAMP ACT, 1899

78. In the Stamp Act, 1899, an anomaly exists in the rate for reconveyances of mortgaged property. This anomaly is proposed to be removed by suitable amendment in the Schedule.

APPENDIX

A. CUSTOMS DUTY

1. (a) Proposal has been made to allow full duty refund on imported raw materials to domestic suppliers bidding in international tenders against payment in foreign exchange treating the transaction on the same footing as export.
(b) Concessionary rate of duty of 20 percent and no sales tax on the machinery, components, accessories and spares of machinery has been proposed to be withdrawn. (+ Taka 1572 lakhs).
(c) The concessionary rate on packing materials of pharmaceutical industry which are produced or can be produced in the country or have alternative uses has been proposed to be withdrawn.
(d) Duty on aluminium rod has been proposed to be reduced to 5 from 35 percent and the duty on finished aluminium conductor steel reinforced and all aluminium conductor has been proposed to be enhanced to 35 from 20 percent with no sales tax (— Taka 9 lakhs).
(e) Duty on accumulator battery has been proposed to be raised to 150 from 125 percent and duty on containers, lids and separators for accumulator batteries has been proposed to be reduced to 15 from 50 percent. (+ Taka 13 lakhs).
(f) Duty on electric fan imported under WES has been proposed to be enhanced to 100 from 75 percent (+ Taka 10 lakhs).
(g) Duty on fatty-acid palm oil has been proposed to be reduced to 100 from 125 percent.
(h) Duty on components and spare parts of domestic sewing machine has been proposed to be reduced from 75 to 35 percent.
(i) Duty on gramophone recording blanks has been proposed to be reduced from 300 to 75 percent.

2. Proposal has been made to reduce the rate of duty on X-ray, medical, surgical, optical, dental and veterinary equipments and instruments to 10 percent from the existing 15 percent. (— Taka 17 lakhs).

3. (a) Proposal has been made to reduce the extent of concession on raw materials imported under WES from 40 percent of the effective rate to 25 percent of the effective rate. (+ Taka 80 lakhs).
(b) Proposal has been made to exclude snowcem colour paints, tools and workshop equipments, sand, glass and emery paper, domar batu, prepared glue in retail packing, photographic film in reels, plates and paper, brake-fluid in retail packing, PVC and adhesive tapes, paint brush all sorts, stapler and steel files, embroidery thread in retail packing, condensed milk in retail packing, nuts and bolts and ball-point refils, etc. from the

concessionary rates for raw materials imported under WES. (+ Taka 15 lakhs).

(c) Proposal has been made to withdraw the special concessionary rates on refrigerator, deep-freezer, gas and electric cooking range, pressure cooker, washing machine, electric filament lamp, cassette recorder and tapes thereof and locks and pad-locks etc. when imported under WES. (+ Taka 15 lakhs).

(d) Proposal has been made to accord concessionary rate of duty for raw materials when imported under WES for M.S. Billets. (— Taka 10 lakhs).

4. (a) Duty on cotton fabrics of below 57 counts has been proposed to be refixed at 40 percent in place of existing 30, 75 and 150 percent. (+ Taka 50 lakhs).

(b) Duty on cotton fabrics like jeans, broken jeans, twill, denim, corduroy, sheeting and bed-sheeting of width exceeding 45", furnishing and upholstery in which the percentage of cotton is 85 percent or more by weight is proposed to be refixed at 125 from 30, 75 and 150 percent. (+ Taka 65 lakhs).

(c) Tariff value on all types of fabrics has been proposed to be enhanced by 10—15 percent. (+ Taka 410 lakhs).

(d) Tariff value on grey fabrics has been proposed to be kept 10 percent lower than that of white fabrics.

5. (a) Duty on yarn of man-made fibre has been proposed to be reduced to 50 from 60 percent when imported under normal licence and to 30 from 35 percent if imported under WES. (— Taka 190 lakhs).

(b) Duty on coasters and tankers has been proposed to be reduced to 10 from 15 percent. (— Taka 10 lakhs).

(c) Duty on tyres and tubes of automotive vehicles has been proposed to be reduced to 75 from 100 percent (— Taka 173 lakhs).

(d) Duty on springs and leaves of automotive vehicles has been proposed to be reduced to 100 from 125 percent. (— Taka 15 lakhs).

(e) Duty on tyres and tubes of motor cycles, motor scooters and auto-rickshaws has been proposed to be reduced to 35 from 50 percent. (— Taka 53 lakhs).

(f) Chains and parts thereof of motorcycles and motor scooters has been proposed to be reduced to 50 from 125 percent. (— Taka 5 lakhs).

(g) Duty on reeds and wire-healds has been proposed to be reudced to 50 from 125 percent. (— Taka 10 lakhs).

(h) Duty on computer has been proposed to be reduced to 50 from 100 percent.

6. (a) Duty on flask has been proposed to be reduced to 50 from the existing 100 percent.

(b) Duty on advertising materials (diary and calender) has been proposed to be reduced to 50 from 125 and 150 percent.

(c) Duty on musical instruments of various kinds including tape-recorder and cassettes thereof has been proposed to be reduced to 75 from 100 percent and the duty on two-in-one in which radio is an integral part has been proposed to be reduced to 75 from 150 percent. (— Taka 20 lakhs).

(d) Duty on coloured and black and white television has been proposed to be reduced to 50 from 60 and 75 percent. (— Taka 10 lakhs).

(e) Duty on water sterilizer has been proposed to be reduced to 50 from 125 percent.

7. Duty on educational instruments like slide rule, geometry and biology box, blotting paper, microscope and telescope has been proposed to be reduced to 15 and 50 from 25, 50 and 100 percent. (— Taka 42 lakhs).

8. (a) Proposal has been made to withdraw the partial exemption on raw materials imported by private dockyards. (+ Taka 10 lakhs).

(b) Proposal has been made to withdraw the present exemption on television in CKD condition and to levy a duty @ 5 percent *ad valorem*.

(c) Proposal has been made to withdraw full exemption on ocean-going vessels having capacity of 7,000 DWT and to impose a duty @ 2.5 percent and to reduce the rate of duty on aircrafts from 3 to 2.5 percent. (+ Taka 50 lakhs).

(d) Duty on betelnut has been proposed to be converted to and fixed at 125 percent from the specific rate of Taka 11.00 per kg. (+ Taka 50 lakhs).

(e) Duty on alcoholic beverages has been proposed to be enhanced to 125, 150 and 300 percent from the existing 100, 125 and 250 percent respectively. (+ Taka 12 lakhs).

(f) Proposals have been made to marginally enhance the concessions and simplify the Baggage Rules, Transfer of Residence Rules and Tourist Baggage Rules and to fix flat rates of duty on goods not covered by the Baggage rule.

(g) Duty on coal has been proposed to be enhanced to 7.5 from 5 percent. (+ Taka 62 lakhs).

9. Proposal has been made to impose a development surcharge @ 1 percent *ad valorem* on all dutiable imports. (+ Taka 3,350 lakhs).

10. Export duty on tea has been proposed to be reduced from 50 poisha to 25 poisha per pound. (— Taka 200 lakhs).

B. EXCISE DUTIES

11. Rate of duty on blended yarn up to 48 counts has been proposed to be reduced and exceeding 48 counts has been proposed to be enhanced. (— Taka 20 lakhs).

12. Hard waste cotton yarn has been proposed to be exempted from the existing duty of 10 percent *ad valorem*. (— Taka 5 lakhs).

13. Nylon yarn of three plies having a weight not more than one gramme per metre used in making fishingnets by fishermen has been proposed to be exempted from the existing duty of 35 percent *ad valorem*. (— Taka 35 lakhs).

14. Duty on storage battery has been proposed to be reduced from 20 to 15 percent of the retail price. (— Taka 10 lakhs).

15. Duty on syrups, squashes and fruit juices has been proposed to be reduced from 30 to 15 percent of the retail price. (— Taka 5 lakhs).

16. Duty on vegetable non-essential oils has been proposed to be reduced from Taka 7 to Taka 5 per cwt. (— Taka 6 lakhs).

17. Duty on toothpaste and shaving cream has been proposed to be reduced from 35 to 25 percent of the retail price. (— Taka 10 lakhs).

18. Duty on colour T.V. of a screen size not more than 19" and of a screen size exceeding 19" has been proposed to be reduced from Taka 3,000 and Taka 4,500 to Taka 2,000 and Taka 3,000 respectively. (+ Taka 10 lakhs).

19. Duty on metal containers and wires and cables has been proposed to be reduced from 30 to 25 percent *ad valorem*. (— Taka 156 lakhs).

20. It has been proposed to merge the existing exchange duty and sales tax on paper, paperboard, jute manufactures and to refix a single rate of excise duty on each of these items after giving relief in some cases at the rate of 15 percent on paper and paperboard, 25 percent on jute carpets and Taka 1,250 per ton on Bitumen. (+ 2301 lakhs).

21. Duty on mild steel products has been proposed to be enhanced from Taka 250 to Taka 500 per ton. (+ Taka 500 lakhs).

22. It has been proposed to marginally increase the existing duty on quality packed tea (+ Taka 15 lakhs).

23. Proposal has been made to withdraw existing exemption on steel furniture, fittings and fixtures and restore statutory duty of 10 percent *ad valorem* and impose duty at the rate of 20 percent *ad valorem* on aluminium fixtures and fittings. (+ Taka 25 lakhs).

24. It has been proposed to impose duty at the rate of 10 percent *ad valorem* on wooden furniture. (+ Taka 25 lakhs).

25. It has been proposed to enhance duty on natural gas from Taka 4.50 to Taka 6.00 per 1000 cft. used in the generation of power and manufacture of fertilizer and from Taka 5.00 to Taka 14.00 for other uses and to impose duty at the rate of Taka 6.00 per imperial gallon on condensate obtained in the gas fields. (+ Taka 2471 lakhs).

26. It has been proposed to merge the sales tax of 20 percent with the duty on narcotics and liquor. (+ Taka 200 lakhs).

(+ Taka 5300 lakhs).

Conference Diary

DECEMBER 1981

Investment and Property Studies: Overseas companies, setting up, uses and practices (including: tax efficient finance for overseas operations; successful use of tax havens; double tax agreements; personal taxation of international executives) (Seminar), London (United Kingdom), December 2 (English).

Management Centre Europe: International Cash Management (including: international tax aspects in cash management), London (United Kingdom), December 7-9 (English).

Seminar Services International: International tax planning (including: introduction to international tax and business planning; tax systems in major European countries; tax treatment of exchange gains and losses; the taxation aspects of intercompany pricing), Amsterdam (The Netherlands), December 7-9 (English).

UK Tax Congress Ltd.: 1st Annual UK tax congress (including: business tax incentives (workshop); tax planning review; tax avoidance today and (concurrent sessions) agricultural taxation; group tax administration, taxation of intellectual property; effective tax administration), Wembley Conference Centre, London (United Kingdom). December 10 and 11 (English).

British Branch of I.F.A.: Stock relief, London (United Kingdom). December 9 (English).

JANUARY 1982

British Branch of I.F.A.: Treaty shopping, London (United Kingdom). January 19 (English).

FEBRUARY 1982

Business Perspectives Ltd.: 7th International Tax Conference (including: developments in legislation and practice in U.S.A., U.K., Canada, Australia and the Far East as they affect companies and individuals with world wide interests; and tax problems involved in investment in Mexico and the Caribbean area). Mexico City (Mexico), February 1-5 (English).

Management Centre Europe: International Tax Management (including: tax treatment on technology import and export; anti tax haven legislation, handling of disputes between tax administrations). Brussels (Belgium), February 1-2 (English).

British Branch of I.F.A.: Tax haven and company residence. The revenue proposals (tax workshop), London (United Kingdom), February 9 (English).

Management Centre Europe: Leasing (including tax aspects of leasing), Brussels (Belgium), February 24-26 (English).

MARCH 1982

British Branch of I.F.A.: Indirect taxation of international services (tax workshop), London (United Kingdom). March 4 (English).

MAY 1982

The inter-American Center of Tax Administrators (C.I.A.T.): XVIth General Assembly on the basic subject: Tax evasion and tax compliance, Asunción (Paraguay), probably in May, 1982 (date unknown yet) (Spanish).

SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada), September 12-16 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: Secretariat c/o Williams & Glyn's Bank Ltd. New London Bridge House, 25 London Bridge Street. London SE 19 SX (United Kingdom).

Business Perspectives Ltd., 11 Alexander Place, London SW7 2SG (United Kingdom).

Inter-American Center of Tax Administrators (C.I.A.T.), Executive Secretary of C.I.A.T., P.O. Box 215 zona 1, Panamà.

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

Institute for International Research, 70 Warren Street, London W1P 5PA, (United Kingdom).

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4 (United Kingdom).

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

Seminar Services International, 1- passage Perdonnet CH-1005 Lausanne (Switzerland).

UK Tax Congress Ltd., Freepost, Horsham, West Sussex RH 12 1ZA (United Kingdom).

THE INSTITUTE FOR FISCAL STUDIES

1/2 Castle Lane

London SW1E 6DR

United Kingdom

The Editors of the Bulletin wish to draw the attention of readers to the Institute for Fiscal Studies, 1/2 Castle Lane, London SW1E 6DR. The I.F.S. is an organisation established in the early 1970s for the purpose of doing or promoting impartial research in all sectors of the fiscal area. It also organises conferences or lectures on topics of current interest.

This year's autumn programme of the Institute includes a conference on Local Government Finance (16th November), a lunchtime seminar on Share Repurchase (25th November) and a lunchtime lecture on Tax Based Incomes Policies (11th December). Detailed information about membership, the Institute's overall activities and its publications may be requested from the Director at the above address.

IFA INTERNATIONAL FISCAL ASSOCIATION NEWS

GOODBYE MR. DAVIES

On September 25, 1981 Mr. Alun G. Davies' presidency of IFA came to an end. How successful the period 1977-1981 has been can be measured by IFA's growth from about 5,000 members in 1977 to over 6,000 in 1981. The General Assembly, wishing to honor Mr. Davies' inspired leadership during these past years, unanimously elected him Honorary President. The International Bureau of Fiscal Documentation, which is proud to have Mr. Davies on its Board of Trustees, is happy to congratulate him on this election and expresses the wish that IFA may benefit from his wisdom and experience for many years to come.

WELCOME MR. LAXAN

On September 25, 1981 Mr. Max Laxan, who successfully presided over the Paris Congress in 1980 and who was elected as Mr. Davies' successor at that Congress, took office as President of IFA. It is a happy coincidence that the first Congress to be held under his Presidency of IFA will be in a French-speaking environment. The International Bureau of Fiscal Documentation, which is proud to have Mr. Laxan as a member of its Advisory Council, congratulates him on his election and wishes him the best of luck.

SOME HIGHLIGHTS

from the Secretary General's 1980-81 Report presented at the Berlin Congress 1981

PARIS CONGRESS 1980

The 34th Congress held in Paris organized by the French Branch of IFA under the supervision of Mr. Max Laxan was very successful and all sessions were well attended. Mr. Laxan was appointed president-elect to succeed Mr. Alun Davies of IFA.

With respect to Subject I: "The dialogue between the tax administration and the taxpayer up to the filing of the tax return", Prof. Baron J. van Houtte (Belgium) acted as the discussion leader. Mr. Guy Delorme (France) was the general reporter and panelists were Messrs. B. Meier, M. Abrutyn, N. Amóros Rica and J.B. Shepherd.

With respect to Subject II: "Rules for determining income and expenses as domestic or foreign", Mr. Pierre Kerlan (France) was the discussion leader, Mr. Robert J. Patrick Jr. (U.S.A.) the general reporter and panelists were Messrs. S.O. Lodin, A.R. Lopéz, A.J. Rädler and H. Kaneko.

Chairman of the seminar on "Recourse to tax havens — use and abuse" was Prof. Dr. K. Vogel (Federal Republic of Germany) and persons who contributed background material and/or acted as panelists were Messrs. M.J. Ellis, E. Gnazzo, R. Baconnier, M.J. Langer, R.E. Moore, John Avery Jones, Hans Flick, J.C. Goldsmith, Yoshihide Ishiyama, W. Ryser and D.A. Ward.

MITCHELL B. CARROLL PRIZE

Mr. Lofumbwa Bokila — who originates from Zaire — received the Mitchell B. Carroll Prize (1980) for his work "Les régimes fiscaux visant à encourager les investissements directs et de portefeuille dans les pays en voie de développement, l'interaction du système fiscal zaïrois et des régimes préférentiels des pays de l'OCDE. [1]

1. See 34 *Bulletin for International Fiscal Documentation* (1980) at 507.

IFA OFFICERS COME AND GO

The Permanent Scientific Committee regretfully announces the death of its member Prof. G.A. Micheli who will be replaced by Prof. Avv. A. Fantozzi (Italy). Dr. E.J. Reig and Dr. Macón (Argentina) attended the spring meeting in view of the Buenos Aires Congress, 1984.

The Executive Committee met in spring and welcomed a new member in the person of Mr. C.A. Poissant (Canada). Mr. R. Caraza Escobedo (Mexico) was nominated 3rd vice-president. Mr. R.M. Hammer (U.S.A.) and Dr. K. Beusch (Federal Republic of Germany) will remain 1st and become 2nd vice-presidents, respectively.

Mr. J.L. Perez de Ayala (Spain) is due for statutory retirement from the Executive Committee at the Berlin Congress.

Mr. A. Elvinger (Luxembourg) was appointed Chairman of the Nominations Committee.

NATIONAL BRANCHES

During the Paris Congress two new branches were recognized: Indonesia and Malaysia. Singapore applied for membership. [2]

MEMBERSHIP FEES

IFA will not increase its membership fees for 1981-82. Thus they will remain:

- US$ 38 for individual members of IFA branches
- US$ 40 for direct individual members of IFA
- US$ 90 for corporate members, both direct and of National branches.

BERLIN CONGRESS 1981

At the time of writing the 1980-81 Report the preparations for the Berlin Congress 1981 were nearing completion. The general reporter for Subject I: "Mutual agreement — procedure and practice" is Dr. K. Koch (Federal Republic of Germany) and the discussion leader Prof. P. Fontaneau (France). With respect to Subject II: "Unilateral measures to prevent double taxation" Dr. D. Juch (Netherlands) acts as general reporter and Prof. E. Höhn (Switzerland) as discussion leader. The Chairmen of the respective resolutions committees are Mr. A. Elvinger (Luxembourg) and Mr. J.G. O'Brien (U.S.A.).

Seminar 1 deals with a "virgin" subject in the field of international tax law, i.e. the taxation of income arising from the international seabed. The Chairman of the Seminar is Prof. Dr. K. Vogel (Federal Republic of Germany) and panelists are Messrs. Ch.M. Bruce (U.S.A.), J.C. Delespaul (France), K.H. Oetting (Federal Republic of Germany) and P. Kirthisingha (Sri Lanka).

Seminar 2 given in a number of languages is meant to explain the German tax system.

2. Singapore was recognized as a branch during the Berlin Congress 1981.

FUTURE CONGRESSES

1. Montreal Congress 1982

During the spring meeting of the Permanent Scientific Committee (PSC) the directives for the Montreal Congress were thoroughly discussed. At the request of the Canadian Branch, Subject II, which was initially to have dealt with international transportation, was changed. The topics which will be discussed are:

Subject I — The tax treatment of interest in international economic transactions. General reporter: Prof. E. Höhn (Switzerland).

Subject II — Taxation of payments to non-residents for independent personal services. General reporter: Mr. G. Coulombe (Canada).

The Montreal Congress will be held from September 12-17, 1982. (See for more details, p. 521.)

2. Venice Congress 1983

During the PSC's spring meeting the following subjects were selected:

Subject I — Tax avoidance/Tax evasion. General reporter: Prof. V. Uckmar (Italy).

Subject II — International problems in the field of turnover taxation. General reporter: Prof. Dr. H.G. Ruppe (Austria).

The Venice Congress will be held from October 10-15, 1983. (See for more details, p. 521.)

MITCHELL B. CARROLL PRIZE FOR DR. MORIS LEHNER

On September 25, 1981, at the final meeting of the General Assembly of IFA during the Berlin Congress, the Mitchell B. Carroll Prize was presented to Dr. Moris Lehner (32) for his work entitled: *Möglichkeiten zur Verbesserung des Verständigungsverfahrens auf der Grundlage des EWG-Vertrages.* Dr. Lehner received his doctor's degree at the Ruprecht-Karl University in Heidelberg (Federal Republic of Germany) for this work on the mutual agreement procedure as proposed by the EC Commission in its Draft Directive of November 29, 1976. The medal which goes with the prize was awarded in the presence of its founder, Dr. Mitchell B. Carroll. Dr. Lehner is currently employed by the research institute for international financial and tax law of the University of Munich which is headed by Professor Dr. K. Vogel.

BRITISH BRANCH

The Annual General Meeting of the British Branch of IFA was held on May 28, 1981.

A number of officers were reelected, Mr. R.T. Esam as Chairman and Messrs. D.A. Clarke, C.J. Crowe and D.F.A. Davidson as Vice-Chairmen and Messrs. J. Reynolds and L.B. Havard as Honorary Secretary and Assistant Secretary, respectively.

Mr. R.J.G. White wishes to retire as Treasurer and it was agreed that Mr. White would for some time share the position with Mr. J.S. Phillips and that the latter would take over at a mutual convenient time.

For 1981-82 the Branch's Committee comprises the following persons:

J.F. Avery Jones	H.L. Duncan
I.D. Barnett	Miss M.S. Erskine
Dr. J.B. Bracewell-Milnes	W.K. Evans
J.F. Chown	D.E. Evennett
M.J. Gammie	J.D.B. Oliver
D.N.C. Gray	H.R. Roe
L. Halpern	B.E.V. Sabine
E.J. Henbrey	F.H. Seale
J. Hickman (co-opted)	D. Tapper

Messrs. Esam and Davidson will represent the British Branch on the IFA Council with Messrs. Reynolds and Henbrey as their respective alternates. Dr. Barry Bracewell-Milnes will represent the Branch at the Permanent Scientific Committee.

On October 8, 1981 the British Branch will discuss the draft national report on Subject I of the Montreal Congress 1982 (The tax treatment of interest in international transactions). The British national reporter is Mr. Eric Henbrey.

On October 21, 1981 the British Branch will discuss the draft national report on Subject II of the Montreal Congress 1982 (Taxation of payments to non-residents for independent personal services). The British national reporter is Mr. John Staddon.

36th IFA CONGRESS MONTREAL (CANADA) September 12-17, 1982

PROVISIONAL PROGRAMME
(subject to change)

SUNDAY, SEPTEMBER 12, 1982
Day: Registration
Evening: Welcome Reception

MONDAY, SEPTEMBER 13, 1982
Morning: Opening Ceremony, Place des Arts
Afternoon: Working Session, Subject 1
Evening: Dinner in Old Montreal, Street dancing

TUESDAY, SEPTEMBER 14, 1982
Morning: Breakfast, Quebec style
Working Session, Subject 1
Afternoon: Working Session, Subject 2
Evening: Opera or Concert (to be determined)

WEDNESDAY, SEPTEMBER 15, 1982
All Day: Excursions, including Quebec City or other areas
Evening: Free

THURSDAY, SEPTEMBER 16, 1982
Morning: Working Session, Subject 2
Afternoon: Seminars & Committees
Evening: Gala

FRIDAY, SEPTEMBER 17, 1982
Morning: Seminars & Committees
Afternoon: General Discussions on Resolutions and Annual Assembly
Evening: Free

37th IFA CONGRESS VENICE (ITALY) October 10-15, 1983

PROVISIONAL PROGRAMME

Apart from the working sessions the social events include:

SUNDAY, 10 OCTOBER: Registration and Welcome Cocktail at Fondazione Cini

MONDAY, 11 OCTOBER: Opening ceremony at "Palazzo del Cinema"
Evening: Reception by the Mayor of Venice

TUESDAY, 12 OCTOBER: Musical performance at the Theatre "La Fenice"

WEDNESDAY, 13 OCTOBER: Musical performance at the Theatre "La Fenice"

THURSDAY, 14 OCTOBER: Choice of excursions

FRIDAY, 15 OCTOBER: Gala Dinner

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Reprinted as at 31 December 1980, with tables of provisions, note and index to act and regulations. Canberra, Commonwealth Government Printer, 1981. 1009 pp. $ 16.00. (B.51.767).

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A Spur in the Side of Revenue Canada?

The Federal Court of Appeal in Canada reverses the decision of the Federal Court of Canada (Trial Division) on the case of Spur Oil Ltd. *v.* Her Majesty the Queen.

By Alun G. Davies

The ways of judges are past finding out. The trial judge of the Federal Court of Canada gave his decision in the case of Spur Oil Ltd. *v.* Her Majesty the Queen on 22nd February 1980. The case went to appear before the Federal Court of Appeal of Canada which rendered judgment at Ottawa on July 3rd 1981. Not only was the decision of the trial judge reversed, but on every point in the case, his judgment was set aside.

In Bulletin No. 4 of 1981 (at 168) the case at trial was summarised. For convenience, the salient facts and findings are recapitulated:

(i) Spur Oil Ltd., a Canadian corporation, bought crude oil from Tepwin, a Bermuda corporation set up for the purpose, under a contract dated February 1, 1970.

(ii) Prior to the date of the Tepwin contract, Spur bought crude oil from an affiliate, Murphy Oil Trading Company (U.S.) under an "arrangement" which the trial judge held to be a continuing and valid contract (dated 2 August 1968). The difference between the purchases from Murphy Oil Trading and the purchases from Tepwin amounted to 27c. a barrel. It was this 27c. which was the subject of the case. The Revenue had disallowed it, and the trial judge upheld the disallowance.

(iii) In order to challenge the arm's length nature of the Tepwin contract with Spur Oil, the Revenue produced an expert witness whose evidence is condensed into 9½ pages of the trial judge's reasons for judgment. The witness said, inter alia, that the sub-charter which Tepwin signed with a fellow-affiliate company was unusual and untypical of the trade (it was drawn up by an in-house manager who clearly did not understand the technical terms of the trade). As regards the terms of this sub-charter, which were *below* market rates, not *above* them, the expert said that therefore the fixing of the terms could not have been motivated by commercial considerations. It was therefore not related to the market, and could not, according to the expert, be said to constitute "fair market value". (If this was meant to help the Revenue case, the expert's logic is astounding. With friends like him, the Canadian Revenue does not need enemies). The sub-charter freight rates paid by Tepwin were of course charged out in the same amounts to Spur Oil. The expert witness said that they were *below* fair market value at 1st February 1970 but had been arrived at arbitrarily with no reference to market factors. They did not reflect the going market rate nor were they arrived at for valid commercial reasons and therefore according to the expert could not be taken to constitute fair market value. It is interesting to note that despite what the expert said — and his lack of logic is difficult to follow — the trial judge made no specific finding of fair market value. Moreover, the appeal judges *did* say that the fair market value of the oil purchased by Spur Oil from Tepwin was *in excess of* Spur Oil's purchase price from Tepwin. In its verbal submission to the appeal court, the Revenue conceded this, but submitted that it did not make the contract less artificial.

(iv) A great deal of the Revenue case was taken by evidence that there were no acts of control and management of its Bermuda operations by Tepwin, and that they acted as puppets of the various parent officers and directors in Arkansas, Calgary, Alberta and point east. The Tepwin company exercised no decisions on any of its operations and the freight was dealt with by way of book-keeping entries. (How else?)

The Revenue claims are detailed in 9 pages of the reasons for judgment of the trial judge, and include page after page of quotations from Canadian and English jurisprudence on "artificiality" and "sham". After reciting all these things, the trial judge said that the questions for determination were whether the "sub-charter" arrangements with Tepwin and the delivery of crude oil under them by Tepwin were artifical transactions. He said that this determination must be based on either where the residence of Tepwin was in reality or on the validity of the so-called contract of 2 August 1968 (which was replaced by the Tepwin contract) or a mixture of both.

He held that management and control of Tepwin was not in Bermuda; that Tepwin did nothing with the purchase of the crude oil in question; and that the contract of 2 August 1968 was the basis of trading in crude oil purchased by Spur Oil, as it was never formally abrogated. Consequently, all the Tepwin transactions were artificial, so that the freight charge by Tepwin was not allowable.

The judgment of the Federal Court of Appeal is refreshing and short when compared with that of the trial judge (17 pages compared with 37 pages). Of the 17 pages, 3 pages merely reproduce the contract of 2 August 1968.

The Court of Appeal found that the trial judge was in error in finding what they called "the quotation letter" of 2 August 1968 to be a valid subsisting and enforceable contract. There was no consideration by Spur Oil in the agreement. Two critical terms of the contract had not been settled, namely quantity and quality of crude oil. The question was decided by the Appeal Court as a matter of law, not on whether the parties intended to enter into a binding contract. Neither did the Appeal Court find that there was any contract "by conduct". The Tepwin contract supplanted the Quotation letter of 2 August 1968 and the fact that there was no formal termination of the latter did not matter if Spur Oil was aware that it was no longer operative.

By ruling out any part of the 2 August 1968 arrangement in having any validity after 1st January 1970, the Appeal Court left only the "artificiality" point to be decided.

The way the Appeal Court dealt with this is most interesting. The Court said that it was not enough to find that the transactions were *artificial*. In order to disallow the payments to Tepwin, there must be shown to be an *artificial reduction of income*. "Undue" means "excessive". As Spur Oil was admitted by the Revenue to be paying slightly *less* than fair market value for its crude oil from Tepwin, it could not be said that the Tepwin charges resulted in an artificial reduction of income.

When the Appeal Court examined the meaning of "artificial" in relation to the reduction of Spur's income by reference to the payment to Tepwin, it pointed out that the payments were neither fictitious nor simulated. The contracts set out precisely what quality crude oil should be provided by Tepwin, and stated precise prices. The actual payments effected by set-offs in the Tepwin accounts were all fully documented. There was no fiction or simulation in these entries.

The Revenue had argued before the Appeal Court that the trial judge's finding of artificiality amounted to a finding of sham. But the facts of the case did not indicate sham. Detailed, uncontradicted evidence with regard to sales and complex accounting procedures did not make possible a finding of sham.

The Court of Appeal pointed out that the contract of 2 August 1968 could itself have been amended on 1st February 1970 to the Tepwin level, leaving Spur with the same reduced income as it had under the Tepwin contract.

The prohibition about disbursements which unduly or artificially reduced income (Section 137(1) of the Canadian Income Tax Act) was only valid if the costs of crude oil were increased above the cost prevailing in the industry at the same time and under similar circumstances.

The Revenue allegation of "puppets", "artificiality", and "sham" fell away when the Court of Appeal said that the price was fixed under a valid contract at a price from an affiliated company which was no greater than that arising from a similar party with whom Spur Oil might have dealt with at arm's length.

India:

DOUBLE TAXATION AVOIDANCE AGREEMENT BETWEEN INDIA AND THE U.K.

by Kailash C. Khanna

A Convention for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income and capital gains between the Government of India and the Government of United Kingdom has been notified in the Official Gazette.

Under the Convention, business profits derived by an enterprise will be charged to tax only in the country of its residence unless the enterprise carries on business in the other country through a permanent establishment, in which event the profits which are attributable to that permanent establishment may be taxed in that other country.

Income derived from the operation of aircraft in international traffic will be taxed only in the country of taxpayer's residence. Income from the operation of ships will be taxed only in the country of taxpayer's residence unless the income arises during the first 10 years for which the Convention has effect, in which case the income may be taxed in the country from which it is derived. However, for the first 5 years the tax charged in the country of source will be limited to 50% of the tax which would have been charged in the absence of the Convention and for the next 5 years to 25% of such tax.

The Convention provides that where a United Kingdom company pays a dividend to a resident of India (other than to a company which controls 10% of more of the voting power in the paying country), the recipient will, subject to certain conditions, receive the tax credit to which an individual resident in the United Kingdom in receipt of a dividend would be entitled, less tax at a rate not exceeding 15% on the aggregate of the dividend and the tax credit. In the case of a dividend paid by an Indian company to a resident of the United Kingdom, the tax charged in India will not exceed 15% where the dividend is paid in respect of a new investment made after October 21, 1981, that is, the date with effect from which the Convention has come into force.

The rate of tax to be imposed in the country of source on interest paid to a resident of the other country in respect of a loan first made after October 21, 1981, will, in general, not exceed 15% of the gross amount of the interest. In the case of interest paid to a bank, the rate of tax in the country of source will not exceed 10% irrespective of the date the loan was made. Any interest paid to the Government, or a local authority, of either country will be exempt in the country of source.

The rate of tax in the country of source on royalties and fees for technical services flowing to the other country in respect of rights first granted on contracts first signed after October 21, 1981, will not exceed 30%.

Income from immovable property may be taxed in the country in which such property is situated. Capital gains may be taxed by either country in accordance with its domestic law.

Governmental remuneration and pensions will normally be taxed by the paying Government only. The remuneration of visiting teachers and certain payments made to certain visiting students and trainees will, subject to certain conditions, be exempt for specified periods in the country visited.

Where a particular income is taxable in both the countries, relief from double taxation will be given by the country of the taxpayer's residence. The credit to be given in the United Kingdom for tax payable in India is to include credit for tax spared under certain specified provisions of the Indian law.

The Convention also provides for exchange of information or documents for the prevention of fraud, or the administration of statutory provisions against legal avoidance in relation to taxes which are subjects of the Convention.

The Convention will have effect in India in respect of income arising in any previous years beginning on or after April 1, 1981.

Indirect Tax Harmonization:
The Case of LAIA?

by Carlos A. Longo *

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1. INTRODUCTION

For a long period, Latin American countries pursued import-substitution industrialization policies, in many cases closely geared to autarkic goals. The oil crisis and the recent problems of trade balance changed the development strategy of most countries toward reliance on export-led growth, with negative implications for intra-area trade. However, export expansion of the required magnitude will encounter some significant difficulties: domestic policies toward the export sector must come at the expense of "net" subsidies, and success in deploying export promotion measures is likely to engender threats of retaliation from importing countries. In this setting, growth in intra-Latin American trade could be expected to brighten trade prospects for the region as a whole without running into those difficulties.

The Treaty of Montevideo,[1] which first brought the Latin American Free Trade Association (LAFTA) into existence in mid-1961, was originally signed by 7 Latin American countries in early 1960, and shortly afterwards by Colombia, Ecuador, Venezuela and Bolivia. LAFTA covered all of South America (with the exception of the Guianas) and Mexico. The Treaty established a rather complicated trade negotiation system suggesting the gradual elimination within 12 years – or by mid-1973 – of customs duties and any other restrictions on essentially all reciprocal trade. On August 12, 1980, the member countries voted to abolish LAFTA and to replace it during 1981 with LAIA, the Latin American Integration Association.

The original Treaty established procedures for arriving at a free trade area as a step toward an eventual Latin American common market. The goal is a higher level of welfare to be attained through faster economic development, which in turn will require a larger market than any one of the nations offers at present.[2] Most of the Treaty is concerned with reducing tarriffs among the member countries and making their national economies more complementary. Even though LAFTA did not inject much dynamism into Latin America's economic development, it succeeded in raising regional interchange during a particularly difficult period. The intraregional share of total trade rose from 7% in 1961 to 12% in 1973. In absolute terms, trade among LAFTA members increased from about $500 million in 1961 to about $12 billion in 1973. This represents a 320.5% increase in intra-LAFTA trade against an increase of only 147% in the member's total exports for the same period.[3] While LAFTA has not met the expectations of its promoters or the broader needs of the Latin American economies, it cannot be considered a failure as a trade liberalization mechanism.[4]

A major factor in LAFTA's lack of success may have been its initial attempt to copy the EEC model and thus not paying much attention to differences in the level of economic development of the countries involved. Therefore, subgroups were formed, such as the Andean Group, as an additional alternative to further regional economic problems.

The literature on trade within Latin America has paid little attention so far to its fiscal aspects. Essentially we are interested in suggesting the way in which LAIA countries should go about tax harmonization if they decide to do so. At the outset, in section 2, this paper will offer some possible explanations for the apparent lack of interest in the effects of national finances in this free trade

* Fundação Instituto de Pesquisas Econômicas and Universidade de São Paulo. This paper was presented at the XIV Meeting of the Asociacion Argentina de Economia Política-AAEP, Facultad de Ciencias Económicas, Universidad Nacional de Cuyo, Mendoza, Argentina, November 1979.

1. Treaty of Montevideo, "Tratado que Establece una Zona de Libre Comercio e Instituye la Asociación Latinamericana de Libre Comercio", suscrito en Montevideo el 18 de febrero 1960, in *Instrumentos Relativos a la Integration Economica en America Latina* (Instituto Interamericanos de Estudios Juridicos Internacionales, Washington, D.C., 1964), pp. 177-92. On August 12, 1980, the member countries voted to abolish LAFTA and to replace it during 1981 with LAIA, the Latin American Integration Association.

2. A group of countries forms a preferential trading arrangement when they place lower restrictions on trade with each other than on trade with the outside world. We can imagine several different mechanisms for describing preferential arrangements: (1) Free-Trade Area: members eliminate tariffs among themselves but keep their original tariffs against the outside world; (2) Customs Union: members not only eliminate all tariffs among themselves but also form a common tariff against the outside world; (3) Common Market: members proceed beyond the requirement of a customs union to eliminate restrictions among themselves on international movements of factors of production; and (4) Economic Union: members proceed beyond the requirement of a common market to unify their fiscal monetary, and social policies. The preferential arrangements are analytically interesting – and complex – because they both distort and liberalize trade. Trade is freed because the inter-member flow of goods faces lower restrictions than before (trade creation effect). but trade is also distorted because goods coming into a member country from outside the group face a common external tariff (trade diversion effect). Because of this two-faced character of preferential arrangements, they can either improve or worsen the economic welfare of their members or of the world as whole. See R.E. Caves and R.W. Jones, *World Trade and Payments, An Introduction* (Little Brown, Boston, 1977), chap. 14.

3. See Appendix I.

4. See J. Grunwald and others, *Latin American Economic Integration and U.S. Policy* (Brookings Institution, Washington, D.C., 1972).

area. Next, in section 3, it will examine the fiscal provisions of the Treaty of Montevideo. The actual pattern of indirect taxation within Latin American countries will be described in section 4 and in section 5 we discuss principles of tax harmonization.[5] Finally, in section 6, the implementation problems associated with these principles are presented. A summary and concluding section close the paper.

2. LAIA'S RECENT HISTORY

The original Treaty of Montevideo envisaged completion of a free trade zone by 1973. In view of the progress in LAFTA's first 8 years, a target of 1985 for a common market was agreed on at a summit meeting. The Council of Ministers have failed to reach agreement on several key resolutions so far, including the rescheduling of the reductions of still existing tariffs, the reduction of such non-tariff barriers as quotas, the preferential treatment of the least developed countries within LAFTA, and the establishment of a common external tariff on goods originating outside the LAFTA zone.[6]

While Latin Americans are showing a strong interest in tax reform, there is little evidence that they relate their plans for fiscal reform to the successful operation of LAFTA. In general, their concern for their public finances is national rather than area-wide, being directed toward increased public revenues and economic development in each country. Even a slight reduction in the conventional barriers to trade among the member nations must reveal many conflicts between the 9 different tax systems and the goals of integration in the area. In fact, interested business groups, public officials, and even members of LAFTA's Secretariat do not generally consider the fiscal aspects of the free trade area. Their attention is concentrated more on problems of customs duties, foreign exchange, transportation, and the lack of balance in the economic development of the area as a whole.[7]

Although unharmonized tax systems can create differences in cost of production and return on investment that interfere with competition and distort the allocation of resources, it seems that internal taxes are not considered as a serious obstacle to free trade until other barriers have been removed. Along this line, LAFTA countries have been confronted with serious problems of inflation and exchange depreciation which might produce differences in costs of production and investment yields greater than those resulting from the difference in the countries' internal taxes or from likely changes in them.[8] The Treaty of Montevideo contains no provisions curbing the distortions of competition and the allocation of investment that may result from changes in price levels and exchange rates. Thus, it is not suprising that consideration of the experience of the LAFTA nations with inflation and depreciation causes these nations to put these problems in the area ahead of the harmonization of their internal taxes.[9]

An additional consideration is related to transportation, i.e. that the likelihood of establishing an area without internal customs controls is limited. One of the advantages to be sought in a common market is an area where goods can move freely from one country to another without complex customs inspection. But this is not likely to be achieved where a large part of intra-area trade enters and leaves through the same channels as trade with third countries. This could also be an explanation for the lack of incentives to form close integration within LAFTA, including the harmonization of internal indirect taxation.[10]

Furthermore, it may be argued that the lack of interest in fiscal harmonization simply indicates that Latin American countries do not want a close integration of their economies. They might pursue the freedom to have any kind of tax system that best suits their particular needs. In this case they committed themselves in the treaty of Montevideo only to the formation of a free trade area, thus retaining national control of domestic fiscal policies and their tariffs toward the outside world, except for the agreement to maintain the margin of preference negotiated for LAFTA products.[11]

On the other hand, the least developed countries of the area have expressed their fear that without deliberate interference in the allocation of investment the bulk of new investment will go to the most developed countries, such as Argentina, Brazil and Mexico, and widen the gap already separating them from the rest. The least developed countries (Ecuador, Bolivia and Paraguay) have already recognized that they may have national markets too small for the development of certain industries. Also, some businessmen operating in LAFTA countries and hoping to expand with the growth of the domestic market have expressed fear for their enterprises in a too rapid approach to free trade in the area. Their fear is that a foreign company accustomed to large-scale operations will enter the area and by its greater efficiency eliminate the older Latin American enterprises before they can adapt to the larger market.[12]

LAIA is more flexible, however, and less ambitious in its goals. It pursues only gradual integration of Latin American economies which are further classified by levels of income per capita. Three groups of countries were formed from the outset: (i) the relatively developed

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5. Only general indirect taxes will be considered here such as production taxes, value-added taxes, turnover taxes, and retail sales taxes; the common element is that they apply to all goods and services, or at least a very large share of the total, not to one or a few as do the special excises. We implicitly assume that member countries are not expected to integrate their special excises. Special excises would be justified for increased rates imposed on luxury goods or on those deemed injurious to health.

6. While in 1965, 90% of the products traded within the area received favorable treatment, today the special treatment is reduced to 50%. See *Gazeta Mercantil*, "Aladi: Andinos Criam Impasse", 19/11/80, p. 2.

7. See M.H. Gillim, "Some Fiscal Aspects of the Latin American Free Trade Association", in C.S. Shoup (ed.), *Fiscal Harmonization in Common Markets,* Vol. II(Columbia University Press, New York, 1967), pp. 524-52.

8. If inflation and depreciation tend to follow one another, each mitigating the effects on trade of the other, no major problem arises. If, however, prices rise, say, faster than exchange rates the effect should be similar to that of an increase in taxes without rebate for exports and with no compensating tax on imports; in other words, similar to adoption of an origin-principle sales tax.

9. See Gillim, note 7, pp. 529.

10. Id., p. 531.

11. Id., pp. 531-32.

12. Id., p. 532.

(Argentina, Brazil and Mexico); (ii) the intermediate developed (Venezuela, Colombia, Peru, Chile and Uruguay); and (iii) the less developed (Paraguay, Bolivia and Ecuador). Trade agreements in LAIA fall in two general categories: "partial" agreements which comprise sub-groups of countries and "general" ("multilateral") agreements which necessarily include all members. LAFTA recognized only the latter. In both types of agreements, differentiated treatment is expected to favor countries in the lower categories, in the above sense.

The LAIA countries eliminated the most favored nation clause, which means that special treatment can now be accorded between two or more countries without having to extend it to the remaining countries of the area. It seems that LAIA countries are not yet ready for an overall reduction of trade barriers but prefer instead to go slow in that direction with bilateral agreements. Trade rules of the new association are not too different from LAFTA's except for those already mentioned. Procedures which actually will govern future trade are still pending, being legislated by special delegations of each country. It is not difficult to discern two blocs of interest in LAIA: first, countries with a relatively large consumption market and a reasonable level of industrialization, who clearly favor free trade in the area; second, countries with a small market and which are basically producers of raw material which would favor planned integration of their economies.

The above fears of both government and business suggest that member countries may resist integration beyond that agreed to in the LAIA Treaty, including any sacrifice of control over their internal taxes in the interest of tax harmonization. However, as we will try to show below, an adequate system of internal tax coordination should not necessarily impose any control on national autonomy.

3. FISCAL PROVISIONS OF THE LAIA TREATY

The LAIA Treaty signed in Montevideo in the fall of 1980 has some articles that are applicable to internal taxes.[13] Specifically, Articles 30 and 31 refer to internal taxation. These provisions prohibit the use of internal taxes resulting in the discriminatory treatment of the trade or capital of LAIA members or in offsetting the progress made toward free intra-area trade. Thus, a member nation of LAIA cannot use its internal taxes to discriminate in favor of its own products against those of other countries. Article 30 (Treatment in Respect of Internal Taxation) states:

> *With respect to taxes, rates and other internal duties and charges, products originating in the territory of a Contracting Party shall enjoy, in the territory of another Contracting Party, treatment no less favorable than that accorded to similar national products.*

The Treaty contains another set of provisions designed to conserve the progress made towards a free trade area in each annual negotiation. Under these provisions, nations are prevented from negotiating a tariff reduction for a product and then attempting to replace at least a part of the sacrificed revenue, either by levying internal indirect taxes on the product or by reducing the external duty on the product just enough to facilitate its import from outside the area.

In fact, the Treaty anticipated that changes in internal taxes as well as in tariffs might offset trade advantages negotiated within the area. It provides that a member nation cannot levy internal taxes on products coming largely from other countries of the area after negotiations have reduced the barriers to trade in these products. Article 31 states:

> *Each Contracting Party shall endeavor to ensure that charges or other domestic measures applied to products included in the liberalization program which are not produced, or are produced only in small quantities, in its territory, do not nullify or reduce any concession or advantage obtained by any Contracting Party during the negotiations.*

According to Article 33, member countries can estabish supplementary rules on trade policy which regulate, among other things, the adoption of non-tariff restrictions, the principle of origin, the adoption of other restrictive clauses, tax rules of export subsidies and the flow of border trade.

Another possible source of discrimination within a free trade area is the taxation of goods as they are shipped through a country. Article 35 of the Treaty provides tax exemption for goods in transit, as follows:

> *Products imported or exported by a Contracting Party shall enjoy freedom of transit within the area and shall only be subject to the payment of the normal rates for services rendered.*

The explicit permission for rebates of internal taxes, drawbacks of tariffs on exported goods and charges on domestic consumption suggests the expectation that indirect taxes should be levied on a destination basis. In all, we must recognize that the Treaty provides some principles for tax harmonization through its provisions against discrimination of products traded with or within the area. But it does not touch on other important fiscal issues. There are no explicit provisions calling for the harmonization of fiscal systems in that entity or for treatment of the special problems of turnover taxes and value-added taxes. The fact that the Treaty contains no provisions for the harmonization of national fiscal systems was not an oversight. In the discussions preceding the signing of the Treaty, one of the main concerns expressed was that the member nations would distort the allocations of investment within the area by continuing to compete for investment through the granting of fiscal incentives. But provision for seeking uniform incentives was omitted because of the anticipated difficulty in consolidating the widely different national tax laws.

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13. See *Gazeta Mercantil,* "ALADI, a Busca da Integração Regional Flexível", 8/8/1980, pp. 7-9.

4. BASIC STRUCTURE OF INDIRECT TAXATION

Indirect internal taxes have yielded over one fourth of the central government revenues of each of the LAFTA members except Colombia and Venezuela.[14] Recently, many LAFTA countries switched from multiple stage turnover taxes to taxes of the value-added type. A roughly general type of value-added tax is a main source of indirect tax revenues in Argentina, Brazil, Chile, Ecuador, Mexico, Peru and Uruguay. General sales taxes of the turnover type are essentially utilized only in Bolivia. A single stage retail sales tax is utilized in Colombia, Paraguay and Venezuela. Currently, the destination principle, implicitly or explicitly, is adopted by almost all member countries. In the following, we briefly describe the principal features of the major indirect taxes in each LAIA country.

A value-added tax was introduced in Argentina to replace a sales tax in 1975. This is a federal tax applied on a nation-wide basis in accordance with uniform rules and rates. The value-added tax is assessed on the sales value of products and of certain specific services; it is also applicable to imports. Its assessment is on a financial year basis, and the law includes a large list of products exempt from the tax. All exports are tax exempt. The rate of tax is 13% except for certain specifically mentioned products, services and imports, which are subject to a 21% rate. The amount of tax is invoiced separately from the sales price of the products or services and taxpayers are generally entitled to take credit in their own tax returns for the value-added tax paid by their suppliers of raw materials, finished products, services, and fixed assets.[15]

In Bolivia a sales tax is applied to the sales made by individuals and corporations whose annual sales exceed a certain amount. The tax is applied generally at a 5% rate. There are a number of products exempt from this tax and others which are subject to rates of 10, 15 and 20% in addition to 5%.[16]

Indirect taxation in Brazil is regulated by the national tax code which was issued in 1966. This code defines the taxes which may be levied by the federal, state and municipal governments. There are two important indirect taxes in Brazil, both applied according to the value-added criterion. The IPI (Imposto sobre Produtos Industrializados) is a federal tax payable, with a few exceptions including exports, on all industrial goods imported or produced in Brazil. The IPI rates are determined on a selective basis, e.g. chemicals are taxed at 3%, clothing at 12%, automobiles at 20%, and cigarettes at 300%. The ICM (Imposto de Circulação de Mercadorias) is a state tax payable with few exceptions, on all goods imported into or produced in Brazil. The export of manufactured goods is not taxed and the export of agricultural goods is often exempt. The ICM is uniformly applied at a 15% rate (14% in some states). The amount of tax is invoiced separately from the sales price of the products and taxpayers are generally entitled to take credit in their own tax returns for the value-added tax paid by their suppliers of raw materials, finished products and fixed assets.[17]

A national sales tax is applied in Colombia on services and sales of finished products, except food, school textbooks, drugs and exports. Imported products and raw materials are included in the tax base except those used in re-export operations.[18] Present rates vary from 6 to 35% according to the type of product. Municipal and sales taxes are generally of minor importance.[19]

As of March 1975, a national value-added tax was introduced in Chile to replace a national turnover tax.[20] Imports, transfers and other operations regarded as sales, as well as services in general, are subject to a 20% value-added tax. Exports of all products are exempt from the tax. The base for local purchases is the sale price and the tax is applied on imports at the same rate. The value-added tax paid on imports and local purchases and services incurred on exports may be recovered either as a credit against the tax due or by requesting reimbursement.[21]

A 5% sales tax of the value-added type is levied in Ecuador on all sales and commercial transactions, with the exception of sales of food staples and medicines. The tax applies to imports as well as to the manufacturing, wholesale and retail sectors. Most exports of manufactured and semi-manufactured items and minor agricultural goods have been exempt since 1972.[22]

Mexico introduced in January 1980 a national value-added tax to replace the gross receipts tax and a number of special taxes. The value-added tax is applied at a 10% rate on sales of goods, services, rentals and imports. The law defines a sale as any transfer of goods, including those made on a conditional basis. Services are considered to be those rendered by one person to another on an independent basis, transportation of persons or goods, insurance, agency activities, technical assistance and transfers of technology. Any type of rent of tangible property in exchange for a fee is taxable. The tax applies to imports of goods and services; exports are exempt. The exporter has the right to recover charges on his purchases of goods and services, either through a refund or a deduction against tax liabilities on domestic sales. A number of significant exemptions is provided for in law. Sales of cattle and agricultural products are exempt unless they have been processed. Services rendered directly by the Government are exempt as well as services of banking institutions. Rentals of real property for residences also used for agricultural purposes are exempt.[23]

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14. See Appendix II.
15. See Price Waterhouse, *Information Guide, Doing Business in Argentina* (1975).
16. See Price Waterhouse, *Doing Business in Bolivia* (1974).
17. See *Código Tributário Nacional* (Law 5172, October 1966), (Atlas, São Paulo, Brazil, 1978).
18. See *Investing, Licensing and Trading Conditions Abroad* (Business International Corporation, New York, 1978).
19. Price Waterhouse, *Information Guide, Doing Business in Colombia* (April 1978).
20. In 1977, indirect taxes produced a considerably higher proportion of the national tax revenue than direct taxes (71% as compared to 29%).
21. Price Waterhouse, *Information Guide, Doing Business in Chile* (March 1979). See also *Código Tributário* (Editora Jurídica do Chile, Santiago, Chile, 1978).
22. *Investing, Licensing and Trading Conditions Abroad.* See also *Código Tributário* (Corporation de Estudios y Publicacion, Quito, Ecuador, 1977).
23. Price Waterhouse, *Information Guide, Doing Business in Mexcio* (October 1979). See also *Código Fiscal de la Federacion* (Editora Porrua, Mexico, D.F., 1979).

A national single stage sales tax is levied on the sales value of imports and certain national goods in Paraguay. The tax does not apply to exports, to transactions between registered individuals or entities, and to raw materials, semi-processed products and other material they may use. The law exempts certain imported and national goods such as unprocessed agricultural, livestock and forestry products. Machinery, tools and equipment used in these activities are also exempt. The basic tax rate on local goods is 3%, on imported goods 5% and on special goods (usually luxuries) 10%. Tax liability is calculated on a monthly basis of the net selling price of the goods.[24]

In Peru, a value-added tax was introduced in 1973 which replaced various taxes, in particular stamp taxes. The tax applies to production, trade, construction and some services. Imports are included in the tax base. The basic tax rate is 22%, but there are exceptions to which other rates apply. Some luxuries are taxed at 42%, certain types of foodstuffs at 6% and fuel and lubricants at 7%. Exports are subject to a tax rate of 3%. As a general rule, the tax is charged on the sales price at the level of the wholesale manufacturer and retail importer. Sellers are authorized to deduct the tax paid upon purchase of the products they sell.[25]

In Uruguay, of the total national tax revenue collected, 70% comes from indirect taxes. Approximately 40% of the sales of goods and services rendered by industry and trade are subject to a value-added tax which is applies at two different rates: a basic rate of 18% and a reduced rate of 7% for some special goods and services (food products, construction activities, medical goods, fertilizers and others). All exports are exempt and the sale of several products and services is also exempt. The tax is collected according to the credit method. In the case of exempt sales, no credit is allowed with respect to tax paid in previous stages. Such credit is allowed only in the case of exports.[26]

Indirect general taxes are of minor importance in Venezuela. Concessionaires engaging in manufacturing or refining activities pay an excise tax on manufactured or defined products – such as cigarettes, tobacco and alcoholic beverages – sold within the country. A refund may be obtained by the purchaser if the products are subsequently exported. The tax is established at 50% of the import duties that could have been assessed, had the products been imported.[27]

5. TAX HARMONIZATION PRINCIPLES

Commodity taxes on products entering international trade can be levied on either of two bases. If the product is taxed where produced (and not where consumed) the tax is an "origin principle" tax, or a tax on production. If, on the other hand, the product is taxed where it is consumed (but not where it is produced) we have a "destination principle" tax, or a tax on consumption. A retail sales tax is an almost perfect example of a destination principle tax. In this case, goods (and ideally services) are taxed at the point of sale to the ultimate consumers, whether they are produced domestically or imported. Thus, the tax is levied only upon consumption or at the point of destination.

On the other hand, a tax on value-added, VAT, could be a perfect example of an origin principle tax. In this case, goods (and ideally services) are only taxed on the value added at each stage of the productive process, whether they are produced domestically or imported. Thus, the tax is levied only upon production, or in the nation of origin. But what if we wished to tax commodities under the VAT where consumed, and only there? In that case we would need to exempt exports from tax and refund any tax already paid so that they could enter world trade unencumbered by taxes levied in their nation(s) of origin. Similarly, it would be necessary to levy a tax on imports to equalize tax burdens vis-à-vis domestically produced goods. The exemption from and rebate of taxes on exports and the compensating duties on imports levied to convert an otherwise origin principle VAT to a destination principle are called border tax adjustments or BTA.

Whereas it is possible under a VAT or a retail sales tax system to impose a same percentage of tax – i.e. place an identical tax burden – on the products of various industries, the (cascade-type cumulative) turnover tax discriminates in favor of vertically integrated industries. As a rule, the turnover tax discriminates against industries the value-added of which is created early in the production process. It was because of the distortions created in the domestic economies by this non-neutral tax plus the difficulties in calculating border tax adjustments that the Neumark Report recommended that cascade-type turnover taxes be replaced in the countries of the European Economic Community by the non-distorting tax on value added.[28] For industries in which value is added in earlier stages, it would be virtually impossible to implement accurately export refunds under the turnover tax, especially if goods had passed through several stages. This is easily understood by noting that, besides the direct exemption of exports from the tax, a refund of taxes would need to be made at different rates on the value of input purchases at several stages.[29] There is no way that in this case refunds could be given automatically and accurately, as under the VAT. Refunds would of necessity be based on averages, which means that discrimination would occur between industries, methods of production and firms. The situation is, of course, the same on the import side.[30]

Although in theory the VAT and the retail sales tax are

24. See C. A. Mersán, *Legislación Fiscal del Paraguay* (Asunción, Paraguay, 1979).

25. See P.F. Polo, *Manual del Codigo Tributario* (Cultural Cuzco, Lima, Peru, 1977).

26. Price Waterhouse, *Doing Business in Uruguay* (January 1979).

27. Price Waterhouse, *Doing Business in Venezuela* (1975).

28. See Neumark Report, "Report of the Fiscal and Financial Committee", in *The EEC Reports on Tax Harmanization,* translated by H. Thurston (International Bureau of Fiscal Documentation, Amsterdam, 1963), pp. 95-156; also translated by the editors of Commerce Clearing House, Inc., *Tax Harmonization in the Common Market* (Chicago, 1963).

29. Note that there is no reason to expect that the effective tax rate, which is given by the ratio of tax liability to value added, is the same along the various stages of the productive process.

30. See C.E. McLure, Jr., "The Tax on Value Added: Pros and Cons", in *Value Added Tax: Two Views,* C.E. McLure, Jr., and N.B. Ture (American Enterprise Institute, Washington, D.C. 1972), pp. 24-26.

economically equivalent, in actuality the two taxes are likely to be different from the standpoint of international fiscal relations, quite aside from differences in their tax bases that result from administrative reasons.[31] While the retail sales tax automatically enforces the destination principle, the value-added tax may be applied more or less easily on either basis. It follows that the enforcement of a mixture of origin and destination principles, as well as the origin principle only, if deemed necessary, would require a tax of the value-added form.

The first systematic treatment of BTA appeared in the Tinbergen Report of 1953 in connection with the different treatment accorded to internal sales tax by the countries of the European Coal and Steel Community.[32] Despite the elimination of customs barriers, the products of the Common Market still passed from one taxation system to another when they moved from one country of the Community to another. A solution had, therefore, to be found which avoided superimposing taxes of the same kind, and which thus enabled products to move freely throughout the Community.[33]

One of the main results that emerged from the analysis of BTA is that when exchange rates or price levels are flexible and taxes are truly general, international trade will not be disturbed if a country moves from the destination principle to the origin principle, or vice versa, provided that international trade is balanced and provided that international flows of factors and transfer payments are either zero or balanced before and after the exchange rate or price levels are altered.[34]

The above argument is nothing but the direct application of the theory of comparative advantage based on a static equilibrium model of international commodity trade. Essentially, it states that international trade is not based on any absolute cost advantage a country may possess over other countries in the production of any particular good, but, rather, it depends on the difference between relative costs of producing a particular good in one country or another. A truly general tax does not change relative prices within a country, regardless of which principle of taxation that country employs, since the rate of tax is the same for every product. Since the relations between the two countries in real terms remain the same, the effect of a change in tax principle is a nominal one, expressed in monetary terms, and is compensated for automatically by changes in the value of the respective currencies, or, under a system of fixed exchange rates, by changes of the absolute price level.[35]

Proposals in the late 1960s to substitute a value-added tax for the corporation income tax in the U.S.A. arose because the provisions of the General Agreement on Tariffs and Trade (GATT) do not allow tax rebates on direct taxes. It was contended that nations like the U.S.A., which use factor taxes rather intensively, are at a competitive disadvantage compared to nations which rely relatively more on product taxes. The basic shortcoming of this argument is that it fails to distinguish clearly between the effects a *nation's tax structure* may have on international trading patterns on the one hand, and the effect that *changes* in the nation's tax structure may have on international trading patterns on the other hand. In other words, when price levels are allowed to fluctuate, changes in general tax structures are equivalent in the long run to a devaluation or an appreciation of the currency and therefore should not have major implications on existing patterns of trade.[36]

Discussion of the BTA issue has usually been confined to cases of open economies under balanced international trade, flexible price levels and/or exchange rates, and internationally immobile factors of production. In this setting the allocation effect of a general tax on products is equivalent to a general tax on incomes, since no factor income flows between countries. Thus, an interesting correspondence develops between the origin-principle pro-

31. For the administrative contrasts between these two taxes see McLure, "The Tax on Value Added: Pros and Cons."; and C.S. Shoup, "Theory and Background of the Value Added Tax", *Proceedings of the 48th Annual Conference on Taxation, NTA* (Detroit, Michigan, October 1955), pp. 6-19.

32. See Tinbergen Report, *European Coal and Steel Community, High Authority,* Report on Problems Raised by Different Turnover Tax Systems Applied within the Common Market (Luxembourg, March, 1953).

33. The provisions on the treatment of internal taxes in the General Agreement on Tariffs and Trale (GATT), the most widely accepted international agreement, contain rules prohibiting the subsidization of exports and discrimination against imports through internal tax systems. However, the rationale of the GATT provision was implicitly based on a partial equilibrium analysis, and was written with respect to excise taxes and tariffs on particular goods, rather than broadly based indirect taxes which apply to all or nearly all goods. See R.H. Floyd, "GATT Provisions on Border Tax Adjustments", *Journal of World Trade Law,* Vol. 7 (5), Sept./Oct. 1973, pp. 489-99.

34. See Neumark Report; H. Shibata, "The Theory of Economic Unions: A Comparative Analysis of Customs Unions, Free Trade Areas, and Tax Unions", in *Fiscal Harmonization in Common Markets,* Vol. 1, edited by C.S. Shoup (Columbia University Press, New York, 1967), pp. 145-264; H.G. Johnson and M. Krauss, "Border Tax Adjustments, Comparative Advantage and the Balance of Payments", *Canadian Journal of Economics,* Vol. 3(4), November 1970. pp. 595-602; E. Berglas, "Devaluation, Monetary Police, and Border Tax Adjustments", *Canadian Journal of Economics,* Vol. 7 (1), February 1974, pp. 1-11.

35. Note the similarity of movement from origin to destination principle and movement from export tax to tariff. The symmetry between export taxes and tariffs was first noticed by A.P. Lerner, "The Symmetry Between Import and Export Taxes". *Economica,* Vol. 3, August 1936, pp. 306-313.

36. See R.A. Musgrave and P.B. Richman, "Allocation Aspects, Domestic and International", in *The Role of Direct and Indirect Taxes in the Federal Revenue System,* N.B.E.R. and Brookings (Princeton University Press, Princeton, 1964), pp. 81-139; R.A. Musgrave, "Tax Policy", *The Review of Economics and Statistics,* Vol. 46, May 1964, pp. 127-30, "Effects of Business Taxes upon International Commodity Flows", in M. Krzyzaniak (ed.) *Effects of Corporation Income Tax* (Wayne State University Press, Detroit, 1966), pp. 118-35; W. Salant, "The Balance of Payments Deficit and the Tax Structure", *The Review of Economics and Statistics,* Vol. 46, May 1964, pp. 131-38; R.W. Lindholm, "National Tax System and International Balance of Payments", *National Tax Journal,* Vol. 19, June 1966, pp. 163-72, "The Value Added Tax: A Short Review of the Literature", *Journal of Economic Literature,* Vol. 8(4), December 1970, pp. 1178-89, "The Value Added Tax: Rejoinder to a Critique", *Journal of Economic Literature,* Vol. 9(4), December 1971, pp. 1173-79; C.E. McLure, Jr., "Taxes and the Balance of Payments: Another Alternative Analysis", *National Tax Journal,* Vol. 21, March 1968, pp. 57-69, "The Tax on Value Added: Pros and Cons", in *Value Added Tax: Two Views* (American Enterprise Institute, Washington, D.C., 1972), pp. 1-68, "Economic Effects of Taxing Value Added", in *Broad-Based Taxes: New Options and Sources,* R.A. Musgrave (ed.) (Johns Hopkins University Press, Baltimore, 1973), pp. 155-204; R.H. Floyd, "Domestic Tax Systems and the Provisions of the GATT: A Theoretical Analysis of their Implications for Economic Efficiency", *ibid.*; M. Krauss and R. Bird, "The Value Added Tax: Critique of a Review", *Journal of Economic Literature,* Vol. 9(4), December 1971, pp. 1167-73; A.C. Harberger, *Taxation and Welfare* (Little Brown, Boston, 1974).

duct tax and the source-principle income tax on the one hand, and the destination-principle product tax and the residence-principle income tax on the other hand.[37]

Suppose, however, that besides product trade there are movements of factors of production across borders and/or movements of residence of factor owners. For example, an individual may export his capital but stay in his home state, or he may decide to move to some other state but leave his capital service in the former home country. Once we allow for the existence of factor mobility and changes of residence between countries, the correspondence between origin and source principles on one side and destination and residence principles on the other side ceases to hold. Only in the special case where an origin-principle tax is fully reflected in lower factor prices is the origin-source correspondence preserved. The correspondence between destination and residence principles, however, is less close, since incomes earned abroad may be spent and used abroad, thereby avoiding the domestic destination tax but not the domestic residence tax.[38]

The long run equivalence between the origin and the destination principles in connection with general taxes is not universal and depends crucially on the assumptions of the model. In fact, the equivalence of principles breaks down completely with factor/owner mobility. When factor services can move across the border, an origin-principle tax induces movements of factor services, unless the rate of tax is the same as that applied by the rest of the world. Similarly, when factor owners, instead of factor services, can move across the border a destination-principle tax induces movements of factor owners unless the rate of tax is the same as that applied by the rest of the world.[39] Finally, when factor services and factor owners can move across the border, any form of tax induces one of these movements, except when tax rates are equal in all jurisdictions, since factor owners can minimize their destination tax burden by living in the low tax state or employing their factors in the state of low origin tax.[40]

A switch from the origin to the destination principle has, in this case, allocative effects which are absent with immobile factors of production. Suppose that capital services are internationally mobile. While changes in BTA do not affect capital services directly, changes in the exchange rate do affect the rate of return of international factors of production. A switch from the origin to the destination principle which leads to an appreciation of the exchange rate can be thought of as an import subsidy of factor services. Domestic residents supplying capital services abroad face a reduced value for their repatriated factor earnings at the new exchange ratio. On the other hand, foreign residents supplying capital services domestically face an increased value for their repatriated factor earnings at the new exchange ratio. Thus, a switch toward the destination principle induces capital to flow into the country. For a similar reason a switch toward the origin principle induces capital to flow out of the country.[41]

It has been shown that even when we allow for the assumptions embodied in the standard analysis of BTA (balanced international trade, flexible exchange rate or price levels and internationally immobile factors) and furthermore restrict ourselves to uniform as well as general taxes across products and countries, the choice of BTA need not be irrelevant.[42] In effect, a change-over from an over-all destination or origin principle to the *restricted origin principle* (ROP), i.e. the origin principle applied to domestic trade and destination principle applied to foreign trade, may affect the interstate distribution of revenues and the domestic and foreign trade patterns as well. In particular, when a triangular trade flow of goods takes place and, say, two countries decide to form an economic union or a federation and the restricted origin principle is adopted in this union or country, a reallocation of tax revenues is generated between these two countries or states which cannot in general be compensated by a change in the exchange rate or absolute price levels.[43]

Efficiency, as seen above, from a world point of view requires that an investor's (individual's) choice of country in which to invest (live) should not be affected by differentials. However, government expenditures have not been considered explicitly in this framework. Thus, in the following we suggest that inter-nation equity as well as efficiency will require that an investor and a household's choice of a country in which to invest and live should not be affected by tax-benefit differentials or fiscal residues (à la Buchanan).[44] In this setting we examine the choice of BTA by introducing the expenditure side of the public.[45]

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37. The closed economy counterpart of this result is the equivalence between a general tax on factor payments and a general tax on sales. See Musgrave, *The Theory of Public Finance*, pp. 350-53.
38. The tax rate will not provoke movements of factor services and/or factor owners across the border if it can be assumed that income recipients regard the tax as a payment for governmental services provided. See C.K. Sullivan, "Indirect Taxation and Goals of the European Economic Community", in *Fiscal Harmonization in Common Markets*, Vol. II (see note 34), pp. 1-102, particularly pages 73-79.
39. Aside from considerations of commuting transport costs.
40. See R. Varsano, "Border Tax Adjustments, Factor Mobility, and Growth", doctoral dissertation, Stanford University, July 1977; M. Schmundt, "The Value Added Tax and International Factor Mobility - A General Equilibrium Analysis", unpublished paper, 1974.
41. See Schmundt, note 40.
42. See C.A. Longo, "Restricted Origin Principle under Triangular Trade Flows: Implications for Trade and Tax Revenues", *Journal of Development Economics*, forthcoming.
43. Difficulties related with the adoption of the ROP have been analysed for general and uniform taxes which are not equal between countries. See H. Shibata, note 34, T. Georgakopoulos, "Tax Harmonization and International Income Distributions", *National Tax Journal*, Vol. 25, December 1972, pp. 541-55.
44. See J.M. Buchanan, "Federalism and Fiscal Equity", *American Economic Review*, Vol. 40, September 1950, pp. 583-600. More specifically, we would like to establish a set of guidelines which can be used to define a neutral system of border tax adjustments, applicable to product taxation. Analogous problems arise with the taxation of income and profits but they will not be dealt with here. See however R.A. Musgrave and P.B. Musgrave, "Inter-nation Equity", in R.M. Bird and J.G. Head (eds.), *Modern Fiscal Issues, Essays in Honor of C.S. Shoup* (University of Toronto Press, Toronto, Canada, 1972), pp. 63-85. For a recent atempt to approach this problem in the context of LAFTA see R.A. Balbi, "Los Paises de la ALALC y los Tratados", *Sintesis ALALC*, Ano 13 (129), Sept./Dec. 1978, pp. 6-9.
45. See C.A. Longo, "Tax Coordination Under Benefit Taxation", *National Tax Journal*, Vol. 31(4), December 1978, pp. 385-89. See also N. Andel, "Problems of Government Expenditure Harmonization in a Common Market", in C.S. Shoup, *Public Finance* (Aldine, Chicago, 1969) chapter 25.

The proper choice of border tax adjustments by national governments may be regarded as essentially concerned with the benefit aspects of product taxation in a geographically limited area. Product taxes may be intended as a method of collecting taxes from individuals in their capacity as consumers or producers. In other words, product taxes may be intended as a tax assessed on individuals in their capacity as consumers of *final* public goods. Alternatively, product taxes may be used as a tax assessed on business enterprises in their capacity as users of *intermediate* public goods. Under such a system, a distinction would be drawn between the financing of final and intermediate public expenditures.[46,47]

The cost of public expenditures used to render final services to the consumer would be defrayed from taxes levied directly upon him. Such taxes would be imposed on the consumer at the place where he lives and where he enjoys the consumption benefits. When products are exported, such taxes should not be paid for by the foreign consumer who, in fact, does not become the beneficiary of public services. Revenues to cover the cost of such services should be collected according to the *destination* principle if product prices rise as a result of the introduction of the tax. Otherwise non-resident purchasers of domestic output will be subsidizing domestic consumers of imports, who are exempt, under the *origin* principle, from the tax collected on exports. However, if product prices remain unchanged, the *origin* principle should be enforced, otherwise non-resident purchasers of domestic output will be subsidized by domestic consumers of imports, who collect, under the *destination* principle, the revenue lost on exports. Thus, in rendering services that basically benefit resident consumers, the government functions in the same way as private producers of final goods and acts to recover the cost of these services through consumption taxes.

On the other hand, intermediate public goods provide for the supply of public services that reduce the cost of private output. This cost, under the benefit rule, should be charged to the producer of that output. These charges enter into his cost of production and may be reflected in the price paid by the consumer. If the products happen to be exported, such taxes should be paid for by the foreign consumer, who, in this case, becomes the beneficiary of the public service. Revenues to cover the cost of such services should be collected according to the *origin* principle if product prices rise as a result of the introduction of the tax. Otherwise non-resident purchasers of domestic output will be subsidized by domestic consumers of imports, who collect, under the *destination* principle, the revenue lost on exports. However, if product prices remain unchanged, *exports should be taxed,* otherwise non-resident purchasers of domestic output will be subsidized by domestic consumers of imports, who collect, under the *origin* principle, the revenue lost on exports. Thus, in rendering services that basically benefit business enterprises, the government functions in the same way as private producers of intermediate goods and acts to recover the cost of these services through production taxes.[48] The conditions indicated in the preceding and the foregoing paragraphs are summarized in Table 1.

TABLE 1

Benefit rule for the choice of BTA

Product price / Benefits to:	Rise	Unchanged
Consumers	Destination principle	Origin principle
Business firms	Origin principle	Export tariff

The application of product taxation according to the criteria suggested above to the actual categories of government activities is bound to raise many statistical problems. The only way in which goods and service expenditures of the government can be divided between expenditures of final and intermediate products is through a qualitative analysis of each expenditure item in the budget. A few expenditures fall clearly into one or the other category. For instance, the following categories of government services may be distinguished:

46. The use of benefit taxation in connection with the choice of BTA has been suggested before. See C.S. Shoup, "Export Exemption and Import Taxation under Sales Taxation", paper contributed at request of the Ways and Means Committee, in *Excise Tax Compendium* (U.S. House of Representatives, Committee on Ways and Means, U.S. Government Printing Office, Washington, D.C., 1964), pp. 57-64; E.R. Morss, "Tax Policy Implications of Free Trade", *Public Finance,* Vol. 21(3), 1966, pp. 372-89; and Musgrave, *Fiscal Systems,* chapter 9.

47. The problem of separating government services to business from those to consumers is discussed extensively in the literature on national income accounting, where its significance lies in the need to identify the final output of the economy. Some part of the output of the public sector is not final output, but may be used up in the production of other goods (maintenance of law and order, roads used for business purposes, and so on). To reckon this as well as other public services provided directly to individuals (public parks, roads used for recreation, and so on) as national output could involve double counting. The contention that it is impossible to distinguish final and intermediate output of government activity is scarcely defensible if it means inability to identify the two categories of output as distinct from measuring them in the ordinarily available data. See S. Kuznets, *National Income and Its Composition, 1919-1938* (National Bureau of Economic Research, New York, 1941), *Natinal Income: A Summary of Findings* (National Bureau of Economic Research, New York, 1946); C.S. Shoup, *Principles of National Income Analysis* (Houghton Mifflin, Boston, 1947), chapters 4 and 7; and Musgrave, *The Theory of Public Finance,* note 37, chapter 9. Samuelson's formulation of pure public good has been extended to include intermediate public goods by K. Kaizuka, "Public Goods and Decentralization of Production", *The Review of Economics and Statistics,* Vol. 47, 1965, pp. 118-20.

48. Intermediate public services can be represented as a form of technical change as well as a cost reduction type of public service. We distinguish between a government service to business firms which reduces the cost of producing a given output or increases equally the productivity of household's factors, from a government service to consummers which increases household's income directly. A government service to business has been compared with a technical change which is neutral in the Hicks sense. See P. Mieszkowski, "The Distributive Effects of Local Taxes: Some Extensions", in *Public and Urban Economics,* R.E. Grieson (ed.) (Lexington Books, D.C., Heath, Lexington, 1976), pp. 293-312.

(1) services of direct benefit to individuals in their capacity as final consumers such as public parks, health care, welfare programs, housing, free entertainment, and transfer payments;
(2) services of direct benefit to business firms such as industrial and agricultural research, economic and statistical reporting, and subsidies to enterprises.

In many instances, however, the same expenditures benefit both consumers and business firms, thus elements of both final and intermediate products. Highways are used for pleasure driving and business transport; education provides consumer satisfaction and raises productivity, and so forth. Those expenditures of joint benefit to consumers and business firms include general administration, judiciary, police protection, transportation, communication, and education expenses.[49] If all expenditures of the public sector were of this latter type, a mixture of origin and destination principles should be applied on interjurisdictional trade, ideally reflecting the tax induced change in the absolute price level as well as the share of benefits which accrues to both producer and consumer.

A rigorous enforcement of BTA along the foregoing lines might pose administrative difficulties which could neutralize the positive effects of a well designed border tax plan. This may happen, for instance, if the benefits of public expenditures and/or the tax induced change in price level are specific across jurisdictions. Each state, then, would have to calculate separately differentiated rates of BTA. The complexity of such a system would seem impossible in the context of a federation where border controls on interstate commerce are not sufficiently implemented. On the other hand, if the benefits of public expenditures and the tax induced change in price level are fairly uniform across jurisdictions, then the enforcement of BTA would pose no major administrative problems.

The type of VAT which should be adopted depends on the treatment of investment goods. The gross product variant makes no allowance whatsoever for investment and its conceptual base is the gross domestic product. The income variant permits the deduction of annual depreciation and its conceptual base is net domestic income. Finally, the consumption variant exempts the full value of investment goods and, in this form, the VAT reaches only consumption expenditures. The value-added tax of the gross product type seems to be the best form of business taxation to be implemented on a benefit basis. This tax, which is related to the jurisdictional concept of output on a gross product basis, provides a better approximation to a firm's volume of activity, for the use of government services accrues whether capital is replaced or not. The consumption basis, by excluding capital goods as well as depreciation, omits an important share of the business activity and thus is an inadequate index of the firm's utilization of public services. On the other hand, the retail sale tax or the value-added tax of the consumption type seems to be the best form of consumption benefit taxation. While the retail sales tax enforces the destination principle automatically, the value-added tax may be applied on either principle, since by means of BTA jurisdictional taxes of the value-added form can be transformed easily from origin to destination principle taxes. It follows that enforcement of a mixture of origin and destination principles, if deemed necessary, would require a tax of the value-added form.

6. PROBLEMS OF IMPLEMENTATION

We have indicated above that fears of both government and business suggest that LAFTA member countries may resist integration beyond that agreed to in the Treaty of Montevideo, including any sacrifice of control over their internal taxes in the interest of tax harmonization. However, an adequate system of international tax harmonization might not unduly impose problems on national autonomy. It seems reasonable to expect that independent units of national governments should, in principle, be free to improve the allocation of public revenues through diversification of public services according to local preferences.[50] Also, a decentralized provision of public services usually implies non-uniform tax rates across countries which in turn may generate problems of international reallocation of revenues and resources. In this section we enquire as to what type of general tax could best implement the foregoing benefit rule of inter-nation equity. As we stated before, while the retail sales tax enforces the destination principle automatically, the value-added tax may be applied more or less easily on either basis. It follows that the enforcement of a mixture of origin and destination principles, as well as the origin principle only if deemed necessary, would require a tax of the value-added form.

The two most straightforward methods of calculating tax liabilities under the VAT are variants of what can be called the deduction method. Under the first, the subtraction method, the statutory tax rate is applied directly to the firm's value added, which in turn is calculated by subtracting purchase inputs from sales. Under the second variant of the deduction method the firm calculates its gross tax liability by applying the statutory rate to its total sales. It then deducts from the result the amount of tax it has paid on its purchases in order to calculate its net tax liability. Because a credit is allowed for the taxes previously paid on inputs, this method of calculating tax liability is called the credit method.

It has been suggested that the destination principle is the only alternative to existing border tax adjustment practices, when tax rates are not equal among countries.[51] Because the tax rate in the "last" jurisdiction along the productive process is the only one that matters with the

49. For an analysis of the benefits of the chief services commonly supplied by governments, see C.S. Shoup, *Public Finance,* note 45, chapter 5. The difficulties related to estimation of the benefits of public expenditures are well known. See, for instance, C.E. McLure, Jr., "On the Theory and Methodology of Estimating Benefit and Expenditure Incidence", paper presented at the workshop on "Income Distribution and Its Role in Development", Rice University, 1974; L. De Wulf, "Fiscal Incidence Studies in Developing Countries: Survey and Critique", *IMF Staff Papers,* Vol. 24, March 1975, pp. 61-131; and C. Ballentine, J. Dean, and W.R. Thirsk, *Some Measures of Fiscal Incidence in Canada: 1969,* unpublished Research Report, 1977, chapter 4.
50. See C.A. Longo, "Federalismo Fiscal e as Alíquotas do ICM entre Estados", *Revista Brasileira de Economia,* Vol. 33 (2), 1979, pp. 301-17.
51. K. Messere, "A Defense of Present Border Tax Adjustment Practices", *National Tax Journal,* Vol. 32(4) December 1979, pp. 481-92.

credit method, the rates applied in previous jurisdictions are irrelevant and it becomes difficult to treat different jurisdictions differently. A formal representation will clarify this argument. Let t^x and t^m be the tax rates applied on the value added according to the *origin* principle in the exporting, X, and importing, M, jurisdictions, respectively. If, for example, X sells a product value at V^x to M, and this product reaches the consumer in M, at the value $V^x + V^m$, then tax revenue in M should be:

$$T_m = t^m (V^x + V^m) - t^x V^x$$

or

$$T_m = (t^x - t^m) V^x + t^m V^m$$

Thus, unless tax rates are equalized ($t^x = t^m$), tax revenues in M will not be proportional to the jurisdictional value added, V^m. Alternatively, unless the destination principle applies ($t^x = 0$), tax revenues in M will not be proportional to the jurisdictional consumption.

We have indicated that the subtraction method of tax collection can apply the origin principle as well as the destination principle without major administrative problems.[52] This method of tax collection applies the tax rate directly on the value added in each stage of the production process, without affecting tax collection in subsequent stages. Thus, different treatment of a particular stage, if deemed necessary, will be transferred to later stages in the form of reduced (or increased) tax burden on the products that have passed through that stage.[53]

Considering that the subtraction method may discriminate between productive stages and, therefore, between different jurisdictions, this method can be utilized advantageously, instead of the credit method, to implement a value-added tax according to the origin principle with differentiated rates among jurisdictions. Adoption of the origin principle requires the application, by each firm, of the jurisdictional tax rate to the difference between sales receipts and input costs independently of their destination and origin, respectively. Thus, the tax is applied to exports but imports are exempt and the destination principle is not necessary to regulate interjurisdictional taxation of commodities. However, if the destination principle is applied and taxes are actually rebated at the border, then either the subtraction or the credit method of tax collection would enforce non-uniform tax rates on value added across countries.

7. SUMMARY AND CONCLUSION

Although unharmonized tax systems can create differences in costs of production and return of investment that interfere with competition and distort the allocation of resources, we recognize that non-coordinated internal taxes will not appear as a serious topic in the agenda to free trade until other, more conspicuous barriers have been removed. While the Treaty of Montevideo has some Articles that are applicable to internal taxes, the fact is that this document contains no provision for complete harmonization of national fiscal systems. Even though, many LAIA countries have recently switched from multiple-stage turnover taxes to taxes of the value-added type, there still remain significant differences in their indirect tax bases and methods of tax collection.

In the belief that tax harmonization may ultimately be essential to the successful operation of LAIA, we examined some problems of border tax adjustments generated by non-coordinated systems of indirect taxation. In this respect we stressed the inconveniences associated with cascade turnover taxation and suggested that while the retail sales tax enforces the destination principle automatically, the value-added tax may be applied more or less easily on either basis. Thus, if divergent systems of a national fiscal structure must remain independent in an integrated area, indirect taxes of the value-added type should be preferred on administrative grounds.

By introducing the expenditure side of the public budget we suggested a set of rules which can be used to define a neutral system of inter-nation taxes, as it applies to product taxation. We concluded that, when public expenditures are in the nature of final services, inter-nation tax neutrality would require adoption of the destination (origin) principle if product prices rise (remain unchanged) with the tax. On the other hand, when public expenditures are in the nature of intermediate services inter-nation tax neutrality would require adoption of the origin principle (export tariff) if product prices rise (remain unchanged) with the tax.

An adequate system of internal tax harmonization should not impose unnecessary control on national fiscal autonomy. In fact, independent units of nationl governments should be free to improve the allocation of public resources through the diversification of services according to local preferences. However, a decentralized provision of public services implies, in general, non-uniform tax rates across countries which in turn might generate problems of international reallocation of revenues and resources. Thus we enquired as to what type of general tax would best implement the benefit rule of inter-nation equity with non-uniform tax rates among countries, and suggested that adoption by LAIA countries of differentiated rates of tax on value added, if deemed necessary, would require the subtraction method of tax collection or the credit method coupled with the destination principle.

52. C.A. Longo, "Uma Contribuição para a Reforma do ICM: O Caso dos Ajustamentos de Impostos na Fronteira", *Pesquisa e Planejamento Econômico*, Vol. 9(3), December 1979, pp. 803-18, "Defense of Present Border Tax Adjustment Practices: A Comment", *National Tax Journal*, Vol. 33(4), December 1980, p. 501.

53. Note that the credit method can be used to discriminate among final output, but cannot apply a distinct treatment in productive stages if necessary. On the other hand, the subtraction method can discriminate among productive stages, but cannot provide distinct treatment to final output. See C.E. McLure, Jr., "The Tax on Value Added: Pros and Cons", in *Value Added Tax: Two Views* (Washington, D.C., American Enterprise Institute, 1972), pp. 1-68.

APPENDIX I

Trade within LAFTA countries and the rest of the world
(thousand dollars)

	LAFTA		*Rest of the world*		*Total trade*		*Balance*		
Countries	*Exp. (FOB)*	*Imp. (CIF)*	*Exp. (FOB)*	*Imp. (CIF)*	*Exp. (FOB)*	*Imp. (CIF)*	*LAFTA*	*R.O.W.*	*Total*
Argentina	747	440	2501	1657	3248	2097	+ 307	+ 844	+1151
Bolivia	32	33	233	145	255	178	− 1	+ 78	+ 77
Brazil	543	598	5658	6257	6201	6855	− 55	− 599	− 654
Colombia	123	96	759	752	882	848	+ 27	+ 7	+ 34
Chile	127	267	817	774	944	1041	− 140	+ 43	− 97
Ecuador	38	52	267	301	305	353	− 14	− 34	− 48
Mexico	156	126	1454	2926	1610	3052	+ 30	−1472	−1442
Paraguay	24	50	103	72	127	122	− 26	+ 31	+ 5
Peru	88	174	962	852	1050	1026	− 86	+ 110	+ 24
Uruguay	32	122	290	163	322	285	− 90	+ 127	+ 37
Venezuela	142	111	2881	2434	3023	2595	+ 31	+ 397	+ 428
TOTAL	2052	2069	15915	16383	17967	18452	− 17	− 468	− 485
RATIO $\frac{1973}{1972}$	+ 30.0%	+ 27.3%	+ 28.3%	+ 18.9%	+ 28.5%	+19.8%			
RATIO $\frac{1973}{1961}$	+320.5%	+253.1%	+134.7%	+147.6%	+147.1%	+156.2%			

Source: *Latin American International Trade Yearbook,* 9th edition, 1974-75 (EPISA-Editores de Publicaciones Interamericanas, Rep. de Costa Rica).

APPENDIX II

Domestic taxes on goods and services as a percentage of total tax revenues

	1972	*1973*	*1974*	*1975*	*1976*	*1977*
Bolivia	—	28	32	32	32	26
Brazil	—	35	33	30	57	54
Chile	27	30	30	29	—	—
Colombia	16	16	16	20	22	—
Ecuador	—	20	17	21	18	—
Mexico	32	32	33	35	—	—
Paraguay	30	27	26	25	24	—
Peru	—	39	40	40	46	48
Uruguay	—	36	39	50	46	69
Venezuela	09	07	03	04	04	—

Source: *Government Finance Statistics Yearbook, Vol. II* (International Monetary Fund, Washington, D.C., 1978).

VAT RATES IN LATIN AMERICAN COUNTRIES

Argentina 16%
Bolivia 5%
Brazil 15%
Chile 20%
Colombia 15%
Costa Rica 8%
Dominican Rep. .. 4%
(not yet in force)
Ecuador 5%
Honduras 3%
Mexico 10%
Nicaragua 8%
Panama 5%
Peru 22%
Uruguay 14%

The rest of the Latin American countries have general consumption taxes, with the exception of Venezuela, which has none.

IFA NEWS

Berlin Congress 1981

Results of the Discussions

At the end of the Berlin Congress of IFA the following two resolutions were adopted.

SUBJECT I:

Mutual agreement procedure and practice

The resolutions on Subject I were originally drafted in German and later translated into English. We reproduce here first the final German original text and below the English translation.

Der Kongress hat zum Thema I "Das Verständigungsverfahren - Verfahren und praktische Handhabung" folgende Schlussfolgerungen erarbeitet:

I

Das Ergebnis des Verständigungsverfahrens stellt ein Übereinkommen zwischen den zuständigen Behörden dar und nicht - es sei denn ein Gesetz sieht etwas anderes vor - ein Erweiterung des Vertrages. Dies ist unabhängig davon, ob das Verständigungsverfahren als Mittel zur Vermeidung der Doppelbesteuerung in einem konkreten Einzelfall im Wege der gegenseitigen Sachverhaltsermittlung (einschliesslich einer Gewinnberichtigung), zur Abkommensauslegung oder zur Lückenfüllung des Abkommens dient oder ob es ein Konsultationsverfahren zum Ziel hat, um bestehende Abkommensbestimmungen für eine Vielzahl von Fällen klarzustellen oder zu ergänzen.

Dem entspricht es, dass das Ergebnis eines Verständigungsverfahrens, das die Lösung eines Einzelfalles anstrebt, vom Steuerpflichtigen nicht akzeptiert werden muss und dass es die Gerichte, auch soweit es diesen Fall betrifft, nicht bindet.

Ohne Rücksicht darauf, ob das Ergebnis sich auf einen Einzelfall bezieht oder eine allgemeine Regelung vorsieht, kommt ihm in den meisten Ländern - anders als dem Abkommen - keine Gesetzeskraft zu. Daher bindet es weder die Steuerpflichtigen noch die Gerichte.

Im Hinblick darauf ist das Verständigungsverfahren ein wirksames und geeignetes Instrument zur Auslegung, Anwendung und Weiterentwicklung der Abkommen und ein sachgerechtes Mittel zur Beseitigung sowohl der juristischen als auch der wirtschaftlichen Doppelbesteuerung.

II

Für die Durchführung eines Verständigungsverfahrens im engeren Sinne sollte folgendes beachtet werden:

1) Der Steuerpflichtige sollte das Recht haben, einen Antrag auf Einleitung des Verständigungsverfahrens zu stellen und darauf, dass sein Antrag nicht unbegründet abgelehnt wird.
2) Der Steuerpflichtige sollte über den Verlauf des Verfahrens informiert werden und berechtigt sein, seine Auffassung zu jedem Zeitpunkt im Verfahren vorzutragen.
3) Die Steuerpflichtigen sollten durch Richtlinien über die Verfahrensweise aufgeklärt werden.
4) Man sollte sich bemühen, das Verfahren abzukürzen.
5) Das Verständigungsverfahren sollte nicht dazu benutzt werden, weitere Steuertatbestände, die nicht im unmittelbaren Zusammenhang mit dem Verfahrensgegenstand stehen, zu überprüfen.
6) Bereits während der Laufzeit des Verständigungsverfahrens sollten sich die zuständigen Behörden darauf einigen, eine doppelte Belastung bis zum Abschluss des Verfahrens zu vermeiden. Dabei sollten Unbilligkeiten, die sich aus einer eventuellen Zinserhebung ergeben, beseitigt werden.

III

Um das Verständigungsverfahren weiter zu verbessern:

1) Sollten die Staaten ihre Abkommen soweit als möglich an Art. 25 des OECD-Musterabkommens 1977 und Art. 25 des UN-Musterabkommens anpassen.
2) Die innerstaatlichen Gesetze sollten so angewendet und wenn nötig ergänzt oder geändert werden, dass
   a) die Umsetzung der zugunsten des Steuerpflichtigen erzielten Verständigungsergebnisse unabhängig von den zeitlichen Grenzen des innerstaatlichen Rechts sichergestellt wird, und die Einleitung des Verständigungsverfahrens die innerstaatlichen Fristen hemmt, ebenso wie die Einlegung innerstaatlichter Rechtsbehelfe die Fristen für die Einleitung eines Verständigungsverfahrens hemmen sollte;
   b) Die Ergebnisse eines zur Ausfüllung von Lücken des Abkommens eingeleiteten Verständigungsverfahrens aufgrund des innerstaatlichen Rechts Gezetzeswirkung erlangen;
   c) eine Gerichtsentscheidung, die eine Doppelbesteuerung bestehen lässt, die Durchführung eines Verständigungsverfahrens nicht hindert;
   d) der Steuerpflichtige nicht gezwungen ist, den innerstaatlichen Rechtsweg zu beschreiten und auszuschöpfen.
3) In die Abkommen sollten Regelungen aufgenommen werden, die das Entstehen von Doppelbesteuerungen auf ein Minimum beschränken, insbesondere bei der Gewinnabgrenzung verbundener Unternehmen. Dies sollte dadurch erreicht werden, dass die Vertragsstaaten Beschränkungen für die Gewinnberichtigung unterliegen, insbesondere zeitlicher Art.
4) Das Ergebenis von Konsultationsverfahren und allgemeine Regeln, die für Einzelfälle zur Anwendung kommen, sollten veröffentlicht werden, wobei die Belange der Steuerpflichtigen insbesondere jedoch das Steuergeheimnis, zu wahren sind.

IV

Dem Kongress ist es ein besonderes Anliegen, dass baldmöglichst folgende Massnahmen getroffen werden:

1) Es soll anerkannt werden, dass der Steuerpflichtige ein Recht auf eine bindende Lösung zur Beseitigung der Doppelbesteuerung durch die beteiligten Verwaltungen hat: daher sollte den zuständigen Behörden eine Verpflichtung auferlegt werden mit dem Ziel, bei den Verhandlungen eine Einigung zu erreichen.
2) Es soll gewährleistet werden, dass die Auslegung von Bestimmungen eines Doppelbesteuerungsabkommens, über die im Wege der Verständigungsvereinbarung Einigkeit erzielt wurde, Vorrang vor Begriffsbestimmungen des innerstaatlichen Rechts hat.
3) Es sollen auf regionaler oder internationaler Basis Voraussetzungen geschaffen werden, die es ermöglichen den Rat von Gutachtern, Schiedsrichtern oder Gerichten einzuholen oder sich deren Urteil im Einzelfall oder aufgrund allgemeiner Vereinbarung zu unterwerfen.

The work of the Congress on the institution of mutual agreement procedure has led to the following conclusion:

I

Mutual agreement procedure result in an understanding between the competent authorities and is not, unless domestic law is to the contrary, an extension of the treaty. This is true regardless of whether it is contemplated as a means to avoid double taxation in a particular taxpayer's case by mutual recognition of facts, (including the case of profit adjustment), interpretation of the treaty, or filling up of a gap in the treaty's provisions, or as a consultation aiming at general applicability by clarifying or completing existing treaty provisions.

Accordingly, if its purpose is the solution of a specific taxpayer's case, its result may be declined by him and is not binding upon the courts even with respect to the taxpayer individually as to his specific case.

Whether it is specific or general, its result will, in most countries, unlike the treaty, not be law, and accordingly is not binding upon the taxpayers generally and the courts.

So described, the institution is an efficient and flexible instrument in the interpretation, application and development of the treaties and a suitable means for the elimination of both juridical and economic double taxation.

II

In implementing the mutual agreement procedure on a specific taxpayer's case, the following should be observed:

1) The taxpayer should have the right to submit a request for mutual agreement procedure to be instituted and for such request not to be unreasonably refused.
2) The taxpayer should be kept informed of the proceedings and be authorized to submit his observations during the course of the procedure.
3) Guidelines should inform taxpayers as to the procedures to be followed.
4) Efforts should be made to shorten the procedure.
5) Mutual agreement procedure should not be used to review other tax matters not directly connected with the subject of the procedure.
6) The competent authorities should, subject to the final outcome, agree among themselves so as to grant relief for double taxation during the course of the procedure. Hardship which could result from interest being payable should be eliminated.

III

In order to further improve the functioning of this institution:

1) Countries should, to the extent possible, adapt their treaties to Art. 25 of the 1977 OECD and Art. 25 of the UN Model Conventions.
2) Domestic legislation should be used, and if necessary, completed or amended, so as to ensure that
   a) settlements reached under mutual agreement procedure in favour of the taxpayer can be inplemented irrespective of time limits imposed under domestic law; the initiation of mutual agreement procedure should suspend domestic time limits and conversely, the initiation of domestic procedures should suspend the time limits of mutual agreement procedure,
   b) the results of mutual agreement procedure initiated with a view to filling gaps in treaty coverage should be given force of law through the normal constitutional procedure,
   c) if double taxation has occurred as a result of a court decision, this should not be an obstacle to the mutual agreement procedure,
   d) the taxpayer should not be obliged to introduce or exhaust domestic remedy procedures.
3) Provisions should be included in the treaties to minimise the occurrence of double taxation, specifically in respect of cases involving transfer pricing, by means of imposing upon the contracting parties limits as to the time during which correcting asessments can be made.
4) The result of the consultation procedure and the general rules applied in specific taxpayers' cases should be published provided that the interest of the taxpayers with regard to secrecy is safeguarded.

IV

The Congress expressed its particular interest in having countries take as soon as possible the following measures:

1) Countries should recognize the right of the taxpayer to obtain a solution for the avoidance of double taxation by way of agreement binding upon the competent authorities. To this end, an obligation should be imposed upon such authorities to pursue negotiation so as to reach agreement.
2) Measures should be taken to ensure that the interpretation of provisions of a double taxation treaty on which a settlement has been reached in the mutual agreement procedure should take precedence over

the definition of the terms under domestic law.

3) Voluntary or compulsory arrangements should be made for regional or international expert, arbitration or judicial facilities or institutions to resolve double taxation conflicts where they cannot be resolved by mutual agreement procedures.

The resolutions on Subject II were drafted in English and we reproduce the final text below.

SUBJECT II:

Unilateral measures to prevent double taxation (Original verson)

1. The further development of adequate unilateral measures to avoid international double taxation is highly desirable. This is especially the case where no tax treaty exists.
2. Each country should consider, in the light of its own tax system, whether it is preferable to adopt an exemption or credit method or to adopt a combination of such methods for different classes of income.
3. Each country should consider, in the light of its own tax system, economic policies and fiscal affairs, whether it is preferable to respect incentive systems of other countries through tax-sparing credits or other means.
4. In every case each sovereign state must consider the mutuality of interests between source countries and resident countries. In those cases in which double taxation has not been eliminated by exemptions, a country should, subject to appropriate source and limitation rules, allow credit for foreign withholding taxes. A country which adopts the credit system should also allow credit for other income taxes imposed on or with respect to earnings distributed or attributed to taxpayers subject to tax by such country. It also follows that source countries should observe international standards regarding sources of income and refrain from taxation that would tend to hamper international trade and investment.
5. In order to prevent the possibility of double taxation, unilateral measures for relief should be available to non-residents.

FRENCH BRANCH OF IFA

The Board of the French Branch of IFA met on October 8, 1981 under the presidency of Mr. Max Laxan. However, because the latter was elected President of central IFA he resigned as president of the French Branch. The Board accepted his resignation after having expressed its high appreciation for the work Mr. Laxan had done for the French Branch. Under his presidency the number of members of the French Branch has considerably increased and the success of the Paris Congress of IFA in 1980 was to large extent due to his efforts. The Board elected unanimously Mr. Guy Delorme as the new President of the French Branch of IFA.

The following meeting of the Board will take place on March 10, 1982.

The Board announced a study meeting to be held on November 6, 1981 devoted to the discussion of the net wealth tax. Speakers would be Mr. Willemsen, head of the tax division of the Bundesverband der Deutschen Industrie (Confederation of German Industries) who would speak on the German net wealth tax and Mr. Delmas-Marsalet, head of the Legal Tax Department of the Ministry of Finance who would speak on the French proposed tax on large fortunes (impôt sur les grandes fortunes) which is currently under debate in French Parliament.[1]

1. A discussion in English of the French proposals has been published in 21 *European Taxation* 10/1981.

ERRATUM

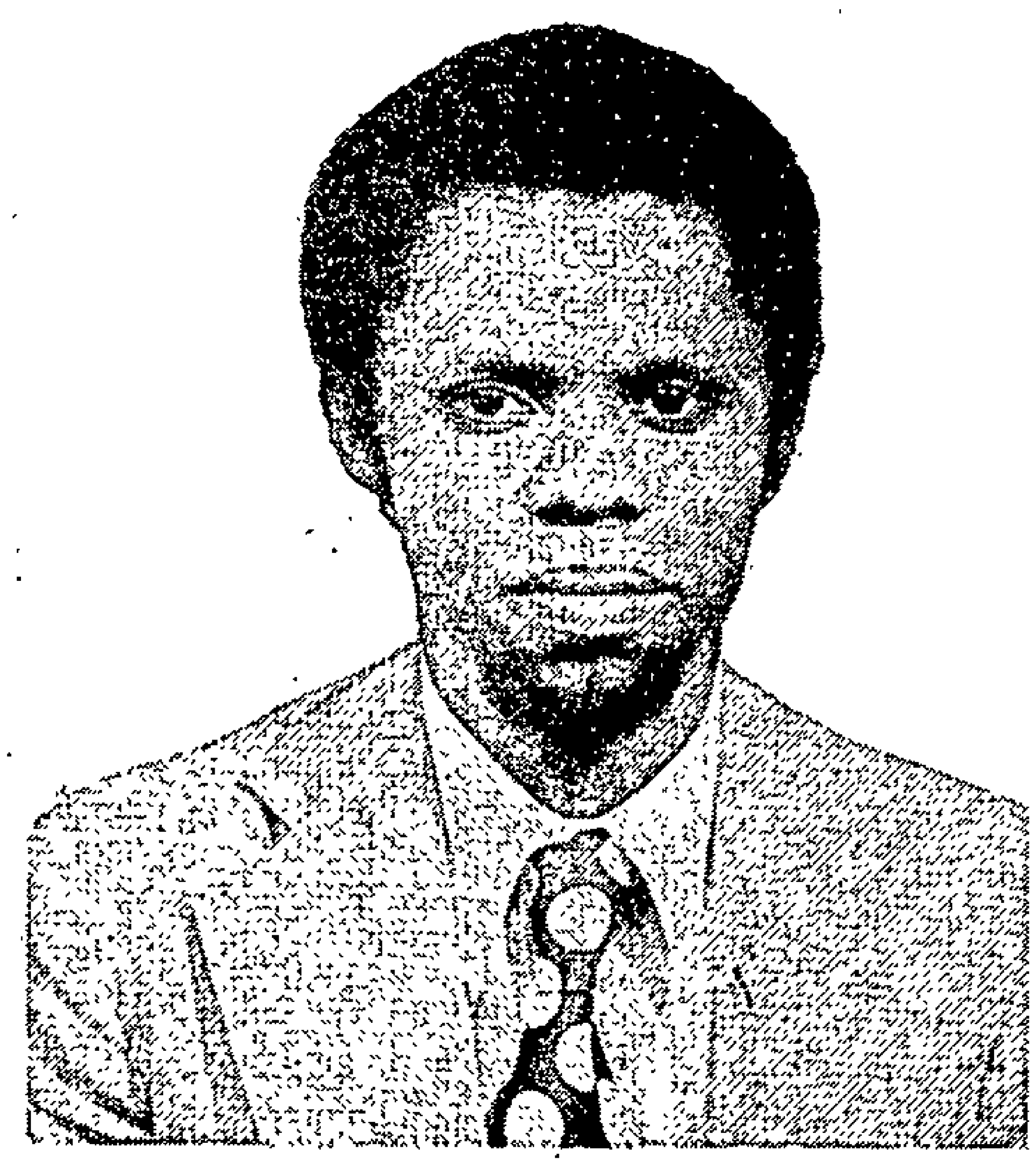
OECD Report on Transfer Pricing and Multinational Enterprises

(*Bulletin* October 1981)

In footnotes 4 and 16 (at pages 436 and 442, respectively) to the article of Mr. Nathan Boidman entitled "International Tax Avoidance – The Impact on Legal Systems", it was erroneously indicated that the OECD Report on Transfer Pricing and Multinational Enterprises was published by the Dutch publishing house Kluwer. It was brought to the Editors' attention that it was the OECD which published this Report. No reprint published by Kluwer exists.

Impact of Residence on Tax Liability in Nigeria

by A. C. Ezejelue*



I. INTRODUCTION

The importance of the determination of residence for income tax purposes in Nigeria, in fact in many countries, cannot be over-emphasized. Its necessity may vary, depending upon the tax laws of the country concerned. In Nigeria the determination of residence has relevance for a number of reasons, including:

(a) the determination of whether a person is liable to Nigerian tax;
(b) the determination of the relevent tax authority[1] for purposes of income tax, and hence the tax authority[2];
(c) the determination of whether an income has been "accrued in", "brought into", "received in" or "derived from" Nigeria for purposes of taxing non-residents[3];
(d) the determination of whether a non-resident Nigerian could be assessed on the "remittance" basis;
(e) the determination of the double taxation relief[4] in respect of commonwealth income tax;
(f) the determination of liability to Capital Gains Tax[5];
(g) the determination of entitlements to personal reliefs[6] and incomes subject to deduction at source.[7]

The importance of residence is further highlighted by Section 4 of Income Tax Management Act (ITMA) 1961 (as amended) which provides that tax shall be payable upon income accruing in, derived from, brought into, or received in Nigeria in respect of gains, profits, salaries, wages, fees, rent, dividends and pensions among others. Whether these incomes are subject to Nigerian tax depends on whether they arise in Nigeria or are remitted to Nigeria from outside.

For an exhaustive treatment of the subject we shall examine the meaning of residence and thereafter, for convenience, discuss it from the two aspects of "extra-territoriality" and "intra-territoriality", incorporating where necessary the positions of juristic persons.[8] The issue of "extra-territoriality" will deal with whether a taxpayer is deemed to be resident in Nigeria or not, and "intra-territoriality" will deal the State or territory of residence within Nigeria.

II. MEANING OF RESIDENCE

A. Indicative rules

Neither Section 3(2) of, and the First Schedule[9] to, ITMA nor any other known Nigerian Tax Acts defined the terms "residence", or "ordinary residence" despite the free use of the terms in the Acts. This position is not peculiar to Nigeria. According to Colley and Newman,[10] there is no definition of "resident" in the Canadian Income Tax Act, and it has been stated about Britain by many authors[11] that "residence" and "ordinary residence" are not defined by the Tax Acts.

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1. "Relevant tax authority" means, in relation to an individual for a year of assessment, the tax authority of the territory on which the individual is deemed to be resident for that year. See Section 2 of the Income Tax Management Act 1961 (ITMA) (as amended). The Section also states what it means in relation to an executor, a trustee, a partnership, and a village. However the Federal Board of Inland Revenue is the relevant tax authority in respect of persons, such as members of the armed forces, to whom the Income Tax (Armed Forces and other persons) (Special Provisions) Act (Decree No. 51) of 1972 applies (see Section 1(2) (a) (1) of Decree No. 51).
2. "Tax authority" means the person or body of persons responsible under a law of a territory imposing tax on the income of individuals for the administration of that law. See Section 2, ITMA.
3. The terms "accrued in", "derived from", "brought into" and "received in" have been compared, or likened, or contrasted, or explained in decided cases. See, for example: *Re John Robert Potter* 11 WACA 144; *Toufic Karam v. Commissioner for Income Tax* 12 WACA 331.
4. See Sections 22, 23 and 10, ITMA.
5. See Sections 2 and 46, Capital Gains Tax Act, 1967.
6. See Section 20A(3), ITMA as amended by Schedule 1 of Income Tax Management (Uniform Taxation Provisions, etc.) Act, 1975 (No.7).
7. See, for example, Section 14, Finance Law (Eastern Nigeria), 1962 as amended.
8. Juristic persons are those things or groups of persons which the law deems capable of holding rights and duties. Corporations, which in Nigerian law are either corporation aggregate or corporation sole, typify juristic persons.
9. The First Schedule to ITMA deals with the determination of residence.
10. G.M. Colley an E.J. Newman, *Tax Principles to Remember - An introductory course in Canadian Income Tax* (Toronto; CICA publications, 1973), pp. 2-6. See also Section 250 of Canadian Income Tax Act, 1973-74.
11. See, for example, Mervyn Lewis, *British Tax Law* (London, M&E 1977), p. 296. See also R. Glynne Williams, *Comprehensive Aspects of Taxation* (London, Cassell, 1980), p.157.

As a guide to the determination of residence our Tax Law enumerated some factors and circumstances the consideration of which would be necessary to determine residence or non-residence. Some of these factors are based on the following, among others:
(a) whether it is an earned income, an unearned income, or a Nigerian pension;
(b) whether the employment is foreign or Nigerian;
(c) whether the taxpayer has a "place of residence" or a "principal place of residence";
(d) whether the non-resident can be deemed to be resident in Nigeria for a period or periods amounting to 183 days or more in that year;
(e) whether the income is earned in or outside Nigeria;
(f) whether the tax is imposed on an individual, an executor, a trustee, a partnership, a family, a community, a body of individuals, a corporation sole, a limited liability company.

B. A matter of fact

It follows from the foregoing that no single factor will necessarily be decisive to determine residence in any situation. It is in fact a matter for the courts to determine whether a person is resident in Nigeria or not and if so where, depending on the particular set of facts available.

Residence is normally a question of fact. It has nothing to do with the person's legal right to reside[12] and does not depend on the individual's domicile.[13] It has been established by *Lloyd v. Sulley*[14] that a person can be resident in two countries. The terms should be construed in their ordinary sense[15] since they possess no technical or special connotation. According to Lord Buckmaster, *"It may be true that the word 'reside' or 'residence' in other Acts may have special meanings, but in the Income Tax Acts it is, I think, used in its commonsense meaning and it is essentially a question of fact whether a man does or does not comply with its meaning."*[16]

However, attempts have been made in some decided cases to attach some connotations to the terms. In *Levene v. C.I.R.*[17] Lord Cave stated, *"I think that 'ordinary residence' connotes residence in a place with some degree of continuity and apart from accidental or temporary absences"*,[18] and Lord Warrington of Clyffe emphasized, *"If it has any definite meaning I should say it means according to the way in which a man's life is usually ordered."*[19] In *Lysaght v. IRC*[20] Lord Buckmaster concluded, inter alia, *"... if residence be once established, 'ordinary residence' means in my opinion no more than that the residence is not casual and uncertain but that the person held to reside does so in the ordinary course of his life."*

III. DETERMINATION OF EXTRA-TERRITORIAL RESIDENCE

A. Residence of persons working abroad

It would appear from the relevant provisions of the Act that a resident abroad can be deemed to be resident in Nigeria only if the person has spent in the aggregate at least 183 days in Nigeria in the year of assessment under consideration. It follows therefore that a person who is in Nigeria for some temporary purpose only and not with the intention of establishing his residence there shall not be deemed to be resident in Nigeria if he has not spent in the aggregate at least 183 days in Nigeria in that year of assessment.

The Tax Act specifically provides that *"any income of an individual chargeable to tax solely by reason of it being brought into or received in Nigeria during any year preceding a year of assessment if the individual is not in Nigeria at any time during that year of assessment, or is not in Nigeria for a period or periods amounting to 183 days or more during that year of assessment"*[21] shall be exempt from Nigerian tax.

Using the same criterion of 183 days as a measure of residence in Nigeria, paragraph (e) of the Third Schedule to ITMA specifically exempts from Nigerian tax the following interest accruing to any person who is not resident in Nigeria:
(a) the interest on any loan charged on the public revenue of the Federation and raised in the United Kingdom;
(b) the interest on any bond issued by the Government of the Federation to secure repayment of the loan raised from the International Bank for Reconstruction and Development under the authority of the Railway Loan (International Bank) Ordinance, 1958;
(c) the interest on any moneys borrowed by the Government of the Federation or of a Region *(now State)* upon terms which include the exemption of such interest from tax in the hands of any non-resident person;
(d) where the Minister of Finance of the Federation so consents, the interest on any moneys borrowed outside Nigeria by a corporation established by a law in Nigeria upon terms which include the exemption of such interest from tax in the hands of any non-resident person.

It seems that the criterion of 183 days is not peculiar to Nigeria. For example, Section 51(2) of the British Taxes Act 1970 provides that a person shall be treated as resident in the United Kingdom only if he has in the aggregate spent at least 6 months in the United Kingdom in that year of assessment. A comparable rule is extended to chargeable income on persons in respect of profits or gains received from possessions or securities outside of the United Kingdom.[22] According to the British Inland Revenue Booklet[23], 6 months is regarded as an aggregate of 183 days, notwithstanding that the year is a leap year.

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12. See *Bayard Brown v. Burt* (1911) 5 T.C. 667.
13. *Cooper v. Cadwalader* (1904) 5 T.C. 101.
14. (1884) 2 T.C. 37.
15. *Lysaght v. I.R.C.* (1928) 13 T.C. 511; A.C. 234.
16. Id., at pp. 533-4.
17. (1928) A.C. 217; T.C. 486.
18. Id., at p. 225.
19. Id., at p. 232.
20. (1928) 13 T.C. 511, 533-4.
21. See Para. (x) of Third Schedule to ITMA.
22. See Section 51 (1) of British Taxes Act 1970.
23. See IRB, Paragraph 8 of IR 20, *Residents and Non-Residents,* 1973.

Similar provisions are found in the Canadian Income Tax Act. Subsection 250(1)(a)[24] extended the persons deemed to be resident in Canada throughout a taxation year to include a person who sojourned[25] in Canada in the year for a period of, or periods the aggregate of which is, 183 days or more.

The fact of the 183-day criterion is not based on the existence of an established place of residence.[26] Provided that the person spends an aggregate of 183 days in Nigeria, the availability of a permanent abode is irrelevant. Places of temporary lodging will satisfy this particular condition of residence. Confirming the question of an abode in this respect, Rowlatt, J. said:

> *··· one must remember ··· that one must not look for an establishment ··· a tramp has a 'residence' ··· If a man chooses to live at hotels instead of in his own house, or even stay with friends, it really does not affect the question of residence.*[27]

Cooper, expressing the same view, said: *"where he [the taxpayer] is engaged whole-time in an office or employment all the duties of which are performed abroad, the question of his residence is determined without regard to the existence of an available 'abode'"*.[28]

One implication of the 183-day sojourn rule in Canada is that such a taxpayer will not be treated as a part-year resident, but will be deemed to have been resident in Canada throughout the year, and therefore will be liable to taxation in Canada on his world income for the entire year, subject to appropriate credits for foreign taxes paid on the same income.[29] But it seems that in Nigeria, the liability should be restricted to that part of the income which is brought into or received in Nigeria.[30]

It is to be noted, however, that remuneration from an employment by a Government in Nigeria is liable to Nigerian tax, wherever the remuneration is paid, if the employee performs the duties of that employment in a country other than Nigeria, which country under an agreement or diplomatic usage exempts the employee from tax on that remuneration.[31]

B. Some foreign nationals working in Nigeria

Although it seems that liability to Nigerian tax is based on residence, there are a few instances in which exemptions under certain conditions are granted to foreign nationals working in Nigeria. These instances include the following incomes which are exempted from Nigerian tax:

(i) *Consular fees*[32]

All consular fees received on behalf of a foreign state, or by a consular officer or employee of such a state for his own account, and all income of such an officer or employee other than income in respect of any trade, business, profession or vocation carried on by such an officer or employee or in respect of any other employment exercised by him, within Nigeria; provided that this exemption shall not apply where such an employee is engaged on domestic duties or where such an officer or employee ordinarily resides in Nigeria and is not also a national of such foreign state.

(ii) *Certain emoluments payable from U.K. funds*[33]

The emoluments payable from United Kingdom Funds to members of Her Majesty's Forces and to persons in the permanent service of the United Kingdom Government in Nigeria in respect of their offices under the United Kingdom Government and the emoluments payable to members of the armed forces of any power or body allied to or associated with the Federation, including the emoluments payable to members of any civilian component, and the income of any authorized service organisation accompanying any such visiting force; provided that this exemption shall not apply to any individual who is a citizen of Nigeria or who ordinarily resides in Nigeria.

(iii) *Gains from ships or aircraft operated by non-residents*[34]

Gains or profits from the business of operating ships or aircraft carried on by an individual not resident in Nigeria in so far as in the case of ships the business is not carried on in inland waters only and by means of ships to which the provisions of Part IV of the Shipping and Navigation Ordinance apply; provided that:

(a) the relevant tax authority is satisfied that an equivalent exemption from tax is granted by the country in which such individual is resident to persons resident in Nigeria;
(b) a person shall be deemed to be resident in that country only in which the central management and control of his business are exercised.

It is to be noted that the provision in relation to companies (as will be discussed later) is different.

C. Employments wholly or partly performed in Nigeria

Where the duties of an employment are wholly or partly performed in Nigeria, the remuneration from such an employment is deemed to be derived from Nigeria and therefore subject to Nigerian tax.[35] There is, however, no liability to Nigerian tax if;

(a) the duties are performed on behalf of an employer who is in another country;
(b) the employee is not in Nigeria for 183 days or more in a year of assessment and

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24. See Canadian Income Tax Act 1973-74, part XVII.
25. The word "sojourned" implies "stayed temporarily".
26. "Place of residence" in relation to an individual means a place available for his domestic use in Nigeria on a relevant day, and does not include any hotel, rest-house or other place at which he is temporarily lodging unless no more permanent place is available for his use on that day. See Paragraph 1 of First Schedule to ITMA.
27. *Lysaght v. IRC* (1928) 13 T.C. 511, 516.
28. J.M. Cooper, "Employment Abroad and Tax Liability", *The Certified Accountants Journal*, February, 1970, pp. 106-108.
29. G.M. Colley and E.J. Newman, op. cit., pp. 2-6.
30. See Section 4 of, and Paragraph (x) of Third Schedule to ITMA.
31. Section 8(2).
32. See paragraph (b) of Third Schedule to ITMA.
33. See paragraph (c) of Third Schedule to ITMA.
34. See paragraph (d) of Third Schedule to ITMA.
35. Section 8(1)(a).

(c) such remuneration is liable to tax in that other country.[36]

Such a remuneration will, however, be liable to Nigerian tax if the employer is in Nigeria, unless the duties of the employment are wholly performed, and the remuneration paid, in a country other than Nigeria save during any temporary visit to or leave in Nigeria.[37] This latter provision of our law appears to be in line with the position in Britain where if a person works full-time in an office or employment, the question of whether he is resident in the United Kingdom is to be decided without regard to any place of abode maintained in the United Kingdom for his use, provided that all the duties of the office or employment are performed outside the United Kingdom.[38] In this regard, any duties of an office or employment performed in the United Kingdom are treated as overseas duties provided, inter alia, that they are merely incidental to the other duties outside the United Kingdom. Duties of an employment performed in the United Kingdom which were qualitatively of a similar nature to duties outside the United Kingdom were, in *Robson v. Dixon,*[39] held not to be merely incidental to the other duties outside the United Kingdom. One expects that the Nigerian situation will follow exactly the British approach when put to test. Hence it is provided in Section 8(5) of ITMA that remuneration from any employment the duties of which are mainly performed outside Nigeria shall be deemed to be derived from Nigeria to the extent that those duties are performed in Nigeria.

Temporary absence on duty from Nigeria is without prejudice to Nigerian tax liability if the duties of the employment are wholly or mainly performed in Nigeria.[40]

D. Certain interest on foreign loans

Section 11 of ITMA as amended by Decre No. 65 of 1966 provides a number of conditions under which the income from any interest on money lent by an individual or an executor, or a trustee, outside Nigeria to a person resident, present or in Nigeria at the time of the loan shall be deemed to be derived in Nigeria and therefore subject to Nigerian tax. Specifically, these conditions are:

(a) if there is a right to payment of the interest in Nigeria;
(b) if the interest is by deed, will or otherwise charged upon or reserved out of real or personal estate situated in Nigeria, the property of the person paying the same, or as a personal debt or obligation by virtue of any contract which is entered into in Nigeria; or
(c) in the case of money lent to a Nigerian company, the loan is evicenced by mortgage, debenture, loan or other stock, whether secured or unsecured, issued by the company in recognition of its debt;
(d) if the interest is payable on money lodged at interest in Nigeria.

The conditions are, however, different in the case of companies. For companies, interest shall be deemed to be derived from Nigeria if:

(a) there is a liability to payment of the interest by a Nigerian company or a company in Nigeria regardless of where or in what form the payment is made; or
(b) the interest accrues to a foreign company or person from a Nigerian company or a company in Nigeria regardless of how the interest may have accrued.[41]

E. Business partially carried on in Nigeria by non-residents

The gains or profits from a trade or business the operations of which are only partially carried on in Nigeria by an individual, or an executor, or a trustee who is outside Nigeria, shall be deemed to be derived from Nigeria to the extent to which such gains or profits are not attributable to that part of the operations carried on outside Nigeria.[42]

IV. DETERMINATION OF INTRA-TERRITORIAL RESIDENCE

The issue of residence for income tax purposes in Nigeria does not stop with the determination of whether the taxpayer is subject to Nigerian tax. It extends to the determination of *intra-territorial residence,* i.e. the determination of the taxpayer's relevant tax authority in relation to any of the States or the Federal territory of Lagos. This latter issue of residence had greater impact on taxpayers before the promulgation of the Uniform Taxation Decree of 1975 when rates of taxes as wel as reliefs and allowances varied from one State to another. Some States were then "high-tax" States and others were "low-tax" States. But the rates, reliefs and allowances have since 1975 been unified.

The determination of intra-territorial residence is provided for in Section 3 of and the First Schedule to ITMA as amended. Generally, an individual other than an itinerant worker is subject to tax, for any year of assessment, in the State in which he is deemed to be resident.[43] However, the Act provides rules and positive indications as to the circumstances in which the question of a taxpayer's residence within Nigeria is to be decided. These rules, which hinge on a number of factors, are discussed separately for clarity.

A. Persons holding foreign employments[44]

An individual who holds a foreign employment on the relevant day[45] in a year of assessment is deemed to be resident for that year in the territory or State in which the principal office of his employer is situated on that day.[46]

36. Section 8(1)(a) (i-iii).
37. Section 8(1)(b).
38. See Section 50, British Taxes Act, 1970.
39. (1972) 48 T.C. 527.
40. Section 8(4).
41. See Section 8(2), Companies Income Tax Act (CITA), 1979.
42. Section 5, ITMA (as amended by Section 3(1) of Decree No. 58 of 1968).
43. Section 3(2).
44. "Foreign employment" means any employment the duties of which are wholly performed outside Nigeria save during a temporary visit of the employee to Nigeria (see paragraph 1 of First Schedule to ITMA).
45. "Relevant day" in relation to Nigeria is the first day of January; year of assessment being a period of twelve months commencing on the first day of January.
46. Paragraph 2 of First Schedule.

But where he first becomes liable to income tax in Nigeria for a year of assessment by reason of his entering such foreign employment during that year, he is deemed to be resident for that year in the State where the principal office of his employer is situated on the day his foreign employment commences.[47]

B. Persons holding Nigerian employment[48]

Paragraph 3(1) provides that an individual who holds Nigerian employment on the relevant day in a year of assessment is deemed to be resident for that year in the State in which he has a place or principal place of residence[49] on that relevant day. Where the individual first becomes liable to income tax in Nigeria in a year of assessment by reason of his entering such Nigerian employment during that year, he is deemed to be resident for that year in the territory where he has a place or principal place of residence on the day on which he assumed the full duties of that employment in Nigeria.[50] However, paragraph 3(1) has a proviso to the effect that if an individual is on leave from Nigerian employment on the relevant day in a year of assessment, he shall be deemed to be resident for that year in the State where he had his place or principal place of residence immediately before his leave began.

C. Persons in full-time employment in the Nigerian armed forces

Paragraph 3(2) makes a sharp exception to the provisions of paragraph 3(1) as it concerns individuals who are in full-time employment in the Nigerian armed forces whether in a military or civilian capacity. Such individuals who are so employed on the relevant day in a year of assessment, or who first become liable to income tax in Nigeria for that year by reason of being so employed during that year, shall be deemed to be resident for that year in the Federal territory of Lagos.

This provision is, however, subject to the proviso that the aggregate tax collected from such individuals for each year of assessment shall be apportioned between the States either by reference to the place where each such individual has resided longest during that year, or by any other basis acceptable from time to time to the State Governments. This proviso is highlighted by Section 149 of the Constitution of the Federal Republic of Nigeria, 1979, which excepted the proceeds from the personal income tax of the personnel of the armed forces of the Federation, the Nigerian police force, the ministry or department of government charged with responsibility for external affairs and the residents of the Federal Capital Territory from the special account of the Federation called "the Federation Account" into which shall be paid all revenues collected by the Government of the Federation. It is, however, further subjected to the constitutional provision that where under an Act of the National Assembly, tax or duty is imposed in respect of any of the matters specified in item D of Part II of the Second Schedule to the Constitution (which includes imposition of income tax on certain persons), the net proceeds of such tax or duty shall be distributed among the States on the basis of derivation.[51].

D. Employees with indeterminate residence status

An employee whose remuneration is subject to income tax in Nigeria for any year of assessment, but whose residence cannot be determined under the provisions relating to individuals who hold Nigerian employment, shall be deemed to hold foreign employment. If thereafter his residence cannot be determined by reference to the provisions relating to persons who hold foreign employment, he shall be deemed to be resident in Lagos.[52] This is subject to treating as coming under the authority of the Federal Board of Inland Revenue:[53]

(a) persons employed in the Nigerian army, navy or air force other than in a civilian capacity;
(b) officers of the Nigerian foreign service;
(c) persons in receipt of Nigerian pensions where such pensions are payable overseas; and
(d) persons resident outside Nigeria who are shareholders of Nigerian companies.

E. Pension as only source of earned income[54]

Paragraph 5(1) provides that an individual whose only source of earned income arising in Nigeria on a relevant day in a year of assessment is a pension shall be deemed to be resident where he has a place or principal place of residence on that day. But if such an individual has no place of residence on that day, he shall be deemed to be resident:

(a) if the pension is a Nigerian pension[55] wholly payable by a State Government, in that State;
(b) if the pension is not a Nigerian pension, in the place in which the principal office in Nigeria of the pension fund or other person authorising payment of the pension is situated.[56]

Where however the pension is a Nigerian pension payable by more than one Government or if there are two or more pensions arising in different territories to the individual on that day, the individual shall be subject to the Federal Board of Inland Revenue.[57]

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47. Id.
48. "Nigerian employment" means any employment, not being a foreign employment, the duties of which are wholly or partly performed in Nigeria (see paragraph 1 of First Schedule).
49. Where an individual has more than one place of residence in different territories on a relevant day, his "principal place of residence" means: (a) if his only source of earned income is a pension liable to tax in Nigeria, the place in which he usually resides; (b) if he has a source of earned income, other than a pension, liable to tax in Nigeria, the place which on a relevant day is nearest to his usual place of work (see paragraph 1 of First Schedule).
50. Paragraph 3(1) of First Schedule.
51. See Section 150 of the Constitution of the Federal Republic of Nigeria, 1979.
52. Paragraph 4 of First Schedule.
53. See Income Tax (Armed Forces and other persons) (Special provisions) Act, 1972, Section 1(1) and (2).
54. "Earned income" of an individual means remuneration from employment; income derived from a trade, business, profession, or vocation; and a pension derived in respect of past service, (see paragraph 1 of First Schedule).
55. "Nigerian pension" means a pension in respect of past service under, and payable by, a Government or Governments in Nigeria (see paragraph 1 of First Schedule).
56. Paragraph 5(2) of First Schedule.
57. See Income Tax (Armed Forces, etc.) Act 1972, Section 1(3).

F. Earned incomes other than from employment or pension

An individual who has a source of earned income in Nigeria, other than from an employment or a pension, for a year of assessment is deemed to be resident for that year in the territory where he has a place or principal place of residence on the relevant day of that year.[58] If, however, the source of such earned income is first acquired by the individual during the year of assessment and he has no place of residence on the first day of that year, he is deemed to be resident for that year in the State where he first establishes a place of residence during that year. The paragraph further provides that in any other case the individual shall be deemed to be resident for that year in any place from which any part or the whole of his earned income arising in Nigeria is derived, if such income is derived from more than one territory.

G. Unearned income

Paragraph 7 of the First Schedule provides that an individual whose only income in Nigeria for a year of assessment is derived from unearned sources is deemed to be resident for that year in the State where he has a place or principal place of residence on the relevant day in that year. But if he has no place of residence on the first day of that year, he is resident:
(a) if all such unearned income arises in one State, in that State:
(b) if all such unearned income arises in more than one State, in the territory from which any part of the unearned income arises.

H. A corporation sole or a body of individuals

A corporation sole or a body of individuals (other than a family or community) shall be deemed to be resident for a year of assessment in the territory in which its principal office in Nigeria is situated on the relevant day in that year.[59] If it has no office in Nigeria on that day, it is deemed to be resident in the territory in which any part or the whole of its income liable to tax in Nigeria arises for that year.

I. Community income and family income

Section 3(4) of the Act provides that in the case of a village or other indigenous community, tax may be imposed for any year only by the legislature of the State in which that community is found. It is to be noted that such tax may be based on:
(a) the estimated total income of all its members; or
(b) the estimated total income of those of its members whose income, in the opinion of the relevant tax authority, it is impracticable to assess individually; or
(c) the amount of any communal income which, in the opinion of the relevant tax authority, it is impracticable to apportion with certainty among its members.

But in the case of a family income recognised as such under any law or custom in Nigeria, and in which the several interests of individual members of the family are indeterminate or uncertain, tax may be imposed only by the State in which the member of the family who customarily receives that income in the first instance in Nigeria usually resides.[60]

J. Income of settlements, trusts and estates

Income tax on income arising to a trustee of any settlement or trust, or to an executor of any estate of a deceased person, may only be imposed by the relevant tax authority in relation to such settlement, trust or estate.[61]

In relation to an executor, the relevant tax authority is the tax authority of the territory in which the deceased individual was last deemed to be resident or would have been deemed to be resident if the provisions of the Act had been in force prior to the date of his death.[62] But in relation to a trustee of any trust or settlement the relevant tax authority becomes:
(a) where all the income of the settlement or trust for a year of assessment arises in one territory, the tax authority of that territory; or
(b) where the income arises in more than one territory, or where the relevant tax authority cannot otherwise be determined, the Federal Board of Inland Revenue.[63]

The foregoing is subject to treating any part of the computed income which accrues to any beneficiary under the terms of the deed of settlement or trust or will under the discretion of the trustee or executor as income of that year which is assessable to tax in the hands of the beneficiary.[64] In that case, the relevant tax authority of the beneficiary becomes the tax authority of the State in which the beneficiary resides. This is further subject to the provision that if during the life of the settlor any income is paid to or for the benefit of a child of the settlor who is an infant and unmarried, that income shall be treated as the income of the settlor for that year of assessment.[65]

K. Itinerant workers[66]

Tax may be imposed on an itinerant worker for any year by any territory in which he is found during that year.[67] However, in assessing him for any year, credit shall be given against the tax payable, but not exceeding the amount thereof, for any income tax he may already have paid to any other tax authority for the same year. If an itinerant worker leaves any territory in any year of assessment with an unpaid tax in that territory, the collection of such unpaid tax shall remain in abeyance during his absence in that territory. But if he returns to that territory, having during his absence paid tax in another

58. Paragraph 6 of First Schedule.
59. Paragraph 9 of First Schedule.
60. Section 3(5), ITMA.
61. Section 3(6), ITMA.
62. Section 2, ITMA.
63. Id.
64. See paragraph 3 of Second Schedule to ITMA.
65. Id., paragraph 4(1).
66. An itinerant worker is an individual who works at any time during a year of assessment (exept in the armed forces) for a daily wage or who customarily earns his livelihood in more than one place in Nigeria and whose total income does not exceed N 400. (see Section 2, ITMA).
67. Section 3(3), ITMA.

territory for the same year, he will be given credit against that unpaid tax in the first-mentioned territory (but not exceeding that unpaid amount) for the tax paid in that other territory.

The effect of Section 3(3) is that any State in which an itinerant worker is found may collect some tax from him as long as the tax imposed by the present State is greater than the aggregate amount of tax he may have paid in other States that might have imposed tax on him in that same year. However, such individuals are not easily traced because they have no known or fixed address anywhere.

L. Partnership income

The income of a partner from a partnership in Nigeria shall be deemed to be derived from the territory of the relevant tax authority[68] in relation to that partnership.[69] But where the partner is taxable for a year of assessment in the territory of some other authority, by virtue of his residence status, the relevant tax authority in relation to the partnership shall supply to that other authority particulars of the determination of the income or loss of that partner from the partnership.[70] However, an appeal against an assessment by any partner, no matter to which tax authority he pays his tax, shall lie only to the appeal tribunal or court specified for income tax purposes in a law of the territory the tax authority of which is the relevant authority in relation to that partnership.[71]

V. LIMITED LIABILITY COMPANIES[72]

Companies are subject to the Companies Income Tax Act 1979 (CITA) as amended. Tax is payable at the specified rate for any year of assessment upon the profits of any company accruing in, derived from, brought into, or received in Nigeria in respect of any trade or business, rent, dividends, interest, discounts, charges, annuities, etc.[73] Companies which are liable to Nigerian tax are deemed to be resident in the Federal capital of Nigeria irrespective of their location, and their profits are assessed to tax by the Federal Board of Inland Revenue.[74]

A. Nigerian companies[75] and non-Nigerian companies

The profits of a Nigerian company shall be deemed to accrue in Nigeria wherever they have arisen and whether or not they have been brought into or received in Nigeria.[76] But the profits of an non-Nigerian company from any trade or business shall be deemed to be derived from Nigeria only to the extent to which such profits are not attributable to any part of the operations of the company carried out outside Nigeria.[77] Whether any part of the operations of the company is carried out in Nigeria is a matter of fact.

It is unlikely that the profit of a company incorporated, managed and controlled outside Nigeria will be deemed to be derived from Nigeria if all that the company does is to do business with Nigeria. This is different from a situation where the business is operated in Nigeria, and has staff who reside and work for it in Nigeria on its payroll. The profit of a company whose presence in Nigeria is only for the purposes of installation or similar services may not be deemed to be derived from Nigeria. But even where such a profit of a non-Nigerian company is deemed to be derived from Nigeria it could be exempted as commercial profit of a non-resident company which has no permanent establishment in Nigeria; provided that it comes within the terms of a double taxation arrangement existing between Nigeria and the country of residence of the company.

Before the promulgation of the 1979 Companies Income Tax Act which took effect from April 1, 1977, a company was a Nigerian company only if the control and management of its activities were exercised in Nigeria.[78] Although the place of incorporation was important, it was not decisive. Consequently, the position then was that a company which was incorporated under the Nigerian law might be a non-Nigerian company if its management and control were exercised outside Nigeria. What constituted management and control was a matter of fact.[79] Under that condition, what was established in an English case of *De Beers Consolidated Mines Limited v. Howe*,[80] that a company resides where "the central management and control actually abides", was of particular relevance to Nigeria.

Since 1977, drastic changes have taken place in Nigeria. The concept of residence of a company is now based on whether or not the company is incorporated under Nigerian law, and no longer on the place of effective management and control. It follows, therefore, that the findings in some English cases - that registration (though a strong circumstance to be taken into consideration) is not of itself a sufficient test of residence,[81] or that a company is capable of having double residence where control of its general affairs is distributed among more than one coun-

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68. The relevant tax authority in relation to a partnership for a year of assessment is the tax authority of the territory in which the principal office or place of business of that partnership in Nigeria is situated on the first day of that year or is first established during that year (see Section 2, ITMA).
69. Section 6(6), ITMA.
70. Section 6(4), ITMA.
71. Section 6(5), ITMA.
72. "Company" means any company or corporation (other than a corporation sole) established by or under any law in force in Nigeria or elsewhere (see Section 78 of Companies Income Tax Act (CITA) 1979 as amended).
73. Section 8, CITA 1979.
74. See Sections 1 and 2, CITA 19790.
75. "Nigerian company" means any company incorporated under the Companies Act 1968 or any enactment replaced by that Act (see Section 78, CITA 1979).
76. Section 11(1), CITA 1979.
77. Section 11(2), CITA 1979.
78. See Section 2, CITA 1961.
79. See *Bullock v. Unit Construction Co. Ltd.* (1959) 38 T.C. 712; 38 A.T.C. 351. *Apthorpe v. Peter Schoenhofen Brewing Co.* (1899) 4 T.C. *Kodak v. Clark* (1903) 4 T.C. 549. *Stanley v. Gramophone & Typewriter Co.* (1908) 5 T.C. 358.
80. (1906) A.C. 455; 5 T.C. 198. See also *Swedish Central Railway Co. Ltd. v. Thompson* (1925) A.C. 495; 9 T.C. 342.
81. *See Cesena Sulphur Co. v. Nicholson* (1876) 1 T.C. 88; *Swedish Central Railway Co. v. Thompson* (1925) A.C. 495, 9 T.C. 342;*Egyptian Delta Land and Investment Co. v. Todd* (1929) A.C. 1, 14 T.C. 119.

try[82] - cannot apply to Nigeria.[83] The same is true of the decision in the *American Thread Co. v. Joyce*,[84] that a company registered abroad could be resident in the United Kingdom for the purpose of assessment to income tax. Once a company is registered under the Nigerian Companies Act of 1968 or any enactment replaced by it, it becomes a Nigerian company and its profits shall be deemed to accrue in Nigeria wherever they have arisen and whether or not they have been brought into or received in Nigeria. As a corollary, a company incorporated under a law other than Nigerian law but which is managed and controlled in Nigeria shall not be deemed to be a Nigerian company.

It is worth noting that any income accruing or derived from the use in Nigeria of the asset of a foreign company,[85] where no accounts in respect of such income have been rendered, shall be liable to Nigerian tax at the specified rate, subject to a deduction of 45% of such income as capital allowance and for other expenses.[86] Section 9 of CITA 1979 also provides for the imposition of appropriate tax on interest accruing to a foreign company from Nigeria subject to some waivers granted by subsections (6) and (7) in stipulated cases relating to foreign and agricultural loans respectively.

B. Non-Nigerian companies engaged in shipping or air transport

Where a non-Nigerian company carries on the business of transport by sea or air, and any ship or aircraft owned or chartered by it calls at any port or airport in Nigeria, its profits or losses deemed to be derived from Nigeria shall be the full profits or losses arising from the carriage of passengers, mail, livestock or goods shipped, or loaded into an aircraft in Nigeria.[87] This provision will not apply to passengers, mail, livestock or goods which are brought to Nigeria solely for transshipment or for transfer from one aircraft to another or in either direction between an aircraft and a ship.

Where a non-Nigerian company carries on the business of transmission of messages by cable or by any form of wireless apparatus, it shall be assessable to tax as though it operates ships or aircraft, and the provisions which apply to ships or aircraft shall apply mutatis mutandis to the computation of its profits deemed to be derived from Nigeria as though the transmission of messages to places outside Nigeria were equivalent to the shipping or loading of passengers, mail, livestock or goods in Nigeria.[88]

VI. CONCLUSION

It has been shown that tax liability in Nigeria is inextricably tied up to the issue of residence. With only a few exceptions, all residents are generally liable to Nigerian tax. Non-residents can, in some cases, be liable to Nigerian tax if their incomes are derived from or accrue in Nigeria or if they are deemed to be resident in Nigeria for tax purposes.

The impact of residence on tax liability is of importance mainly in the case of the determination of extra-territorial residence. While a resident is invariably liable to Nigerian tax, a non-resident may escape liability. The territory of residence within Nigeria has little or no influence on the amount of tax payable. In the case of companies, the degree of liability is the same and to the same authority, notwithstanding the territory of residence of the company within Nigeria. In the case of individuals, the tax liability has remained virtually the same in all States with the introduction of uniform principles in 1975. Any differences may be in other forms of taxes such as purchase tax[89] which has not been introduced by all States. But even then, it is not solely dependent on residence per se in the State where it operates, but on the utilization of taxed facilities such as restaurants and drinking houses in those States.

In view of the importance of residence on tax liability it is expected that the tax authorities will come up with comprehensive guides, particularly for foreign nationals who do business in or with Nigeria.

82. See *Union Corporation v CIR* (1953) 34 T.C. 207, 32 A.T.C. 73.
83. The change has not extended to Pioneer Companies. To that extent, therefore, such English decisions may be of relevance to Nigeria. See the Industrial Development Income Tax Act 1971 (Pioneer Legislation).
84. (1913) 6 T.C. 163.
85. "Foreign company" means any company or corporation (other than a corporation sole) established by or under any law in force in any territory or country outside Nigeria (see Section 9(8)(c), CITA 1979).
86. Section 8(1)(g), CITA 1979.
87. See Section 12(1), CITA 1979.
88. See Section 13, CITA 1979.
89. Only a few States, such as Imo and Oyo, have introduced purchase tax in restaurants and drinking houses.

Conference Diary

JANUARY 1982

British Branch of I.F.A.: Treaty shopping. London (United Kingdom), January 19 (English).

European Study Conferences Limited: Tax planning for non-domiciled persons. How to avoid the U.K. tax net. London (United Kingdom), January 13 (English).

European Study Conferences Limited: Introduction to U.K. oil taxation. London (United Kingdom), January 21 (English).

FEBRUARY 1982

Business Perspectives Ltd.: 7th International Tax Conference (including: Developments in legislation and practice in U.S.A., U.K., Canada, Australia and the Far East as they affect companies and individuals with worldwide interests; and tax problems involved in investment in Mexico and the Caribbean area). Mexico City (Mexico), February 1-5 (English).

Management Centre Europe: International Tax Management (including: Tax treatment on technology import and export; anti tax haven legislation, handling of disputes between tax administrations). Brussels (Belgium), February 1-2 (English).

British Branch of I.F.A.: Tax haven and company residence. The revenue proposals (tax workshop). London (United Kingdom), February 9 (English).

Management Centre Europe: Leasing (including tax aspects of leasing), Brussels (Belgium), February 24-26 (English).

MARCH 1982

British Branch of I.F.A.: Indirect taxation of international services (tax workshop). London (United Kingdom), March 4 (English).

Management Centre Europe: Foreign exchange and international money management (including: Foreign exchange implications of European tax laws). Montreux (Switzerland), March 10-12 (English).

APRIL 1982

Management Centre Europe: International Tax Conference (including: Organisation of international groups; Selected tax aspects of international business planning; Governmental attitudes towards business in the tax field: the carrot and the stick). Nice (France), April 5-7 (English).

Management Centre Europe: Managing and developing foreign subsidiaries (including: Tax in international operations), Brussels (Belgium), April 5-7 (English).

MAY 1982

The Inter-American Center of Tax Administrators (C.I.A.T.): XVIth General Assembly on the basic subject: Tax evasion and tax compliance. Asunción (Paraguay), probably in May, 1982 (date unknown yet)(Spanish).

Management Centre Europe: Leasing in the 80's (including: The harmonisation of taxes in the E.E.C. and relevance for leasing). Brussels (Belgium), May 5-7 (English).

SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada), September 12-16 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: Secretariat c/o Williams & Glyn's Bank Ltd., New London Bridge House, 25 London Bridge Street. London SE19 SX (United Kingdom).

Business Perspectives Ltd.: 11 Alexander Place, London SW7 2SG (United Kingdom).

European Study Conferences Limited: Kirby House, 31 High Street East, Uppingham, Rutland, Leics. LE15 9PY (United Kingdom).

Inter-American Center of Tax Administrators (C.I.A.T.), Executive Secretary of C.I.A.T., P.O. Box 215 zona 1, Panamá.

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

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

COLOMBIA: Terms for filing 1981 income tax returns and withholding rates on dividends paid to residents during 1982

Resident taxpayers who have derived during 1981 an income over 58,000 pesos or whose gross wealth amounts to more than 230,000 pesos on December 31, 1981 must file income tax returns before May 4, 1982 in case of individual taxpayers; and before April 21, 1982 in case of corporations, partnerships limited by shares and foreign companies.

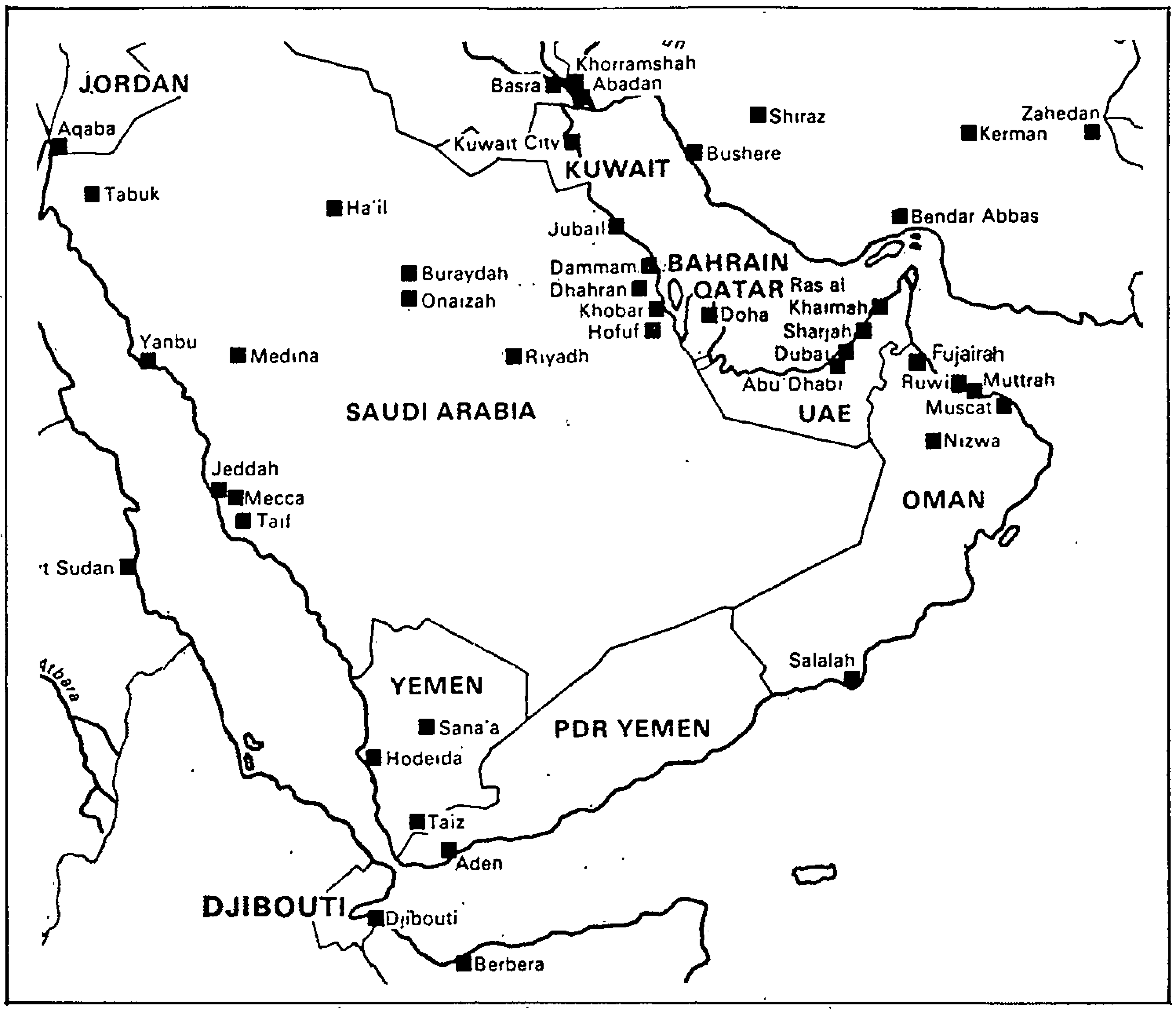
On the gross amount of dividends paid or credited monthly in 1982, the following withholding rates will be applied to residents:

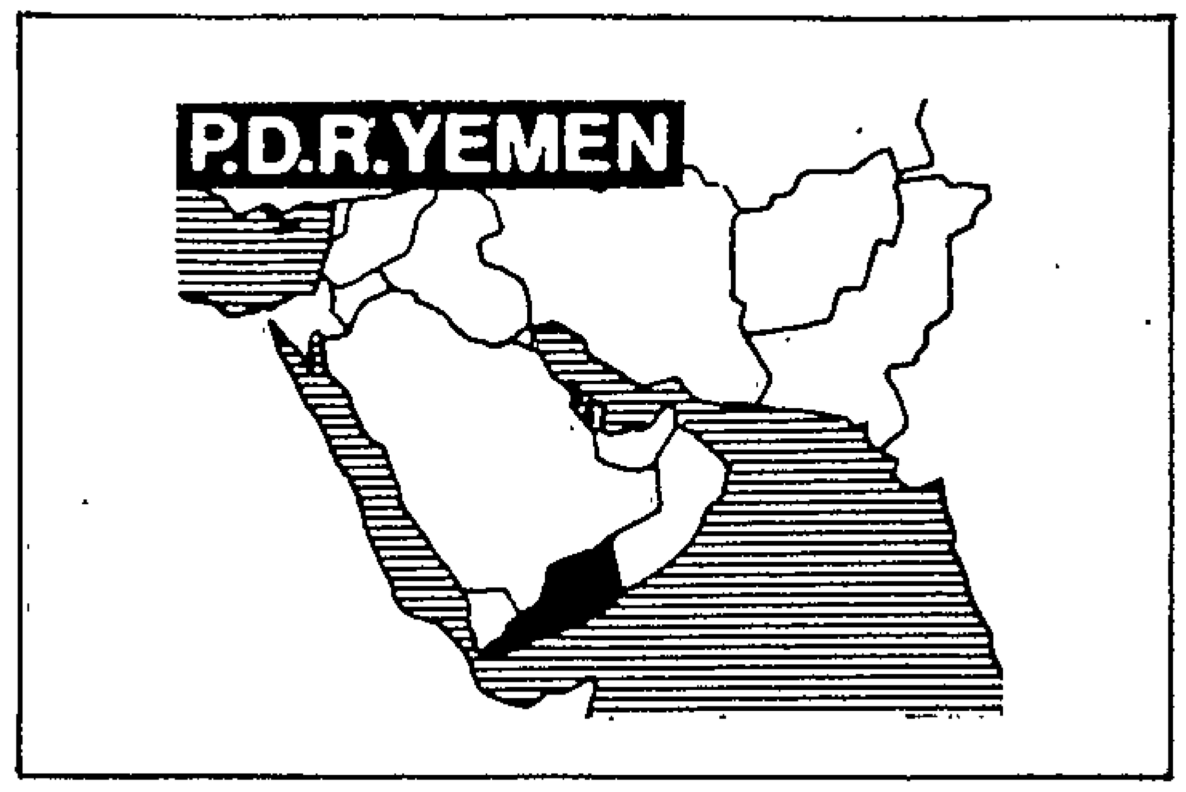
Gross dividend per month (in pesos)	*Withholding rate (%)*
Gross dividend per month (in pesos)	*Withholding rate (%)*
Up to 4,500	0
4,501– 5,000	1.0
5,001– 6,000	1.5
6,001– 7,000	2.0
7,001– 8,000	2.8
8,001– 9,000	3.5
9,001– 11,000	3.8
11,001– 13,000	4.8
13,001– 15,000	6.5
15,001– 17,000	9.2
17,001– 19,000	12.8
19,001– 21,000	16.0
21,001– 25,000	19.0
25,001– 30,000	22.5
30,001– 40,000	26.0
40,001– 50,000	30.0
50,001– 60,000	32.5
60,001– 70,000	33.5
70,001– 80,000	34.5
80,001– 90,000	35.5
90,001–100,000	36.5
100,001–110,000	37.5
110,001–120,000	38.5
above 120,001	39.8

A similar table applies to taxes withheld on wages at slightly lower rates.

Taxation of Individuals in the People's Democratic Republic of Yemen

By Ahmed Abdullah Al-kadi





Mr. Ahmed Abdulla Al-kadi, born in Aden on 3 May 1945, was a student at the Faculty of International Law and International Relations at Kiev University in the Soviet Union from 1968 to 1973. In 1973, he obtained the L.L.M. (with honours) from Kiev University and from 1973 to 1980 worked as a legal adviser to the Ministry of Finance in Aden, P.D.R.Y.

Since 1980, he has been a research associate at the Faculty of Law and Political Sciences, Department of Financial Law, Budapest University.

I. THE CONSTITUTION

Taxing competency according to the Constitution[1] is a legislative competency. The Constitution empowers[2] the People's Supreme Council, and between sessions the Presidential Council, to impose taxes by means of Laws or Decree-Laws.[3]

However, in order to be able to impose tax two requirements provided for in the Constitution have to be fulfilled. The first as indicated above is the legislation requirement: taxes may only be imposed by Law. The second requirement is that, when imposing taxes, the State should take into account the citizens' incomes, their amount of earned income and their social status,[4] i.e. married, single, etc. This should be distinguished from the administrative or executive powers of the Council of Ministers or Minister of Finance in the course of enforcing and executing the tax laws. Articles 71 and 59 of the Amended Constitution are the only two articles embodying concrete tax principles.

II. HISTORICAL BACKGROUND

Before independence,[5] taxes were of little significance except in two areas of the country: Aden Colony and Ku'aiti Sultanate.[6] In the territory of Aden Colony, the Indian Tax Law of 1922, which was the governing tax legislation in the British East African Colonies, was then in force. In Aden, it was revoked in May 1937 by Tax Law No. 4 of 1937. The latter was repealed by Law No. 5 of 1951.

1. The Amended Constitution of October 1978. The first Constitution of the Republic was the Constitution of 1970.
2. Article 71 of the Amended Constitution.
3. The power of passing Laws is vested in the People's Supreme Council. Decree-Laws are vested in the Presidential Council. Decree-Laws should be approved by the People's Supreme Council in its next session.
4. Article 59 of the Amended Constitution.
5. The country was a British Colony for 129 years. It acquired its independence on 30 November 1967.
6. Ku'aiti Sultanate was part of what is now Hadramout province, one of the six provinces in the Republic. Two kinds of taxes were then collected - tax on importers at rates ranging between 4% and 7% of the estimated value of imported goods, and taxes on high government officials.

Law No. 5 of 1951 was issued to give more relief and tax incentives for the prospering commerce in the port of Aden. It has in its turn undergone several amendments, and finally was repealed by the current Income Tax Ordinance No. 8 of 1961.

III. INCOME TAX ORDINANCE

Income Tax Ordinance No. 8 of 1961 (hereinafter, Ordinance)

Until 1969 the Ordinance was effective only in the territory of Aden province. By virtue of Resolution No. 17 of 1969, issued by the Minister of Finance,[7] the Ordinance was enforced in the entire territory of the Republic.

All direct taxes payable by individuals and legal entities, with few exceptions,[8] are laid down by this Ordinance. In its amended form, the Ordinance remains the ruling legislation in the field of direct taxation. It came into force on April 1960[9] and consists of fourteen parts and three schedules.

IV. INCOME TAX

(a) Chargeable income

Tax is charged upon the income[10] of any person in respect of:
(a) gains or profits from:
 (i) any business, for whatever period of time carried on;
 (ii) any employment or services rendered;
 (iii) any right granted to any other person for the use or occupation of any property;
(b) the occupation of premises for residential purposes;
(c) dividends, interests or discounts;
(d) any pension, charge or annuity;
(e) any amount received by way of alimony or allowance;
(f) the value receivable in respect of the use of capital, property, seed or stock for the purpose of husbandry or any share of profits receivable in respect of such use.

In addition to the above-listed sources of income, the whole of any gains or profits derived from any trade, profession or vocation carried on partly within and partly outside the Republic by a resident person or body of persons[11] shall be deemed to have accrued in or have been derived from the Republic and is, consequently, taxed under the provisions of this Ordinance.

(b) Individuals

The expression "individual" is not defined by the Ordinance, although "resident individual rate", "individual interest rate" and "non-exempt individual rate" are frequently used by the provisions of the Ordinance when computing the taxable profits and gains of individuals. However, it defines the expression "person" as including any body of persons, any corporation sole and any trustee.

The amending Law No. 52 of 1971 clearly defines the term "person" as any person whether natural or a body corporate. Hence, individuals under both the Ordinance and Law No. 52 of 1971 are all natural persons earning income from any source in any year of income. This includes workers and employees in both State and non-State sectors and private businessmen including partners in partnerships.[12]

The latest amending Law No. 5 of 1980 gave a specific definition of the expression "individuals". Section 2 of Law No.5 of 1980 interpreted "individuals" as: "Those who receive salaries and wages in accordance with the approved framework of salaries and wages for local workers and also those whose basic payments are taxed under the Special Tax Law." The reason for introducing a specific interpretation of the expression "individuals" for taxation purposes is examined in this article.

(c) A resident

A resident in a year of income (a tax year) is defined under the Ordinance as meaning when applied to a body of persons or a body corporate, etc., that the control and management of the affairs of such a body of persons is exercised in the Republic in such year of income.

The definition of resident when applied to individuals was slightly altered by Law No. 52 of 1971.

Under the Ordinance the fact that one owned a home in the Republic and was present for any period in a year of income was enough to qualify an individual as resident.

Law No. 52 of 1971 approved the test of ownership of a residence in the Republic, but the ownership must last for a period or periods of not less than six months in one year of income and the owner must have been in the Republic for a period of thirty days or more in that year of income.

An individual shall also be deemed to be resident if:
(i) he was in the Republic for a period or periods exceeding in the aggregate six months in a year of income, or
(ii) he was present in the Republic at some time during a year of income and in each of the two preceding years of income for periods averaging more than four months in each year of income.

The idea behind insisting on keeping a house for not less than six months in one year of income and being present for at least thirty days in that year of income in the Republic was a consequence of the fact that many individuals, mainly businessmen, kept homes in the Republic as well as running businesses through agents or their partners in the Republic, but were effectively settled outside the country where they conducted another business; when taxed in the Republic on their gains or profits accruing in the Republic, they applied for the resident individual rate treatment (see below).

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7. The Minister of Finance was granted such a power under Law No. 8 of 1969.
8. Special Tax Law No. 10 of 1968, and National Defence Law No. 45 of 1972.
9. Under the Ordinance, the tax year or year of income began on 1 April, and ended on 31 March. Now it coincides with the calendar year.
10. For a resident person, the chargeable income is that which accrued in, is derived from or is received in the Republic: for a non-resident, that accrued in or derived from the Republic.
11. A body of persons means any company, association, fraternity, e.g. Hindu fraternal society, fellowship or society, whether incorporated or unincorporated.
12. Partnerships are not defined in the Ordinance nor in any other tax legislation. Nevertheless, the expression partner is defined under the Ordinance as any person over the age of twenty-one who is carrying on business in partnership with any other person or persons. Chargeable income of a partnership is computed in the same way as that of a company. After deductions from gains and profits, expenses, capital depreciation losses incurred in the course of producing the chargeable income are made, the net profits are distributed to partners who are taxed at the individual tax rates.

(d) Allowances

Chargeable income as interpreted under the Ordinance means the total income of any person for any year of income less personal allowances to which he is entitled in respect of such year of income. To render more relief to certain categories of taxpayers, the interpretation of chargeable income was altered by Law No. 52 of 1971. In addition to the personal allowances any resident individual is entitled to deduct the special tax paid in that year of income. Furthermore, this interpretation was modified under Section 2 of Law No. 5 of 1980, by adding the national defence tax paid in the year of income to the personal allowances and special tax paid in that year of income. Consequently, the resident individual, in respect of any year of income, is entitled to deduct special allowances, defence tax paid and special tax paid if his income is subject to the Special Tax Law.

(1) Personal allowances

Personal allowances under the Ordinance are either married or single allowances. Schedule 2 of the Ordinance provided for 500 Y.D. (Yemeni Dinars) as married allowance and 350 Y.D. as single allowance in any year of income. Non-residents are not entitled to any personal allowances. The Ordinance, from the standpoint of personal allowances, did not discriminate between residents who are government employees and other individual residents. Law No. 22 of 1968, an amendment to the Ordinance, started the trend. Under Section 5 of Law No. 22 of 1968, the amount of married allowance was reduced to 300 Y.D. and the single allowances to 175 Y.D. for those residents who are not government or public institution employees,[13] or whose salaries, in respect of private-sector employees, are not chargeable under the Special Tax Law. These two categories of taxpayers shall, pursuant to Law No. 22 of 1968, continue to enjoy the personal allowance provided for under the Ordinance (500 and 350 Y.D.).

Furthermore, Section 4 of Law No. 5 of 1980 raised the personal allowance for the above-mentioned two categories of resident individuals to 600 Y.D. as a married allowance and 420 Y.D. as a single allowance in a year of income: other shall continue to enjoy the 300 Y.D. and 175 Y.D. married and single allowances.

(2) Family allowances

(i) Child allowance

The expression "child" includes a step-child, an adopted child and an illegitimate child. The child should be less than sixteen years old, unless it is receiving full-time instruction at any university, college, etc. For an unmarried, widowed, or divorced female child, regardless of her age, the taxpayer may claim the child allowance.

(ii) Dependent allowance

This allowance is available for those persons maintained by the taxpayer. These include wife, parent and parent-in-law.

Under the Ordinance, child and dependent allowances are 70 Y.D. This was raised by Law No. 5 of 1980 to 120 Y.D. per person. Child and dependent allowances are enjoyed provided that the subjects of the allowance do not exceed six and each of them does not earn more than 170 Y.D. from any source of income in the year of income.

(3) Other allowances

(i) Education allowance

A sum of 100 Y.D. is deducted for each child studying abroad at the personal expense of the taxpayer.

(ii) Insurance allowance

Any resident who proves that in any year of income he has paid a premium for insurance concluded by him on his life or the life of his wife; or has made a contribution to an approved pension scheme, is entitled to the insurance allowance. The amount of the insurance allowance pursuant to Law No. 5 of 1980 shall be the amount of the premiums and contributions, provided they do not exceed 200 Y.D. or one-tenth[14] of the total income of the resident in the year of income, whichever is less.

(e) Tax rates

Individual tax rates provided for in the Ordinance have been subjected to several modifications. The latest is the one provided for under Law No. 5 of 1980.

(i) *For individuals*[15]

Taxable income (Y.D.[16])		Rate
On the first	200	2.5%
On the next	200	5.0%
On the next	400	4.5%
On the next	400	10.0%
On the next	400	12.0%
On the next	400	14.0%
On the next	1,000	15.0%
On the next	1,000	16.0%
On the next	1,500	17.0%
On the next	1,500	18.0%
On the next	2,000	19.0%
in excess of	9,000	25.0%

(ii) *For others* (not individuals as interpreted under this Law)

Taxable income (Y.D.)		Rate
On the first	200	10%
On the next	200	15%
On the next	400	20%
On the next	400	25%
On the next	400	30%
On the next	400	35%
On the next	500	40%
On the next	500	45%
On the next	1,000	50%
On the next	2,000	50%
On the next	2,000	55%
On the next	2,000	60%
On the next	2,000	65%
In excess of	10,000	75%

The non-residents' rate is 20 percent on the first three slices of taxable income shown in table ii) above but otherwise is the same.

13. Wages and salaries of government and public institution workers and employees were curtailed by Law No. 1 of 1968 at the rate of 1 to 60%.

14. Under the Ordinance these amounts were limited to one-sixth of the total income.

15. See Section IV(b) of this article.

16. One Yemeni Dinar is divided into 20 Dirhams (Shillings): one Y.D. is almost US$ 3.

V. INCOME EXEMPT FROM INCOME TAX

In respect of individuals, certain income is exempt from income tax. Examples of exempt income are:

(1) emoluments received by the armed forces;

(2) emoluments received by persons working in the Republic who serve in the public services of foreign countries in accordance with the agreements made between the Government of the Republic and the governments of those foreign countries, provided that such emoluments are paid by the governments of those foreign countries in lieu of services rendered by those persons inside the Republic;[17]

(3) gratuity payable to an employee on the termination of his service under the contractual terms of service between himself and his employer: provided that the exemption shall not apply to any part of a gratuity in excess of 13.5% of the total salary payable under the contract;

(4) pensions or gratuities granted in respect of wounds or disabilities caused in the course of performing a duty or in war and suffered by recipients of such pensions or gratuities;

(5) scholarships granted to meet the cost of education;

(6) interest on personal accounts in a bank or income from an approved pension scheme.

VI. COLLECTION OF TAXES

Generally, the Department of Income Tax serves every chargeable person with an annual assessment of the amount of tax to be paid. Pursuant to the provisions of Section 90 of the Ordinance, the tax charged shall be payable on or before a date thirty days after the date of service of such notice.

Those who fail to pay the tax on or before the due date incur an additional sum equal to 5% of the tax then payable by way of penalty. The 5% penalty is not regarded as a tax. The Director of the Tax Department may in his discretion remit the whole or part of the penalty. He may also extend the period within which any tax is payable and may specify another due date for payment.

In practice the power of remitting the whole or part of the penalty is exercised by the Minister of Finance.

Taxes from salaries and wages are usually withheld by the employers who are obliged to remit the withheld taxes either to the tax authorities or to the department of Treasury. This mechanism is well observed by government offices and departments.

VII. DISPUTES

Taxpayers are granted by Law the right of objection and appeal. A taxpayer may by notice in writing to the Director of the Tax Department object to the assessment made upon him within fifteen days after the date of service of the notice of assessment. Notwithstanding the fact that the disputing taxpayer is not satisfied with the assessment made upon him, he is obliged to pay either the first instalment, where the tax is payable in instalments, or one-half of the tax so charged as the case may be. This payment should be made before the Director determines to confirm or modify the assessment. If the disputing taxpayer does not agree with the decision of the Director, he may appeal to a judge within forty-two days after the date of service of the Director's decision.

VIII. DOUBLE TAXATION RELIEF

Unilateral relief for double taxation is provided in the Ordinance. This was slightly modified by Law No. 52 of 1971. Any person chargeable to tax for any year of income relating to any part of his income, proving to the satisfaction of the Director that he has paid income tax in any country for that year and on that part of his income in accordance with the Law applicable in that country, will be exempted from tax in the Republic. Non-residents do not enjoy the relief unless there are special arrangements between them or their governments and the government of the Republic.

IX. TAX CLEARANCE CERTIFICATE

Any person intending to leave the Republic must be in possession of a tax clearance certificate. Certain persons are not obliged to possess such certificates.[18] Tax clearance certificates are granted to applicants by the Director of tax authorities when an applicant proves to the satisfaction of the Director:

(1) that he has paid all taxes due according to the Law; or
(2) is not a chargeable person; or
(3) that sufficient measures have been taken to ensure the payment of taxes due.[19]

Owners of any means of transport are prohibited by Law from conveying any person out of the Republic, unless he has the tax clearance certificate. Conveyors who transport any person in contradiction to this requirement are liable to pay the taxes as if they were the actual chargeable person.

X. LAW NO. 5 OF 1980

Law No. 5 of 1980 was issued on 8 September 1980, and retrospectively applies with effect from January of the year of issue. It is to be considered as part of the Ordinance.

The principal aim of this Law is to decrease the tax burden on government workers and employees.

In addition to the discussed amendments to the Ordinance, Law No. 5 of 10980 includes the following new tax provisions:

(1) The personal allowances for any employed married couple shall be 660 Y.D. for each spouse provided that such a couple does not enjoy the child or dependent allowance which is raised under this Law to 120 Y.D. per person with a maximum of six persons.

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17. There are no specific taxes imposed on foreigners. Foreigners are either residents or non-residents. Consequently, they are charged at either the resident individual rates or non-resident individual rates. Moreover the Ordinance grants unilateral double taxation relief, regardless of the existence or non-existence of reciprocal agreements.

18. These persons are: public servants assigned on official duties outside the Republic; persons whose age does not exceed sixteen years; passengers in transit or tourists whose stay in the Republic does not exceed 90 continuous days; members of the foreign diplomatic and consular corps; employees of the United Nations and its specialized agencies; employees of foreign governments visiting the Republic on duties concerning their governments and the like.

19. If the applicant is in possession of real estate, the competent authorities may acknowledge by written notice that measures, e.g., a mortgage charge, have been applied to secure the payment of taxes due.

(2) Income earned by "individuals" in addition to their official wage and not connected with their official employment is surtaxed at the rate of 10%.

(3) Until 1980, the income of a married woman living with her husband was deemed to be the income of the husband for the purposes of ascertaining his total income, and was assessed on, and the tax thereon charged on, the husband. This provision was revoked by this Law and under Section 5 the income of a married woman living with her husband is assessed and the tax charged separately on her.

Although Law No. 5 of 1980 was enacted to decrease the tax burden on Government employees and those who pay the special tax, the real beneficiaries are those male taxpayers whose wives are not employees. This is due to the fact that women have recently, i.e. after Independence, entered the labour market with full and equal rights with men but the average of a woman's income from a profession is in general below that of chargeable income. The male spouse, being deprived of the child and dependent allowances, is more burdened with income tax than before.

(4) Exemption from tax on leave salaries enjoyed by persons on leave outside the Republic was abolished by this Law.

XI. SPECIAL TAX

The special tax is imposed on workers and employees of the private sector. It is a tax on their salaries only. Other sources of income are not subject to this tax. Special Tax Law No. 10 of 1968 was issued on 11 June 1968. The tax base is the basic wages and salaries received monthly by this group of taxpayers. On the one hand, this Law was passed to narrow the gap between payments in the State sector and those monthly wages and salaries earned by employees in the private sector. This gap was created by the application of the salaries reduction scheme introduced by Law No. 1 of 1968 to government workers and employees. On the other hand, levies from special taxes would feed the State budget with new sources of important revenue.

Special tax rates are:

Basic monthly salary (Dirhams)	Rate
470 - 500	0 - 5 %
500 - 600	5 - 7.5%
600 - 700	7.5 - 10 %
700 - 800	10 - 12.5%
800 - 900	12.5 - 15 %
900 - 1,000	15 - 17.5%
1,000 - 1,500	17.5 - 27.5%
1,500 - 2,000	27.5 - 37.5%
2,000 - 3,000	37.5 - 42.5%
3,000 - 4,000	42.5 - 45 %
4,000 - 5,000	45 - 47.5%
Over 5,000	47.5%

Note: 20 Dirhams equal one Yemeni Dinar: instead of the word Dirham people still use the word Shilling.

The tax is calculated by applying the first percentage for the slice to the first amount quoted for that slice. The excess is taxed at the higher rate, e.g. a monthly salary of 1,250 Dirhams is taxed as follows:

1,000 Dirhams × 17.5% =	175	Dirhams
250 Dirhams × 27.5% =	68.75	Dirhams
Total tax payable	243.75	Dirhams

Special tax taxpayers enjoy higher personal and dependent allowances equal to State sector employees. Under Section 7 of this Law, foreigners working in the private sector with whom employment contracts were concluded outside the Republic are exempted from special tax. Employers are obliged to withhold the due taxes on their employees and remit them to the tax authorities monthly. Seeing that the base of special tax is the monthly basic salaries of their employees, employers cleverly reduce the basic salaries and constitute several kinds of increments and non-salary emoluments in order to evade the payment of the special tax.[20]

XII. NATIONAL DEFENCE TAX

Unlike certain tax systems where defence tax is collected as an obligation on male citizens who do not enter compulsory military service,[21] defence tax is imposed on all individuals (males and females) who earn income and on all bodies corporate operating in the country. National Defence Law Tax No. 45 of 1972 was issued on 19 November 1971. Pursuant to the provisions of the Law, defence tax is imposed on all salaries and wages of workers in government offices, public and social organizations, and bodies corporate.

The defence tax rate on salaries and wages is 3% of the total monthly salary. Self-employed persons, craftsmen, private businessmen, retail shop owners, those running private resturants etc., are liable to pay the defence tax monthly. The Minister of Finance was authorized by this Law to decide the rates or amounts of tax to be levied upon this group of taxpayers. Under Resolution No. 25 of 1974, the second group of defence taxpayers was classified, and the amounts of tax payable were also specified.

In the following table, examples are given of defence taxpayers as well as the amounts of tax payable as provided for in the Minister's Resolution:

Taxable persons	monthly tax in Aden Dinar/Fils[22]	monthly tax in other provinces Dinar/Fils
Owners of vehicles for public transport	–/500	–/300
Drivers of vehicles for public transport	–/300	–/250
Public and mixed corporations	10/100	5/000
Factories	2/000	2/000
Private importers (more than 50,000 Y.D. a year)	10/000	—
Retail shops and restaurants	–/500	–/250
Lawyer's offices	2/000	–/500

From the table above, it is clear that the Minister's Resolution is discriminatory. Those residing in Aden province pay more defence tax than their counterparts residing in other provinces of the Republic. This discrimination does not at all prove or re-

20. This situation is under consideration of fiscal authorities who may propose to modify by Law the interpretation of chargeable income.

21. As in the case of Hungary: see Hungarian People's Republic: Taxation of Individuals and Companies in the Non-socialist Sector and Foreign Legal Entities. Prof. Dr. Tibor Nagy in 20 *European Taxation* 11 (1980), p. 347.

22. 1,000 Fils equals one Yemeni Dinar; 50 Fils equals one Dirham.

flect the fact that those residing in Aden earn more than those residing in the other five provinces.

Defence tax is deducted from wages and salaries by employers from their employees' monthly payments and remitted to the tax authorities. The collection of defence tax from those provided for under the Minister's Resolution is one of the most boring tasks of the tax authorities. Several non-tax authorities help in the process of collection of defence tax especially in the provinces far from the Capital. From the point of view of revenue, contributions to the State budget from defence levies equal special tax contributions. The situation, in the writer's opinion, should be different. Defence tax is more universal than the special tax limited to certain categories, and can yield more revenue than the latter. This can be made possible by removing the discrimination indicated above and improving methods of tax collection.

Exemptions from defence tax levies are enjoyed by daily-payments workers who do not stay in one job for thirty days continuously. This exemption was provided for under Resolution No. 26 of 1974 of the Minister of Finance.

XIII. OTHER DIRECT PAYMENTS

These payments are of no significant importance. They take the form of obligatory contributions. These include contributions to the trade unions and to such approved funds as the Martyrs' Fund and the Yemeni Child Fund.

XIV. INDIRECT TAXES

Indirect taxes include stamp duties, duties imposed on the importation of goods and gifts, and taxes imposed on locally produced or manufactured products.

Stamp duties are imposed under Law No. 8 of 1971. They are levied on various kinds of "writings," i.e. documents, such as commercial licenses, different kinds of certificates (including school certificates), contracts, agreements, bank loans, etc. Contracts and agreements include those establishing partnerships, sales, and exchange or transfer of property. Stamp duties are either fixed duties, i.e. 100 Fils on a contract, 15 Y.D. on the incorporation of a stock company, etc., or they can be proportional duties rising gradually in proportion to the amount of money comprising the subject matter of a document. There are several methods of collecting stamp duties: by the purchase of a stamp for a specific value or by applying special stamp-value indicators on the document in question. Revenues to the State budget from stamp duties are so far not encouraging owing to the fact that this Law is not yet well enforced in other provinces save Aden and Hadramout.

Customs duties are of great importance to the current State revenues. They comprise almost one-half of all revenues to the State budget from obligatory levies. This is due to the introduction of the general tariff on all goods imported into the Republic.[23] Law No. 28 of 1970, which is to be read as part of Ordinance No. 2 of 1961 in connection with import and export[24] duties, embodies all indirect taxes save the stamp duties levied in the country.

Under this Law specified tariffs are imposed on classified goods entering the country and gifts either accompanied by travellers or sent by post, duties on tobacco and alcohol, and on products manufactured or re-manufactured or produced in the Republic.[25]

XV. RELIGIOUS TAXES

The Shari'a[26] lays down four kinds of taxes:[27]
(1) Zakaat - A tax levied on property from able Muslims at specified rates;
(2) Khums Al-ganaem - one-fifth of the booty won by Muslims on the battle-field;
(3) Jizya (tribute) - paid by able non-Muslims in return for protection by the Muslim State and also for being exempted from any military duties;[28]
(4) Ushoor at-tijara (commerce duties) - generally, an amount of money, similar to customs duties, imposed on foreign traders entering the Muslim country to sell their goods. Rates of these duties ranged between 2.5% and 10% of the estimated value of the wares destined for sale. The period during which the foreign seller was supposed to stay and the name of the country he came from were the factors determining the rates of duty payable.

Revenues levied from the above-mentioned four kinds of taxes were remitted to Bait Al-mál (House of Treasury) which was the financing organ of public needs and of charitable distributions to the needy.

Nowadays, the only remaining and most universal Islamic tax is the Zakaat. Ushoor at-tijara was replaced by modern customs duties.

Zakaat

Until recently, Zakaat was collected regularly by the tax collectors of the Sultan in Hadramout,[29] one of the six provinces of the Republic. Two kinds of Zakaat exist: the Sadaqa (charity) voluntarily given by able[30] Muslims and the obligatory Zakaat, collected for the needs of the nation. Those who evaded the payment of obligatory Zakaat were pursued by the Sultan's authorities and in certain cases punished by confiscation of up to half of their land. Mainly peasants fell into the hands of the Sultan's brutal Zakaat collectors. Large estate owners were feared and left unharmed. They paid Zakaat at their own pleasure.

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23. The general tariff was first introduced in 1970 by Law No. 28 of 1970 issued on 8 September 1970.
24. In practice export duties do not exist.
25. Like Income Tax Ordinance 8 of 1961, the Imports and Exports Ordinance No. 2 of 1961 has been subjected to numerous modifications and amendments by Laws, Presidential Resolutions and even Ministerial ones. In October 1979, this Ordinance was repealed by Customs Law No. 12 of 1979, and by Law No. 14 of 1979 in connection with the imposition of a Production Tax on local products.
26. The Shari'a is the Islamic Law which is more correct than the term "Koranic Law" used by many European writers.
27. Abdul Sami' Al-Massri, *Taxes in Islam* (Arabic text).
28. When a Jizya payer takes part in battle with the army of the State collecting Jizya from him or when the state fails to protect him, he is entitled to be refunded the tributes levied upon him.
29. Mohamed O.Al-Habshi, *South Yemen* (Beirut, 1968), pp. 459-463 (Arabic text).
30. Every Muslim owning property in excess of his needs is considered to be able. Mentally sick Muslims are considered unable for Zakaat purposes.

Zakaat, according to the teachings of Islam, should be levied on the whole of the Muslim's property which includes:

(a) agricultural products for human consumption;
(b) fruits such as dates, etc.;
(c) livestock;
(d) items of value including gold or silver coins;
(e) movable goods.

Those whose farms do not yield as much as they themselves need are according to the Shari'a exempted from Zakaat.

On the first two categories of property listed above, the owner[31] pays Ushr[32] or Khums[33] of products as Zakaat. The season of harvest is regarded as the time for estimation of Zakaat.

Ushr of the agricultural products is levied on products which were irrigated by rain. Khums is levied on products irrigated by artificial methods. As for cattle, one out of thirty male and one out of forty female cattle is the rate of Zakaat. On other property Zakaat is levied when the property is for one year in the taxpayer's continuous possession.

In Aden, positive tax laws were long ago in force. The payment of Zakaat is left to the conscience of the able Muslims. Now, in the whole territory of the State, Zakaat in the form of Sadaqa is voluntarily distributed to the needy by the end of Ramadan of each year, without the interference of the fiscal authorities.

Zakaat is a wealth tax levied in respect of all property (mál). The idea of mál in Islamic Law is simple. It means all forms of property over which dominion can be exercised.[34] The expression Az-zahira is an adjective which means visible or seen. But when we apply it for tax (Zakaat) purposes, Al-amwal az-zahira,[35] the accurate interpretation is "all tangible assets" which are visible in the sense that they can be seen or publicly used or invisible in the sense that they can be concealed and hoarded. This is well illustrated, from the point of view of the economic role of Zakaat which is emphasized by Shari'a, under one of the Koran's teachings, namely the avoidance of hoarding wealth which is directly prohibited by the Koran: "Allah has granted you an abundance of wealth to use in the directions indicated by Him, not for hoarding."

Thus Zakaat is also a tax on that hoarded, invisible or unseen wealth, "lying idle for a year, and not put to any productive use".[36]

XVI. CONCLUSION

The contribution to the State budget from taxes charged upon individuals according to the author is as follows:

		%
(a)	income tax	
	(i) wages and salaries (not including special tax)	1 - 1.5
	(ii) all other gains and profits	6 - 7
(b)	Defence tax	3 - 3.5
(c)	Special tax	2.5 - 3
(d)	Stamp tax	0.5 - 1

The above figures are calculated in proportion to current local revenues. These figures with all other taxes, duties (including customs), fees and obligatory receipts, payable by all chargeable persons (including legal entities) accounted in the latest fiscal years for approximately 80% of all local revenue payments to the State budget. In the future, the proportions estimated above will remain stable. Where, in certain cases, certain increases occur in one or two of the referred taxes, e.g., stamp or defence tax, this will be mostly from legal entities and as a result of improvement of methods of collection.

31. Under the Koran the owner of "everything" is God. Human owners are regarded as His mere trustees. They are asked to pay contributions from the wealth put by Him in their trust to the poor, the needy and wayfarers otherwise they are liable to His punishment.
32. Ushr is not a tax by itself - see *Bulletin for International Fiscal Documentation* 1981. Vol. 35, No. 3, p. 132. Ushr is a tax (Zakaat) rate. It simply means one-tenth of . . . .
33. Khums which means one-fifth of . . . , is regarded by several writers as a tax by itself and not a tax rate. This is simply because it was cited by the Koran - "Whatever you (Muslims) gain from war, Khums goes to God, his prophet, orphans, the needy and the wayfarers." See Economic foundations of Islam - S.A. Ali, Orient Longmans, 1964, p. 132.
The expression Khums above, corresponds to the word "whatever," which in other words means "all that can be acquired by Muslim warriors winning a war." One fifth goes to the State.
34. Outlines of Muhammadan Law - Asaf A. Fyzee - Oxford, 1960, p. 194.
35. *Bulletin for International Fiscal Documentation* - the same issue, p. 134.
36. S.A. Ali - the same reference, p. 134.

In next issues:

The financing of the Southern Region and other regional governments of the Sudan
– by *John F. Due* and *Jean M. Due*

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– by *Ahmad Khan*

Pakistan: Summary of new tax concessions in Budget 1981-1982
– by *Abdul Waheed*

Pakistan:

AIR TRANSPORTATION TAX *

1. The mode and manner of assessment of air transport business by non-residents has undergone major change due to amendments brought about by Finance Ordinance, 1980.

2. Under the newly introduced Section 80A, if a non-resident person carries on the business of operation of aircraft and any aircraft owned or chartered by such person calls on any airport in Pakistan, the aggregate of the receipts arising from the carriage of passengers, mail, livestock or goods carried from Pakistan [shall] be deemed to be the income received in Pakistan by the Principal from the said business. Such non-resident person is required to file return showing:

(a) the assessment paid or payable to him, or to any person on his behalf, on account of carriage of passengers, mail, livestock or goods loaded at any airport in Pakistan; and

(b) the amount received, or deemed to be received in Pakistan by him, or on his behalf of, on account of carriage of passengers, mail, livestock or goods at any airport outside Pakistan.

The total receipts would be treated as income and charged to tax at the rate of 3 percent of the receipts. The tax so paid shall be deemed to be the discharge of tax liability of the assessee and he shall not be required to file the return of income under Section 55 of the Income Tax Ordinance, 1979.

3. Under the new law, the principal or an agent authorized by him in his behalf shall prepare and furnish the reutrn referred to in para. 2, to the Income Tax Officer on a quarterly basis, which will cover the periods as under:

(1) 1st Quarter . . . . July/August/September
(2) 2nd Quarter . . . . October/November/December
(3) 3rd Quarter . . . . January/February/March
(4) 4th Quarter . . . . April/May/June

The return is to be filed within 45 days from the last day of the quarter to which it pertains. To give an example, the return for the first quarter i.e. July, August, September, 1980 is to be furnished by 15th November, 1980.

4. The return inter alia would show:

(a) the amount paid or payable whether in or out of Pakistan to the principal, or to any person on his behalf, on account of the carriage of passengers, mail, livestock or goods loaded from the Pakistan airport, and

(b) the amount received or deemed to be received in Pakistan, by, or on behalf of the principal, on account of carriage of passengers, mail, livestock or goods at any airport outside Pakistan.

5. The person signing the return must be the representative of the airlines holding powers of Attorney on behalf of that airlines in Pakistan.

6. On receipt of the return, the Income Tax Officer may, after calling for such particulars, accounts of documents as he may require, determine the aggregate of the amounts referred to in para. 2 and charge tax at 3 percent.

7. The specimen of a form of quarterly return which has been designed for non-resident operators of air transport business is enclosed herewith. This return is to be filed with the Income Tax Officer C-3, Central Zone C, Karachi.

8. Tax is to be paid in the State Bank of Pakistan and a photo copy of the challan along with other documents is to be attached with the return.

9. Following documents should accompany the quarterly return:

(a) Photo-copy of the company's documents from which the figures filled in the return have been extracted (e.g. computer tabulation) or any other authenticated statement in support of income and other particulars declared in the quarterly return.

(b) Photo-copy of challan showing tax paid.

10. Where the principal fails to pay tax due for more than three months, the Commissioner of Income Tax may issue to the authority by whom clearance may be granted to that aircraft, a certificate empowering and requiring him to refuse clearance from any airport in Pakistan to any aircraft owned or chartered by such person until the tax has been paid.

* Circular No. 26 of 1980 (Income Tax).

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